Volume 10 //

# Acuity

The greatest wealth is **your peace of mind...**

# How much do I really need to know?

> To invest successfully over a lifetime does not require a stratospheric IQ, unusual insights or inside information. What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding the framework.
>
> **Warren Buffett, Preface to the Fourth Edition of The Intelligent Investor**

## Seven things you need to know

Perhaps not that surprisingly, few people are particularly interested in investing. After all, who cares whether a company's dividends are growing or how much a five year government bond is yielding today? Most are more interested in getting on with life, enjoying time with family and friends, pursuing careers or enjoying a relaxed time in retirement. The truth is, however, that decisions we make relating to our investments may well have a profound impact on our lifestyles today and tomorrow.

So how much do you really need to know to be able to make the most of your investment programme? Luckily, the answer is not much. What you really need to know is enough to spot when things don't make sense. Below are some tips and a few mental tick boxes to help.

## Tip 1: Investing is a 'get rich, slow' process

However much we would all like to get rich quickly (or stay rich) the reality is that investing is a rather long-term and boring process that uses the power of compounding across time to magnify the two steps forward, one step back journey that participating in the markets will result in. The underlying nature and magnitude of those steps is explored further in Tip 3 below.

Yet much of what is taken for investing (the good chance of getting rich slowly), is not investing but more akin to gambling (the low odds of getting rich quickly). These activities include trying to pick 'winning' stocks, attempting to time when to be in or out of the equity markets, chasing the latest star fund manager or hot market (what is it this week: gold, commodities, emerging markets?), spread betting, horse racing, roulette etc.

Good investing is about owning a sensible, highly-diversified, low-cost and stable portfolio, put in place for the long-term, and which is rebalanced back to its original mix from time to time. It is also about having the fortitude to keep 'on message' when the markets feel extreme on both the down and the upsides. A bit boring, sometimes emotionally challenging, but effective.

**Mental tick box 1:** Remember the tortoise beats the hare.

## Tip 2: If it looks too good to be true, it probably is

There are no dead certainties in investing apart from the fact that any product that appears to deliver great returns with low risks has a high chance of disappointment, usually in the form of a material reduction in the value of your investment.

There are two main types of products that fall into this category: a fraud wrapped up in a good story, and a bet wrapped up in a good story. Beware the snake-oil salesman.

The recent Ponzi scheme fraud perpetrated by Madoff was a classic case of someone with the 'gift of the gab', a semblance of credibility, a complex strategy that few investors understood (apparently a split strike conversion strategy, whatever that is) and an air of exclusivity and secrecy.

The second is usually something that sounds so fantastic that you get sucked into the upside and blinded to the risks (e.g. the true cases of firms pedalling freeholds to apartment blocks in Beirut at the height of the troubles there, or repossessed homes in Florida). Alternatively, it is an investment strategy that is akin to picking up pennies in front of a steam roller. Good until you stumble. Any risk-return asymmetry is illusory.

**Mental tick box 2:** If you get excited about a specific opportunity, stand back, take a deep breath and ask yourself where the catch is. Return and risk are always closely related. Ask yourself why, if the opportunity is so great, is someone is trying to sell it to you? Surely they would keep it all to themselves. Remember that the investment world is full of great story-tellers.

## Tip 3: It's not rocket science

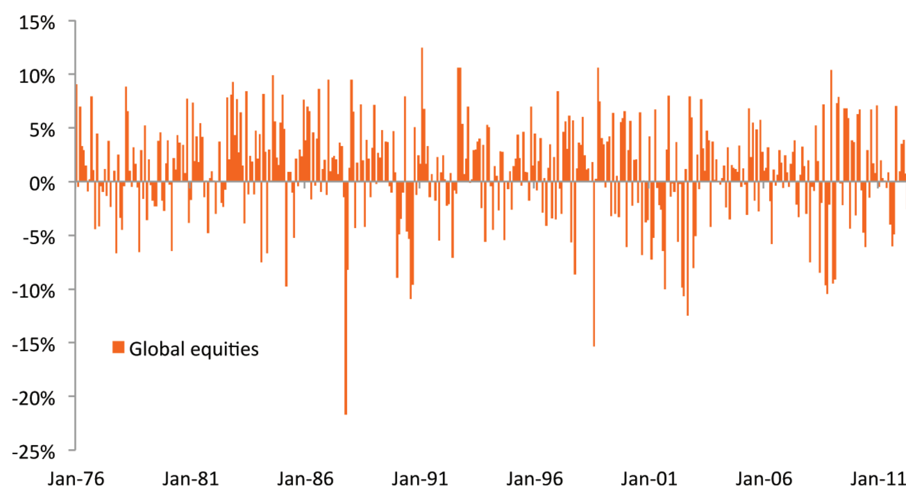
At its very simplest, there are only two things that you can do when investing your money. The first is to become a part owner in a company. That is what equity investing is. The rewards that you receive are the regular dividends the company pays in cash, and the hope that the strategy of the company is a strong one and this will be reflected in growing profits, and a rise in the price of its shares over time.

The second is to lend your money to someone, be it an individual (not usually recommended), a corporation or a government. In return, investors receive interest (usually referred to as a coupon) and their capital back at the maturity date of the loan. Loan instruments are often called 'fixed income' securities, because the interest is fixed at the outset or, alternatively, they are called bonds. In general, the higher the risk of not getting your money back and the longer the time you lend your money for, the higher the rate of interest you will expect to be paid by the borrower. When you next place a bank deposit, remember that you are lending your money to the bank. Perhaps in this context, Icesave's and Northern Rock's high deposit rates were telling a useful story – their strategies were risky.

The fortunes of a company are highly uncertain over time, which can result in wide movements in the price of a company's shares as the market absorbs the latest release of information and how this will impact on the company's future earnings. On the other hand, the cash flows of bonds are known, as is the maturity date. Bonds are generally less risky than equities, but with lower expected returns as a consequence. In a corporate collapse, equities owners lose their money before bondholders.

**'£50 billion wiped off shares today!' (and other such nonsense)**

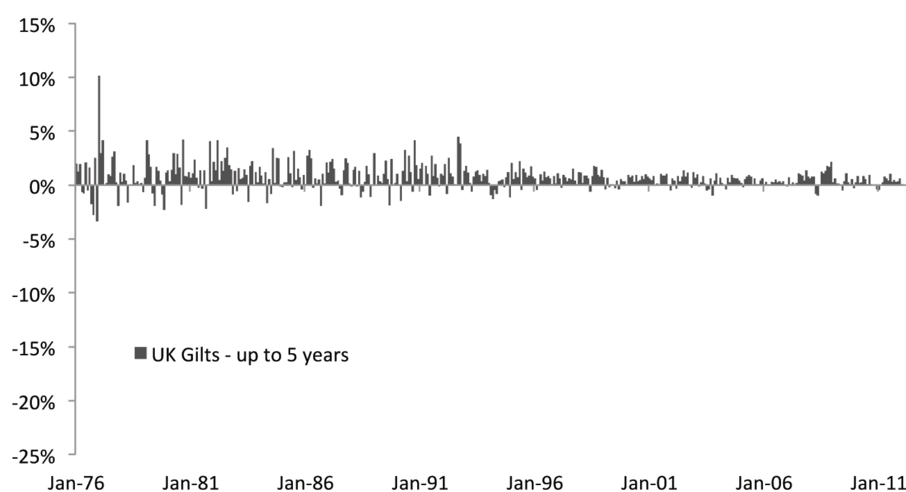
Investors the world over tend to be very influenced by what is happening in the equity markets today, rather than placing this in the context of longer-term history. The press help to whip up this emotional short-term focus, making investors feel unsettled. Headlines such as 'Unprecedented times in the market', 'It's different this time' and '£50 billion was wiped off shares today' certainly don't help. But markets are always like this; that's how they work and will always work. Study the chart opposite. What do you notice? Probably that the 'unprecedented' volatility of today's equity markets is not that different to the past and therefore neither unprecedented, nor unexpected. That's what equity investing is like. Over the longer-term, the dividends paid and the growth in corporate earnings (the economic return of equity investing) will shine through the noise created in a dynamic, forward-looking market.




Data: MSCI World Index. All rights reserved.

Figure 1: Monthly returns of global equities - Jan 1976 to June 2012.

The simple message is that if this volatility scares you to death, then you need to balance the upside of being an owner, by lending some of your money to high quality borrowers (such as the UK government or strong companies) for a relatively short period of time. The chart below clearly shows that this is a lower risk option, and therefore likely to deliver a lower return, over time.




Data: FTSE British Government Index (up to 5 years). All rights reserved.

Figure 2: Monthly returns of short-dated UK gilts - Jan 1976 to June 2012

The most critical decision that you will make in you entire investment programme is finding the balance between the two that is right for you. This balance is a consequence of your emotional capacity for taking risk, your financial capacity to suffer losses, and your actual financial need to take risk. This is an area that any good adviser spends considerable time discussing and evaluating with their clients.

Refining exactly what you should own and to whom you should lend takes some insight, but is simply an important finessing of this initial portfolio decision by your adviser.

**Mental tick box 3:** Make sure that you fully understand what the right balance between ownership and lending (equities and bonds) is that makes sense for you. Understand too, what your investment journey will look like.

## Tip 4: Don't put all of your investment eggs in one basket

The future is uncertain and nobody has a crystal ball that can accurately predict what it holds. This is never more true than in the investment markets. It doesn't take Einstein to work out that placing all of one's investment eggs in one, or just a few, baskets makes little sense. Diversification is simply good practice and should be employed widely in any investor's portfolio.

Diversification takes place at several levels. The first is that as an owner of a company, the value of your investment is beholden to the specific fortunes of that company. The owners of BP, for example, found that out when it suffered the catastrophic oil spill in the Gulf of Mexico in 2011. Owning a broad number of oil companies would have smoothed returns. But the oil sector faces its own sector-specific risks so it makes sense to diversify by sector, by owning the UK equity market more broadly. The trouble is that the UK is less than 10% of global economic output (and market capitalisation i.e. the value of its stock market) and the companies listed on the market have biases towards sectors such as financial services and energy. It probably makes sense to have a material allocation to other developed and emerging markets too. Equities, while expected to deliver higher returns than bonds, deliver no certainty that they will do so, although the odds increase over time. Diversifying away from equities and holding other assets such as bonds makes sense.

> ***'Asset allocation [the mix of your investments] is not a panacea. It is a reasoned – if imperfect – approach to the inevitable uncertainty of the financial markets.'***
>
> **John Bogle, founder of Vanguard, a leading global investment firm.**

**Mental tick box 4:** Is your portfolio well diversified at all levels? Remember that owning a number of funds does not necessarily mean your portfolio is diversified. Look through the fund structure at the underlying investments to see if you are diversified broadly enough.

## Tip 5: Capturing the market return is a valid objective

Human nature drives many of us to try and win at whatever we do, or at the very least to aim to be above average. The majority of fund managers fall into this category, which in itself raises an obvious paradox – not everyone can be a better than average driver (or fund manager).

The problem that most investors suffer from is that they have not thought clearly about the definitions of 'winning' and 'average'. They usually regard winning as generating returns from their investments that beat the market, and often employ fund managers who try to do so. The personal finance pages of the Sunday papers bear testament to this fund/manager picking affliction. The supposition is that the market bogey is an easy one to beat, or at least it is easy to pick a fund manager who can. Where this falls down is that it is not easy! The assumption that markets don't work very well and that mispricing opportunities can be picked up profitably by the skilled (who themselves are easily identifiable), is incorrect.

The problem is that the market is a highly competitive place, and drives prices quickly to fair value. The empirical evidence, in a broad array of studies, across multiple markets, shows that beating the market, after costs, through skill and not luck is exceptionally rare – probably less than three percent of fund managers achieve this.[1] That would not matter if they could be identified, in advance, with a high degree of certainty. The ranking lists in the Sunday papers, based on short-term performance, are certainly not the solution.

The definition of being average needs some thought too. Viewing 'average' as being the return of the market pushes investors emotionally towards a 'try-to-beat-the-market' strategy. Yet all investors are the market and after the costs deducted after trading with each other, the average trading investor (i.e. an 'active' manager) will be below the market return by the average level of the costs incurred. The mathematics stipulates, therefore, that the market will beat the average active fund trying to beat the market. The empirical research supports this. As a consequence, capturing the market's 'average' return, as closely as possible, becomes a worthy goal.

**Mental tick box 5:** Be sceptical of 'market-beating' performance promises and claims. Do not underestimate how hard it is to pick a market-beating fund today, for the years ahead. Remember that the market's 'average' return beats most professional managers and is a worthy goal.

## Tip 6: Investment costs truly matter

In investing, costs matter because they are a drag on a) achieving the market return, which is the goal of a 'passive' manager, or b) beating the market, which is the goal of an active manager. From an investor's perspective, the outcome differential between the actual outcome and what could have been achieved at lower costs, may be substantial over long periods of time due to the negative effects of compounding these costs year on year. A pound of costs saved this year, is saved again next year, and the year after, and this is guaranteed. The extra money saved remains in your portfolio and compounds with time.

Passive funds are very cost conscious, while actively managed funds are less so, as they believe they will add skill-based returns in excess of the costs they incur. In fact, passive costs have fallen considerably in the past three years – you can now access a UK equity 'tracker' fund for a TER of around 0.2% to 0.3%. On the other hand active costs have been rising in the UK and across Europe. In fact 90% of all active funds reporting changes in fees in Europe (including the UK)[2] reported upward movements.

**Mental tick box 6:** Never embark on an investment strategy without knowing exactly what cost drag you will be incurring. Always ask whether there are any other costs of any kind that you will suffer. Costs really matter. In investing, you get what you don't pay for, as John Bogle would say.

## Tip 7. Manage yourself as tightly as your investments

Human beings are all afflicted with minds that battle between being reflective and being intuitive. Unfortunately, with an investor's hat on, the intuitive wins on many occasions, resulting in panic and elation as markets fall and rise. If the intuitive mind dominates in making investment decisions, then investors risk damaging their wealth, usually by buying at the top in a state of euphoria and greed and selling out at the bottom in blind panic. The difference between the published return of a fund and the return an investor receives based on when they enter and exit a fund, illustrates whether investors are good or bad at timing markets. The evidence is that investors across the board are overwhelmingly bad at doing so, giving up somewhere between 1% and 3% a year.[3]

The key to success lies in a number of areas. The first is to own a portfolio that is well diversified across markets and asset classes. The second is a clear understanding of the journey and acceptance of the fact that it will be two steps forwards and one step back and occasionally two steps back and one step forward. Finally it is about putting in place an investment process that mitigates some of the sources of leakage from the portfolio due to emotional, rather than rational, decision making. This includes regular rebalancing of portfolios back to their original mix on a regular basis, selling out of assets that have performed well and re-investing in assets that have done less well - a systematic, contrarian investment process.

**Mental tick box 6:** Accept that you are prone to emotional pressures that drive you to do the wrong thing at the wrong time. Learn to be comfortable with the diversified portfolio that you own. Lean heavily on your adviser, when you need support at times of emotional, investment-related weakness.

## In conclusion

Even if you are not that interested in investing, the tips outlined above are important messages to take on board. Our investment programme ensures that our clients avoid these pitfalls and delivers them with the greatest chance of a successful investment experience.

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## End notes


1. John C. Bogle, (2007) The Little Book of Common Sense Investing, J Wiley & Sons, pp. 80-81 US equity fund data from 1970-2005.
2. Lipper data reported in Marriage, M., (April 9, 2012) Little take-up of ‘low-cost’ active funds, FTfm (April 9, 2012) page 12
3. Phillips, D. (2011, October 15th). Five Lessons from 25 years. (Business & Wealth Management Forum, Interviewer) Morningstar


## Other notes and risk warnings


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