Nine rules for investors to keep in mind

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Key points

> Investing during times of market stress and volatility can be difficult. For this reason it's useful for investors to keep a key set of things – call them rules – in mind.

> The key rules, in my view, are: make the most of the power of compound interest; be aware that there is always a cycle; invest for the long term; diversify; turn down the noise; buy low and sell high; beware of the crowd at extremes; focus on investments offering a sustainable cash flow; and seek advice.

Introduction

Due to an obsession with Taylor Swift and then The Carpenters I decided I needed to have a Carpenters' CD with the full Burt Bacharach medley they performed in the early 1970s. So I went to Amazon and found that it was only on a Japanese Carpenters' Anthology CD which would set me back $US150 from the US or $65 for a "very good" second hand edition from Japan. The last time I got a "very good" second hand Elvis book from Amazon it had some pages missing but I decided to give the Japanese CD a go. When I put the order in I was told it would arrive sometime between October 2 to November 4. Immediately I received an email from Japan to say it had shipped then two weeks later it arrived in a huge box. After cutting through all the cardboard and bubble wrap there was a pristine version of The Carpenters Anthology still in its factory wrapping with handwritten note from a Mr Kinoshita from Kyoto in Japan saying amongst other things that a new version had been substituted…I was starting to wonder whether a "very good" second hand version of something from Japan meant it was purchased by someone but never opened. Needless to say I was very impressed and the Burt Bacharach medley was as good as I had hoped.

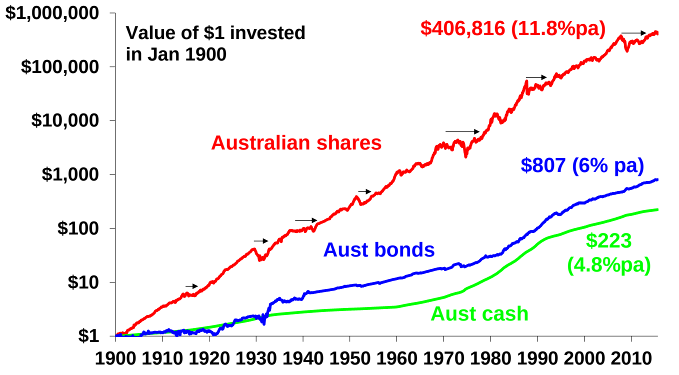
Anyway investment markets are rarely pristine. In fact the well-known advocate of value investing, Benjamin Graham, coined the term "Mr Market" (in 1949) as a metaphor to explain the share market. Sometimes Mr Market sets sensible share prices based on economic and business developments. At other times he is emotionally unstable, swinging from euphoria to pessimism. But not only is Mr Market highly unstable, he is also highly seductive – sucking investors (and forecasters) in during the good times with dreams of riches and spitting them out during the bad times when all hope seems lost.

So during periods when Mr Market is highly unstable – like the weakness and volatility in investment markets we have seen recently in shares – it is useful for investors to keep in mind a list of critical things that are essential for success in investing in order to avoid being seduced by Mr Market.

Obviously when it comes to investing there is much to debate regarding the key things to bear in mind. And I could add lots of other points as well, but here is a list of the nine considerations I find most useful. I hope it is of value to you too.

1. **Make the most of the power of compound interest**. Although the average annual return on Australian shares (11.8% pa) is just double that on Australian bonds (6% pa) over the last 115 years, $1 invested in bonds in 1900 would today be worth $807 whereas $1 invested in shares would now be worth $406,816. Yes there were lots of rough periods along the way for shares just like through the GFC and its aftermath (eg the 1930s, 1970s, 1987-96), but the impact of compounding at a higher long term return is huge over long periods of time. The same applies to other growth related assets such as property, which over long periods has had a similar return to shares. So one of the best ways to build wealth is to take advantage of the power of compound interest and this means making sure you have the right asset mix in your investment strategy.

Shares versus bonds & cash over very long term - Australia



Source: Global Financial Data, AMP Capital

2. **Be aware that there is always a cycle**. The historical experience of investment markets – be they bonds, shares, property, infrastructure, whatever – constantly reminds us they go through cyclical phases of good times and bad. Some are short term, such as occasional corrections. Some are medium term, such as those that relate to the 3 to 5 year business cycle. Some are longer, such as the secular swings seen over 10 to 20 year periods in shares. But all eventually contain the seeds of their own reversal. The trouble with cycles is that they can throw investors out of a well thought out investment strategy that aims to take advantage of long term returns and can cause problems for investors when they are in or close to retirement. But they also create opportunities.

3. **Invest for the long term**. In the 1970s a US investment professional named Charles Ellis observed that for most of us investing is a loser's game. A loser's game is a game where bad play by the loser determines the victor. Amateur tennis is an example, where the trick is to avoid stupid mistakes and thereby win by not losing. The best way for most investors to avoid losing at investments is to invest for the long term. Get a long term plan that suits your level of wealth, age, tolerance of volatility, etc, and stick to it. This may involve a high exposure to shares and property when you are young or have plenty of funds to invest when you are in retirement and still have your day to day needs covered. Alternatively if you can't afford to take a long term approach or can't tolerate short term volatility then it is worth considering investing in funds that use strategies like dynamic asset allocation to target a particular goal – be that in relation to a return level or cash flow. Such approaches are also worth considering if you want to try and take advantage of the opportunities that volatility in investment markets through up.
4. **Diversify**. This is another no brainer. Don't put all your eggs in one basket as the old saying goes. But plenty do. Through last decade many wondered what was the point of having global shares in their investment portfolios as Australian shares were doing so well. But for the last five years or so global shares have been far better performers and have proved their worth. It also seems that common approaches in SMSF funds are to have one or two high yielding and popular shares and a term deposit. This could potentially leave an investor very exposed to either a very low return or if something goes wrong in the high yield share they are invested in. By the same token don't over diversify with multiple – say greater than 30 – shares and/or managed funds as this will just complicate for no benefit.
5. **Turn down the noise**. Once you have worked out a strategy that is right for you, it's important to turn down the noise on the information flow surrounding investment markets. We are now seeing an explosion in the volume and ease of access to information and opinions surrounding economies, investment markets and individual investments. This is great in a way. But there is little evidence that it's helping investors make better decisions and hence earn better returns. We seem to lurch from worrying about one crisis to another. Just like every year now it seems, this year is seeing the usual long worry list with worries about soft US growth earlier this year, Fed tightening, Greece, China, Korean tensions, the emerging world, US budget funding, etc. And as "bad news sells" the negative commentary around this noise gets the loudest airing. The "perma bears" have had a field day since the GFC in simply rolling their predictions of global meltdown from the US (which was supposed to have a debt driven or hyperinflation meltdown), to Europe (where the euro was supposed to blow itself apart) to now China. The combination of too much information has turned investing into a daily soap opera – as we go from worrying about one thing after another. This is all leading to heightened uncertainty and shorter investment horizons which in turn can add to the risk that you can be thrown off well thought out investment strategies. The key is to turn down the volume on all the noise.

   This also involves keeping your investment strategy relatively simple – lots of time can be wasted on fretting over individual shares or managed funds – which is just a distraction from making sure you have the right asset mix as it's your asset allocation that will mainly drive the return you will get.
6. **Buy low, sell high**. One reality of investing is that the price you pay for an investment or asset matters a lot in terms of the return you will get. It stands to reason that the cheaper you buy an asset the higher its prospective return will be and vice versa, all other things being equal. So if you do have to trade or move your investments around then remember to buy when markets are down and sell when they are up. This seems like a no brainer, but most people do the opposite. There's an old saying in investment markets: "flows follow returns"! In other words inflows are strongest after periods of strong returns and outflows are strongest after weak returns. It should be the other way around.
7. **Beware the crowd at extremes**. For periods of time the crowd can be right and safety in numbers provides a degree of comfort. However, at extremes the crowd is invariably wrong. Whether it's lemmings running off a cliff, or investors piling into Japanese shares at the end of the 1980s, Asian shares into the mid 1990s, IT stocks in the late 1990s, US housing and dodgy credit in the mid-2000s. The problem with crowds is that eventually everyone who wants to buy will do so and then the only way is down (and vice versa during crowd panics). As Warren Buffet once said the key is to "be fearful when others are greedy and greedy when others are fearful".
8. **Focus on investments offering sustainable cash flow**. This is very important. There's been lots of investments over the decades that have been sold on promises of high returns or low risk but were underpinned by hope based on hot air (eg, many dot com stocks in the 1990s, resources stocks periodically) or financial alchemy where rubbish was supposedly turned into AAA yield generators (the sub-prime CDOs of last decade). But the key is that if it looks dodgy, hard to understand or has to be based on obscure valuation measures to stack up then it's best to stay away. There is no such thing as a free lunch in investing – if an investment looks too good to be true in terms of the return and risk on offer then it probably is. By contrast, assets that generate sustainable cash flows (profits, rents, interest payments) and don't rely on excessive gearing or financial engineering are more likely to deliver.
9. **Seek advice**. Given the psychological traps that we are all susceptible to (in particular the tendency to over-react to the current state of investment markets) and the fact that it is not easy, a good approach is to simply seek the advice of a coach such as a financial adviser, in much the same way you might use a specialist to look after other aspects of your life like fixing the plumbing, your medical needs or helping you get fit. Even I have one.

Dr Shane Oliver
Head of Investment Strategy and Chief Economist
AMP Capital