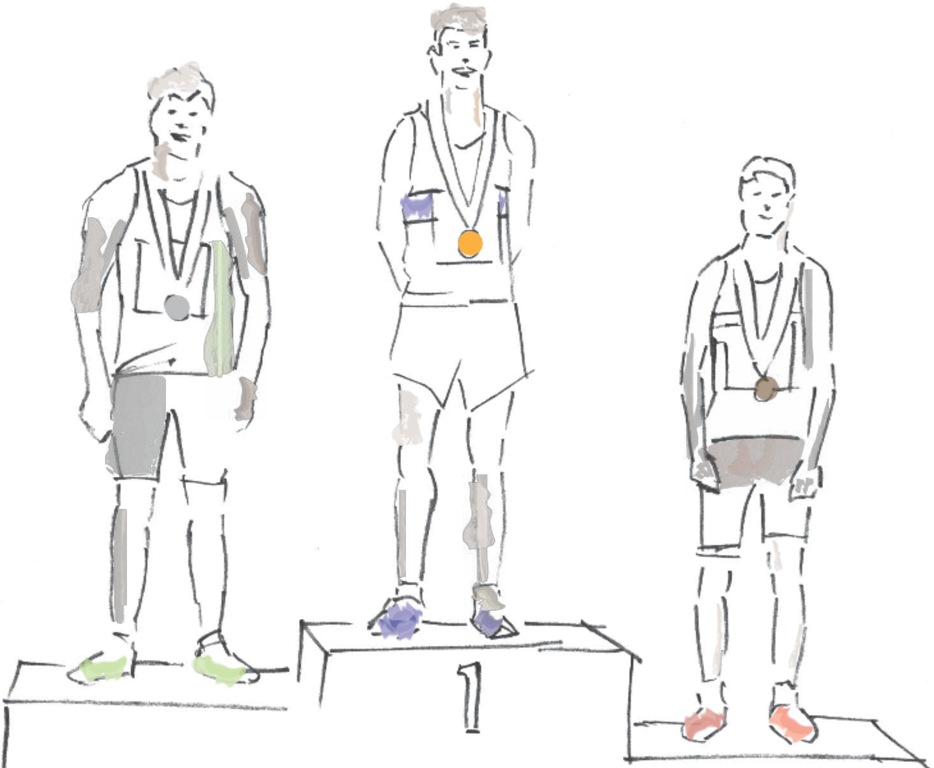
Winning the loser's game



Invest on Purpose
Maximise Equities
Invest Long Term
Retain Some Cash
Keep Emotions in Check
Track Don't Pick

The Six Rules of Sensible Investing

There is nothing more frustrating than reaching emotional readiness for retirement but not having the financial means.

Accumulating wealth into retirement can be achieved in numerous ways, and, again, there is no right or wrong way to get to your required number at your desired retirement age.

Perhaps through some investment in property, either via a large residential home through which equity may be released from in the future (be careful here, as you may be attached to that home) or through investment property? This can be attractive to some, but many will be placing monies into the investment markets through pensions, ISAs and perhaps other financial vehicles.

What financial product you select is down to you and/or your professional adviser. Choose wisely, as this could have a profound impact on your retirement pot, as will your investment strategy.

What follows are some investment rules that if you follow them within a coordinated strategy, should allow you to win what is often known as the 'loser's game'. However, having a suitably qualified financial professional coaching you to avoid mistakes will increase your chances of success significantly.

"To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insights or inside information. What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework."

Warren Buffet, American Business Magnate, Investor and Philanthropist

The media would have you believe that a successful investment experience comes from picking stocks, timing your entry and exit points, making accurate predictions and outguessing the market.

Is there a better way?

It's true that some people do get lucky by making bets on certain stocks and sectors, getting in or out at the right time, or correctly guessing movements in interest rates or currencies. But depending on luck is simply not a sustainable strategy. This is speculating, not investing.

The alternative approach to investment may not sound as exciting, but is far more disciplined and increases your chance of a successful outcome. It essentially means reducing the influence of fortune as far as possible, taking a long-term view, and starting with your own needs and risk appetite.

Of course, risk can never be completely eliminated and there are no guarantees about anything in life. But you can increase your chances of a successful investment experience if you keep these six rules of sensible investing in mind.

The Six Rules of Sensible Investing

1. Invest on Purpose

"If you don't know who you are,
the stock market is an expensive place to find out."

Adam Smith, Economist

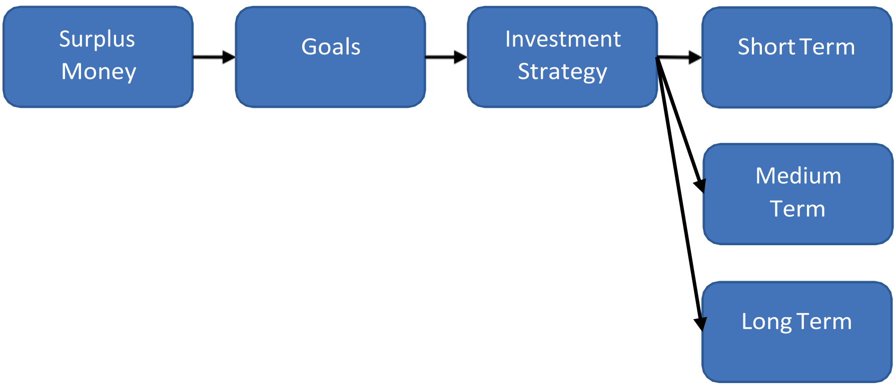
All sensible investment conversations begin with a detailed discussion about the eventual purpose of the investment.

Thinking clearly about your goals and circumstances is an essential ingredient in a successful investment experience and will build the foundation of an investment plan.

So, why are you investing?

The principle of 'investing on purpose', is, having created a financial plan and identified life goals, these goals should determine the investment strategy and provide you with the 'target return' you need to achieve your goals. It is quite common to have a range of different goals, with variable timescales and returns required, and therefore several elements which build together into an overall investment strategy. Cash is the most likely suitable home for goals that need to be paid for within the next few years, while you may have time to be more aggressive with longer-term goals choosing a portfolio of shares.

So, if you are planning to invest... don't! Invest in planning first.



2. Maximise Your Investment in Stocks and Shares (Equities)

I love equities. They have served my clients very well providing almost 25 years of providing advice. Having a multi-generational investment plan (beyond your life) that is not based on equities is just naïve, bordering on stupidity.

Why? It's simple. The real long-term returns on equities are much greater than for bonds and cash, because you get compensated for taking some risk. This is sometimes called the equity risk premium.

There must be a 'draw' for investors to leave the security of cash and bonds for the volatility of stocks and shares, and this is the opportunity for higher returns.

Capitalism works, and the majority of companies are profitable over the longer term, and they share these profits with shareholders in the form of dividends and higher share prices. Of course, there are individual exceptions such as Woolworths and Carillion, but investing in individual shares is speculating; here, we are talking about holding thousands of shares in a diversified portfolio and, as such, the market will reward you, as Warren Buffett commented at a shareholder meeting in 2009:

"Our system works. Over time, people will live better and better. We [the US Economy] have a system that unleashes human potential, and now China has a system that unleashes human potential. We will have interruptions. We overshoot and undershoot sometimes, but your kids and grandkids will live better than you. Over time, we move ahead at a pretty damn rapid rate."

As is demonstrated by the following chart (going back to the inception of the Financial Times Stock Exchange [FTSE] World ex UK index), over the medium to long term, this premium is extensive and proportionate to the degree of increased risk over that of holding cash and bonds.

Pricing Spread: Bid-Bid – **Data Frequency:** Daily – **Currency:** Pounds Sterling

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UK and world equities have a long history of producing much higher real returns than cash and bonds. And, while I am obliged to tell you that past performance is no guide to the future, I personally believe that, over the longer term, the past is a good mirror of the future and we should take it as a given that equities are likely to continue to outperform cash and bonds in the future. Speaking of givens, here is another one: there is no free lunch and past performance tells us that there can be setbacks, even substantial – but these are generally short-term. So, even if we accept this idea, the question forming in our minds must be: what's the catch?

Well, I am sure you know the answer – it is risk.

But there is a common misconception with risk. Nick Murray, US author and financial guru describes this as follows:[19]

"[There is] the inability to distinguish between it (risk) and mere volatility – people mistake a temporary decline in price of their investment for permanent losses in their value. But, in a well-diversified portfolio, temporary price declines have not historically turned into permanent losses in value. In fact, quite the contrary, major declines have been followed by advances which erase the decline and carry prices to significantly higher levels."

Risk in price is really just volatility, which is only temporary.

So, in a suitably diverse portfolio, the only way to turn a fall in the markets into a permanent loss is withdrawing at the point when the markets have fallen, either due to poor advance planning, or fear and panic. But, you may say, there are things happening in the world today that the markets have not witnessed in the past! However, I'm with legendary investor Sir John Templeton, who said this:

"The four most dangerous words in investing are: this time it's different."

Indeed, if you are thinking in terms of anything like a 30-year retirement, and you want your income to at least keep pace with your living costs, to maintain your standard of living and leave something to the children, then the real long-term risk of equities is not owning them. Nick Murray makes the following comment:[20]

"In the long run – and the quest for multi-generational real wealth is the pure essence of a long-run enterprise – it is stocks that are safe, and bonds that are risky."

The effects of inflation will have a devastating impact on your purchasing power, and the best defence against rising prices is an investment that has the potential to provide above inflationary long-term returns.

So, the risk of holding equities for the long-term investor is wildly exaggerated, and confused with volatility, while the long-term risks are near non-existent, and investors totally underestimate the long-term risks of not holding equites. This is illustrated in the next chart, which demonstrates the associated principal high short-term risk of holding equities, and how, over time, this risk is reduced to almost nothing. However, the reverse is true for purchasing power, where, over time, the inflation risks are increased.

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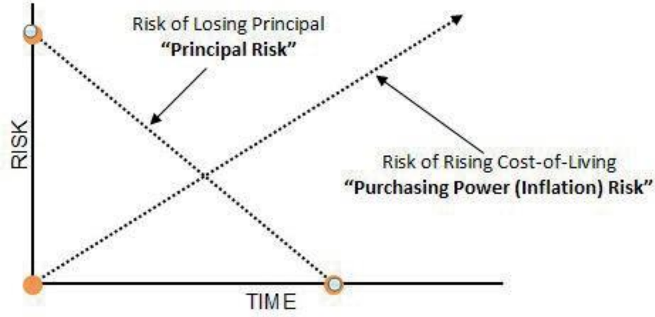
[19] Nick Murray, *The New Advisor* - (Library of Congress, 2001, USA) page 189.

[20] Nick Murray, *The New Advisor*, (Library of Congress, 2001, USA) 189.



Which equities to buy is beyond the scope of this book. But let me make one thing clear, when you invest in equities buying just one or two, is speculating not investing – you should hold a diverse range of equities, probably in hundreds if not thousands of companies. Also, academic studies and historic evidence demonstrate that you can exploit different drivers of return when building a portfolio with added diversity, using variables such as geographical variance (UK, global and emerging markets) or share type (value[21] and small[22]), which is frequently rebalanced,[23] and that these variables can increase the long-term return on a portfolio, while potentially also reducing the overall risk. Be sure therefore to build your portfolio with that aims to give you the optimal return for your risk profile.

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[21] These are companies that are unloved by the market, and have maybe gone through a rough period that is reflected in a stock price decline, which means they have more potential for recovery. Yes, it is riskier to own them, but, as a result, the potential for return is also greater.

[22] You are likely to get a higher long-term return from small companies than large companies, mainly because they, of course, have more scope for growth, but, again, these come with greater risk, which investors are rewarded for. Microsoft was a small company once.

[23] Over long periods of time, portfolios tend to drift away from the original and agreed investment positions, often resulting in investors holding assets above their risk profile. The concept of rebalancing a portfolio (that is, returning it back to its original proportions) is an often-overlooked risk-management mechanism. It may seem counter-intuitive to sell something doing well and reinvest in something that has performed relatively less well; however, unattended, the portfolio will increasingly become overpowered by the riskier asset class. A beneficial by-product of rebalancing is the return bonus that comes from a 'buy low, sell high' strategy.

3. Invest for the Long Term

"Our favourite holding period is forever."

Warren Buffett, Letter to Berkshire Hathaway, 1988 Investors

know they should be long-term investors. This often gives rise to the question *"How long is long term?"* The answer for many investors is surprising – your long-term horizon should be as far into the future as possible. One of the many surprising facts about investing is that having a long horizon is a powerful advantage, given the impact of compound returns and the risk reduction factors over time. You want your horizon to be as long as possible because, as an investor, time is your biggest ally.

Furthermore, there is no magic wand in the field of investing, yet many investors still believe (perhaps due to the noise that emanates from the City and the media) that there are active managers who can predict the future, anticipate market movements and select 'the next top-performing stocks', which enables them to deliver outperformance. Thirty years ago, maybe, but this is far less likely today. The overwhelming evidence, and study after study demonstrate that this is certainly not the case, and, indeed, it is a futile and costly exercise.

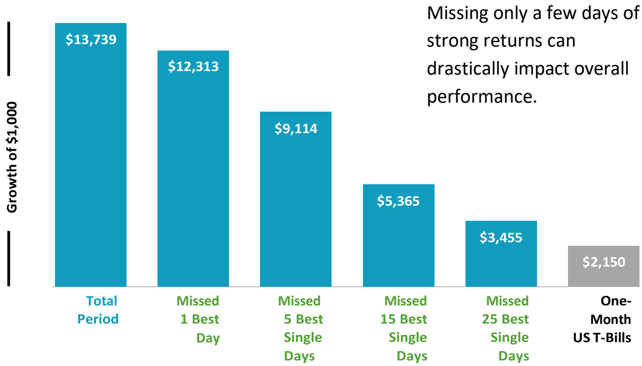
The good news, however, is that you do not need a crystal ball to enjoy a good investment experience. In fact, overwhelming evidence proves that adopting a 'buy and hold' strategy, which ensures that investor emotions do not precipitate wealth-destroying 'buy high, sell low' behaviour, will, over time, deliver a successful investment experience.

You would not plant a tree and dig it up every year to see how the roots are doing, and if you are not happy, move it to another part of your garden. Investing is no different; leave it alone to let it flourish. Of course, it is important to position the portfolio right from outset, but then you will get rewarded for being lazy. As Warren Buffett said, *"The hallmark of our investment process is benign neglect, bordering on sloth."*

More recent data reinforces the message that *it is time in the markets, not timing the market that is important.*

Reacting Can Hurt Performance

Performance of the S&P 500 Index, 1990–2017



	Total Period	Missed 1 Best Day	Missed 5 Best Single Days	Missed 15 Best Single Days	Missed 25 Best Single Days	One-Month US T-Bills
Annualised Compound Return	9.81%	9.38%	8.21%	6.18%	4.53%	2.77%

Past performance is not a guarantee of future results.

In US dollars. For illustrative purposes. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. The missed best day(s) examples assume that the hypothetical portfolio fully divested its holdings at the end of the day before the missed best day(s), held cash for the missed best day(s), and reinvested the entire portfolio in the S&P 500 at the end of the missed best day(s). Annualised returns for the missed best day(s) were calculated by substituting actual returns for the missed best day(s) with zero. S&P data copyright 2018 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. "One-Month US T- Bills" is the IA SBBI US 30 Day TBill TR USD, provided by Ibbotson Associates via Morningstar Direct. Data is calculated off rounded daily index values.

The above chart demonstrates the potential devastating impact on returns of missing market upturns, which can often occur when investors engage in a tactical investment strategy trying to beat the markets – or what we call the 'loser's game'.

So, get your portfolio set up correctly, then leave it alone!

> ***"Design a portfolio you are not likely to trade...akin to premarital counselling advice; try to build a portfolio that you can live with for a long, long time."***

Robert D. Arnott, President, Research Affiliates

4. Cash is King, So Retain Healthy Cash Reserves

Behind every successful long-term investment strategy there should be cash reserves held to fund any projected short-term financial commitments, i.e. a 'cushion for caution', which is kept separate from your long-term investment portfolio. This will allow you to sustain the long-term investment commitments without having to draw down funds, allowing you to avoid distressed sales when the markets have fallen. It means you don't have to panic, and you have the capacity to cope with market volatility, reducing the short-term risks of equity investments and allowing you to share in their long-term benefits.

When cash reserves are low, then this should be topped up via portfolio withdrawals at a time to suit you and your portfolio. This process may then be repeated throughout the life of your investment.

The amount of cash you need is determined by a number of factors. If you have surplus income and you are accumulating money, then your cash reserve can be lower. If your expenditure exceeds your income, then your levels of required cash reserves will be higher. As a rough guide, if your income covers your outgoings, then we would suggest keeping about 6–12 months' worth of annual income within your cash reserve to fund emergencies or opportunities. However, if your expenditure exceeds your income, then you should keep at least three years of cash to cover this projected three-year shortfall, with the balance topped up by your investment portfolio extracting profits at suitable times. In both examples, planned one-off expenditures within a one-to-five-year period should also be held in cash.

5. Keep Emotions in Check and Stay the Course

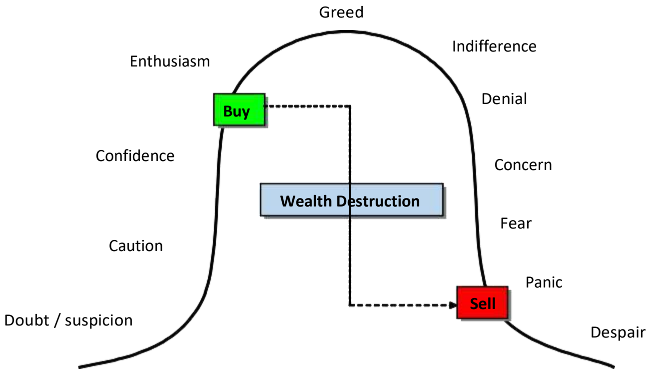
"The investor's chief problem – and even his worst enemy – is likely to be himself."

Benjamin Graham, Security Analysis, 1934

The crucial question is not simply whether long-term returns on equities will exceed those of bonds or cash if the investor holds on through the many startling gyrations of the market. I think we have established this. The crucial question is whether the investor will, in fact, hold on for the long term, so they can benefit from the returns that the markets actually achieve. The problem is not in the markets, but us as investors, with our perceptions and our all-too-human reactions to these perceptions as explored in the following.

Investing is often likened to a ride on an emotional roller coaster. If you consider the typical behaviour of the vast majority of investors, you can understand why. When an upward trend (either for an individual stock or, indeed, the market as a whole) starts to emerge, the investor follows the trend, but only buys in once he/she is convinced that it is for real. Unfortunately, this is usually at the point that all the gains have been had and is when the trend reverses. Thus, it can be seen how the emotions that drive investors are a powerful force that lead them to buy high. As you will see from the following diagram, a similar set of emotions (although in reverse) comes into play when stocks/markets fall, causing investors to sell low.

The classic 'greed and fear' rollercoaster destroys wealth.



As the diagram illustrates, human emotions play a large part in the success or failure of investors to meet their goals and maximise their wealth. As Jack Bogle, founder of The Vanguard Group, one of the US's largest and most respected asset management firms states the following:

"If I have learned anything in my 52 years...it is that, for a given individual or institution, the emotions of investing have destroyed far more potential investment returns than the economics of investing have ever dreamed of destroying."

It is inevitable that, at some point on your investment journey, the value of your investments will fall, and maybe even plunge in value. This is part of investing and something that you, the investor, should accept as the norm. If you don't understand the loss potential from the outset, then, when the markets fall, you are more likely to panic and bail.

It is important, therefore, before you invest, to check that you can emotionally cope with any falls, and, just as important, that you can financially afford the take the hit of a market fall. So, and this is crucial, understand the potential for loss before you invest.

So, we all need to be disciplined and informed investors; it is you, rather than the market, who will harm your returns. A great investment strategy that is being controlled by an investor with no discipline is doomed to underperform, and, like many before them, lose the 'loser's game'. Don't be a loser!

6. Track Don't Pick

"There are two kinds of investors, be they large or small: those who don't know where the market is headed, and those who don't know that they don't know. Then again, there is a third type of investor – the investment professional – who indeed knows that he or she doesn't know, but whose livelihood depends upon appearing to know."

William Bernstein, Author, The Intelligent Asset Allocator[24]

Having studied the arguments of the active[25] verses indexed investment approach,[26] and there is much debate, I believe there is overwhelming evidence in favour of an indexed approach to investing.

The decision about whether to employ an index or an active approach revolves around three key questions:

- Do markets exhibit inefficiencies that managers can use to their advantage?
- Can these inefficiencies be profitably exploited after all costs, including taxes?
- Can skilful managers be distinguished from lucky managers in advance? I believe

the answer to all these questions is *no*.

The inability of a majority of active equity managers to consistently outperform their benchmark index over the long term, in both efficient and inefficient markets, after costs, is broadly documented.

Numerous studies of active managers' performance consistently suggest that previously good performance is at best a weak and unreliable predictor of good future performance and where it has occurred, it was only in the short term; additional findings indicate that bad past performance sometimes persists, in many cases due to high costs.

Investors cannot control the markets, but they can often control what they pay to invest. And that can make an enormous difference over time. The lower your costs, the greater your share of the return and the greater the potential impact of compounded returns.

Fees destroy investor returns.

Patricia C Dunn, CEO of Barclays Global Advisers, stated the following:

"Investment managers sell for the price of a Picasso [which] routinely turns out to be paint- by-numbers sofa art."

Building an indexed portfolio, however, is not just about tracking one or two indices, such as the FTSE-All-Share Index or the Dow Jones. There is far more to it than that now with the ability to build a diverse sophisticated portfolio using low-cost tracker funds,

[24] McGraw-Hill Education October 2000

[25] An active approach is based upon trading to beat the stock market's average returns, in an attempt to take tactical advantage of short-term price fluctuations. It relies on knowing when to pivot into or out of a particular stock, bond or any other asset. This will typically be carried out by a team of analysts, who look at qualitative and quantitative factors to try to determine where and when that price will change. Successful active investment management requires being right more often than wrong.

[26] An indexed approach is one in which the underlying holdings of the fund reflect one of the global indices, such as the FTSE All-Share or the Standard & Poor (S&P) 500. Whenever these indices switch their constituents, the index funds that follow them automatically switch up their holdings by selling the stock that's leaving and buying the stock that's becoming part of the index. While this will prompt some trading, it is still significantly less than that of the active approach, making this a typically lower-cost method of investing. The strategy generically follows a buy-and-hold approach, removing the temptation to react or anticipate the stock market's every next move.

where asset classes are negatively correlated to reduce risk, while also tracking specific equity types (small, value and growth) in worldwide geographical sectors to potentially drive higher-than-market returns.

Conclusion

One rule that I have omitted, and I confess to self-interest here, is the positive influence that engaging a financial planner (not an investment manager – they are a different breed) can have on a successful investment journey. Done well, a financial planner will create the correct portfolio for you from day one, while ensuring the investment plan remains aligned to your financial life plan and providing behavioural coaching to make sure you avoid wealth-destroying silliness, such as panic selling or buying products that are unsuitable (largely motivated by greed).

Research from global fund manager, Vanguard,[27] suggests the principle of Adviser Alpha, which is that the difference between the return the investors might achieve with an adviser against the return they will achieve on their own is around 3% per annum. This, amongst other things, is largely a result of creating a suitable asset allocation that is rebalanced frequently, lowering costs, maximising tax allowances and providing behavioural coaching (avoiding mistakes). When taking compound interest into consideration, such Adviser Alpha will have a positive impact on your retirement nest egg.

Following these rules with a great financial planner at your side will undoubtedly improve your chances of a successful investment outcome and winning the 'loser's game'.

[27] Vanguard Adviser Brief, March 2015