Volume 33 //

Acuity

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

The foundation stones of good investing

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> **Successful investors operate with a coherent investment philosophy that they apply consistently to all aspects of the portfolio management process. Philosophical principles represent time-tested insights into investment matters that rise to a level of enduring professional convictions**

David Swensen, CIO Yale University Endowment

When investing money, it is often tempting to spend time thinking about what to invest in rather than how to invest. If investors spent more time thinking about the latter, their investment experience is likely to be a more fruitful one. Although investing is not easy, these ten simple foundation stones lay the platform for success.

The challenge of investing

Investing is the process of delaying consumption from today to sometime in the future, and employing that money in the meantime in the markets to grow at a rate at least in line with inflation but preferably more. Not scaring oneself to death along the way is also a key goal. As the old saying goes, investing is simple but not easy.

This edition of Acuity summarises what we believe to be a sensible and highly effective way to invest your money. Investing may never be easy, but it can be far easier once you employ a systematic approach, like the one we adopt.

Start by building your investment compass

Investing money well requires a logical and robust framework on which to build a lifelong investment programme. It needs to be grounded in investment theory, supported by empirical evidence and enhanced with an insight into the behavioural traps and pitfalls that all investors face, that can and do cost them dear.

a) Five lifelong principles

We start by looking at five guiding principles that provide the backbone for how we should think about investing, rather than what we should invest in.

Accept capitalism and have confidence in the markets

As investors, we need to accept capitalism as a robust and resilient economic system and recognise that the markets are an efficient mechanism for rewarding those who provide capital to those engaged in the pursuit of wealth creation.

Despite the apparent doom and gloom, the world's economy continues to grow, year-on-year, creating wealth and return opportunities for investors. The future looks bright from where we are sitting, despite current market challenges.

Accept that risk and return go hand in hand

One of the inescapable truths of investing is that to achieve higher returns, you have to take on more risk[1]. That seems logical enough, but you would be surprised just how many investors seem to think that it is possible to get high returns with low risk. Risk should not be feared, however, because when appropriate risks are taken, they generally lead to the returns that investors seek.

The one thing we know for sure about risk is that if an investment looks too good to be true, it probably is. If you ever see such an opportunity, you need to establish what the hidden risk is, as you have not spotted it. Risk and reward are always related.

Let the markets do the heavy lifting

In investing, there are two main sources of potential returns. The first is the return that comes from the markets; and the second is the return generated through an investor's skill.

At its simplest, there are two main ways in which an investor - using their skill - can try to deliver a better return than the market return: one is to time when to be in or out of the markets (market timing), the other is to pick great individual stocks (stock picking).

Empirical evidence suggests that trying to beat the market - through either market timing or stock picking - is a tough game, with very few long-term winners. Our view - in line with both academia and many major institutional investors - is that it is not a game worth playing. Letting the markets do the heavy lifting on returns takes a great weight off your shoulders; you no longer need to worry about picking the right stock, the right manager or deciding if you should be in or out of the markets. As one cannot control the returns of the markets, the structure of your portfolio becomes key.

Be patient - think long-term

One of the great challenges that all investors face is that there is no easy or quick way to investment success. Aesop's fable of the tortoise and the hare is a useful metaphor. You have to use the time on your side – which could be over multiple decades – to capture the returns of the markets effectively, but often slowly. In the short-term, market returns can be disappointing. The longer you can hold for, the more likely the returns you will receive will be at worst survivable, and hopefully far more palatable. It is time that allows small returns to compound into large differences in outcome for the patient investor. The reality is that markets go up and down with regular monotony.

If you want to be a good investor, you have to be patient. On your investing journey, you will spend a lot of time going backwards, recovering from the set back and then surging forward again, often in short, sharp bursts of upward market movement. You just have to stick with it. Remember that you have to be in the markets to capture their returns. Impatient investors tend to lose faith in their investments too quickly, with often painful consequences.

Be disciplined

Patience and discipline are close bed fellows. Once you realise that generating good long-term returns takes time, patience and belief in the markets, it is essential to put in place the discipline to stop yourself succumbing to impatience and ill-discipline.

Discipline comes in many forms: sticking to the principles above; constructing well-researched and tested portfolios that should weather all investment seasons relatively well; not chasing investments that have gone up dramatically, but sticking with the logical reasons for not owning them in the first place; and the discipline to not become despondent about short-term, unimportant market noise, and to focus on your long-term strategy.

We know from research in the field of behavioural finance that we tend to feel at least twice the pain from losses compared to the pleasure from gains of a similar magnitude. So every time portfolio falls, investors feel glum. The key to this discipline is to understand the very ordinariness of these market falls and not to look at your portfolio too often. If you look at your portfolio every day you have about a 50/50 chance of seeing a loss, yet over five years that drops to around a 1-in-10 chance, falling further to around a 1-in-20 chance over 10 years[2]. Time is your friend.

b) Five effective investment practices

Having established a sensible set of investing principles, let's turn our attention to five key investment practices that the evidence and theory suggest we should focus on.

1. Build a well-structured portfolio

Once you accept that returns come from markets and are rarely enhanced by the judgemental approaches of professional managers, market timing and stock picking, it is evident that structuring a well-thought-out mix of different investments (referred to as asset classes) should sit at the heart of your investment programme. Your long-term portfolio structure will dominate the investment returns obtained during your investment lifetime[3].

Successful investing is all about taking on well-understood risks that deliver a positive return expectation – these are carefully selected market risks associated with ownership and lending[4]. It avoids taking on risks that add little (or worse) to the portfolio, such as illiquidity, poor judgemental portfolio manager performance, and opaque and complex product structures.

2. Use diversification to manage an uncertain future

Not putting all of your eggs in one basket is an intuitive and valuable concept. No-one knows what the future holds, and owning a highly diversified portfolio, spread widely across asset classes (bonds, equities and commercial property, for example) and across global markets, industry sectors and by company, helps make sure that we are prepared for whatever the markets throw at us over time; a portfolio for all seasons, if you like. Diversification is the key tool that we have against the uncertainty of the future.

Owning a diversified portfolio brings its own challenge. Inevitably there will always be one or two parts of the portfolio that are doing well, but one or two that are not. The patient and disciplined investor knows that there is little point in knee-jerk responses, and that this is simply the way that markets are. The impatient and ill-disciplined will seek to change their strategy. More fool them.

3. Avoid cost leakage from your portfolio

Costs eat away at the market returns that you should be gathering for yourself. Small differences in costs will compound into large differences over extended periods of time. Investment industry costs are high, particularly those related to judgemental (active) managers. The costs of investing are more than simply the annual management charges (AMC) charged by the fund manager. Other fund related costs can also be offset against the fund's performance which roll up into the ongoing charges figure (OCF). Yet that is not all. When a manager buys and sells equities or bonds they incur transaction costs, which eat further into returns.

If we take two portfolios with the same gross (pre-cost) returns - one with a low cost of 0.25% a year and the other with a high cost of 1.5% a year – the low cost strategy will, on average, end up with a staggering 65% more money in the pot over 40 years[5].

4. Control your emotions using a systematic, disciplined approach

Unfortunately, evolution has hard-wired the human brain to be particularly poor at making investment decisions. A deep-seated subconscious battle is constantly being waged between greed and the desire for reward against the fear of uncertainty and loss, which creates ongoing anxiety and irrational decision-making in many investors.

Investing is certainly not emotionally easy. Evidence of wealth destroying, emotion-driven decision making is plentiful, as impatient and ill-disciplined investors have a propensity to chase fund managers, and markets, that have previously performed well, and sell poorly performing investments. Buy-high, sell-low is not a good investment strategy. Research[6] reveals that this bad behaviour may cost investors around 2.5% per annum, on average. Given that equities have only returned around 5% above inflation, on average, that is a material erosion of potential wealth.

Recognising that both investors and advisers suffer from a range of behavioural biases that are more likely than not to result in the erosion of wealth, we believe that the design of a disciplined, systematic and understandable investment process, and its ongoing implementation, is central to your success as an investor, reducing this 'behaviour gap' as the industry calls it.

5. Manage risks carefully across time

Our approach to investing positions us as risk managers, rather than performance managers, as advisers have traditionally been. We have identified three key areas of risk management.

The first is rebalancing a portfolio: having spent considerable effort ensuring that a client's portfolio is both suitable for them and robustly structured, it is important to keep it that way. Rebalancing involves selling out of better performing assets and buying less well performing assets, i.e. selling, rather than buying 'hot' performing asset classes. This enforces a systematic, rather than a market valuation-based, defence against possible market bubbles. Rebalancing is simple in concept, but in practice it is hard to do; it requires considerable discipline and fortitude, particularly at times of market turmoil, when our emotions, particularly fear or greed, are heightened.

The second is fund selection: choosing which funds to recommend to our clients is a big responsibility that we take very seriously. We employ a detailed and insightful due diligence process to ensure that we are asking the right questions from product providers. Our focus is always on risk management that starts with eliminating fraud, explores operational risks, then focuses on product structure risks and, finally, looks at the ability of the fund firm to deliver market returns effectively.

The third is ongoing governance of the investment programme: it is entirely possible, and likely, that your portfolio will look much the same between one time period and the next with little activity, except for rebalancing. That most definitely does not mean that nothing is happening. We hold regular Investment Committee meetings that focus on reviewing any new evidence supporting or challenging our approach, the latest research on asset classes, and additional due diligence ensuring that our best-in-class funds remain just that.

In conclusion

Employing a systematic investment approach – like the one we have developed – provides the discipline and objectivity that is required to avoid the pitfalls that all investors inevitably face. It certainly makes investing far simpler and easier, but never easy.

End notes

1. Sharpe, William F. (1964). 'Capital asset prices: A theory of market equilibrium under conditions of risk', Journal of Finance, 19 (3), pp. 425-442.
2. Albion Strategic Consulting – internal research 2016.
3. Brinson, Gary P., Hood, L. Randolph, and Beebower Gilbert L., (1986) 'Determinants of Portfolio Performance', Financial Analysts Journal, vol. 42, No. 4, pp 40-48.
4. Fama, Eugene F., and Kenneth R. French, (1993) 'Common risk factors in the returns on stocks and bonds', Journal of Financial Economics 33, 3-56.
5. Sharpe, W. F., (2013), The Arithmetic of Investment Expenses, Financial Analysts Journal, Volume 69 · Number 2, 2013 CFA Institute.
6. Mind the Gap 2014 by Russel Kinnel, Morningstar. http://news.morningstar.com/articlenet/article.aspx?id=637022

Other notes and risk warnings

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