Volume 5 //

Acuity

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How to sleep like a baby

Learning to live with your portfolio

> “An investment in knowledge always pays the best interest.”

Author unknown, commonly attributed to Benjamin Franklin.

Understanding ourselves and the portfolio we own is a big step in living comfortably with our choices. What science can we apply to help us and how do we deal with the uncertainty that future market events will deliver?

Learning the lessons of investing can be costly

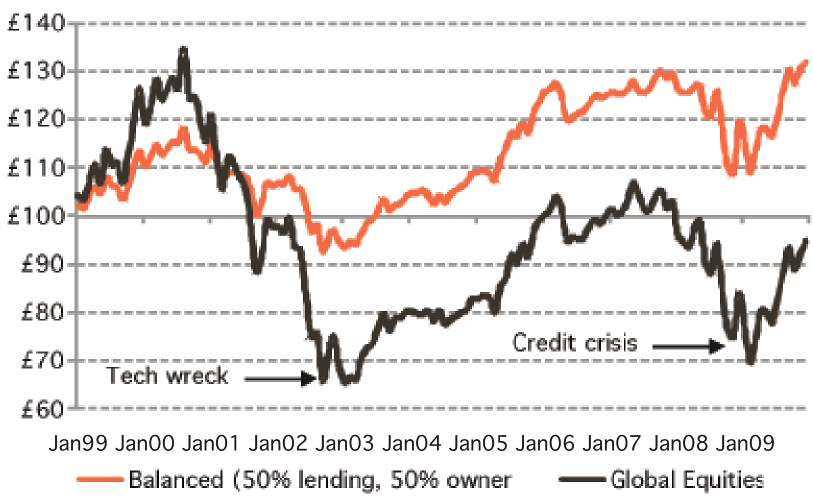
There is an old joke about a young banker who has made a big and disastrous loan to a small company that is now in administration. He walks into his manager’s office looking downcast at the prospect of the imminent end to his short-lived career. When asked why he looks so glum, he responds that he is expecting to be fired on the spot, to which his manager replies, *‘Fired? You must be joking, we’ve just spent £5 million on your education!’*

Many investors, each in their own way, have suffered painful lessons (actual losses or sub-optimal outcomes) from the markets and the individual investments that they have made at some point along their investment journey. These experiences can be very painful, cause sleepless nights and may result in subsequent avoidance of risk, often a significant cost to future lifestyle choices. So what lessons can we learn from history about how markets behave, which may help us to sleep better at night in the future?

Lessons from the lost decade of equity investing

The ‘Noughties’ (2000-2009) and the beginning of this decade has been a period that will be best remembered by investors as a rollercoaster ride in the global equity markets, with global developed markets finishing the decade at around the same level at which they started, after taking account of inflation. It does, however, provide some interesting insights that can be quite instructive, particularly that it has not been all doom and gloom as the news and market commentators would have us believe. Some parts of client portfolios actually performed well, such as emerging market equities, high quality bonds and commercial property. With broad diversification, balance and discipline, the ‘lost decade’ was survivable. In fact, a simple balance between lending and ownership, not putting all your eggs in one basket, and rebalancing the mix back to its original proportions once a year actually grew £100 to a little over £130, after the effects of inflation. Not a bad result, given the circumstances.

Figure 1: An insight from the ‘Noughties’



Simulation data – see note [1]

Diversification is the key to sleeping soundly

The following words of wisdom from two highly respected investment practitioners perhaps sum up why, as a firm, we place so much focus on building robust and diversified portfolios for our clients. The first are from John Bogle, the founder of Vanguard, one of the largest and most respected passive (index tracker) investment firms in the world.

> *'Asset allocation [the mix of investments] is not a panacea. It is a reasoned – if imperfect – approach to the inevitable uncertainty of the financial markets.'*

William Bernstein, who originally started out as a neurologist, but is now a leading thinker, practitioner and author on investing, states:

> *'Since the future cannot be predicted, it is impossible to specify in advance what the best asset allocation will be. Rather, our job is to find an allocation that will do reasonably well over a wide range of circumstances.'*

Finding the right balance between ownership and lending for you

At its most fundamental, investing simply aims to capture the bulk of the returns that the markets (i.e. capitalism) delivers. A simple strategy of lending to the government in return for an inflation-linked return (owning bonds) plus owning the growth potential of global companies (via equities), can now be achieved with minimal effort. More sophisticated solutions exist to improve this portfolio further, such as the one we offer our clients.

However, the most important decision is getting the balance right between lending and ownership. Get that wrong and you will either be ruing the low returns on your investments or scaring yourself to death every time you look at your portfolio valuation. So what can we do as investors, to allow ourselves to feel comfortable with our own balance (otherwise known as our investment strategy) and to sleep comfortably at night, without worrying about our portfolios?

A little knowledge is sometimes a good thing

The answer lies in knowledge: knowledge about the way we individually respond at an emotional level to losses and uncertainty; knowledge of the nature of our portfolio and how it is likely to behave; and knowledge of the discipline we can wrap around ourselves through our investment process to keep us feeling comfortable, even in the tougher times in the markets.

Knowing how much risk you are *willing* to take

The first step in finding the right balance between lending (bonds) and ownership (equities) is exploring how you feel about uncertainty and the chances of an unfavourable outcome occurring because of the markets. The Financial Services Authority (FSA) calls this emotional tolerance for risk, a client's '*willingness*' to take it. Fortunately, an increasing use and acceptance of psychometric risk profiling[2] and other well considered approaches is helping investors (and their advisers) to gain more insight into limits on the level of risk that they feel emotionally comfortable with. Your risk profile does not change much – it's all part of who you are, how you think and how you behave.

Psychometric tests, in general, are widely accepted in business: most FTSE 100 companies use them in recruitment, as do the Police, the Civil Service, airlines and even AC Milan, the football club. In terms of risk profiling, the results are neither right nor wrong, but simply a reflection of your own personal willingness to take risk – a useful starting point in the discussion about risk that you have with your adviser.

Knowing how much risk you are *able* to take

The second step is understanding the amount of risk you are able to take, which is a function of your ability to recover from losses inflicted on your portfolio by adverse market conditions. This will depend to some extent on the level of assets that you have invested, the importance to you of the goals that you have set, and your ability, perhaps through contributions over a lifetime of work, to replenish these losses. You will have your own unique circumstances and your capacity to recover from losses will be different from others. These issues are all part of the financial planning process. Running worst-case portfolio scenarios through a lifetime cash flow model can be useful. The FSA refers to this as the amount of risk an investor is *'able'* to take.

Knowing how much risk you *need* to take to meet your goals

The third step is understanding how much risk you actually *need* to take on. For example, just because an investor has a high risk profile and ability to withstand losses, it does not mean that they should own a high risk portfolio. Perhaps to achieve his or her goals the investor needs to take very little risk. Again lifetime cash flow modelling can help to establish how much risk (and thus return) is needed in the investment portfolio.

Knowing how your portfolio works

The tools above provide some useful inputs into the dialogue that we have with our clients to find the right balance between ownership and lending (often referred to as the equity/bond or growth/defensive assets split). A useful additional tool in these discussions is the insight sheet that we prepare for each of our model portfolios. This provides insight into both the upside and the downside of the mix of ownership and lending under discussion. The table below provides the worst outcomes over different investment horizons, over the past 30 years or so, to illustrate simply the value of these insights. It uses a basic mix of global equities and inflation linked gilts. This is not a suggested strategy, simply an example of the value of such analysis.

Figure 2: Downside risk exposed - outcomes over the past three decades

Period: 6/1981 to 8/2011	Allocation to equities (ownership)					
	None	20%	40%	60%	80%	100%
Historical attributes						
Annualised return after inflation %	4.1%	4.7%	4.7%	5.2%	5.6%	5.9%
Risk %	7%	7%	9%	11%	13%	16%
Worst real returns over:						
1 year	-10%	-13%	-20%	-26%	-33%	-39%
3 years	-4%	-4%	-6%	-11%	-15%	-20%
5 years	-1%	0%	-2%	-4%	-6%	-8%
10 years	1%	1%	0%	-1%	-2%	-4%
15 years	2%	3%	3%	2%	1%	0%
Worst growth £100 (real):						
1 year	-£90	-£87	-£80	-£74	-£67	-£61
3 years	-£90	-£89	-£82	-£71	-£61	-£51
5 years	-£93	£100	-£92	-£83	-£73	-£64
10 years	£107	£114	£102	-£90	-£79	-£67
15 years	£138	£156	£150	£136	£121	£106

* The annualised standard deviation of returns. Note that 'real' = after inflation. Data simulation: see note[3].

Tips for living with your portfolio

> *'You can't always control the wind, but you can control your sails'.*
>
> Anthony Robbins

Successful investing is a bit like sailing. Like the wind, we cannot control the movements of the market, but we can control how exposed we are to equities by owning lower risk, bond assets to help us weather the storms. As Peter Lynch, a well-known (retired) fund manager once stated:

> *'The key to making money in stocks is not to get scared out of them'.*

Tip 1:

Believe in your investment programme

Understanding, confidence and belief in the way your money is invested are really important. We have put in place a well-thought out, evidence-based and robust investment process, which is thoroughly documented, both in our internal investment process documents, but also in readily accessible form for our clients. We are always happy to talk through our process with you. Believing in the approach allows you to stand firm when the market storms hit from time to time, as they inevitably will. Clients who have weathered previous storms know what it is like to own the right portfolio. These market lessons, like the young banker's loan disaster, are a valuable part of the investment learning process. New storms can be weathered with a calmer, experienced head.

Tip 2:

Invest only in things that you (and we) can understand

Our investment process can be described simply as being founded on evidence that places emphasis on only selecting risks that we fully understand and which we judge, based on the evidence, will be rewarded over time. We spend considerable time making sure that each client holds the mix of ownership and lending that is most appropriate for them and implement the strategy using transparent, institutional quality, low-cost passive funds that return the bulk of the market return to our clients. We regularly rebalance portfolios back to the original equity/bond mix and monitor all other risks via our formal Investment Committee. Again, Peter Lynch has some words of wisdom for us, which could nicely represent our approach to investing.

> *'Never invest in an idea you can't illustrate with a crayon'.*

Tip 3:

Do not look at your portfolio too frequently

Once invested in the right portfolio for you, one of the key tips is not to look at your portfolio too often. The dangers of doing so are immense – it exaggerates the risk of the portfolio by focusing on the short-term noise, making you feel unsettled. One of the old tongue-in-cheek adages for reviewing your portfolio is that you could allow yourself to look at your cash position every day, if you so wish; your bonds every three years; and your equities every ten years. Did you know that looking at the equity portion of your portfolio every day gives you a 50% chance of seeing a loss? Even over any one year period you have around a 30% chance of seeing a loss. Be strong – stay away from that online login!

Tip 4:

Look at the whole portfolio, not its individual component parts

It is important too, to view your portfolio as a whole, not its individual pieces. The whole point of a well-diversified portfolio is that some parts of it will be zigging, while others are zagging. In addition, do not get focused on discrete periods of performance. The important thing is to check where you are against your plan, and, where necessary, focus in on the variables of the plan that you can alter. Our regular reviews help to place the portfolio performance in context.

Tip 5:

"Talking back at the news" [4]

The BBC and many other news outlets feed off bad news, but rarely do they provide much value or balance in their reporting. No-one ever says how resilient capitalism is; no-one presses the point that the world's GDP grew by around 5% last year in aggregate; no-one talks much about the fact that UK companies hold record levels of cash (estimated at £70bn) on their balance sheets waiting to invest when positive sentiment returns – in the US companies are holding cash of around $2 trillion (£1.3 trillion). So, the news in 2011 was bad, but it passed! Hold firm and believe in capitalism.

We are on this journey with you

Finally, we know that investing is not something that comes easily to many, and that the stakes (i.e. our future lifestyle) can be high. Part of our service is to help our clients to feel comfortable with their investment portfolios and to hold firm when markets get tough. We are always happy to talk you through our investment process and to run through the rationale for the portfolio that we have recommended to you. Do not hesitate to call us if you have any questions or worries – that is what we are here for.

Take-home points

- The hardest part of being an investor is learning to believe in our portfolios and being able to sleep comfortably at night.
- Owning a well-diversified portfolio is critical.
- Establishing the right balance between ownership (equities) and lending (bonds) is the most important decision that investors make.
- Knowledge about our emotional willingness to take risk, our capacity for losses, and our need to take risk to meet our goals forms the basis for a rational and informative discussion as to what the mix between equities and bonds should be.
- Understanding the downside, as well as the upside of our portfolios is the key to sleeping well.
- Key tips: believing, understanding, looking at your portfolio less often, viewing the big picture and tempering the seemingly bad news, will all contribute to a more restful night's sleep.

End notes

1 This simple analysis uses market indices for global equities (40%), emerging market equities (5%) from MSCI © All rights reserved; Global REITs i.e. commercial property (5%) – Standard & Poors © All rights reserved; Index-linked gilts (25%) – Barclays Capital © All rights reserved; 0-5 years UK gilts (25%) – FTSE © All rights reserved. No costs of any kind have been deducted. Past performance is no guarantee of future performance.

2 'Psychometrics is the field of study concerned with the theory and technique of psychological measurement, which includes the measurement of knowledge, abilities, attitudes, personality traits, and educational measurement. The field is primarily concerned with the construction and validation of measurement instruments such as questionnaires, tests, and personality assessments.' Source: Wikipedia.

3 This simple analysis uses market indices for global - MSCI © All rights reserved; Index-linked gilts - Barclays Capital © All rights reserved. No costs of any kind have been deducted. Past performance is no guarantee of future performance.

4 Nick Murray on 'Managing Investor Behaviour' at the IFP Annual Conference 2011 – this was a magnificent presentation that provides one of the clearest and simplest set of insights and rules to make sure that investors keep the faith with their investment programmes. His principles are closely aligned to our own.

Other notes and risk warnings

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