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Keys to successful investing

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Introduction

The last five years have been difficult for investors. The global financial crisis (GFC) and its aftermath of private sector deleveraging, public sector debt problems and household, business and investor caution have led to poor and volatile returns from shares. It seems we are constantly on edge with prognostications of doom getting constant replay with every twitch in markets. Just like The Rolling Stones single last year "all I hear is doom and gloom". Methods of investing that seemed to work well for years have seemingly broken down, or at least many have lost faith in them.

So what should investors do? The following is a list of things that are critical for investors to know and do. Obviously when it comes to investing, everything is debatable to some degree, but I hope you find this list to be of value. First, some investment market realities.

Investment market realities

There are four key things to bear in mind about investment markets.

1. **There is always a cycle.** The historical experience of investment markets - be it bonds, shares, property, infrastructure, etc - constantly reminds us they go through cyclical phases of good times and bad. Some are short 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. Ultimately there is no such thing as new eras, new paradigms and new normals. Such jingles - as wheeled out through the tech boom and more recently through the post-GFC gloom - make good marketing spin. But markets tell us there is nothing new under the sun. In fact, when someone tells you about a new 'whatever', it's probably already run its course.

2. **It's a mad, mad, mad world.** It's well known that investment markets are prone to bouts of irrationality which take them well away from levels that may be justified on a long-term basis. This is rooted in investor psychology, which is far from rational and flows from a range of behavioural biases investors suffer from. These include the tendency to overreact to the current state of the world, the tendency to look for evidence that confirms your views, overconfidence (particularly amongst males!), an erroneous feeling of safety in numbers and a lower tolerance for losses than gains. While shifts in fundamentals may be at the core of cyclical swings in markets, they are usually magnified by investor psychology if enough people suffer from the same irrational biases at the same time. This in turn creates opportunities for investors who can take a longer-term approach and look through extremes of market madness either on the upside or the downside.
3. **Starting point valuations matter, a lot.** It stands to reason that the cheaper you buy an asset, the higher its prospective return will be and vice versa. Good guides to this are price-to-earnings ratios (the lower the better) and yields, i.e. the ratio of dividends, rents or interest payments to the value of the asset (the higher the better). But while this seems obvious, the reality is that many find it easier to buy after shares have had a strong run because confidence is high, and sell when they have had a strong fall because confidence is low.
4. **The power of compound interest.** Although the average annual return on Australian shares (11.9% p.a.) is just double that on Australian bonds (6% p.a.) over the last 113 years, $1 invested in bonds in 1900 would today be worth $704 whereas $1 invested in shares would now be worth $350,356. Yes there were lots of rough periods along the way for shares just like the last few years (e.g. the 1930s, 1970s, 1987-96), but the impact of compounding at a higher long-term return is huge over long periods of time.

What should investors do?

So given these market realities what should investors do.

1. **Know yourself.** Now I know we all like to think that everyone is mad except you and me, but the reality is that we all suffer from the psychological weaknesses referred to earlier. But smart investors have an awareness of their weaknesses and seek to manage them. One way to do this is to take a long-term approach to investing. But this is also about knowing what you want to do. If you want to take a day-to-day role in managing your investments then regular trading and/or a self managed super fund (SMSF) may work, but you need to recognise that investing is not easy. If you are going to trade or run your own investments with, for example, an SMSF, then recognise that this requires a lot of effort to get right and will need a rigorous process. If you don't have the time and would rather do other things like sailing, working at your day job, or having fun with the kids then it may be best to use managed funds.
2. **Seek advice.** Flowing on from the last point, given the psychological traps we fall into as investors and the fact 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.
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 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 a focus on funds targeting a particular return outcome or level of cash lows when you are close to, or in, retirement.

4. **Diversify.** This is another no brainer. Don't put all your eggs in one basket as the old saying goes. But plenty do. It 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.
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. The past couple of decades have seen an explosion in the volume and ease of access to information 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 after another. Just think about this year: already we have seen a long list of worries starting with the US fiscal cliff, then worries the US Federal Reserve may exit monetary easing too early, then the Italian election, the US budget sequester, Cyprus, bird flu, North Korea, China, etc. In fact, the combination of too much information has turned investing into a daily soap opera - as we lurch from worrying about one thing after another. You'd be better off turning the financial soap opera off and watching The Days of Our Lives or Home and Away!
6. **Avoid short-termism.** Flowing from the last point, the ease with which information on returns can be accessed is likely reinforcing shorter and shorter investment horizons for investors. An end result of taking a shorter and shorter investment horizon is an ever higher allocation to perceived safe assets such as bonds and cash/term deposits. This may have been fine through the GFC and its aftermath, but will ultimately mean locking into ever lower returns given the low yields now prevailing for bonds and bank deposits. You might say, "at least I won't lose money on term deposits", but the point is that low yielding deposits will lock in low returns, making it hard to meet long-term financial goals.
7. **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 (e.g. 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. 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.
8. **Recognise there is no free lunch.** Related to the last point, if an investment looks too good to be true in terms of the return and/ or riskiness on offer, then it probably is.
9. **Buy low, sell high.** 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.

10. **Don't fret the small stuff.** It's easy to spend lots to time worrying about an individual share investment or whether to use this fund manager over that fund manager. But the reality is that the key driver of your return is the assets (shares, bonds, cash, property, infrastructure, listed/unlisted, onshore/offshore, hedged/unhedged) that you are exposed to. In other words, asset allocation is paramount and it's very hard to avoid this.
11. **Don't over rely on expert forecasts.** The well known economist J.K. Galbraith once observed that there are two types of economists: "those who don't know and those who know they don't know". While that may be a bit harsh - you might say I would say that, being an economist - the reality is that point forecasts as to where the share market will be at a particular time or as to its short-term return, have a dismal track record. Hence all the bad jokes about economists! Good experts will help illuminate and point you in the right direction, but this is what they should be used for.
12. **Recognise the aim is to make money, not to be right.** Many investors miss this. Lots of people have lost money doggedly following some assessment that they were sure would be right. But the key is to recognise that getting some view right is not what it's about. What it's about is making money. Don't get hung up on extreme views about where markets are going.
13. **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".
14. **Finally, if you have the right long-term strategy, never despair.** Things normally turn out ok eventually. Fortunes are invariably made out of tough times.

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