INVESTMENTS DECODED

Building your own investment plan

ABSTRACT

Investments seems difficult. However, the basics stay the same. Understand the basics and you will understand investments. It all starts with a clear understanding of risk and your own personal risk profile. Then you can have to know the principles of putting a winning portfolio together. This ebook will guide you to do that and help you to at least ask the right questions when it comes to investments.

Compiled by: Eben Smith

The topic of investments is an evasive topic for most. Firstly, because it seems so hard to win at the game of investing and secondly, because of the language which is used within the field of investing. If you don't win at something we tend to find the fault within ourselves believing that we are not good enough at something or too dumb to understand it. Within the financial industry some would want you to believe that you are not so smart when it comes to investing. Then the experts can come in and save the day – at a cost off course. I believe it is part of your responsibility to understand investments so that you at least can have an informative discussion on the topic with your financial advisor.

So how do we understand investments? Here we go….

1 Understanding Risk

Fund managers will often say: "We do not manage assets, we manage risk." If you understand risk you will not only understand investments, you will also have a clearer idea of your own investment strategy. Investment risk is defined as follows: **Investment risk** can be **defined** as the probability or likelihood of occurrence of losses relative to the expected return on any particular **investment**. Stating simply, it is a measure of the level of uncertainty of achieving the returns as per the expectations of the investor.

So, in the definition you have the words, "occurrence of losses" and "expected return". This means that the expected return must be in relation towards the amount of risk which you are prepared to take on. The amount of risk which you are prepared to take on can yet again be defined as 1. your own personal ***appetite*** for risk, and 2. your own personal ***capacity*** for risk.

1. Appetite for risk: When it comes to appetite for risk the big question is: "How much losses must you incur before you feel a substantial amount of pain?" Daniel Kahneman, who was awarded the Nobel prize in Economics in 2002, did groundbreaking work in the psychology of investing. He says that one of the major findings in his studies is that people are not so risk averse as they might think. As we say in the investment world, "Everybody is an investor, until they start to lose money." Kahneman says that people hate losing money more than rejoicing in gaining the same amount of money. We see this as well when people are very excited when they say that the

taxman gave them money back, even though this actually means that they paid too much in the first place. Some insurance companies use the same psychological strategy when they let clients pay a little higher on the premiums and then promise to give them a portion of their premiums back at a later stage. The important concept to grasp here is that you may not be so risk averse as you may think and that you should really try to pin point your own appetite for risk, as best you can.

Understanding your own appetite for risk also means that you are also aware of investment biases which you are inclined too. These include:

- The Gambler Fallacy: Human reasoning is that there should be a balance to everything. If the markets fell today, it must rise again tomorrow. If I lose now, the next effort must be a win. The idea that everything is going to work out fine is typically a gambler's fallacy. Who says it will not get worse from here? *The best approach here is: to take the situation as it comes and handling best you can.*

- The Review-mirror Fallacy: This fallacy is nearly opposite as the gambler's fallacy. Here the individual argues that ABC worked for me in the past/ or did not work for me. Therefore, the same should apply under similar circumstances. This approach looks for similar patterns, and try to apply the same pattern to a new situation. The problem with the review-mirror approach is 1. the situation is never exactly the same, and 2. it is a human tendency to choose selectively from the past. Think about a holiday: usually people will tell how wonderful it was, selective forgetting the bad memories such as the suitcase that got lost, etc. *The best approach here is: to take a step back. Write down the detail of the past situation and not only the good times. Now look at the present with the "whole past" in mind. Where was it different? Where should you find new solutions and not only recycle old ideas for present use?*

The most famous example of the gambler's fallacy occurred in a game of roulette at the Monte Carlo Casino on August 18, 1913, when the ball fell in black 26 times in a row. This was an extremely uncommon occurrence, although no more or less common than any of the other 67,108,863 sequences of 26 red or black. Gamblers lost millions of francs betting *against* black, reasoning incorrectly that the streak was causing an "imbalance" in the randomness of the wheel, and that it had to be followed by a long streak of red.

- The Sunk-cost Fallacy: This fallacy works with the reasoning that further investment is warranted on the fact that the resources already invested will be lost otherwise, not taking into consideration the overall losses involved in the further investment. “I have already invested so much, I will lose if I change now.” Good example are people not wanting to get rid of a suit or dress in the closet which haven't been worn for years. They say, “I can’t throw that away because I paid good money for it?” Other examples are, the magazines and books piling up or the dead-end relationship which just cannot be ended. “I can’t give it up because I have already put in many years and I have to make it work out”? We fear regret so we ride a loser and hope that things will improve. *The best approach here is to be decisive. Decide beforehand how much you are prepared to lose. In other wise decide on a stop-loss. If your stop-loss is triggered – be decisive. Listen to your rules or your stop-loss, not to your inner temptation to stay in a bad deal.*

- The Self-control Fallacy: This fallacy works with the notion that enough knowledge and skill is obtained to be successful, not recognizing that even the most competent investor gets it wrong at times. In other words, self-control is not always present and all people are inclined to follow the voice of the masses. The Ash experiment shows how an individual, planted as the test subject between a group of actors, eventually gives in to peer pressure and choose the same “wrong” answer as the rest. In the end, the investor thinks he/she is in control, only ending up following the crowd. Look at the graph below; this is typically what happens to investors. *The best approach here is not to follow the voice (or noise, depending on how you look at it) of the crowd. Look for a mentor which you can bounce ideas from and devise a strategy which takes worst case scenarios into consideration. Then, stick to your plan no matter if the crowd tries to convince you otherwise.*

Exercise: Find your investment tolerance

Indicate the type of growth you will be happy with in …

Weak Market Conditions:	Excellent Market Conditions:
5%	10%
0%	12%
-5%	15%
-10%	18%
Less than -10%	More than -18%

> **Actively and Passively Managed Funds**
> There is plenty of debate around actively and passively managed funds. Passively managed funds track the markets while active fund managers try to choose individual stocks which beats the market. The main argument for passively managed funds is that they keep the investment cost low. Whereas the active fund managers argue that beating the market justifies the cost.

Look at your answers; what do you think most other people would choose? The same as you, or will they choose a different number? In my experience, most people want at least double digits, no matter what the market conditions are. The above exercise is useful to understand that markets does not always run up but goes have corrections and goes down as well. In other words, the important thing to take in mind is that it is not so much the fund managers which does well in good time who are the better managers. The fund managers' true skills are really tested when markets are down. Therefore, the best way to measure an investment portfolio is to look at its **drawdown** back in history. The drawdown measure the depth with which an investment has fallen into the negative, and how long it took to recover. A fund manager worth his salt will at least beat the overall markets on a down turn.

Exercise 2: Dealing with investment biases

The best way to beat biases collectively is to follow the path of what is said under the Self-control Fallacy. We said, the best approach here is not to follow the voice of the crowd. Look for a mentor which you can bounce ideas from and devise a strategy which takes worst case scenarios into consideration. Then, stick to your plan, no matter if the crowd wants to convince you otherwise. This is what you are going to do in the next section.

2. Capacity for Risk: Now that you have some sort of indication of your risk appetite you need to understand your capacity for risk as well. This is fundamental in building your own investment strategy. Capacity for risk will include:

- How much time do you have to invest?
- How much capital do you have to invest?
- And if you are already retired; what is the least possible amount you can withdraw from your investment to live from.

In the business-building section I argued for the fact that having plenty of funding is not always a good thing because it leads to unnecessary expenditure. In this section, it is better to have more capital than less. The difference is, when you build a business you need money to do something with. On the other hand, when you invest, you need money to do something for you. The reason why a lot of people stay poor is because they over estimate their own abilities and under estimate wat money working for them can do.

CASE STUDY:

I had a young couple who receive a large sum of money with the sale of their business. They had no plans to continue in the same industry and was unsure what to do. They asked me for advice.

After I calculated their retirement needs, this was my reply:

Because of the fact that you are unsure of what business you want to go into next, do the following:

1. Invest the proceeds you received from the sale of the business.
2. Decide on a modest lifestyle – where enjoying the small things in life are more important for you than buying expensive toys.
3. Find a job in the direction of where you as a person want to grow into. In other words, a job where you can learn from, so that you can do your own thing later on when the experience is plentiful.
4. Live from your salary and not from your investment – allow your money to work for you. My calculations showed that the investment at the age of 65 would be enough to take care of them for life. But, and this is an important BUT, then they must not use anything from their investment until retirement age.
5. If you want to become super rich become an expert in this new job which you are contemplating in doing. DO NOT USE THE INVESTMENT TO DO THIS.

Instead, each of them bought a new car. They then started business ventures of which they know nothing about and in the process used up all their investment. Their businesses when bust and they are dead broke, without fancy cars. The bottom line is this: do the calculations, understand the risks and then devise a well thought out plan. The calculation for this couple showed that they had enough for retirement for life. Logic showed that they were at a point of risk, with no work and strong ideas of starting unknown business ventures. They also clearly over estimated their own abilities and wanted a high-end life style. This created a perfect storm and they lost everything.

2 The Investment Plan

Investments are not complicated if you understand why you want to invest (investment goal) and what your risk profile is. These two are also interlinked with one another. Your investment goal will also determine in some part the risk you need to take. I say, in part, because your risk profile is also determined by personality and preferences, as shown in the previous section. Your investment plan should include the following:

1. Understand where I am (how much do I have and how much can I afford to put away)

2. Understand where I am going (what is the number which I am aiming at)

3. Understand in witch life cycle you are at. I identify normally two: before retirement and after retirement.

To achieve the above your plan should at all cost be aimed at: 1. Capital Preservation and then 2. Beating Inflation then 3. Investing for growth (choosing the right funds at low costs) and finally 4. Investing tax wise.

When it comes to fund choices the selection should allow for capital preservation on the one hand and capital growth on the other hand. Certain portfolios are known for being winners in bad times and others are known to be better in good times. A well devised portfolio should therefore:

- have both capital preservation investments and capital growth investments. In the end, you will end up with a portfolio which is not correlated. This means that they move in opposite directions. If the markets fall some fall with the market and others go up against the market. This will give you the best opportunity to beat the market.
- have a mixture of conservative, moderate and aggressive funds. The bulk should be moderate with a small portion exposed to aggressive funds. If you are a retiree who needs to live from your investment, you should have a portion in conservative portfolios where you do your withdrawals from.
- have low investment costs. This must be negotiated with your advisor and make sure he/she will be able to explain to you their value-add.
- keep tax efficiency in mind. Switching between portfolio's will trigger CGT and therefore your fund selection should be done right from the beginning to avoid frequent switching.
- allow for liquidity needs. Certain investment vehicles such Retirement Annuities are efficient when it comes to annual income tax but you cannot withdrawal from them. A Unit Trust on the other hand can be used as a bank, putting money in as much as you like and withdrawing as often as you like, but is not very tax efficient.

Finally, in the beginning I said that investing is not complicated, however I could argue that it is confusing. What makes it confusing are the many conflicting messages and the multiple options you have in the market. Therefore, talk to someone you can trust. Not the family friend but someone you know has a lot of experience. Also find someone who can truly give you independent advice. Be careful if the person is linked to one insurance company or to a bank. It is best to make sure where the person is contracted before you deal with him/her.

3 More investment tips

- Make use of rand-cost-averaging. We tend to put money in our investment at the wrong time and we also take money out of the market at the wrong time. The aim is to put money in when markets are low and take it out when markets are high. Rand-cost-averaging when investing is when you park your money in something like a money-market and then you phase it in over time. When you disinvest (take money out) you should do the same. If you know that you are going to withdrawal on a regular basis it is advisable to put the portion which you are going to withdrawal in a stable or money market fund where the fluctuations of the markets are not that high.
- Planning for the worst: I have already mentioned that you have to plan for the worst-case scenario. This fact cannot be emphasized enough. When you talk to investors the big question is always. How much growth can I get? The loss factor is almost a bigger question because it is usually the high growers that falls the hardest in bad times. Plan in other words for a market crash, and the easiest way to do this is to have the bulk of your investments in proven moderate portfolio's.

- When you retire keep your investment as big as possible. In other words, early in your retirement withdrawal less and increase it later. I call it, to stagger your retirement. This will ensure that your investment pool where the growth should happen are as big as possible. If you withdrawal too much, too little capital will remain; resulting in less growth.

MARKOWITZ: Harry Markowitz is known as the father of modern portfolio theory. He explains the fundamental concept behind the work that won him the Nobel Prize. In short, investments in a portfolio should not just be looked at individually, but rather as a group. There is a trade-off for risk and return, so don't just listen to one instrument, listen to the entire orchestra.

Exercise: Building your investment strategy

Investment Goals: What do you want to invest for? 1. ______________________________

2. ______________________________

3. ______________________________

How much do you need and the time you have left? 1. ______________________________

2. ______________________________

3. ______________________________

How must/ can you afford to put away on a regular basis to achieve your goals? If it is too much to afford you should rethink your investment goals or think of alternative ways to produce an income.

1. ______________________________

2. ______________________________

3. ______________________________

NOW WITH THE HELP OF AN ADVISOR DECIDE IN WHAT PORTFOLIOS TO INVEST: Considering,

1. portfolio mix of conservative, moderate and aggressive portfolio's, which are not correlating

2. the track record of the fund manager (use drawdown as a basis of comparing),

3. platform costs (rather use LISP platforms).

You are now set. Do not forget to negotiate advice cost and how regular you can expect feedback on your investment. How will your portfolio be rebalanced and what will the level of your relationship with your advisor be? Make sure that you receive your advisor’s investment policy statement.