

Stabilise your shares – and mind

Investing “properly” is often easier said than done but these strategies may help

With the world's sharemarkets plunging, residential property looking expensive and the future of local finance companies uncertain to say the least, maybe Sir Robert Muldoon was right with those TV advertisements telling us that leaving the money in the bank was the way to go.

In fact, with dividend yields for many stocks at record levels, sharemarket investment - on that basis anyway - looks more attractive than it has in a long time ... providing it is done properly.

However, “properly” is often easier said than done. Frequently, the combined effects of fees, commission and investment banking biases - not to mention greed and fear - make “doing the right thing” elusive.

The following are five simple strategies to help mum and dad investing for their retirement to stay safe in the sharemarket.

DIVERSIFICATION

This is the very simple strategy of not having all your eggs in one basket, which everyone knows but nonetheless many ignore. It also relates to the slightly more complicated “efficient market” hypothesis that the entire “sharemarket portfolio” is the least risky portfolio.

An extreme example of this latter proposition is that owning one company is more risky because it could go bust, but owning every stock in the market means that even if a depression occurs some companies will survive.

What often happens in a downturn is that the investor with a big position in a single stock gets such a fright when its share price falls significantly below his cost price that he suddenly loses confidence in the stock and feels compelled to sell before it goes bust.

With a diverse portfolio of 100 stocks, such a doomsday scenario is improbable.

The basic asset classes are bonds, property and shares. Diversification is the simplest, most fundamental rule and it applies equally to people who know that they don't know what they are doing and to people who don't know that they don't know what they are doing.

For the latter group in particular, diversification protects against the possibility that whatever investment sector or product you



BRENT SHEATHER

“Only experienced traders should use geared instruments like options warrants and margin trading”

are most enthusiastic about is popular with everyone else as well, and consequently is chronically overpriced.

Unfortunately, while there are now hundreds of good, low-cost products available which offer small investors a diversified portfolio of equities, bonds and properties, commission and fees are often higher for the more esoteric and riskier instruments - the ones most likely to be on an adviser's radar screen.

When looking at products, it is often helpful to ask yourself: “Will investing in this instrument make my portfolio look more or less



CAUTION: Everyone knows not to put all your eggs in one basket but many, nonetheless, ignore it.
PICTURE/TRACEY GRANT

like the market portfolio?” Seen in this light, buying that emerging market biotech IPO might not look so sensible.

RISK TOLERANCE

Investors frequently overestimate their tolerance for risk, with the result that far too many people panic and sell out at the bottom. Anecdotal evidence suggests that right now many people are reflecting on January's substantial downward movement in the value of their investment portfolio and wondering whether to stick to the plan or abandon ship.

Human nature is such that often people get the urge to invest when markets have shown a good historic performance; that is, after share prices have risen. By starting off with a conservative asset allocation profile, you are less likely to panic when/if markets fall and are more likely to have the intestinal fortitude to “stay the course”.

For this reason, only experienced traders should use geared instruments like options, warrants and margin trading. The markets are

risky enough without leveraging your position and geared products are frequently engineered to lock in good profits for the originator of the product rather than the end consumer.

FEES MATTER

So many aspects of the investment world are uncertain that it is helpful to focus on what facts are at hand. Foremost among these is the fees that you will be paying your fund manager. Research shows that high fees mean low returns. But to put fees in a proper perspective, we need to know what sort of return we can expect from a diversified portfolio.

With bonds yielding 8 per cent and shares maybe 3-5 per cent, total prospective returns are around 9 to 10 per cent a year. The average management expense ratio for a managed fund is 1.5-2 per cent a year, and financial advisers usually charge another 0.5-1 per cent to manage your portfolio.

All up, annual fees can total 3 per cent, which effectively means you are taking on the risk of shares but earning, after fees, the return

of bonds. Total annual fees therefore should be as low as possible - a maximum of say 0.6 per cent a year.

The differences between bonds, property and shares are becoming blurred so it can be difficult to tell high-risk products from low-risk ones. Fees can often give you a clue - high fees frequently occur with high-risk, specialist products and vice versa. Government stock attracts lower rates of commission than finance company debentures, and index funds don't pay trailing fees.

DON'T UNDERSTAND IT? DON'T BUY

Financial services products are becoming increasingly complex. But complexity doesn't necessarily make a product attractive. If you don't understand how a product works, you may not be alone.

It could be that the only one who truly knows how that capital guaranteed, collateralised debt obligation works in terms of benefits and costs is the financial institution that

originated it, which could well mean that its interests are being looked after more than yours.

Structured instruments, guaranteed investments, CDOs and the like are extremely complicated and their salesmen frequently make extraordinary claims as to their future performance.

CDO salesmen used to boast they could turn non-investment-grade debt into AAA-rated products. This turned out to be wrong. Locally, one product claims to be able to generate a 10 per cent dividend from a portfolio of international shares yielding around 3 per cent. That may indeed be so, but there are likely to be substantial costs associated with the strategy. If it sounds too good to be true, it probably isn't.

RISK AND RETURN

Another old favourite but, as with the diversification rule, one that is frequently forgotten. As a general principle, risk increases with returns. Bonds are less risky than property, which in turn is less risky than shares. But it isn't always so - one finance company debenture, while technically a fixed-interest investment, almost certainly has a higher chance of default than a widely diversified, managed share fund.

Many people base their investment decisions on historic performance. However, we should take performance data with a large grain of salt - high historic returns from shares may mean low dividends, which implies lower returns going forward.

Is that top-quartile, small-company manager skilful or lucky - or is this just one of those periods when small stocks outperform?

A fund or company with lots of debt will look like a winner when markets are rising but may not survive a more austere environment.

Make sure you have some genuinely low-risk instruments in your portfolio which can be relied on to increase in value when the sharemarket falls. These will stabilise your portfolio - and your mind.

Copyright B Sheather 2008