The 5 minute money guide to:

Investing

What is 'investing'?

It may seem odd but one of the most important things to start with is to clarify what investing actually means: many people use the word investing when they mean saving but the two things are very different. Investing is essentially about placing money into a **portfolio of assets** with the intention of creating **long term gains** and/or **generating an income**.

Investing will naturally therefore include **risk**.

Saving is more about salting money away or accumulating money for a later date.

The most important factors?

It is clear that there is no “one right way” to invest, many different methods can be employed. However there are some constants that all investors must look out for:

1. Investing will always include an element of risk and just about every successful investor will be an expert in managing their risk. Successful investing it seems is largely about successful risk management.
2. Risk is often misunderstood, for most investors the definition of risk is simple: the likelihood and propensity to lose money. Investors should therefore investigate whether they have a clear picture of how much their investments could lose. Likewise investors should have a clear and detailed idea of how the risk on their invested money is being managed.
3. Long term it is proven that most funds and most fund managers do not produce a return for their investors which ‘beat the market’. Investors can worry about this, try and navigate around this or simply accept this. By accepting this, investors can therefore focus on trying to create returns by following the markets and can adopt a strategy around ‘beta’. This probably means pursuing an ‘asset allocation’ strategy. A strategy whereby the focus is on finding the asset classes and geographical areas which are likely to produce the best longer term returns.
4. Investors often pursue a narrow range for reasons which are not always clear. Historically in the UK investors have tended to be overweight in UK Equities and UK Gilts, simply because they are close-to-home assets, not because they have been identified as the best asset areas.
5. Surveys conducted over long periods show that real assets will ultimately produce higher returns. Real assets include equities, government bonds, company (corporate) bonds, property and commodities.
6. By diversifying between these real asset areas investors can produce a portfolio which matches their risk position (a mix between their attitude to risk and their risk tolerance) and has the prospect of producing above cash returns.
7. Investors must always remember that their desired investment return (after charges) must be significantly higher than the cash return that they could get if they did not invest; otherwise why take the risk of losses?

A simple strategy

If readers take on board these various points above it is possible to see how they can all be catered for by following a simple strategy as follows:

Any investment approach and therefore the portfolio that is constructed to follow this approach should start with a dedicated statement of intent. This can appear in many forms, possibly as a report which states what the investments used will be, why they are being used, how they work together, what the risk level is, what the income prospect is, how they will be reviewed in the future and what the benchmarks will be for whether they are working or not.

Putting the investment approach and strategy into a written form of this type should be pre-requisite of any successful action plan.

The ideal and simplest strategy that will work for most investors is to design the investment portfolio around an asset allocation structure, which has a high regard for well-balanced diversification and risk management.

Underpinning this top level approach should be a focus on a number of other factors:

Charges

The level of charges imposed is very important. The historic ambivalence that many investors have had towards how much their investing is costing them, has proved very beneficial for the Investment Industry and very costly for the investor!

This may be because charges have not always been clear to see and also because small numbers, often quoted as percentages, seem relatively innocuous.

For example, it appears that investors generally do not perceive an annual charge across their investments of, say, 1.8% as being any more significant than an annual charge of 1.2%, say, even though the former is 50% higher than the latter!

In a world of expected returns of 6-7% per year gross (i.e. before charges are applied) from Equities, of 3-5% per year from Gilts/Bonds, then charges are very pertinent. For example a charge of 2% per year could conceivably drag investment returns down by one third from their gross level. Whereas a 1% charge might only drag the return by one sixth.

Investors should strive to find ways of pursuing their strategies from the lowest possible cost base.

Reviews

Any strategy of whatever form, should have a defined review process built in. The purpose of the review is to monitor the performance of the portfolio against the benchmarks, expectations and targets laid out by the original plan. It is also appropriate to use the review to consider the changing nature of the economic and financial environment and to see if this impacts the strategy.

Rebalancing

The review process should also encompass some form of regular 'rebalancing'; this is a systematic approach to keeping the diversification of the assets in line with each other and ensuring that the asset allocation split remains in a consistent form with the stated and original strategy.

For example if the asset allocation as decided within the original strategy is deemed to be appropriate for an investor, as follows: 30% UK Equities, 30% Overseas Equities, 20% UK Bonds, 10% Overseas Bonds and 10% Property then - all other things being equal – this should remain the split for the duration of the investment period. However, over time, say three years, the asset classes may have performed very differently – by default throwing the asset mix off course.

If, after the three years in the example, UK and Overseas Equities had fallen by a third, but the UK and Overseas Bonds and Property risen by a third (all because of performance) then by default the asset allocation would have shifted to: 22% UK Equities, 22% Overseas Equities, 28% UK Bonds, 14% Overseas Bonds, 14% Property.

Rebalancing is a movement in these assets split back to the original split as deemed by the investment strategy. The investor would therefore move monies out of UK Bonds, Overseas Bonds and Property in proportion and back into UK Equities and Overseas Equities to get the percentages back to where they started.

Rebalancing is an established practice in this regard and it has the effect of keeping the portfolio aligned with the strategy.

How often rebalancing takes place, or should take place, is open to some debate but most commentators agree it should be at least once every three years and possibly more often.

Taking Losses

One vital part of any strategy and any review process within the strategy is to have a clear position on making changes: when and how changes should be made and this includes a policy towards taking losses.

Investors often seem to hold on to dud investments and appear to have psychological difficulties in taking losses.

The loss on an investment is always real: the only question at any given point in time is whether the investment should be allowed to work forward and the loss incurred tolerated (after all within any true investment portfolio not everything will go up all of the time) or whether the loss is because the investment is not working. This may be a difficult position to analyse or 'call' however investors have to view any current value as a matter-of-fact position whether there is a loss or a profit.

Losses are a part of any investor's expected outcomes from time to time and there is no reason why taking a loss should be seen as a negative factor. Professional investors are especially good at accepting and taking losses as matter of course.

Getting advice and help

The strategy that investors pursue should involve paying high regard for getting the best and most appropriate advice. Investing is a mixed bag of requirements, involving assessments of risk, appropriate holdings, getting the asset allocation mix just right, having regard for tax and income amongst many other factors.

There are two reasons why seeking out advice generally works:

1. The best advisers are full time professionals, trained in these areas, they will have access to software and research and will be experienced in investing and all that goes with it. They should be able to add considerable value as a consequence.
2. As with anything of this type, getting an outside view and one that is reflective is almost always beneficial. Somebody else, particularly a professional, is likely to offer a good perspective of the investor's position and requirement.

In many respects it may be that the **single, most important, job** any investor has is to pick the right and the best adviser. This selection and decision may well be the one thing above all others that decides the long term results attained by the investor from their portfolio.

There is considerable evidence to show that investors who have made expensive mistakes in their investing have often done so at the hands of poor advisers. The opposite is also true. Pick and use good advisers and the best help.

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