

A Better Way to Invest

Eight points for all of us to remember during scary times.

There are comments frequently overheard these days on the bus, at the gym, supermarket and at Saturday sporting events: “The markets are in such a state. I’m worried about my retirement. There has to be a better way to invest.”

There’s no doubt about it. At times like these, when markets are hugely volatile and unpredictable, the patience of even the most disciplined investor can be tested. The good news is that there is a better way:

First, there is nothing to be gained from trying to second guess the market. The fact is most people go wrong taking stock-specific bets or seeking to time their entry and exit points. Ultimately, they just end up buying high and selling low. This is never a recipe for success.

Second, it’s worth remembering that risk and return are related. This means the best approach is to structure a portfolio around the risks that research shows carry a reliable long-term reward. In tough economic times like we are currently going through, uncertainty increases and people gravitate toward safe assets. To attract investors back to risky assets and prices adjust lower. What’s often overlooked is that a lower price equates to a higher expected long term return.

Third, the best protection against volatility is diversification. It should be evident by now that even “gurus” have no idea which asset class will be the next top performer and which will lag (See the Fearless Forecast piece on our website www.frankdanielson.ca). But if you remain broadly diversified, you don’t have to take those sorts of bets.

Fourth, the biggest determinant of portfolio performance is in how capital is allocated among selected asset classes: Cash, fixed income, domestic and global equities, real estate and emerging markets—and within equities, large, value and small stocks.

Fifth, while markets are inherently unpredictable, there are several things investors can do to lessen the pain.

Among one of the more important ones is paying heed to investment costs. Paying big fees to fund managers

to invest money is not recommended. Neither are high turnover strategies that leave investors with a big tax bill and higher than necessary commissions.

Sixth, indexing is not the only alternative to stock picking and market timing. Why pay managers to outsource decisions to an index provider? There are unnecessary costs involved, such as when stocks enter and leave the index. A better way is to structure highly diversified portfolios around the specific dimensions of risk.

Seventh, in choosing a professional to invest your money, ensure that they follow the above advice. They should minimize transaction costs, be mindful of the tax effects of trading, and remain patient, disciplined and focused on long-term returns. The emphasis should be on implementing those strategies as efficiently as possible, not chasing last year’s best performers or trying to time the market.

Eighth, keep it simple. Much of the financial services industry has a vested interest in making investing sound complicated. That, after all, is how this global crisis started. People got complacent and started taking highly leveraged bets on complex securities that few understood. You need to be absolutely clear what risks you are taking on.

As investors we also need to remind ourselves that capital markets are unpredictable and random over the short term. And while no one can know exactly what happens next, the good news is you don’t need to know to have a successful long term investment experience.

You also don’t need to pick the next “top performing” investment or try to time the market. That’s speculation, not a long term investment strategy.

Instead, all investors need to do is put together a highly diversified, low-cost investment portfolio built around the known sources of risk and return.

A Better Way, continued

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