EXTRACT 5

Investing basics

Extracted from ***Brilliant Investing***

Before you become a brilliant investor, you need to understand the basics. These are the fundamental building blocks for investment that will ensure your portfolio has a solid foundation. Get these basics wrong and every investment decision you make will be doomed to failure. I don't mean to sound melodramatic, but that's the size of the matter!

brilliant tip

Learning the investing basics will enable you to make better decisions, avoid bad investment choices and invest your hard-earned cash with confidence.

The building blocks for a brilliant investor

There are three important investment concepts you need to understand. The first – compounding – was considered by Albert Einstein to be the 'eighth wonder of the world'. That's arguable, but it is certainly a very important investment concept. The other two concepts are equally important if you are to understand the way your investments are likely to behave.

Compounding

Einstein got so excited about this investment concept because it shows how investments can grow at a much faster rate. Compounding describes the way that investment growth is added to investments and then new returns are based on the original investment and the growth. As time goes by and more growth is added, the investment gets larger at a much faster rate.

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Imagine that you have £1,000 to invest and you get an investment return of 5% each year. If you took this growth out of the investment each year the total value of the investment (and the growth you had taken out) would be £1,500 after ten years. Not a bad return over ten years, but now look what happens if you leave the growth invested and allow it to 'compound'. After ten years the compounded return would be £1,628 – a whopping £128 more just because you left the growth invested.

Pound cost averaging

If you have money to invest it could make sense to invest it gradually – say monthly – rather than in a lump sum. This is because some months you will be buying the investment when it is expensive and other months you will be buying when it is cheap. Over time you will be investing at the average price of the investment. This is known as pound cost averaging. Pound cost averaging is a way of avoiding the risk that you are investing when the markets are too high. It is also a way of making sure you get to buy a larger quantity of a specific investment when the markets are cheap. Because it is difficult to judge when a market is high or low, this is a very simple way of making sure you get best value.

Not everyone agrees that pound cost averaging is a good thing. Some argue that if you have cash to invest today it is better invested for a longer term than gradually drip-fed into investments over time. This is because you might miss out on a rising investment if you take your time over investing.

The time value of money (impact of price inflation)

This is an investment concept that suggests it is better to have a sum of money in your hands today than the same amount at some point in the future. Because things get more expensive to buy over time, as a result of inflation, it is better to have £100 today than £100 tomorrow.

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You also miss out on the opportunity to invest the money if you wait to receive it in the future. Even if you just put the money in a savings account you could make it grow and end up with more than if you received the same amount in the future. This is a double-whammy because as well as inflation reducing the value of the money in the future you miss out on the potential for some investment growth.

Avoid the basic investment mistakes

If you know what the basic investment mistakes look like you are far less likely to make them yourself.
Here are five classic investment mistakes I see being made on a frequent basis.

1. **Following past winners and expecting the same results**
   You will already be familiar with the classic investment risk warning 'past performance is no guarantee of future performance'. The next time you see that risk warning, take the advice! Just because an investment has returned 20% over the past 12 months is no guarantee it will do the same again this year. Infact returns from individual investment funds are rarely repeated in any consistent manner. Too many investors ignore this when making investment decisions.

2. **Investing for the short term**
   However tempting the short-term returns from an investment might look, you must always consider the length of time you have left until you need to get your hands on the cash - is it enough time for your portfolio to recover if and when things go wrong? Only if you can afford to wait three years or longer, should you consider an investment. Any less than this and you should stick with cash. This is a golden rule and one you should never forget.

3. **Putting all of your investment eggs in a single basket**
   Failing to spread risk, or diversify, is a classic basic investment mistake. When all of your money is exposed to a single investment you will lose a lot of money if things go wrong. By spreading your money around you stand a much better chance that some of your investments will perform well if others are performing badly. This makes the overall investment returns much more acceptable, whilst one set of returns in isolation is more likely to be disappointing.

4. **Not taking enough risk**
   Not taking enough risk is another basic investment mistake. Whilst it is important to invest in line with your comfort levels, it is also important to give your money the chance to grow. If you are investing for the very long term (for example, when investing within a pension fund for retirement) you can afford to take more risk than you can with shorter-term investments. Taking more risk and things going wrong is less of a problem if your investments have plenty of time to recover. This is why risk should be linked to the term of your investments.

5. **Relying on your own home as an investment**
   Experts have different views about the role of the main residence in an investment portfolio. Many would argue that, as you cannot easily get your hands on cash unless you sell your house, it should be excluded from your financial objectives when it comes to investment. Your home is not usually an investment. It is a place to live. When your house goes up in value, so do other houses. Most people cannot simply sell up and take the cash from the value of their house because they need a roof over their heads.

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Three things to always consider

There are three things you need to do every time you make an investment. Do these three things every time and you will be well on your way to becoming a brilliant investor. The three crucial brilliant investment actions are – research, plan and review.

Research

Knowledge really is power when it comes to investing. You should ensure you conduct plenty of specific research about the investments you have chosen. Research can come in many forms and might involve reading the personal finance pages of the weekend press, listening to investment experts or meeting with your investment adviser. The golden rule here is only to make an investment you understand. Too many investments end in disappointment because not enough time was taken, before the investment was made, to truly understand what was involved.

Plan

Planning your investments means linking your objectives very closely to your investment choices. You need to have a very clear reason for investing money. This might be as simple as getting a better return than cash but could be connected with life goals, such as becoming debt free or sending your children to a private school. Brilliant investment plans should always have a SMART measurement. This means they should be:

Specific,

Measurable,

Achievable,

Realistic and

Time sensitive.

An investment plan that fails to meet these criteria is likely to lead to mediocre returns or unexpected losses.

Review

Making an investment and leaving it alone for ten years is rarely a good idea. A brilliant investment plan is reviewed on at least an annual basis and sometimes more frequently. This review should involve more research, to ensure that the facts about the investment remain the same, along with revisions to your investment plan, if required. Circumstances and objectives change. It is wrong to assume that your objectives today will continue to be the same in several years' time. When I speak to disappointed investors they have often failed to meet their goals simply because the goal posts have moved. A little action when it is early enough to make a difference can make all the difference between a poor and a brilliant investment.

When things go (badly) wrong

History gives us some fantastic (but quite scary) examples of investments going badly wrong. Here are two cautionary tales from history which should help you to spot the signs of a poor investment opportunity or an overheated investment market.

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The Wall Street Crash
Back in 1929 the USA experienced one of the worst stock market crashes in recorded history. There was a five-year long 'bull market', when prices increased by a multiple of five, which finished on 24 October 1929.

The bull market came to an end on a day known in history as 'Black Thursday'. Share prices continued to fall for a month after this initial crash. It took until the mid-1950s before stock prices on Wall Street returned to their pre-1929 level.

brilliant definition

A 'bull market' is a period of increasing investment returns, usually fuelled by greater confidence from investors who believe that investments will keep going up and up.

To put this in perspective, investors who had invested just before the Wall Street Crash would have needed to wait over 20 years before they got their money back. This assumes that they did not just panic and sell their investments when the crash started.

Most investors did and lost everything. In the run up to the Wall Street Crash a large number of people had been paying over the odds for investments. In some cases they had even been borrowing money to buy shares – a very high-risk strategy. The crash was made worse by panic selling and other stock markets introduced systems to prevent this sort of panic selling occurring in the future.

brilliant example

The Dot Com Bubble
This took place between 1995 and 2001 when stock markets witnessed massive growth as a result of investment in internet sector companies. These companies are often called 'dot coms'. The concept of an internet business was relatively new at the time and investors were piling money into previously untested business models.

brilliant definition

An 'investment bubble' occurs when investors buy investments based on past performance and the general expectation that they will continue to do well. This means that the company investors are investing in is not necessarily worth the money they are paying for it. The bubble builds and often 'bursts' when the real value of the investment is recognised.

Something else to consider before you invest

Investing money successfully is more about being in the right type of investment at the right time. Choosing the best company shares or investment funds can add some value, but it is your exposure to the broad investment type that makes most of the difference between success and failure. Within my own firm of investment advisers we put a lot of emphasis on 'asset allocation'. The selection of individual shares or funds is still important, but once you see how a monkey can do this as well as an investment expert, you will also put a lot of emphasis on asset allocation.

brilliant definition

Asset allocation describes how much of your investments are invested in each of the main investment types, also known as asset classes, which are cash, fixed interest securities, company shares and property.

To prove that stock picking does not necessarily add value, we need only look to America where a website charts the progress of a monkey, called Leonard, against a television investment pundit. Leonard is just an average monkey but has the nickname 'Leonard the wonder monkey' because of his aptitude for selecting investments. Every time the investment expert makes his investment recommendations the monkey gets to choose stocks, at random, from the same selection. After 30 days they see who picked the best stocks. As things stand when I write this, the TV expert picked winning stocks 49.33% of the time. The monkey managed to pick winning stocks 50.01% of the time! The average return on investment – calculated by dividing the returns for each selection by the number of selections – was 0.24% for the expert and 0.43% for the monkey.

Leonard is often the winner in this little investment competition between man and monkey. This just goes to show you that picking stocks at random can be just as

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effective as taking professional advice from an investment expert. Either that or the people behind this particular website have managed to find themselves a very talented monkey. I doubt the latter reason.