TOWN CLOSE
Financial Planning

# The 4 main aspects of investing

*future proofing your finances*

# INVESTMENT STRATEGY

**This document covers the four main aspects of investing:
Strategy, Expectations, Risk and Diversification.**

Your investment strategy is a key part of your financial plan but it's the servant, not the master, of that plan.

To focus only on investment returns means ignoring about 90% of the value and purpose of a financial plan, namely:

1. To have something to stick to;
2. To know you're ultimately safe;
3. To stop you doing anything daft.

## Short term vs. long term

The starting point is to think in terms of the short term (0-3 years) and the long term (3+ years).

Your short term needs to be nailed down, absolutely as secure as can be. That means working out how much money you need to do everything you want in the next three years. That will then be covered by a combination (as appropriate to your circumstances) of earnings, pensions, rent and cash.

The cash is the last bit to make sure you have enough and a bit extra as an emergency fund. This cash might be held in the bank, with National Savings, in your ISAs, your pension pots, other investment plans or in the form of a known inheritance. The key is that it's identifiable, easily-accessed and secure.

Everything else will be invested via your ISAs, pension pots and investment accounts. This is money we do not think you will need for at least three years. It must therefore be put to work.

Put to work means be given every opportunity to grow by more than inflation. If that's achieved, you'll be able to buy more tomorrow than you can today. That, in turn, means your future lifestyle and income should be as protected as it can be. Being poorer tomorrow than you are today is a terrible result.

This three-year cash buffer will allow the invested side of your strategy to weather the inevitable trials and tribulations, helping us avoid panic selling and keeping your plan on track.

Our investment philosophy is that simple.

## Portfolio make up — the long-term invested, non-cash bit

The long term part of your investment strategy requires a long-term investment perspective and strategy. That means investing in a mix of investments that have, historically, produced the sort of returns you need for your plan to work.

With those thoughts in mind, we arrive at a mix of bonds and shares, typically 20% bonds and 80% shares. All of them regulated, liquid and safe funds.

There's nothing esoteric, illiquid, unregulated or "alternative" in our portfolio.

This might not be the best investment strategy ever devised, but the number of worse strategies is infinite.

In total, you can expect to be invested in about 8,000 companies around the world and about 750 bonds. That's a good level of diversification. The alternative is to look for the needle in the haystack; the amazing investment or manager that turns out to be a superstar.

The chances of that being possible are tiny, therefore we choose to buy the haystack rather than search for the needle.

The share part of the portfolio will be invested in the biggest and best companies in the UK, US, Europe, Japan, the Far East and Emerging Markets. We are interested in the gradual accumulation of the returns earned by all those businesses.

In that way, you are capturing and benefitting from global growth; that's the sum total of all the decisions millions of rational human beings make day in and day out. You will share in the success that comes from their ingenuity and enthusiasm.

The bond part will be mainly Government bonds, those being the bonds least correlated to the machinations of shares and the most likely "safe haven" when equities take a serious, prolonged hit. Historically that has produced the results you need and there's no reason to think that won't continue.

## Portfolio review / management

We keep ourselves up to date with the latest developments that might affect investments. Our Investment Committee meets quarterly to discuss the portfolio and any changes that should be considered.

We're not speculating on the future, trying to second-guess, for example, which way Brexit might go. That's folly; you simply can't make an investment policy out of it.

Instead, we're looking for changes in trends (inflation, interest rates, etc.), large market movements (20%+ up or down) and the "temperature" of the investment markets and their participants.

If it's looking too hot or too cold, we may well adjust your portfolio. Most of the time we will be ticking along in the normal or to-be-expected range of activity.

Now and then though, we will approach the peak of euphoria (think 1999) or the depths of despair (2008/09), both of which presented easily-recognised opportunities to take advantage of an investment pendulum that had swung too far one way.

## Summary

1. Your financial plan is the master, your investment strategy the servant – not the other way around.
2. Split your money short term and long term.
3. Invest long term to beat inflation.
4. Know the short-term cash means you can ride out any volatility.
5. Don't look for the "needle", buy the "haystack".
6. Keep a proper eye on what's going on and adjust accordingly.

# INVESTMENT EXPECTATIONS

Everything you don't need in the next three years or as an emergency fund should be invested to beat inflation. Inflation at 3% pa means the value of your money halves every 20 years.

We must beat inflation if we are to provide you with the money you need to do the things you want. If we don't, you will be poorer tomorrow than you are today. That's a terrible result.

Therefore we arrive at a portfolio investment, typically, 20% in bonds and 80% in equities (please see "Investment Strategy" for more detail).

## However, your investments will suffer temporary setbacks!

Over some periods of time, you could be worth less than you were previously and this may persist for quite a few months. In our view, these temporary declines are much more acceptable compared to the permanent loss that inflation will inflict.

We will never know when a correction will begin. We won't know when it will end. But we do know that, however deep or shallow the correction is, it will be temporary.

This level of uncertainty is not a risk (if you stick to your plan) when you have a 30+ year investment horizon. And, when it is over, the permanent uptrend will reassert itself.

Here's a rough idea of what you should expect to happen:

- An average annual drop of around 10–15%, ie., values will drop by 10–15%, then recover.
- We will not flinch; to profit from this perfectly normal occurrence we would have to pick both the top and bottom of the market.
- That means we would have to be right twice. We won't be.
- Nobody will be, not consistently. So, by far the best thing to do is sit on your hands.
- Furthermore, the chance of any decline over the next 12 months is about 25%.
- There's about a 13% chance it'll be 10% — and a 6% chance it's 20%.
- All of which means that, 75% of the time, values fall and then recover in full during the same 12- month period.
- The other 25% of the time, they recover not long after.
- All declines to date have proven to be temporary.
- In return for this, you can expect inflation-beating returns over the years.

# INVESTMENT RISK

Risk is a devilishly slippery and complex concept. One person's "risky" is another's "risk-less". And, of course, what's risky today may not be tomorrow. It's always a matter of context.

I like Elroy Dimson's thought: *"Risk means more things can happen than will happen."*

And Howard Marks' inversion: *"Even though many things can happen, only one will."*

## What is risk?

There are many forms of risk. Here are a few that Howard Marks identified: upside, inflation, interest rates, events, black swans, model, basis, concentration, over-diversification, credit, illiquidity, funding, gearing, falling short and — these days — FOMO.

These risks, and most of the articles or books on risk, relate to investment risk, ie., what affects the value of investments over time.

However, for us, the investments are the servant of your financial plan, not the other way around.

It's the financial plan that determines what and how much investment risk should be taken on. Therefore we should add some specific planning risks; namely the risk you outlive your money and the risk you pose to yourself in panic situations.

All the risks above can be aggregated under one risk heading, which Howard Marks in "Risk

Revisited Again" states as follows: *"What they (investors) fear most is the possibility of permanent loss."*

Risk is permanent loss, with the emphasis on "permanent". We agree wholeheartedly.

Warren Buffett, in his 2017 Letter to Shareholders, thinks more in terms of falling short: *"Investing is an activity in which consumption today is foregone in an attempt to allow greater consumption at a later date. "Risk" is the possibility that this objective won't be attained."*

## Volatility

Neither description mentions "volatility" — the amount by which investments go up and down — which is curious.

Volatility is loved by regulators and the press. It is, de facto, the officially-approved measurement of risk. As a result, its influence on just about everything in the investment world is extensive and probably corrosive. Concentrating on the wrong thing usually is.

Volatility is convenient, which is why it is usually (mis)used to define risk. It can be measured; a number can be put to it. Numbers are essential to the maths, formulas and models that support much of what the investment industry does. So, you see, there has to be a number.

This ignores the fact that volatility only becomes a risk when you react to it in the wrong way; it's benign until that point. Which means that focussing on volatility is a mistake. It draws attention away from the elephant in the room — permanent loss.

The mistake is compounded by many who think that, by dealing with volatility, they have dealt with risk. They haven't. Low volatile, benign investments can — and do — go to zero.

For example, bonds are less volatile than equities most of the time but that doesn't make them less risky most of the time. But a "low risk" investor will, most likely, have a large holding in bonds.

That's as guided by an adviser's compliance department, which is interpreting the regulator's vague wishes, which are necessarily vague to allow the wriggle room needed to ensure they are never to blame. And all this as a result of a simple misunderstanding.

And what does Warren Buffett think of that? *"It is a terrible mistake for investors with long-term horizons... to measure their investment 'risk' by their portfolio's ratio of bonds to stocks. Often, high-grade bonds in an investment portfolio increase its risk."*

Although bonds do, in the main, reduce volatility. But, as Howard Marks says: *"We can ride out volatility, but we never get a chance to undo a permanent loss."*

## Permanent loss

So we start our work by focussing on permanent loss of capital, not volatility, as the major risk to our clients. But there's an immediate issue – there's no number. Or, as Howard Marks points out: *"The probability of loss is no more measurable than the probability of rain. It can be modelled, and it can be estimated..., but it cannot be known."*

That's the opposite to volatility. Incorrect certainty is better than no certainty apparently, and numbers are certain. But, as Carveth Read put it: *"It is better to be vaguely right than exactly wrong."*

## Forecasts

The probability of loss can't be known because future outcomes are unknowable, which makes forecasts worthless. And that's ignoring the fact that there is no consistency amongst forecasters (everyone is right sooner or later, no-one is always right) and, at any given moment, just about every outcome has been forecast to happen.

And, even when the consensus forecast is X, it may not be the most probable one or the one that happens. In hanging our hat on consensus forecasts, we run the risk of ignoring improbable outcomes.

These are all really important points to take on board and acknowledge. When we do, we can recognise our limitations and accommodate them, rather than by blindly acting on forecasts purporting to confirm the future.

If you ever read or hear about someone who's convinced the future is know, bear in mind this from John Kennethy Galbraith: *"We have two classes of forecasters: those who don't know and those who don't know they don't know."*

Of course, all forecasters know they don't know; it's evident in their actions. If they really had faith in their abilities, they'd back their foresight to the hilt every time. And they'd borrow money to get even greater exposure to what they know will happen.

But they don't — it's their tacit acknowledgement that their forecasts aren't worth backing.

## How permanent loss happens

One of the two ways: *"An otherwise-temporary dip is locked in when the investor sells during a downswing… or the investment itself is unable to recover for fundamental reasons."* (Howard Marks).

I'd mention inflation, which is the permanent loss of purchasing power. And that we can help with both inflation and your behaviour. We can help you keep calm and not panic, but we can't stop you ignoring us. In that context, 90% (or more) of the fee we earn is directly linked to helping you "behave" on a variety of fronts — avoiding blind panic being a big one.

## How to handle "risk"

We know we can't avoid all risk, but we can have a good go at controlling it.

It comes down to sticking to the plan which was formulated from the goals we agreed, where the investment strategy is the servant of the plan (and not the other way around).

The first step is to focus on minimising the permanent loss of capital, not minimising volatility. To this end, we use regulated liquid investment vehicles that have a good spread of holdings. Or, put another way, we avoid betting on individual shares and never get involved with anything not regulated, or that invests in illiquid assets like property.

We believe that means none of the components of your investment strategy has the least chance of going to zero or being accessible. Those are two big ticks.

The second part is to help you "behave", as mentioned above. We want both your finances and psyches to withstand significant and prolonged downturns. The best way of doing that is to make sure you have enough in reserve to cover you when the downturns happen.

Our starting position is that your next three years' expected expenditure should be covered by known income and cash. By covering your liabilities in this way, we believe you should be able to withstand the inevitable periods of volatility.

And that's very important because of the third prong of our approach, which is to avoid inflation causing you a permanent loss of capital. That means investing mainly in equities. Only equities have, on average, produced the inflation-beating returns you need. The trouble is they are usually quite volatile, hence the buffer outlined above which will allow you to "survive" drops when they come.

Typically we'd expect you to be invested 80% in equities and 20% in bonds. That will change as we move through the cycle from unsustainable euphoria to abject despair and back again. As we reach those extremes, we can move money to take advantage of the backswings towards the happy medium.

## The real problem?

Not knowing the future can be an issue, especially for those hell-bent on having the sort of answer only numbers can provide. It would seem that having an answer is often more important than not, regardless of the usefulness of the answer.

But, if you're misled by the answer, you're likely to take actions you'll regret in the end. And that increases the chances you suffer permanent losses you can't afford. And a supposedly risk- reducing action has become a risk-increasing folly.

That's the real problem — not being able to quantify something is not. Therefore, we eschew the answers volatility figures provide and accept we don't know the future. And are rational enough to admit both.

But that still leaves us with Howard Marks' conundrum: *"... investing requires us to decide how to position a portfolio for future developments, but the future isn't knowable."*

## In Summary

- Risk exists but isn't what you think it is.
- We can't measure risk, because the future isn't knowable.
- We can take sensible measures to control risk as we understand it to be.
- And thereby remove a decent amount of uncertainty.
- But we can't avoid risk.
- We can be alert to unsustainable euphoria and abject despair and, hopefully, take advantage of both.
- And avoid being drawn in to harmful actions predicated on unhelpful answers.

*With thanks, throughout, to Howard Marks, Nick Murray, Peter Bernstein and a host of other far-sighted and insightful professionals who have shared their wisdom over the years.*

# INVESTMENT DIVERSIFICATION

The two pillars of any sensible investment strategy are asset allocation and diversification. Get either wrong and you run the risk of turning your investments into a betting pool.

Both diversification and asset allocation, done correctly, should reduce the overall level of volatility (upwards and downwards) that your investments experience.

That, in turn, means you're much less likely to blow your financial plan up when the next stock market shock comes along. And that's a very good thing.

Asset allocation is the mix of equities, bonds, property, commodities and cash.

This is a note on diversification; here are the six things you should be aware of:

1. Diversification spreads your money amongst different styles (eg., growth vs value), sectors (e.g., banking vs technology) and geographies (e.g., the UK vs overseas). Each of these have historically had different cycles. Growth tends to cycle in contrast to value, large cap to small cap, and different regions do better at different times.
2. The purpose is to suppress the short-term to medium-term volatility of the overall portfolio, whilst earning the full returns of everything over the long term.
3. Of course, in efficient markets, whatever suppresses volatility must commensurately suppress return. True diversification will always mute returns at any given moment. But this isn't a flaw; it's proof you're on the right track. You must keep your eyes on the prize: the full return of all the components over the long term.
4. In a genuinely-diversified portfolio, something is always “under-performing”. That's how you know you're properly diversified.
5. The last thing on earth a rational investor would ever do is to sell investments that are already down to buy the ones that are already up. This would have the effect of destroying diversification. And it isn't investing; it's speculating. It's the very worst imaginable species of performance-chasing.
6. And, most years — via the free lunch that is rebalancing — you can harvest some of the gains in your winners and reinvest them opportunistically in the laggards. Diversification (and sticking to it) is a character trait. Like all good investment habits, it's tortoise-like, rolling on serenely, year after year.

Properly-diversified clients don't get "great years", instead they get a great life.

By embracing diversification, we acknowledge an irrefutable truth; although we have a very good idea of what will happen over the long run, we never know what's going to happen next.

And neither does anyone else; the difference is we're delighted to admit it.