



**Ten
Investing
Truths**

Insights into successful investing



Ten investing truths

Investing is complex. Think about all the things you have to take into account — markets, products, politics, technology, legislation and regulation, economics.

All that complexity can make investing fascinating — or puzzling. But like all the great challenges in life — raising a child, making a home, taking on a career — success in investing involves understanding a few key truths and sticking to those principles just when it's most tempting to get carried away in the theory.

This guide to successful investing is designed to bring these investment fundamentals to life. While some of these principles have taken centuries to develop, all are simple. They are some of the concepts that separate successful investors from unhappy ones.

We hope you enjoy and learn from this booklet and turn to it especially in those times when fear, greed or hype make the simple truths of investing even more important.

Rob Coombe
Chief Executive Officer
BT Financial Group



**Time is on
your side**



Enrol in a get rich slowly program.

Get rich quick schemes are everywhere. Unfortunately these schemes tend to make their promoters rich quickly — often at the expense of investors.

Like most things in life that are worthwhile, investing takes time. Time to grow (compounding) and time to recover from downturns (volatility).

Compounding

Albert Einstein is said to have called it the most powerful force in the universe, and John D Rockefeller named it the eighth wonder of the world. We call it compound interest.

Why do people regard compound interest so highly? Most of us studied compound interest at school, so we know how it works. But it's not until you start looking at practical examples that you realise how powerful it can be.

Imagine you are 21 again. You decide to invest \$5,000 and then add to it at the rate of \$1,000 a year — until you turn 30. Then you stop saving altogether and leave your nest egg alone until you turn 65.

Let's assume you earn an average return of 8% pa (after fees and taxes) which you always reinvest. And for simplicity let's say inflation is zero (so your real return is a healthy 8%).

Now imagine an alternative scenario

In this version you don't start saving until you turn 31. At 31, you put aside \$5,000 and add another \$1,000 each year until you turn 65. Remember, you are reinvesting income, inflation is zero and you're getting that 8% pa average return.

You figure you will more than make up for lost time by saving harder — ie for 35 years rather than 10 years.

Which is the better strategy? The ten-year saving plan, in which you will have invested a mere \$14,000 (a \$5,000 initial contribution then \$1,000 a year for nine years) will reap \$332,413. The 35-year plan, in which you will have invested \$39,000 — nearly three times as much — earns you considerably less: \$227,077.

→ **The power of compound interest
— an example**

Here are the hard numbers for you to check. The bold type represents those years when you contribute \$1,000. The return, remember, is a constant 8% pa.

Years of age	Example 1 (\$)	Example 2 (\$)	Years of age	Example 1 (\$)	Example 2 (\$)
21	5,000	–	44	66,036	35,093
22	6,400	–	45	71,319	38,901
23	7,912	–	46	77,024	43,013
24	9,545	–	47	83,186	47,454
25	11,309	–	48	89,841	52,250
26	13,213	–	49	97,028	57,430
27	15,270	–	50	104,790	63,025
28	17,492	–	51	113,174	69,067
29	19,891	–	52	122,227	75,592
30	22,483	–	53	132,006	82,639
31	24,281	5,000	54	142,566	90,251
32	26,224	6,400	55	153,971	98,471
33	28,322	7,912	56	166,289	107,348
34	30,587	9,545	57	179,592	116,936
35	33,034	11,309	58	193,960	127,291
36	35,677	13,213	59	209,476	138,474
37	38,531	15,270	60	226,234	150,552
38	41,614	17,492	61	244,333	163,596
39	44,943	19,891	62	263,880	177,684
40	48,538	22,483	63	284,990	192,899
41	52,421	25,281	64	307,790	209,331
42	56,615	28,304	65	332,413	227,077
43	61,144	31,568			

The table shows the dramatic effect that compound interest can have on your savings. Remember — it's not just how much you invest. It's how long you invest.

Volatility

Time heals all wounds. It's a common saying but one that's very powerful in an investment context. Often it's the investments that have the greatest risk of losing money over the short-term that produce the best return over the long term.

Consider international shares. Over the 20 years to 31 December 2004, international shares have lost money in five individual years. But over the full 20 years, the average annual return from international shares has been almost 14% (based on calendar year returns of the MSCI World ex Australia accumulation index denominated in Australian dollars).

That's why many professional investors use the adage: 'It's time in the market, not timing the market that matters'. By investing for the long term, the effect of short-term losses is neutralised.

Timing the market means second-guessing; choosing the best time to buy and sell investments. This is extremely difficult. Many professional investors believe the risks of trying to second guess market movements outweigh the benefits.

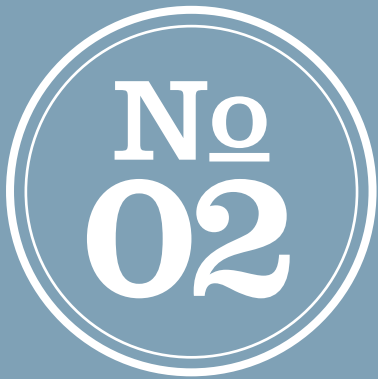
A smarter, simpler approach is what is known as 'dollar cost averaging'. With dollar cost averaging, you don't have to focus on where share prices or economies are headed. You simply invest a set amount of money on a regular basis over a long period of time. By doing so, you buy less when the market is up, and more when it is down — automatically.

Let's look at an example¹. Say you put \$100 per month into a managed fund that initially had a unit price of \$10. Over the next few months, the market falls (causing the unit price to drop) before recovering to its original value. At the end of the five months you have 65 units each worth \$10, so you have \$650. You have invested \$500, so your profit is \$150 even though the unit price is the same as when you first invested.

Month	Investment	Unit price	Units purchased
1	\$100	\$10	10.0
2	\$100	\$8	12.5
3	\$100	\$5	20.0
4	\$100	\$8	12.5
5	\$100	\$10	10.0
Total	\$500		65.0

Of course, dollar cost averaging does not guarantee a profit. But it can smooth out the market's ups and downs and help reduce the risks associated with investing in volatile markets.

¹This table is for educational purposes only. It is not representative of any particular investment product or investment strategy. No allowance has been made for inflation, taxation, fees or expenses.



**Seek
advice**



If senior executives, sports stars, politicians and entertainers all get expert help to manage their money, why shouldn't you?

There are many reasons why it makes sense to seek advice. Some are just common sense.

Common sense reasons to seek advice

→ Expertise

In an increasingly specialised world there are an ever-increasing number of experts we call on to help us. If you listed the experts you consult every year it would probably include mechanics, accountants, doctors, dentists, pharmacists, optometrists, travel agents and gym instructors. Even sports stars rely on expert coaches to remain at the top of their game.

Why do we rely on these experts? Because they are trained to do certain tasks that we are not — book flights, fix teeth, devise a fitness program, fit contact lenses etc. That training means we can rely on them for advice and services that make our lives better and easier. It's no different with managing your money.

→ Efficiency

Given time, a certain amount of natural talent and a lot of training we could do a lot of things we pay others to do. We could spend time researching nutrition, biomechanics and anatomy and devise our own exercise program. Or sweat over the books till we knew enough of the latest tax laws and accounting legislation to do our own taxes.

The reason we don't is that it's **inefficient**. It's more cost effective — in time and money — for us to specialise in what we do best and use other experts when we need help.



The so-called ‘father of economics’, Adam Smith, called this ‘the division of labor’. He made the point that experience in doing a particular task plus the time saved by concentration on this task, produces many times more than if an individual made a complete article. Smith’s famous example involves 10 men, each performing one or more of the 18 operations necessary to make a pin, together producing 48,000 pins a day. Whereas, working separately, they could not make even 200.

Look at it another way. Tiger Woods makes a lot of money from playing golf. So which is the best use of his time and energy? Learning international tax law or improving his putting? Researching investment products or practicing his bunker shots?

What you get from your financial adviser

So what are the most important services you get from a financial adviser?

A holistic approach

A financial adviser can help you take a holistic approach to your finances. They help you understand your existing financial position, clarify what your goals are and devise a strategy to help you achieve them. Most importantly they build a financial plan that’s about you — your age, your plans, your investment experience, your risk tolerance and your lifestyle.

That means that all your financial decisions fit into a logical framework and that the products and services you choose work together to meet your needs.

Asset allocation

Asset allocation is the art and science of allocating your investment between shares, property, bonds, cash and other asset classes. Many investment experts believe asset allocation is the single most important investment decision.

Your financial adviser can work with you to devise an asset allocation structure that suits you, helping you use the mix of growth and defensive assets that meet your needs. Ongoing consultation with your adviser also helps you to stick with your asset allocation strategy in the face of short-term events — such as the tendency to become too defensive when markets are falling or too aggressive when they are rising (see Don’t panic section on page 36).



“The BRW rich list is full of people who use smart financial advisers.”



Security selection

There are literally thousands of shares, managed funds, trusts and super and retirement income products to choose from. Which are best for you?

Your financial adviser has access to the latest professionally-compiled research that allows them to compare these products against each other. That means they can choose the best products for you — both in terms of performance, fees and in terms of quality of management and in how they fit into your portfolio.

An education

One final and often underestimated role of a financial adviser is to help you learn more about investing. No-one will do it better because they are by your side as you make crucial life and investment decisions.

It makes sense to hire an expert — and even more sense to learn from them.

Looking for an adviser?

By logging onto www.btonline.com.au, (look under **New investors** and click on **Financial advisers**) you can use our Adviser referral service to find a selection of financial advisers in your local area. The Financial Planning Association’s booklet, Don’t Kiss Your Money Goodbye has some handy hints on selecting an adviser.



**Find hidden
value**



Your return will be higher — and your risk lower — if you invest in companies that are selling for less than they are worth.

Hidden gems are every investor's dream. Legendary US investor Peter Lynch dubbed these investments 'ten baggers' — shares that grow from small companies into market heavyweights and increase in value tenfold — or more.

Let's look at a few examples:

- Giant US retailer Walmart was founded in 1962. A thousand dollars invested in Walmart in 1970 would now be worth more than \$5 million dollars.
- A thousand dollars invested in Microsoft on the day of its sharemarket listing on 13 March 1986, would now be worth \$250,000 — a 33.8% annual return (as at 1 March 2005).
- Hearing implant company, Cochlear was listed in Australia on 4 December 1995. Invest a thousand dollars on listing and your holding would now be worth \$10,300 — a 28.7% annual return (as at 1 March 2005).

The question is, how do you find them? If it was easy, everyone would be doing it. The problem with hidden gems is that they have their own risks. For every Cochlear, there are hundreds of Compass Airlines.

As the name suggests, hidden gems are hard to find. While every major broking house analyses the BHP-Billitons and Westfields of the world, many smaller companies are under-researched. That means you have to do a lot of the research yourself (or rely on a fund manager to do it for you).

That's why finding hidden gems may be a job for the experts who run managed funds. Managed funds have greater research resources — more analysts, better investment technology and more experience (see Employ experts section on page 40).

Another kind of hidden gem

There are other ways to make money from companies whose true value is poorly understood. As well as searching for the heroes of tomorrow, sometimes it's worth investing in companies who seem on the surface to be suffering but have potential that is often hidden from view.



Even large, well-established companies have periods where their share price wallows. It may be because of poor recent performance, turmoil amongst senior management or because economic factors are acting against the company.

During these periods, the market may pay too much attention to the headlines and not enough to the underlying value of the business. If the price moves below this value (see It's all about income section on page 16) a smart investor can take advantage of this weakness.

If you (or your fund manager) have the research resources, patience and discipline to buy shares when their prices are falling, you may be well rewarded as the share price moves up towards fair value.

Hunting for gems

Companies and their shares are living things. They have a past, a present and (hopefully) a future. In many ways they control their own destiny — how they manage their staff, their operations, their capital. Where they invest their capital, how much they borrow, how they price, market and distribute their products and services are all decisions that can be controlled.

But performance is also affected by events outside their control — the weather, geopolitics, legislation, technology, fashion and the economy.

Smart investors consider all these factors before they buy or sell a share. And they understand that the secret to success is knowing if the price of the company on any given day reflects all these factors. In other words — is the company worth what you are paying for it?

Fund managers use a systematic approach to help them understand a company.

The franchise

The 'franchise' is what makes each business unique. To understand the quality of a franchise, fund managers assess the outlook for the sector the company is in and then look at the company's competitive position within the sector. They want to know:

→ The nature of the industry

How fierce is competition, how fast is the industry growing, how does the industry stack up compared to international counterparts?

→ Cost position

Where does a company's cost structure place it in the industry?

→ What is the company's product positioning


Do its brands give it the power to charge a premium? Or is it competing on price?

→ Risks

Could new technology, products or regulation affect the business?



“Were you the first person in the office to know about it?”



Management

Fund managers also place great importance on management. First, they want to know how well the company manages its operations — production, distribution, marketing, sales etc. They also want to know how it manages its capital — when, how and at what rate it borrows, how it returns profits to shareholders, where it invests, how it manages its cash.

Risks

Each company faces different risks. A miner like BHP–Billiton faces currency risk every day. Pharmaceutical companies like Pfizer live with the risk that a competitor finds a better drug for treating arthritis. Fund managers also look at a company’s financial risks — risks that all companies share. Can the company cover its debt and other costs? Are its earnings predictable or do they vary from year to year, season to season, or product launch to product launch?

What business are you in?

After gaining an understanding of the management, franchise and risks of a particular business, an experienced investor should be able to tell what really drives a business. This is not as easy as it sounds.

Let’s look at insurance. It seems obvious that the premiums they charge and the number of claims they pay would drive the performance of companies like IAG and QBE. In reality much of an insurer’s profit comes from how well they invest their ‘float’ — the flow of premiums from policyholders that they have yet to pay out in claims. Insurance company profits are often driven more by the performance of their share fund investments than their exposure to a recent natural disaster.



**It's all
about
income**



Bonds, property, shares — wherever you invest, it's the income (both current and future) that determines its value.

How do you decide whether a current price represents the real value for an investment?

A good place to start is assessing the asset's fundamental value. The fundamental value of any investment is the income it will produce — both now and into the future. That income might be rent on a property, dividends on shares or interest payments on bonds. Generally the price of an investment will rise and fall as a result of investor's belief in the size of that future income flow.

Interest rates, economic outlook, market sentiment affect the price of investment precisely because investors expect them to have an effect on the future income of the investment. As we discussed on page 12 (Find hidden value), it is the job of the investment manager to weigh up all these factors before buying or selling an asset.

Price versus value

By sifting through vast amounts of information, the fund manager is seeking an asset's 'intrinsic valuation'. By estimating the present day value of its future income streams — profits from a company, rents from a property and interest payments from a bond — a fund manager can arrive at a valuation that reflects the asset's current value. This analysis is known as discounted cash flow analysis.

All other things being equal, the price of an asset will move towards this value over time. That's how investors make money — buying an asset when its price is lower than its value and selling when it is priced beyond its value.

It's important to remember that investors are interested in future income streams. They want to know what the asset will pay them in the future. That's why the many different kinds of valuation — P/E ratios, discounted cash flow calculations, etc are an exacting but still inexact science.



The great debates

It is this tension between price and value that is at the heart of many great investment debates. Prior to the dot.com crash, companies like online sales phenomenon Amazon reached the dizzy heights of US\$100 a share without generating significant revenue.

Caught up in the frenzy of the dot.com boom, many investors were willing to bet on the future earnings of the company. Ultimately, they were disappointed, with Amazon's share price at around US\$35 at end February 2005.

However, today's Amazon does have strong and growing sales (it sold goods worth \$2.54 billion in the fourth quarter of 2004). Now that the dot.com boom — and the tech-wreck — are in the past, it's valued more realistically on the basis of real earnings growth.

Holland's famous so-called 'tulipmania' in the 17th century is another example of this tension. According to the story, the price of one special, rare type of tulip bulb called Semper Augustus was 1,000 guilders in 1623, 1,200 guilders in 1624, 2,000 guilders in 1625, and 5,500 guilders in 1637. Another bulb was sold in February 1637 for 6,700 guilders. On these price levels one single tulip bulb could cost as much as a house on Amsterdam's smartest canal, including coach and garden. The average annual income at the time was only 150 guilders.

After the crash of 1637, prices are said to have fallen to less than 10% of their peak values and by 1739 prices had fallen to 1/200 of the peak price.

The debate over valuation is also being played out in the Australian property market. Over the past few years, the yield on residential property (the rental income a property generates compared to its price) has slipped to around 1%.

Historically this is the level at which property prices start to slide because returns from property become uncompetitive with other assets such as cash and shares. For most of 2003 and 2004 however, this valuation rule of thumb was ignored by investors and property prices continued to rise.

Over the course of 2004 and into 2005, however, property prices have dropped. It appears, once again, that the fundamentals of valuation have reasserted themselves. Over the long run they tend to do that.

“You pay for what you get.”

Some valuation methods used by professionals

Discounted Cash Flow (DCF): A valuation measure aimed at estimating the attractiveness of an investment opportunity. A DCF analysis estimates future cash flows and uses those estimates to calculate a company's value in today's dollars.

The price to earnings (P/E) ratio: A valuation measure that compares a company's current share price with its earnings per-share. The P/E ratio is often considered a fundamental measure of the attractiveness of a particular share compared to other shares. Generally speaking, the lower the ratio, the lower the market's profit (or income) growth expectations. The P/E ratio is calculated as below:

$$= \frac{\text{Market value per share}}{\text{Earnings per share (EPS)}}$$

The P/E ratio is often complemented by measures such as **price to book (P/B)** ratio which measures the value of the company based on the price (or market value) and the book value (the value of assets minus liabilities according to the company's accounting records).



**Understand
risk**



Don't avoid or ignore risk — understand it. Then put it to work for you.

It's human nature to want the highest return possible with the lowest possible risk. But it is very rare to have both.

All investing involves a trade-off between risk and return. Generally, the higher the risk, the higher the potential long-term return will be. But the higher the potential for short-term gain, the higher the potential for short-term loss.

What is risk?

In investment terms, risk is an indicator of the potential gain or loss associated with an investment. Risk is often referred to as volatility. The more volatile an investment, the greater the fluctuations in return from month to month or year to year. Below is a check-list of the major risks and some tips on how to deal with them.

Company risk

There are hundreds of factors that can affect a business. There are external factors such as the state of the economy, interest rate levels or the efforts of competitors. There are also internal issues — wage pressures, capital expenditure costs and pressure on the price a company receives for its products. Factors such as these can cause a company's share price to rise or fall rapidly.

How to manage company risk

→ **Diversify**

By spreading your money across a well-diversified portfolio of shares, you can significantly reduce the risk that a particular company's health will have a major negative effect on the performance of your overall investment.

→ **Leave it to the experts**

Investment professionals are paid to analyse individual companies, industries and the overall economy and to buy and sell shares based on that analysis. They have the time, resources and skills to do a better job than most individuals.

Market risks

No matter whether you are investing in shares, fixed interest or property, there is a risk the entire market will fall. Generally this is a result of market sentiment turning sour, that is, investors believing a particular factor will hurt returns. Broadly this could be caused by two types of risk — economic risk and political risk.



Economic risk involves changes in the rate of economic growth, inflation, unemployment or interest rates which can all have dramatic effects on markets.

Political risk revolves around the ability of Governments to pass laws that affect the overall economy or regulate a market. Geopolitical events — political instability, internal strife, wars etc — can all have significant impact on asset prices.

How to manage market,
economic and political risk

→ **Diversify**

Returns from property, fixed interest and share markets do not always follow each other. Each asset class can react differently to the prevailing economic conditions. For instance, the fixed interest market, may surge when sharemarkets are falling. By investing in a number of different markets, you reduce the effect a fall in one market has on your overall portfolio.

Currency risk

If you are investing in overseas shares, property or fixed interest securities, you face the risk that changes in exchange rates may affect your return.

How to manage currency risk

→ **Hedge your investment**

You can use sophisticated investment products to protect your assets from the effect of moving exchange rates. Many international fund managers **hedge** their international investments in this way.

→ **Diversify**

By investing in Australian as well as overseas markets, you reduce the effect currency movements have on your portfolio.

Manager risk

If you invest through a managed fund, you run the risk that the investment manager makes poor investment decisions resulting in losses. If you invest directly in the markets, you run the risk that your own investment skills are not up to the task.

How to manage manager risk

→ **Choose wisely**

Before entrusting your money with an investment manager, do your homework. Check the manager's investment credentials — how they manage money, how they perform in different market conditions etc. Whatever you do, don't make rash decisions based purely on their performance over the past year or so. Seek the opinion of someone you trust or ask a financial adviser for their expert opinion.

→ **Diversify**

Invest with a number of managers. Investment managers have different investment styles. By investing with a number of managers using different styles, you can reduce the effect that poor performance by a particular manager or style will have on your investment portfolio.

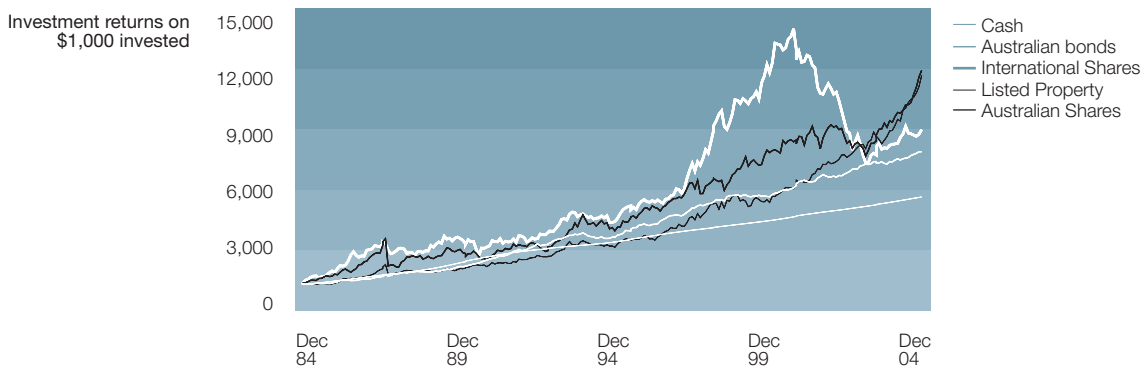
Risk and time

One of the most effective ways to reduce risk is to invest over the long term. Most of the risks described above can have a significant effect on your investments in the short term. Over time, however, their effect tends to be reduced.

The chart below demonstrates that over a long time period (seven years or more) the volatility associated with riskier asset classes such as shares is substantially reduced. If you want to find out more about the benefits of long-term investing, see Time is on your side section on page 4.

Over time, the return from 'growth assets' like shares is generally higher than the return from a low risk investment like cash. If you leave your money in a bank savings account earning a very small interest rate over a longer period of time, you run the risk that your money may 'go backwards' — that is, not keep up with inflation.

It is important to note that the returns shown in the chart are historical. Investment returns are volatile and past performance is not a reliable indicator of future performance.



Indices: Liquids index (Cash), UBS Fixed Interest 0+ yrs index (Australian Bonds), S&P/ASX Property index (Australian Listed Property), S&P/ASX 300 accumulation index (Australian shares), MSCI World ex Aust Accumulation index (International shares).



**Diversify your
investments**



The more you spread your investments, the less chance you have of losing money.

Let's say you invested your life savings into a single company. If the share price soared, you could become very rich. On the other hand, if that company went bankrupt, you could lose your life savings. You may be better off spreading your money around.

This concept is a simple one, but often overlooked by even the most experienced investors.

Diversification is a powerful way to reduce risk. It can do this in two ways. Firstly, if you have a well-diversified investment portfolio and an individual stock (or even an entire asset class) loses ground, your losses may be reduced.

Secondly, the various types of investments will perform better at different times. For instance, shares tend to perform well at the upturn in the economic cycle, while fixed interest investments tend to perform better in the latter parts of the cycle. So diversifying across all the asset classes gives you a better chance of achieving a sound overall return.

There are three main levels of diversification — by asset class, investment security and investment manager.

1_Asset class

This refers to the type of investment — generally shares, property, fixed interest and cash.

As you can see from the table over the page, each asset class has its time in the sun. By investing across all the major asset classes, you will always have exposure to the best performing asset class every year.

Obviously, you will also be invested in the worst performing asset class. However, this performance will at least be partially offset by the performance of other assets.



1 year returns to 31 December ¹										
Australian %	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Cash	7.75	7.45	5.63	5.09	4.89	6.06	5.16	4.66	4.92	5.39
Fixed Interest	18.63	11.87	12.23	9.54	-1.15	12.05	5.50	8.74	3.11	6.95
Property	14.28	14.24	21.76	18.37	-4.20	18.79	14.99	11.85	8.81	32.18
Shares	20.50	14.61	11.84	11.29	17.43	4.09	10.20	-10.09	15.53	27.56
International %	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Fixed Interest	24.13	-2.96	22.18	22.49	-10.26	19.63	7.48	8.63	-14.11	6.05
Shares	26.05	6.24	41.63	32.34	17.20	2.19	-9.96	-27.44	-0.76	9.94

Indices: Liquids index (Cash), UBS Fixed Interest 0+yrs index (Australian Bonds), S&P/ASX Property index (Australian Listed Property), S&P/ASX 300 accumulation index (Australian shares), SSB World Government Bond Index unhedged in \$A (International Bonds), MSCI World ex Aust Accumulation index (International shares).

2_Individual investment securities

This refers to individual shares, fixed interest securities or properties.

Once you have diversified across asset classes, it is time to start thinking about diversifying within asset classes. There are three major ways to do that:

→ Individual companies


Certain market, economic or political conditions could spell trouble for one company and success for another. Investing in a number of companies reduces the effect if an individual stock falls.

→ Industries/sectors

All companies operating in a particular industry can be affected by a change in government policy or economic conditions. But these same changes may have no effect on another industry — they may even make things better! So diversifying across industries will help balance out the effect of these industry-specific changes. The same principle applies to sectors of the property market such as office blocks, houses, warehouses and shopping centres.

→ Countries

While Australia has the second biggest listed property market in the world, it is still only about a fifth the size of the US listed property market. And while Australia's sharemarket is among the world's 10 biggest, it still only makes up less than 2% of the value of the world's sharemarkets. This means that if you only invest in Australia, you are missing out on the diversification benefits of investing in different economies, markets and industries.



“Don’t put your money into a great investment. Put your money into a portfolio of great investments.”



3_Investment manager

One of the easiest and most effective ways to create a diversified investment portfolio is through managed funds. Share funds, for instance, will generally invest in more than 30 individual companies while diversified funds will generally invest across shares, fixed interest, property and cash.

If you choose to invest through managed funds, it can make sense to diversify across different investment managers. Firstly, if one investment manager performs poorly, you only have part of your investment with that manager.

And secondly, most investment managers follow a particular investment style that may perform better under certain market conditions. The most common investment styles are growth, core and value. By combining different investment management companies with different investment styles, you can reduce your risk and smooth out returns.

If you would like more information on investment styles, contact us for a free copy of *The Style Book*. This booklet guides you through all the different investment styles and how you can combine them to smooth out your investment returns.



**Avoid
chasing
returns**



Understand the past but don't
rely on it to give you guidance
on the future.

One of the greatest temptations when deciding where to invest your money is to choose the investment that had the best return last year. You see a return of 40% and curse that you weren't invested a year ago. So you decide to put your money in that investment in the hope that it will do the same thing in the year ahead.

Chasing returns like this is one of the most common mistakes made by investors. It is akin to driving using the rear-view mirror. You can see clearly what is behind you — but not what lies ahead.

It is very tempting to get caught up in the excitement of a bull run on the sharemarket. The same is also true in other asset classes such as property and fixed interest. However, it can also be dangerous to get caught up in the stampede.

Asset classes

Here's a simple example that explains why chasing returns can be costly. Over the past 20 years, if you had switched your money into the best performing asset class during the previous year, you would have received an average annual return of 10%. However, if you had chosen the previous year's worst performer, you would have gained 14% a year.

The chart on page 26 shows the main asset classes and their percentage return each year between 1995 and 2004. The asset class that had the highest return each year is highlighted. It is rare for the same asset class to have the best performance two years in succession. It has happened only twice in the past 20 years. History has shown that if you invest in the asset that performed the best last year, it is unlikely to have the best performance again this year.

It is very tempting to get caught up in the excitement of a bull run on the sharemarket. The same is also true in other asset classes such as property and fixed interest. However, it can also be dangerous to get caught up in the stampede.



Investment managers

There is a saying in the investment management industry: ‘today’s rooster is tomorrow’s feather duster’. Today’s best performing investment manager is often relegated to the middle of the pack or worse in years to come. In other words, it is very difficult for one investment manager to consistently produce the best results.

Rather than relying on one-year performance figures, it makes more sense to do some research on investment managers to find one that consistently produced good returns. We give you a few ideas on how to get started in the section ‘Do your research’ on the opposite page.

Individual stocks

In the years leading up to 2000, technology shares made many people rich. In the two years following, many people lost a lot of money investing in the same stocks. The people who lost the most money were those who invested at the height of the technology stock boom. They made the mistake of buying the previous year’s best performing stocks.

Many highly successful investors do exactly the opposite, buying laggard stocks when they believe the market has not understood the true potential of these companies which are therefore priced cheaply.

How to avoid the trap


So what does this mean for your investing? If you shouldn’t base your investing decisions on past performance, what sort of criteria should you use?

One way is to think about the driving analogy mentioned earlier. Avoid spending too much time looking in the rear-view mirror — concentrate on the road ahead. Another way is to think about a weather forecast. You wouldn’t base a weather forecast on what happened yesterday, rather you would look at high and low pressure systems, cold fronts and long-term climatic conditions. It’s the same with investments — the manager’s investment process and the resources and experience they can deploy are at least as important as past performance.


There are also a few practical steps you can take.

Diversify

Instead of putting all your money into the investment that performed best last year, try spreading your money across the different asset classes, investment managers and stocks. This discipline will help reduce the temptation to chase returns and may also reduce the volatility of your investment portfolio. This is discussed in more detail in the Diversify your investments section on page 24.



“Stick to your guns. And the rewards keep coming back.”



Stick to your guns

Don't chop and change your investment strategy every year. Instead, spend time developing an investment strategy that suits your circumstances and goals, and give it time to work.

Past performance can be useful when you consider longer time periods. For instance, Australian shares was the top performing asset class in the 20 years to 31 December 2004. But Australian shares also lost money over one year six times out of 20.

Do your research

Rather than simply relying on past performance to select your investment, take advantage of the many resources available through newspapers, the internet or professional financial advisers. These can help you track true long term performance and build up the information you need to make the right investment decisions.

You can check out the long-term performance of managed funds and their research company ratings at sites such as www.morningstar.com.au or through newspapers such as the *Australian Financial Review* or magazines such as *Personal Investor*. The Australian Stock Exchange has a wide variety of information on individual shares at www.asx.com.au. Or try the research facilities at broking sites such as www.westpac.com.au.

Seek advice

Finally, and most importantly, financial advisers can help you develop a disciplined approach to investing which will take into account all the issues outlined above. They can also tailor your investment to your circumstances and goals.



**Tax
effective
investing**



Focus on the after-tax return,
not the tax.

It makes sense to consider the tax implications of your investments. However, one of the easiest investment traps to fall into when investing is to concentrate on tax savings and forget the reason why you invested in the first place — to make more money.

What can go wrong?

Some tax schemes have felt the wrath of the tax office in the past. Over the years, a large number of investors have been burnt by rulings from the Australian Tax Office (ATO). Some investors have had tax deductions disallowed by the ATO while others have been fined for their part in illegal tax minimisation schemes. Either way, the results can be costly. It is worth discussing any tax-effective investment with your financial adviser or accountant before investing.

You can become so involved in saving tax that you forget about the reason you are investing — to make more money. If you hear yourself talking about tax savings before mentioning how your investment is performing, it is a warning sign. You might be focusing on the wrong goal. Try focusing on the after-tax return from your investment — not the tax you are saving.

All this doesn't mean you shouldn't take advantage of some sensible tax tips. Over the page, we examine a few to think about.

→ 1_Hold on to your investment for more than a year

If you're an individual (or investing through a trust) and you hold your investment for a year, you only pay capital gains tax (CGT) on 50% of your investment's gain. However, if you sell your investment within a year of your initial investment, you will pay CGT on 100% of the gain.

2_Invest through superannuation

If you invest through superannuation using before-tax money, you'll generally pay only a 15% contributions tax (plus a super surcharge of up to 12.5% if you're a high-income earner). This is likely to be much less than the marginal tax rate you are currently paying (which could be up to 48.5%). So it may make more sense to invest in super rather than other investments — because more of your money is put to work for you.

If you're self employed, you may also be able to claim a tax deduction on your contribution (given certain conditions).


Once you are invested in super, your investment earnings are taxed at a maximum rate of 15%. In non-super investments, tax can siphon off up to 48.5% of your return.

Normally, when you take out life and/or total and permanent disability insurance, you're using after tax money. It's much cheaper to use pre-tax dollars by paying for insurance out of your pre-tax superannuation contributions (if your super fund allows it). For more details on tax-effective super strategies, contact us for a copy of the booklet *Super made easy*.


3_Pay interest on your investment loans in advance

The interest you pay on your investment loan, including a margin loan or the mortgage on your investment property, may be tax deductible. The interest on this loan can be pre-paid, allowing you to bring forward your tax deductions.

For example, pre-paying in June allows you to claim up to 12 months interest as a deduction in the current financial year. For more information on the tax benefits of margin lending, contact us for a copy of the booklet *Margin lending made easy*.



“You can manage your investments. But you can’t manage the tax man — ask Al Capone.”



4_Sseek advice when you are considering retirement

Many people have paid too much tax in retirement because they did not seek advice from a financial adviser or accountant. The rules governing the tax on your retirement savings are complicated so we strongly recommend you get financial advice, even if you haven't used a financial adviser before. For more information on retiring, contact us for a copy of the booklet *Retirement made easy*.

5_Invest in companies that offer franking credits

Some Australian shares offer franking credits. This means that they pay tax on their profits before distributing to shareholders. As a result, you may be able to claim a franking tax credit for the amount already paid by the company. For more information on franking credits, contact us for a copy of our *Why invest in Australian Shares* booklet.



**Don't
Panic**



Maintain your composure and keep the end goal in sight.

We live in an uncertain world. As the events of Boxing Day 2004 remind us, natural disasters can strike at any time. The World Trade Centre bombing on September 11 is now almost three years ago. But the threat of terrorism remains.

Economies and markets are often affected by these sudden tragedies. Every now and then, they have crises of their own. The losses sustained in events like the 1987 sharemarket crash and the Asian currency crisis still live in the minds of some investors.

So how should investors approach these events — unexpected economic, political or natural calamities that strike at the value of investment markets?

Stay calm

Don't panic. History tells us that events — however catastrophic — are soon swamped by the longer term trend.

The chart over the page shows what we mean. It shows the performance of international sharemarkets (MSCI World Index) since 1986¹. As you can see, a whole range of events — the 1987 crash, the Asian currency crisis, the Russian bond market default and September 11 — have all been blips on the long-term ascent of sharemarkets.

The chart illustrates how important it is for investors to think long term when crisis strikes. There is compelling evidence that panic selling is bad for your wealth in the short term as well.

¹As at 31 December 2001.

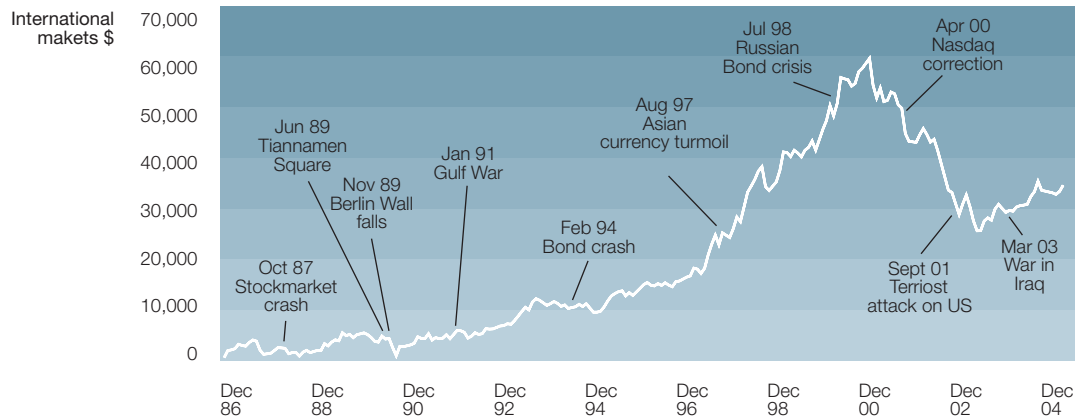


Plunge, then bounce

After the terrorist attacks on September 11, US markets stayed closed until September 17. In the five days following the re-opening, the S&P 500 index fell 11.6%. In a warning against short-term panic, legendary investor Warren Buffett said; "Whatever you thought about the stock market before the World Trade Center is what you should be thinking now."

As usual, he was right. By 15 October, the S&P 500 and the NASDAQ indices were back near their 10 September levels. Investors who panicked simply crystallised losses rather than protecting capital.


Sharemarkets do react, often sharply, to crises. Yet they tend to snap back quickly as investors reassess the real economic impact of these events. During the Iraq invasion of Kuwait in 1990, the S&P 500 dropped around 5% within a month. Within six months, the market was up almost 16%. Within a year, it had leapt 26%.




Coping with crisis

Economics, nature and human nature being what they are, we will undoubtedly face another market-mauling crisis in the future.

Yet we know that over the long term, the effect of these crises will fade. In the late 1980s, the Asian economies were the scourge of world markets. Today Asia is the key to rising commodity prices, cheaper consumer goods and one of the reasons Australia's sharemarket has been booming over the past two years.



“Selling your investments in the wake of a sudden crisis can be a big mistake...”



Yet there are still sensible precautions any investor can take to deal with a future crisis. The most important is to have a financial plan — a written document that reminds you why you’re investing, what your objectives are and how long you plan to invest for.

Such a plan is the perfect antidote to the tendency to panic, a reminder that long-term investors have nothing to gain from short-term reactions.

Understand risk

Coping with crises such as those outlined above should form part of your risk management plan. By understanding risk, you will be in a better position to manage it in times of calamity — plus benefit from risk over the long term.

One way to manage economic and political risk is to diversify your investments across different types of investments. Both the initial impact and repercussions of a major event will affect each type of investment differently. Property, fixed interest and shares may react differently to the prevailing economic and political conditions. By investing in a number of different markets, you reduce the effect a fall in one market has on your overall portfolio. To understand more about risk and diversification, take a look at the Understand risk section starting on page 20 and Diversify your investments on page 24.



**Employ
experts**



The methodical, systematic approach taken by most fund managers helps them avoid many of the mistakes individual investors are prone to.

Even the smartest investors use managed funds. Why? Because managed funds employ disciplines that many individual investors do not.

Since the 1980s, investment experts have paid increasing attention to a field called behavioural finance. It's a science field that investigates whether individuals behave rationally when they invest. Unfortunately many of us don't — and that can prove expensive.

According to academics like Nicholas Barberis and Richard Thaler of the University of Chicago, we exhibit a number of irrational behaviours when it comes to investing.

Exceptional ability

Research quoted by the two Chicago academics says individuals often have an inflated sense of their own competence. For example, around 90% of us believe we are above average drivers. Carry this approach into investing and it's easy to see why some investors take excessive risk given their level of investment expertise.

Researchers have identified other biases. 'Self-attribution bias' is the understandable, but unfortunate, tendency to claim success as a result of our talents and failure as a result of bad luck. An investor might regard a good year in the sharemarket as proof of their stock picking prowess. However, a poor year is the fault of a **bad** market.

'Hindsight bias' is our tendency to believe (often falsely) that we predicted an event. And if we think we successfully predicted the past, we may have an inflated sense of our ability to predict the future.

Behavioural finance and investment manager research also tells us that individuals will sell winners sooner than losers. In other words they carry their losses and cut their profits — exactly the opposite of a rational approach.

It is because of these irrational behaviours that fund managers often outperform individuals. Their investment approach is more structured and they are trained and managed to avoid poor investment behaviours.

Of course managed funds have other advantages.



Safety in numbers

By investing in just a few shares (or other investments) you carry more risk because your whole portfolio can suffer from an event that affects just one or two assets. By diversifying your portfolio, you can reduce risk without sacrificing too much return. Managed funds make it easier to diversify — because you pool your money with that of other investors you have the capital to invest in a wider range of assets.

You can read more about the benefits of diversification in our Understand risk section on page 20.

Better management

Choosing investments — and when to buy and sell them — means gathering a lot of information, processing that information and being able to act upon it quickly (see Finding hidden value section on page 12). Economies of scale means managed funds have the technology, people and research capacity to invest more successfully than most individual investors.

More convenient investing

Those economies of scale — and the power of modern technology — also allow managed funds to offer you services, choices and investment information that make investing easier. For example most modern managed funds can be accessed via the phone and the internet and offer a range of investment choices to suit different needs. Regular statements and investment information also make it easier for you to monitor your portfolio and fill out your tax return.

