

## **Primer on Independent and Successful Investing (November 2005)**

Presented in the form of a dialogue between a novice investor (Q) and an InvestWELL Financial specialist (A).

Q: What are the necessary steps to become an independent and successful investor?

A:

Step 1. Educate yourself about simple yet effective ways of investing (see our 'Resources' and 'Links' pages)

Step 2. Construct a portfolio based on return-risk profile

Step 3. Stay informed and enjoy life

Q: Isn't investing just pure gambling?

A: No, but depending on one's approach to investing, it could be one's best friend (providing solid returns while managing risks) or worst enemy (with poor results and many sleepless nights). It is up to an individual to decide which approach they take.

Q: Is there a difference in investment return between an average investor and a professional money manager?

A: Based on a well-documented and objective study by Dalbar over 13 year period, an average stock investor underperformed a mutual fund manager by 7.4% annually. The study has been update several times but the overall results still hold.

Q: Why is there such a great difference between an average investor and a mutual fund manager?

A: In reality only two things: lack of investment education, and the use of unsound strategies instead of sticking to basics that work. But, we believe that independent investors who possess investment education, discipline and a long-term horizon are able to achieve better investment returns than most mutual fund managers.

Q: What about the difference between professionals and an index.

A: The same study has revealed that professional mutual fund managers underperform an index by 2.3% per annum. Hence, one can conclude that most professional managers find it challenging to even match a performance of an index.

Q: Why do professional money managers as a group under-perform indices?

A:

- high costs (expenses: marketing, research, trading)
- They are competing with each other (in a zero-sum situation there will be some who gain and some who lose)
- They use short-term strategies often aimed at protecting their jobs
- They are human and subject to pitfalls of fear and greed

Q: So why not just buy and index and hold on to it?

A: An investor should always understand what they buy. In addition, a better option is to construct a balanced and efficient portfolio that is based on one's return-risk profile. Such a portfolio will likely deliver the solid returns while reducing the overall risk. In addition, investors should stay informed to take advantage of new opportunities in the market.

Q: What are the rules followed by successful investors?

A:

- They learn about the most credible and well-research forms of investing
- They use long-term proven strategies (investing is a journey not a one-time event)
- They have a disciplined approach to investing and saving
- They minimize costs and taxes

Q: Assuming one takes a long-term approach, how long should investments be held?

A: From an optimal return and risk reduction perspective, investments should be held for over 10 years or at least 5 years minimum. In fact, some of the most successful investors, such as Warren Buffett advocate that the best investments should be held forever.

Q: Why is the long time period so crucial?

A: It relates to time diversification which means that if an investor initially has a few years with negative returns then there will normally be some years with positive returns as an offset.

Q: What about people that just want to invest and save for a vacation three years from now?

A: In case of shorter timeframe, investors should choose a more conservative portfolio with significantly lower proportion of equities. By doing so, they will ensure that the value of their portfolio does not go up or down significantly and they have the predetermined amount needed for their vacation.

Q: What are the most common investment strategies?

A: The four most frequently used strategies are:

- trying to time the market
- investing in shares of individual companies
- investing based on styles (e.g. value investing)
- asset-class investing

Based on the study by Dalbar, individual investors do too much of the first two strategies which leads to very poor results.

Q: What type of investment strategies are the most appropriate for an independent investor?

A: The best strategies for an independent investor are based on patient long-term methods that are simple (though sometimes boring) yet proven to work effectively. To be more specific, the most optimal strategies are focused on asset class investing that is consistent with one's return-risk profile.

Q: What is asset class investing?

A: An investor matches the return-risk profile with appropriate asset classes and constructs a diversified and balanced portfolio. Such a portfolio is relatively easy to construct and maintain.

Q: If it is so easy and simple, why isn't everyone doing it?

A: Mostly lack of education, procrastination, or general confusion about investing. In addition, people at times do not stick to effective yet simple strategies. As strategies become more complex, people are more likely to fall prey to the emotions of fear and greed. When people become more educated about investing, they are more likely to keep a long-term perspective and avoid the rollercoaster of emotions.

Q: What type of asset classes are there?

A: The investment professionals recognize four asset classes:

- cash
- fixed income
- equities
- alternative assets (e.g. real estate, hedge funds, gold, etc.)

These four asset classes are considered efficient and exhibit different characteristics, which makes them very suitable for generating high investment returns and reducing risk.

Q: What does it mean to say an asset class is efficient?

A: It means that there are many buyers/sellers continuously negotiating prices. Hence, prices reflect the reality most of the time and it is nearly impossible for a person without insider knowledge to outwit others consistently (though it is possible to be lucky/unlucky at times).

Q: What are the different characteristics of these asset classes?

A: They have different returns, volatility and behave differently. Thus, when put together in a balanced portfolio, these asset classes will result in a portfolio that has steady returns, reduced volatility and consequently high risk-adjusted returns.

Q: What are the most common investment styles?

A:

- Value
- Growth
- small cap
- large cap
- market-oriented style

The investment philosophy of InvestWELL Financial favors market-oriented style supported with continuous learning. However, some value and small cap strategies may supplement a market-oriented style by enhancing returns and reducing risk, if implemented properly.

Q: Why is diversification of investments important?

A: Diversification is an effective way of reducing risk preserving capital. Some of the most common forms of diversification are via geography, industry, currency or investment style.

Q: Apart from generating high returns, what are other objectives of the balanced, diversified portfolio?

A:

- To capitalize on opportunities offered in global economic growth
- To eliminate almost entirely liquidity risk, company-specific risk, industry-specific risk and manager-specific risk

Q: What are some of the advantages of a balanced and efficient portfolio?

A:

- Investments requiring low maintenance save time
- Low costs and taxes
- Low risk as defined by volatility and diversification
- Investors sleep better at night with investments that are easy to understand