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Three investing tips

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The Last Word

Investments go up and down. You can never be sure if you will win or lose.

Well, that is the common perception. But it is not exactly correct. There are a few things you can do to make winning more likely. For example:

SEEK OUT RISK

You may have heard that risk is your friend. It may sound strange since most of us spend our lives avoiding risk.

The rich do the opposite. Google is famous for "throwing money at the wall to see what sticks". It means Google makes ridiculously risky investments knowing most will fail. Every now and then, however, one sticks.

The Android operating system is an example. Google's chief executive officer Larry Page thought it was cool even if his colleagues did not. But the thinking at Google was: "Let Larry have his fun and, what the heck, it's only $50 million". At Google, that is small money.

Android turned out well. Today, it is valued at over $1 billion and is the operating system used on 80 per cent of the world's smartphones.

You and I can't do that since most of us need to watch every $1,000. But most of us can increase our tilt toward risk and do it safely if we (i) diversify our portfolio, (ii) stay liquid and (iii) hold for the long run.

Take the rule of thumb that one should keep six months of expenses in a fixed deposit. It is good in theory but a slight variation can make it better. Try this: Take more risk by holding your emergency money in shares.

For example, you could invest in the STI-ETF, which is a low-cost fund of 30 large Singapore companies that you buy through a stock broker. On the downside, an emergency might arise and you would have to sell when the prices are low.

Yes, that is a risk, but emergencies are rare by definition. And the stock market could be either high or low when you need to sell. It is a 50-50 bet and fair.

That reduces risk but remember life comes with risks and you can't reduce them to zero except at considerable cost.

QUICK QUOTE

"Get the best people and don't trust them."

DONALD TRUMP, 70, BUSINESSMAN AND US PRESIDENTIAL CANDIDATE

Photo: Thinkstock

GO FOR THE LONG RUN

To convince you further, here is a powerful statistic from the well-known Wharton Business School economist, Jeremy Siegel.

In his book Stocks for the Long Run, Professor Siegel found that the longer you hold a risky investment like stocks, the more certain it is to earn more than a safe investment like bonds.

He looked at stock returns over the past 200 years and found stocks earned more than bonds 60 per cent of the time when held for one year. If held for two years, stocks outperformed bonds 65 per cent of the time.

When stocks were held for five years, stocks outperformed 70 per cent of the time. It rose to 80 per cent for 10 years, 90 per cent for 20 years and 99.5 per cent for 30 years.

And if you look at only recent history – since 1871 – stocks outperform over the 30-year holding period 100 per cent of the time.

It means if you hold risky investments for long enough like 30 years, you are certain of earning a high enough return to beat bonds. Holding for the long term makes stocks less risky and even close to a sure thing.

This lesson goes beyond stocks to every investment that conveys ownership called equities which includes properties and commodities.

How high is the return? It is about 10 per cent per year, which consists of capital gains plus dividends for stocks and rental income for property.

Commodities are more of a wild card. Are they equities and certain to earn high long-run return? There has been some academic work on this but no conclusions so far. Stay tuned.

DIVERSIFY

One more thing. The easiest way to reduce both daily price fluctuations and the chance of a total wipe-out is through diversification. The reason looks complicated but isn't.

Suppose you have a portfolio of 50 per cent each in "up" and "down" shares. Then your return will be the average of the two.

Now, imagine that both movements are exactly offsetting so they reduce the portfolio's volatility and risk to zero.

This shows how diversification does a lot to reduce risk while taking nothing from returns. On top of that, it costs nothing to diversify.

Bonds provide the best diversification since they move opposite stocks, property and commodities.

We see this in a recession when equities fall with the economy, as do interest rates since loan demand drops. The lower interest rates push bond prices up because bonds and interest rates vary inversely.

So, bond prices rise while stocks fall and this opposite price movement provides the superior diversification that only bonds provide.

The drawback is that bonds have lower returns partly because they are less risky. But that is life. You have to take the good with the not-so-good.

Well, that sums up most of what the world has learned from 50 years of investment research. I'll give you another update in 2066.

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