

FIDUCIARY PRACTICES – FORMALISE

The object of formalizing your investment strategy is to determine the parameters you want to work within. You are deciding on some key components that will determine your long term investment vehicles. The key questions are

- How long am I invested for?
- What is my tolerance to risk?
- What is my expected return based on the risk?
- Select asset classes and their ratios based on the risk and return identified
- Select sub-asset classes to create diversification.
- Can I model the expected return to ensure my investment objectives can be met?
- Prepare and Investment Policy Statement

Note that no specific products have been identified yet. However for many investors the product is their first decision when it should be their last.

So why go through all this process with still no firm decision made?

Firstly the length of time can determine what ratio of growth and income assets you need. The longer the period the more it needs to be growth because you need to hedge against inflation you can ride out the volatility of the market. Most New Zealanders will be investing for greater than 15 years. Even those just retired will live probably another 20 years.

Secondly you must understand the risk being taken. There are different types of risk of which everyone has a view. The greatest fear is permanent loss. For example a share is worthless because the company has gone bust (Enron). A property can not be sold and the interest payments build up or a bond is not paid out (Metropolis). Finance companies go broke. (Provincial Finance). There are a number of ways of testing your appetite for risk but ultimately it comes down to understand tolerance to negative returns.

There is no denying that risk is related to return. There is a natural balance otherwise we would all pick the same best investments. Statistical analysis shows that equities give the greatest reward, money in the bank the least and everything else somewhere in between. Years of data shows the expected long term return of different asset classes known as indices. For example equities

have a risk premium of 6%, property and bonds about 4% and fixed interest 0.5% above inflation.

You now know what asset classes to invest in. They can be equities, property, bonds/fixed interest. At this point most investors go and purchase a product and believe they are diversified. Unfortunately this is not the case. Good diversification requires that sub-asset classes be used

Why are investors At Risk of Disappointment?

You have decided to what risk you willing to take and what return asset classes will deliver. The next step is to model the expected returns. This enables you to understand the impact your investment will have on cashflow. There are 2 ways of doing this. The traditional method is to assume you get the same return year after year. When you are investing for retirement this is generally okay. It fails you when you start to live off your nest egg. Volatility of your investments has a big impact. If you draw on 5% of your savings and the markets drop 10% then you are 15% lower at the end of the year. The method assumes a target value will be reached.

In the real world this is not true and alternatively cash flows can be modeled by the Random Walk method. The method assumes returns are random year after year but the asset classes are in some way correlated. Instead of one scenario analysed the Random Walk method is applied to a multitude of scenarios. This gives a probability factor.

Disturbingly if the traditional straight line approach is used as the target value the Random Walk method gives a probability of success of 30-55%. This is why many investors get disappointed over time and why compromises are made.