Investment Basics

Compound Interest

There is a magic formula to investment success. It is called compound interest. Compound interest is simply the process by which money breeds. Capital earns interest, and that interest if re-invested earns further interest, and so on ad infinitum. Investing in equities (stock and shares) rather than bank deposits or bonds, boosts this breeding process by gearing up your savings. Companies prosper, and pay out larger portions of their profits as dividends. These increased dividends mean that the yield - the actual income that investors receive - on those shares that were bought has also increases. All other things remaining equal, the share price then rises so that the yield reduces to its original level. The result is that the investor now has a higher income, and more capital.

Discipline

Compounding works to increase our personal wealth provided we do not spend too much of the income from it, or pay too much for the privilege of investing it. So investors must make some effort to define how they are to achieve their long-term investment objectives, and what these are; otherwise most of the benefits of compound interest will be swept away by the costs of switching investments or just the lack of discipline. This is not difficult, provided that emotions are kept firmly under control, for the key decision is asset allocation. This is how the money we have is to be divided and invested and, whether billionaire or working housewife, there is a basic formula that works for everyone. It has two levels.

Asset Allocation – Family Level

Emergency money is for when things really go wrong, and for unexpected cash requirements. The minimum for this should be the greater of 10% to 15% of our capital, or half a year's expenditure.

Racing money is fun money that we are prepared to lose. The investment world generates powerful emotions and these are best controlled by putting aside not more than 10% of our capital to invest in outsiders - the lottery at one level, or premium bonds, or the exciting tips in the weekend press or, for the really rich, direct investment in business start ups.

Family money is the bulk of our savings. It is what we live on when we no longer have a salary or business income, and our portfolio must then generate this needed day-to-day income.

Asset Allocation – Investment Level

Asset allocation is important because of Murphy's Law, which states that whatever can go wrong, will. This is particularly true in financial markets where investment common sense is easily destroyed by euphoria or gloom. Stock prices will change up or down but bonds have more stable prices. An outsider, preferably a professional such as an IFA can help identify a long term asset allocation - or wealth plan – which will match the asset allocation proportion of the underlying securities to the level of risk you are prepared to take and the objectives you wish to achieve. Sticking to this plan keeps second guesses at bay. It also ensures that when things do go wrong in our personal lives, or markets crash, we have cash in hand.

Personal risk profile

This basic asset allocation must satisfy our need for emotional security. Not everyone will want to have as low a cash reserve as we have suggested, and some will be aghast at the idea of fun money, but this basic framework will allow us to look more objectively at how money should be invested

The detail of how the three sections of emergency, family and racing money are invested depends on the chosen investment objective. In turn, this depends on what income is needed, and a willingness to take a long view. The stock market can be very high, and sooner or later will crash, but that does not matter provided the portfolio is constructed to take into account both the minimum income required from it, and the level of emergency cash. The longer that shares are held, the safer they become since the portfolio benefits from past dividend growth and accumulated capital gains. But at the time of initial allocation, the short-term risk of equity investment is great. There are only three basic investment objectives, these are:

1. Income without risk: savings accounts, current National Savings products, annuities

2. Income now: as above plus income seeking equity unit and investment trusts, bond funds or Post Office list of British Government Gilts

3. Capital growth now, income later: predominantly equity based investment and unit trusts and passive funds and direct equities

The nature of investment risk

Investors must keep some basic realities in mind. First, investment risk is defined as price volatility, but it is this price volatility that creates opportunity. If investors cannot accept the reality that their savings may go up and down in value - and especially so in the early years of portfolio building - they must choose simple compounding for their savings. Simple compounding is only available from assets and products that guarantee capital values at the expense of income and potential capital gain, for example bank deposits and National Savings products; or annuities that guarantee income at the expense of capital.

Secondly, investment is about buying income, whether that income is purely dividend based or, more recently, the total return of dividend plus capital repayments through share buybacks or take overs. However, such total returns as they are known cannot be relied upon to buy the weekly groceries. So the need for regular income will determine how that family money is to be invested. Payment streams from bond funds and equity dividend income from shares held directly or within large generalist investment or unit trusts is surer than short-term movements in capital values.

Need for fund managers

Capital growth comes from successfully choosing those companies that do better than their competitors in gaining market share and making profits. As national barriers to competition break down, and falling prices increasingly expose those companies that cannot compete, this has become harder. Banking is the only major investment sector of 1900 that has survived to the present day, but even banks are now under threat from technology.Imperial Chemical Industries and Marks & Spencer were the anchors of most personal portfolios 10 years ago; a decade later and both shares are selling for less than they cost then.

With business change coming faster than ever, the third reality is that sensible investors, unless they are prepared to devote considerable time to their investments, must use professional investment managers to monitor these changes for them.

What can you afford to pay them?

But whatever is bought, the more money that is invested, the better and faster the compounding of that sum. So the fourth reality is the importance of keeping investment management costs as low as possible. A competent fee earning IFA can ensure that you avoid most initial fees, and advise you on the annual cost by checking for the total expense ratio (TER), now regularly produced by Fitzrovia International for UK and Offshore funds. The benchmark is set by the Government with its price controlled (a policy we find inimical to a supposedly free market) annual 1% Cost, Access, Transparency (CAT) standard or by the 0.5% charged by passive funds and the largest investment trusts. Since the reality is now accepted that future investment performance is not determined by past investment performance (whether good or bad), investors should choose fund managers on what can be quantified, their fees. Of course it is also necessary to assess the manager on other criteria and to buy a fund that has the right risk profile.

Think core and periphery

A proven strategy for investment success with minimum cost is to have low risk buy and hold funds such as passive or index tracking funds or the very large generalist investment trusts (domestic as well as international) as the core holdings in the family section.

Then the more fashionable and higher risk focused and theme funds become the periphery of the investment universe, to be assessed on an annual basis.

Then investors begin to get real value from their IFA. Rather than justifying their existence by buying and selling currently fashionable funds, we can concentrate on our real job. This is to check that the wealth plan remains appropriate despite changing family circumstances, and that the investment of the family money is meeting its agreed objectives.

Please note. This note is based on an article in Money Management magazine written by Russell Taylor