The golden principles of investing

May 2015

The principles for successful investing, in terms of security and return, are little different from the principles of life. Recognise that the world is uncertain, don't rely on the impossible happening, and don't trust strangers or friends. The principles translate into 12 simple rules.

RULE #1	Your career provides your real wealth
RULE #2	Investing is not speculating
RULE #3	Don't invest on the basis of a guess about the future
RULE #4	Be wary of others making your decisions
RULE #5	No system or model works as well in the future as it did in the past
RULE #6	Don't borrow to invest
RULE #7	Don't buy things you don't understand
RULE #8	Don't become dependent on one asset, or one organisation, or person.
RULE #9	Create a portfolio that stands the test of time to achieve your objectives
RULE #10	Keep some assets outside the country in which you live
RULE #11	Beware of tax-avoidance schemes
RULE #12	When in doubt, think safety

RULE #1 Your career provides your real wealth

"Don't assume that wealth can be rebuilt"

For most people, wealth comes from their savings. While a few people will make a fortune through investment, most people make a lot more money from their job. This does not mean that managing your investments is not important, as the investment return can be significant. But it is best not to take risks with complex investments in the hope of multiplying the capital quickly. Any investment plan should focus on protecting what you have built up for when you need it, and protecting it from loss and government intervention.

Given that, what people have comes from, what they have earned, you should not assume that you could earn it again, if you lost it. Some could but most can't. Most people should treat what they have as though they could not earn it again and not take chances with wealth on the assumption that it could always be rebuilt.

RULE #2 Investing is not speculating

"Don't take all your savings to the playground."

When people invest, they should accept and be happy with the general return the markets pay investors. When people speculate, they attempt to beat this return, i.e. to do better than other investors, by timing, forecasting, share selections or manager choice. There is an implied belief by speculators that they are smarter than most other investors. There's nothing wrong with speculating – provided that it is done with money they can afford to lose. But the money that's important shouldn't be risked on the chance of beating other investors.

If you want to try to beat the market, set up a second – separate – portfolio with which you can speculate to your heart's content. But make sure this portfolio contains no more of your wealth than you can afford to lose.

RULE #3 Don't invest on the basis of a guess about the future

"No one can predict the future"

What happens in the economy and the investment markets are as a result of the decisions of millions of different people in different situations with different goals and abilities. Economists, analysts and advisers have no more ability to predict (guess) the future actions of human beings than psychics and fortunetellers. As a result, events rarely unfold as a specific person is so sure they will, but will unfold as someone will have guessed. Someone will make a correct guess the question is who. You need to ensure that you are not seduced by the success of one person's guess and believe it will happen again. No one can consistently predict with accuracy what shares, interest rates or inflation will do next year, or how the economy will perform.

RULE #4 Be wary of others making your decisions

"Don't trust strangers."

Many people lose money because they give someone (a financial adviser, a relative, an accountant, or a lawyer) the authority to make decisions for them. The adviser may take too many chances, to chase returns, be dishonest, or simply be incompetent. No adviser can be expected to treat other people's money with the same respect they would for their own. In practice, investors don't need a money manager. Investing becomes complicated and difficult to understand, only if the investor tries to beat the market. You can preserve what you have with only a minimum understanding of investing. Therefore, never give anyone total signatory authority over money that's precious to you.

Investment advisers can provide valuable assistance. A good adviser helps people understand how to do things that they need to do. They focus attention on potential risks that may have been overlooked and identify alternate strategies. But no one can guarantee to always get it right at the right time and, trying to do so, is fatal to a portfolio for most (but not all).

RULE #5 No system or model works as well in the future as it did in the past

There are many systems that seem to have signalled correctly where to put money in past periods. However, the systems are rarely as good for the next period. Trading systems are also self defeating. When one system is incredibly successful, everyone will start using it and that will cause prices to move until all advantages are cancelled out. Alternatively, the market will behave differently making it less affective.

RULE #6 Don't borrow to invest

History shows that when someone loses their wealth, it's almost always because they used borrowed money. In some cases, they borrow money directly. In other cases, they borrow indirectly because the investment purchased was leveraged. Using debt puts an investor at risk to lose more than their original capital. If all investments are made on a cash basis, it's almost impossible to lose everything.

RULE #7 Don't buy things you don't understand

> "If all your friends drove off a cliff, would you have to do it, too?"

Don't invest in any asset or product that you don't understand. If you do, you may find something happens that you were unaware of. This is particularly true for complex products and investments based on the latest trends.

RULE #8 Don't become dependent on one asset or one organisation or person

Most investments have a good year and a poor year, as they move around the average. Precious metals ruled the roost in the 1970s while shares and bonds were in disgrace. But then gold and silver became the losers of the 1980s and 1990s, while shares and bonds multiplied their value. No investment is good for all periods. Even government bonds can lose real value during times of inflation. Also don't rely on any single organisation to protect your money. All companies are subject to take over merger or failure. The company you think will keep your money safe might not be there when you're ready to withdraw your savings.

RULE #9 Create a portfolio that stands the test of time to achieve your objectives

> "Don't put all your eggs in one basket."

For your money, that you need to take care of you for the rest of your life, set up a simple well diversified portfolio. The portfolio should align the return characteristics of the investments, with your expenditure needs – we call this the bucket approach. You then only need to rearrange the investment mix, even if your outlook for the future changes, when the pattern of your expected expenditure changes. This portfolio should protect your expenditure no matter what the future brings, including an event that would be devastating to an individual element within the portfolio.

RULE #10 Keep some assets outside the country in which you live

Don't put everything you own where your government's policy can significantly influence it. By having something outside the immediate impact of your government, you'll be less vulnerable to change in government policy.

RULE #11 Beware of tax-avoidance schemes

> "Don't get into situations you can't get out."

Any investment that relies on tax to make it competitive, poses greater risks than appear on the surface. Where tax is involved, there will always be the risk of regulatory change to protect the tax base. Tax rates are low enough in NZ that you might gain very little from the risk and effort of constructing elaborate tax shelters. A great deal of money has been lost by people who hoped to beat the tax system. The losses came from investments that provided special tax advantages, but didn't make economic sense and therefore were unsustainable.

RULE #12 When in doubt, think safety

If you don't invest in one particular investment, don't worry, another investment will come along. It is better to be safe than sorry and good investments do not cease to be good. Remember, if you lose your savings just once, you may never get a chance to replace them.

The rules of safe investing are little different from the rules of life: we live in an uncertain world, the impossible doesn't happen, and never trust strangers. If you apply to your investments the same attitude that produced your present savings, you needn't fear that you'll go broke.