Worried about 'The Market'? Don't be.

Four Rules for The Calm Investor

How to Stay Relaxed as you Build Long Term Wealth

Roy Walker

Edition 2 August 2020

"Four Rules for The Calm Investor – How to Stay Relaxed as You Build Long Term Wealth"
Edition 2. Published 8th August 2020.
Author: Roy Walker M.Eng., MBA(Fin)., DIC.

Preface

From time to time, most investors encounter emotional highs and lows. The elation of seeing an investment soar. The stress of deciding whether to stay invested during a downturn. The regret of not having purchased earlier. The fear of missing out when others seem to be doing better than you are. The long-term unease about whether you are doing the right thing.

An accepted truism of investing is that 'our emotions are our own worst enemy', but in today's world our emotions are constantly assaulted by gloomy economic news and scary financial headlines. So, how can an investor stay calm, relaxed and confident?

Calm investing is like a stage-magician's conjuring trick. Observers may be in awe to see the feat performed, but once the secret is revealed, we think to ourselves 'Oh, is that all there is to it?' When we understand the basic principles, the mystery dissolves.

What the ordinary investor really cares about is this: *If the worst happens, will my money still be there, when I want to take it out?*

A solid, comforting, *Yes* response to this question does not require mirrors, secret compartments, or sleight-of-hand. The purpose of *'Four Rules for the Calm Investor'* is to take away the mystery and expose how the trick is done.

Contents

What Is Investing?

Investing is not short-term speculation. We're not trying to outguess or 'time' the market, nor hoping to be smarter than other investors. With millions of market participants, instant communications, and regulated information flows, we can't expect to discover secret gem investments that other investors don't know about. For any given set of market conditions, share prices are generally 'fair', because they reflect the combined expectations of the universe of investors.

When we buy shares, either directly or indirectly (through investment funds), we are owning a piece of a business, and therefore entitled to a share of profits (dividends), plus appreciation of capital value. In other words, we are 'hands-on' participating in, and benefiting from, the never-ending growth of the global economy.

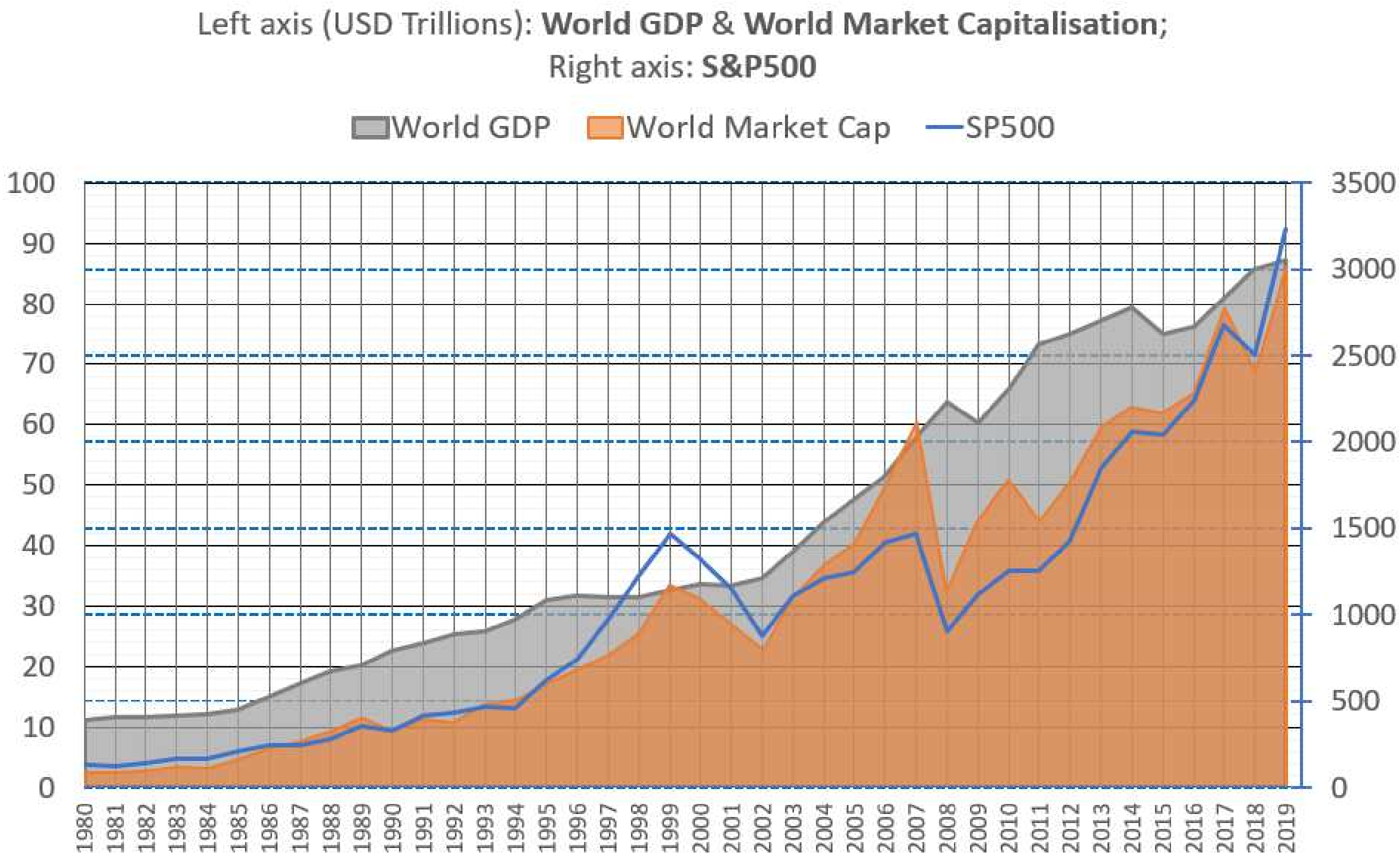
The world economy (GDP of all countries) has grown by 678% since 1980. Meanwhile, the total value of listed companies worldwide (total market capitalisation) has grown by 3340% since 1980.

Global Growth Is Persistent

All economies have cycles of growth and downturns, but in the long term, global economic growth is relentless. Historic decisions by presidents and ayatollahs fall into insignificance when compared with enduring trends in population growth, technological improvements, economic efficiencies, industrial productivity, advance of emerging countries, and global trade.

The S&P500 index, which tracks the largest 500 companies in the USA, has grown by 2280% since 1980 to end of 2019. Global economic growth is enduring, and markets reward patient investors.

YEAR ending	**World GDP (US$ trillion)**	**World Market Cap (US$ trillion)**	**S&P500**
1980	11.220	2.501	135.76
1985	12.787	4.627	211.28
1990	22.603	9.380	330.22
1995	30.865	17.088	615.93
2000	33.582	30.963	1320.28
2005	47.459	40.440	1248.29
2010	66.037	50.942	1257.64
2015	75.003	61.902	2043.94
2019	87.265	86.015	3230.78
Growth	**678%**	**3340%**	**2280%**



The Secret to Stress-Free Investing

The chart above shows the sheer power and irrefutable logic of a long-term view when investing. In the short term however, there will always be market volatility. We should ignore it. For stress-free investing, all we need is to be comfortable that:

(i) there's zero chance of losing money we might need in the near term; and,

(ii) we have enough exposure to a broad range of assets to achieve our desired long-term growth.

That's it.

Why Most Investors Use Investment Funds

Most money invested in companies is through investment funds (a generic term that can encompass mutual funds, unit trusts, European-style SICAVs, and exchange traded funds) and institutions (like pension funds).

Only a relatively small percentage of shares are held by private investors. For example, in mid-2020, only 13% of shares in Alphabet (Google) are held directly by individual shareholders. For Amazon, that figure is 12%. Microsoft, 6%. Tesla, 31%. Apple, 1%.

There are several reasons why private investors prefer to invest in funds rather than directly into shares.

For example, suppose you thought the biotechnology industry had good prospects. One way to invest would be to identify some biotech companies, research them, and then buy shares in perhaps three of your favourite firms. This would certainly get you *exposure* to the biotech sector, though you'll incur transaction costs for each of the three purchases. But you'll also have *concentration risk*, because if one of those firms collapses, you'll have lost a third of your money.

Remember too, that when you buy shares, someone else is selling them. Is your research better than theirs? Are you doing the right thing at the right time? And how long should you hold for? How often will you review, to check you're still betting on the right horse?

Another way to gain exposure to the biotechnology sector would be to find an investment fund that specialises in it. An investment fund is a *collective investment*. When you invest your money into the fund, it is pooled with money from thousands of other investors. The size of the fund could be £500m or more, and the fund could have holdings in 50 or more companies. Hence, in one transaction, you are reducing risk and cost-effectively investing into a wide range of the world's top biotechnology companies, selected by the experts.

By using investment funds, you can focus at the strategy level: '*Do I want to put 5%, 10% or 15% of my money into biotech?*', instead of worrying about the detail: '*Which three of the top fifty biotech companies do I want to buy?*'.

Two Types of Investment Fund – Active and Passive

Investors use investment funds because they provide a convenient way to implement strategy without having to worry about detail at the level of individual stocks.

If the decisions about which company shares a fund should buy or sell are made by human judgement – i.e. the fund management team – then the fund is called *actively managed*. 'Leaving it to the experts' can be highly beneficial for the ordinary investor who is short of time or expertise.

For a *passive fund*, on the other hand, the decisions on which company shares to buy or sell are determined by a set of rules – i.e. those buy and sell transactions follow or 'track' a *rules-based* index. Popular indices include the FTSE100 (UK) the S&P500 (USA) and NIKKEI225 (Japan). For example, if a USA company grows so large that it becomes one of the top 500 largest firms in the US, then it will be automatically promoted for inclusion in the S&P500 index, and the smaller firm that it replaces will be relegated out. An investment fund that tracks the S&P500 will carry out identical transactions.

It is important to remember that passive funds are designed to match, not beat, the performance of their benchmark; whereas, actively managed funds are intended to outperform their benchmark.

Which Is Better – Active or Passive?

In developed markets such as USA, there has been a gradual rise in interest in passive investment funds over the last decade or so. Findings published by Bloomberg suggest that in the USA equity markets, the ratio of active-to-passive funds in terms of assets is about 8 to 1 in dollar terms. Globally, the ratio of active-to-passive equity investing is about 15 to 1 in dollar terms. If you include both equities and bonds, the global ratio of active-to-passive investing is about 60 to 1, in dollar terms.

Arguments for the use of passive funds include:

- Research shows that in developed markets, the majority of actively managed funds do not beat their benchmark in the long run (the benchmark usually being the relevant index).
- Passive funds can be cheaper to implement because they don't need to pay the salaries and overheads of a management team.

These are both extremely good reasons to consider passive funds for implementing the *core segment* of any portfolio.

Arguments for the use of active funds include:

- A passive fund will never do better than the index tracked, whereas an active fund brings to bear the expertise of the management team, to deliver potentially better returns.

- There are some investment sectors where the range of indices available are poor (for example in ethical investing), or do not properly reflect the growth opportunities that exist.

For example, the ‘MSCI Asia-Pacific excluding Japan’ index, by definition covers a broad region – company stocks are included automatically if the firm is of a certain size (market capitalisation). In contrast, an active management team has discretion to include any company in the fund, based on it’s merits, which may be unconnected with the firm’s market capitalisation. Stock-market histories are full of small companies becoming world-leaders, whilst older and larger firms fall into relative insignificance.

Neither active nor passive investing is inherently better than the other. Both investment strategies have a role to play. Investors who blindly follow one principle, to the exclusion of the other, unnecessarily remove potentially great investments from their universe of options available.

As a side note, rules-based index-trackers are usually a type of fund known as exchange traded funds, and so the term ‘ETF’ has become synonymous with ‘index-tracker’. But it is important to be aware that there are also actively managed ETFs, in the same way as there are passively managed mutual funds and unit trusts.

Why We Benchmark Using Stock Market Indices

There are always new investment funds being opened, and old ones being closed. Of the universe of investment funds available today, the proportion that existed more than twenty years ago is very small.

This can make it difficult to carry out any meaningful back-testing, which is the analysis of how a portfolio being constructed today would have performed historically over time, if we had started it years ago.

Whether our ultimate fund choices are active or passive, market indices are extremely helpful when selecting investments. And fortunately, there is an enormous range - covering every asset class we might want to consider investing in. For example:

ASSET CLASS	INDEX
BONDS & FIXED INCOME	
Global Treasury Bonds	FTSE World Government Bond 1-5 Years
Global Investment Grade Bond	Bloomberg Barclays Global Aggregate Bond
Global High Yield Bond	ICE BofAML Global High Yield Constrained
DEVELOPED MARKET EQUITY	
Global Developed Markets	MSCI World
Global Smaller Companies	MSCI World Small Cap
USA Large Cap Companies	S&P 500
USA Small & Mid Cap Companies	Russell 2000
ASIA PACIFIC	
Asia-Pacific	MSCI AC Asia Pacific ex Japan
EMERGING MARKETS	
Global Emerging Markets	MSCI Emerging Markets
PROPERTY	
Global Property	FTSE EPRA Nareit Developed

Indices are commonly used as benchmarks of performance for each market segment, and often have decades of historical data. Moreover, although they have no predictive powers, because indices are rules-based, they will tend to behave in the future similarly to how they behaved in the past, for equivalent market conditions. This makes them invaluable when constructing and analysing a proposed investment portfolio:

(i) firstly, we select the indices to include in our desired portfolio;

(ii) then secondly, we choose the investments to best track those indices.

Four Rules for The Calm Investor

As promised in the Preface, when we discover how the trick is performed, we may end up thinking, '*Oh, is that all there is?*.

Well, *Yes*. Investing is straightforward, and worry-free, so long as we follow four basic rules:

Rule No.1 – Ensure Your Near-Term Cash Requirements Are Covered.

Rule No.2 – Broadly Diversify Your Investment Portfolio.

Rule No.3 – Set Your Asset Allocation to Match Your Investor Risk Profile.

Rule No.4 – Don't Worry about the Headlines or The Market's Manic Fluctuations.

Calm Investor Rule No.1 - *Ensure Your Near-Term Cash Requirements Are Covered*

Simply put, cash you *know* you'll need in the next couple of years or so (for example, a deposit for a property), should not be invested in shares (equities). Instead it should be held in bank term deposits, money market funds, or government bonds (treasuries).

That way, if there's a market downturn in the short term, you know you'll have all the funds you need, regardless of what's going on with the rest of your investment portfolio.

This applies also if you're approaching retirement, or already retired. Think to yourself, '*In the worst-case scenario, if there is a market crash next week, how much cash would I need to live on for the next two or three three years*?'. Then make sure you allocate enough of your portfolio to holdings that are safe.

Government bonds are a good option. Choose bond funds that are denominated in the currency of your potential expenses. For example, GBP bond funds if you are based in UK, AUD bond funds if you are based in Australia, or USD bond funds if you are internationally mobile.

	Nominal Time Horizon		
	Short	**Medium**	**Long**
Investor Imperative	I will definitely need this money back **within 3 years**.	I **might** need to access some of this money **within 3-10 years**.	This is my future wealth. I **don't need access for at least 10 years**, but I certainly want it to grow nicely.
Investment Solution	Cash, Term Deposits, Government Bonds.	Globally diversified portfolio, with a focus on low-cost index tracking funds; an accent on developed markets over emerging.	Globally diversified portfolio, with a focus on low-cost index tracking funds; more geographic accent on Asia-Pacific and emerging markets.
Risk Control Methodology	Consumer regulation and credit rating of banks and governments.	Select your bonds/equity split in line with your investor risk profile. Allocate enough to high quality bonds to let you sleep at night.	Select your bonds/equity split in line with your investor risk profile. Allocate enough to bonds, but not too much.
Worst Case Scenario In A Market Crash	You **get your money back**.	Your **bond holdings provide the cash withdrawals you need** in the near term. With the rest, go shopping for equities - this could be the best market opportunity for decades.	This is money you don't need right now. **There is no worst-case scenario**. Rebalance your asset allocation to take advantage of the buying opportunity.

Now that you *know* that your cash requirements are covered even if the worst-case scenario happened, you are able to calmly plan the rest of your portfolio holdings.

Calm Investor Rule No.2 – *Broadly Diversify Your Investment Portfolio*

There is not one, single, 'market'. Stock markets are global, and your portfolio should reflect a broad range of assets.

The major categories of investment, called 'asset classes', respond differently to changes in global economic conditions. By making sure you have a good mix of assets, you can reasonably expect that if some of your holdings are temporarily performing badly, then it's likely others will be doing ok.

The chart below lays out in 'periodic table' style the annual performance of key asset classes, since 2006. It's immediately obvious that *we can't predict which will be the best performing asset* class from one year to the next.

Key Asset Classes, Ranked By Percentage Growth, Discrete Years, 2006-2019 (%)

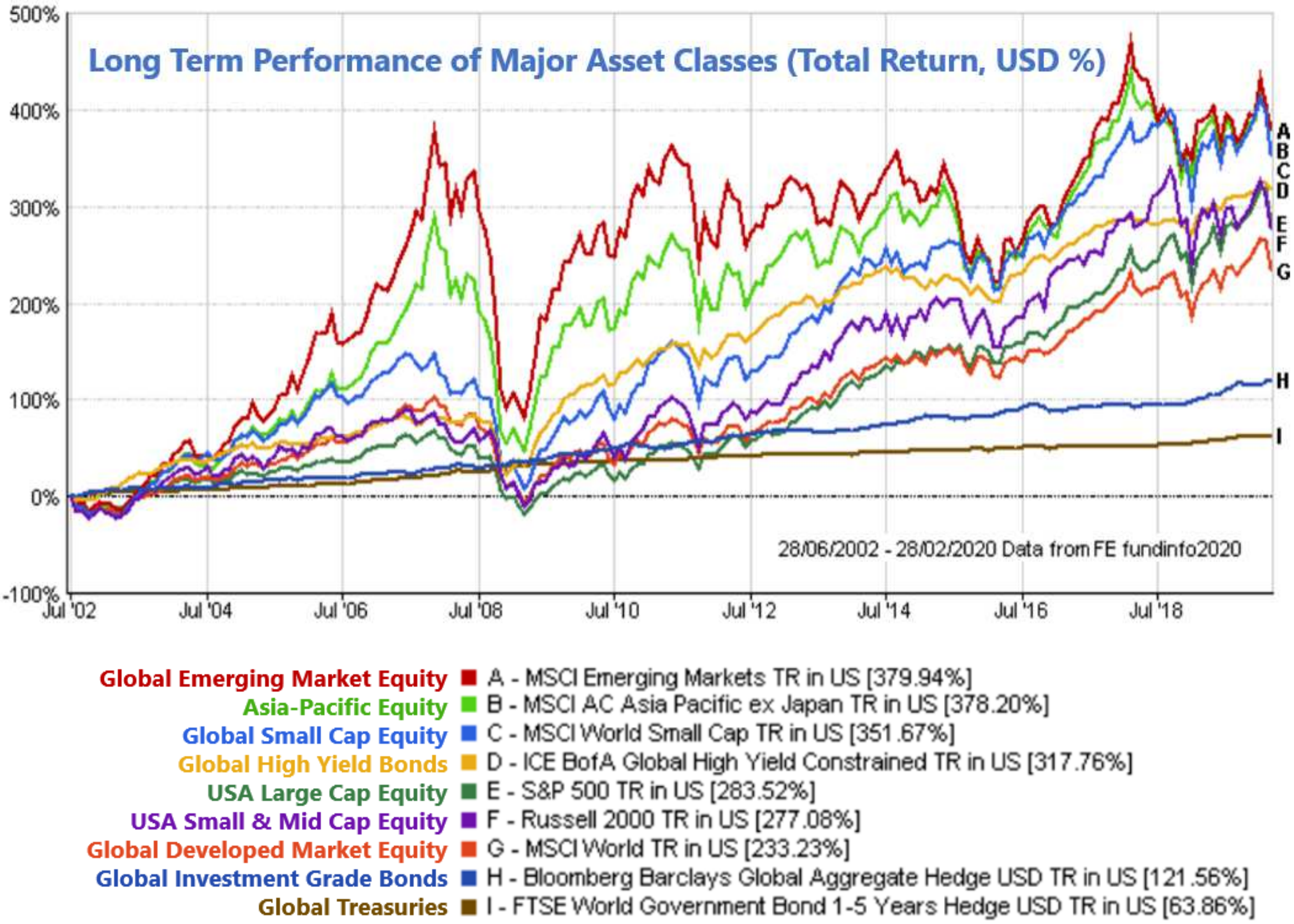
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Highest return	41.81	39.42	6.59	78.51	26.40	5.40	27.73	38.29	15.02	1.02	20.78	37.28	2.12	30.70
	32.39	36.45	5.58	73.22	26.13	2.61	22.31	32.38	12.99	1.00	14.76	36.98	1.76	27.67
	32.15	9.04	-27.48	62.21	19.63	2.31	19.30	31.55	7.59	0.75	12.71	22.66	-3.34	26.19
	20.07	6.30	-34.09	44.12	18.88	1.47	18.22	26.68	4.94	-0.31	11.23	22.40	-4.94	25.00
	17.96	5.33	-37.45	37.13	18.13	-4.55	17.55	7.96	4.50	-0.79	11.19	21.10	-5.63	21.91
	17.20	4.90	-40.71	29.99	14.37	-5.54	15.85	3.67	2.82	-0.87	7.51	14.21	-8.71	19.16
	15.14	3.37	-41.88	26.58	13.76	-6.45	15.83	3.41	1.90	-4.17	6.75	10.36	-11.35	18.44
	12.19	0.79	-48.16	25.55	11.76	-9.06	15.22	0.62	1.90	-4.79	4.06	10.18	-13.86	13.73
	4.09	-1.92	-51.93	5.09	4.61	-15.60	5.72	-0.14	-0.09	-9.37	3.95	3.04	-13.92	8.22
Lowest return	3.64	-7.39	-53.33	2.29	1.99	-18.42	2.10	-2.60	-2.19	-14.92	1.49	1.13	-14.58	3.82

Key:

- Global Emerging Markets
- Asia-Pacific
- Global Smaller Companies
- Global High Yield Bond
- USA Small & Mid Cap
- USA Large Cap
- Global Developed Markets
- Global Property
- Global Investment Grade Bonds
- Global Treasury Bonds

The table also demonstrates how emerging markets stormed ahead in 2017, with 37% annual growth, whilst 'safe and boring' government treasury bonds only delivered 1%. However, the following year, the tables were turned, and bonds were the only positive performing asset, whilst equities took a tumble.

The performance chart below displays the same data and with the same colour scheme. We can now clearly see what we might have guessed from table above: the most volatile asset classes tend to deliver the best returns in the long run. Markets do indeed reward the patient investor.



The above discussion highlights why we need diversification within our portfolio. The selection of the specific proportions of different types of assets is called the *asset allocation*.

How Many Investments Should I Have In My Portfolio?

Investment funds, whether active or passive, can hold shares in a very large number of companies. For example, the Russell 3000 index is a market-capitalisation weighted index of the 3000 largest companies in the US; and the Dimensional World Equity Fund holds shares in more than 11,000 companies all around the world.

Because such funds invest in a huge number of companies, they make it possible to build an extremely diversified portfolio with a small number of fund holdings – for example between 6 to 10 funds - regardless of the overall size of your investment.

Calm Investor Rule No.3 – *Set Your Asset Allocation to Match Your Risk Profile*

Understanding your Investor Risk Profile

Your individual risk profile is important because the potential growth of your investments is determined by the asset allocation of your portfolio.

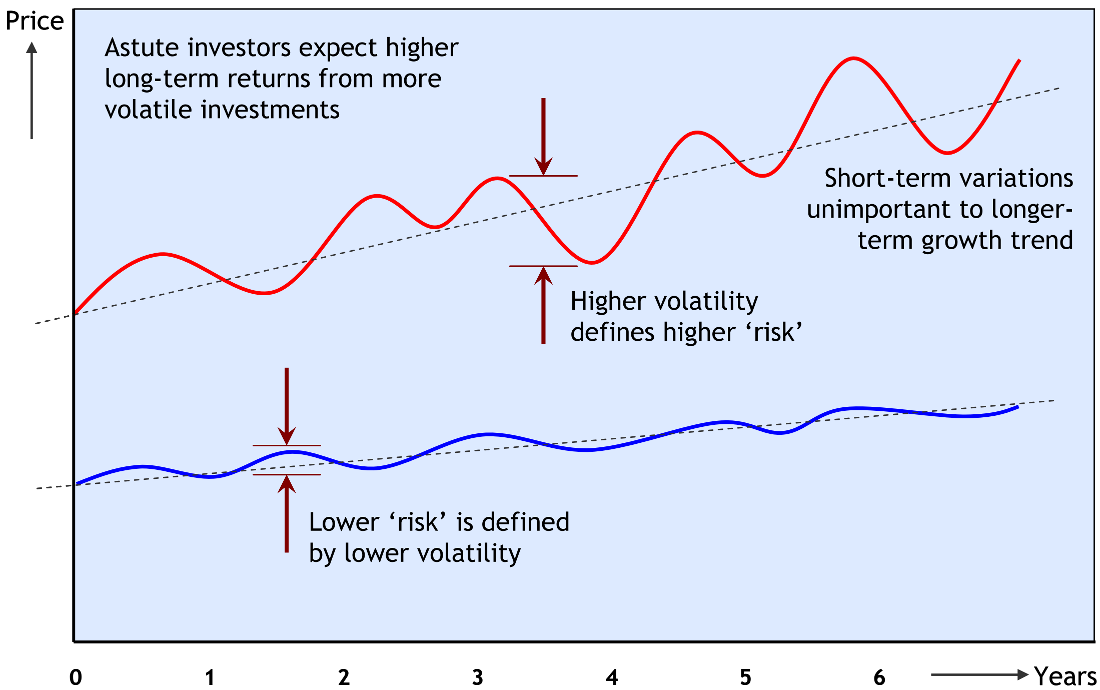
If you hold most of your money in cash, then your chance of losing money is low, but so will be any returns. If you invested most of your money in shares (equities), the chance of losing money in the short term is higher, but in the long term the chances of a greater return are also higher.

By maintaining a portfolio in line with your target asset allocation, you can keep an efficient balance of risk and potential returns, to match your investor risk profile.

Risk Rating of Investments

By choosing large, quality investment funds from the major fund management firms, we can be confident that our money won't suddenly disappear. Many funds that investment professionals recommend are at least USD $1 billion in size, and a fund of USD $200 million might be considered small.

In the investment world, 'risk' is synonymous with 'volatility', and <u>not</u> 'the chance I might suddenly lose my money'. An investor with a long-term investment horizon should ensure that he or she has *enough* risk in their portfolio, to avoid the disappointment with poor eventual returns from an overly conservative asset allocation.



Factors Affecting Your Investor Risk Profile

Regardless of the numerous questionnaires that the financial industry likes us to complete, there is no straightforward and easy way to determine an 'accurate' risk profile. The following factors will have an impact on yours:

1. Your **appetite** for risk
    - your natural tolerance or aversion to a degree of investment risk;
    - note that this is partly in-built, but also learned, because research shows that previous losses tend to make people more cautious in the future; also, investors who've never suffered a major loss may be overly optimistic about the future, or overestimate their investments skills.

2. Your **ability** for risk
    - the size of an investment in relation to your overall holdings and income;
    - the degree to which you can absorb a financial shock.

3. Your **time** horizon
    - all else being equal, a shorter time horizon general implies a more defensive attitude to investment risk;
    - a longer time horizon makes it more likely that long term growth trends will outweigh short term market fluctuations.

4. Investment **methodology**
    - disciplined periodic savings benefit from dollar cost averaging, meaning that a more adventurous investment portfolio might be selected than in the case of a one-off lump sum.

5. Your investment **experience**
    - investors with experience of previous market downturns may be better emotionally equipped to ride out future turbulence;
    - individuals with good knowledge of investment instruments can better assess specific risks in their chosen investments.

At the fundamental level, the overall risk of your portfolio is determined by the split between relatively volatile investments (such as equity), and relatively stable investments (such as bonds and fixed income).

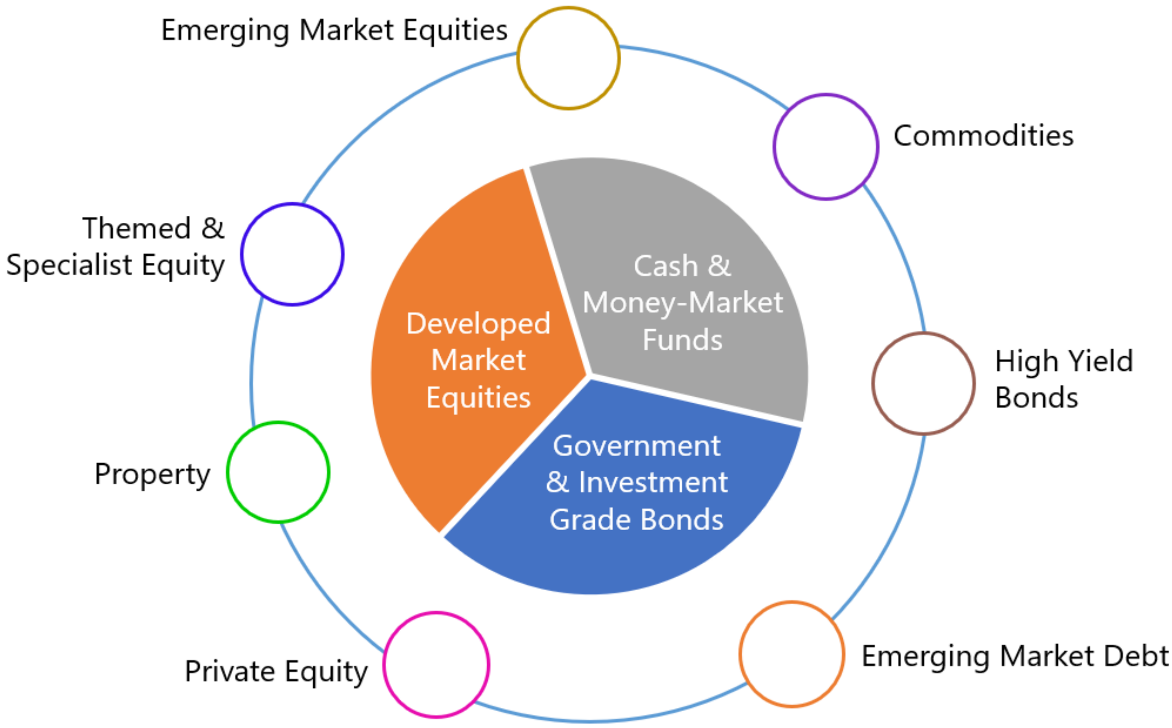
Creating the Right Asset Allocation for Your Portfolio

Building and maintaining a practical investment portfolio is straightforward. Research has shown that *more than ninety percent* of a portfolio's relative performance is dependent on the allocation of funds between the different asset classes, and less than ten percent is attributable to picking specific investments.

This means that getting the asset allocation broadly 'right' for your individual situation is key, so you can be more relaxed about holdings at the granular level.

Core and Satellite Investing

The 'Core and Satellite' investment strategy is a popular and straightforward approach to creating your portfolio.



Role of the Core Segment

The core segment is the foundation of your portfolio, seeking to achieve an appropriate balance between traditional asset classes of cash, bonds and equities (domestic and international developed markets). Investments in this segment are often acquired with a buy-and-hold mindset, typically at least three years and often much longer.

To keep investment costs low, it is common for a major part of the core segment to consist of passively-managed index tracking funds, including ETFs (exchange traded funds). Such funds carry low fees, and track the performance of broadly diversified benchmarks such as the S&P500, or the FTSE100, for example.

Investors can construct their portfolio core by buying individual index trackers directly, typically ETFs. However, since there are over 5000 ETFs traded globally, it can be difficult for a private investor to know where to start. As a convenient option, you can access core strategies through investment funds specifically designed for this purpose. Through a single such fund, you have the opportunity to invest in an expertly chosen mix of cash and cash equivalents, government and corporate bonds, and domestic and global equities.

Examples of funds created to be used as core holdings include Vanguard "Lifestrategy 60%" (with a target 60%/40% equity/bond split), Blackrock "50/50 Target Allocation" (with a 50%/50% equity/bond split), and Optimus "Core Strategy" fund (also with a 50%/50% target equity/bond split).

Role of the Satellite Segment

The satellite segment aims to add enhanced returns to your portfolio by actively targeting specific asset classes - for both diversification and improved growth prospects. Investments in this segment, and the relative balance between them, may be decided upon with a view on current market conditions, and a potentially shorter-term time horizon than core holdings.

Asset classes within the satellite segment might include property, commodities (including energy, precious metals), Asia-Pacific and emerging markets, and themed or specialist sectors such as technology. Many of these asset classes are likely to be of a higher volatility than those within the core segment.

Funds selected for the satellite segment may be either passive index trackers or actively managed investment funds, depending on the rationale for inclusion, and an assessment of the cost-benefit payoff if a fund carries higher than average fees.

The table below shows some sample asset allocations between segments, according to the risk-profile of investor. Please note this is an example only, for the purpose of this discussion ('Bonds' includes 'Cash').

Example Asset Allocation Between Segments

	Core Bonds	Core Equities	Satellite
Adventurous	25%	40%	35%
Moderately Adventurous	35%	40%	25%
Balanced	50%	30%	20%
Cautious	65%	25%	10%
Defensive	80%	15%	5%

Calm Investor Rule No.4 - *Don't Worry about the Headlines or The Market's Manic Fluctuations*

As we already know, the number one enemy for most private investors is our own emotion, which is bombarded daily by noise from the financial press and news channels.

Financial journalists get paid to write articles, or present their shows, several times a week (regardless of whether there's anything newsworthy). This constant news flow might be of general interest to business planners, economists, and day traders, but is barely useful for those whose time horizon is years away. Ninety-nine percent of news items that are covered by the daily financial press are irrelevant to the long-term investor.

Here's a useful analogy - consider the purchase of your main home. Buying a property is one of the most significant financial decisions that people make, and represents one of our largest investments. When we buy our home, we know we are 'in it for the long term'.

So, do we check property prices daily to see what our home is worth today? Nope. Nor weekly. And most people don't even check monthly (unless they are thinking of moving home), because we know that *in the long run, prices go up*.

We should consider our investment portfolio with the same mindset. Generally speaking, today's headlines have little or no bearing on the value of our portfolio in future years. And we certainly don't need to be checking share prices daily - that just leads to stress about the day to day volatility, which we are better served by ignoring.

If we have followed the first three Rules for the Calm Investor, then the fourth is easy.

We just remind ourselves:

(i) that there's zero chance of losing money we might need in the near term; and,

(ii) that we have enough exposure to a broad range of assets to achieve our desired long-term growth.

Rule No.1 – Ensure Your Near-Term Cash Requirements Are Covered.

Rule No.2 – Broadly Diversify Your Investment Portfolio.

Rule No.3 – Set Your Asset Allocation to Match Your Investor Risk Profile.

Rule No.4 – Don't Worry about the Headlines or The Market's Manic Fluctuations.

About the Author

Roy Walker is Regional Manager Abu Dhabi for GWM Financial Planning Ltd. GWM is a UK-headquartered international financial advisory group, with approximately GBP £1 billion of assets under advice.

Originally an engineer, Roy took his MBA in Finance at Imperial College, London, in 1992. Following several years in the corporate world, Roy moved into financial planning and investment management for high net worth and international clients. He worked for many years in South East Asia, including seven years in Singapore, where in 2018 he was awarded "Best Financial Planner (Open Category)" by the Financial Planning Association of Singapore. Roy now lives and works in the United Arab Emirates, personally advising clients worldwide.

roy.walker@gwm-intl.com
www.roywalkerwealth.com