The Three Problems of Investment

“He quits well-paying job to invest full-time” were some of the arresting words in a recent newspaper article about investing.

I do not know the man personally but judging from his portfolio of leveraged trading in commodities, I seriously doubt he is investing. The tell-tale sign he is not investing is that he declared his confidence in returns of six to eight per cent per month. Consider this: if I invest $1 into something that provides six per cent interest per month, my $1 would grow to $1,288,580,323 after 30 years! Looks like I found the miracle solution to saving enough for retirement! In fact, I think I will have more than enough money!

Back to reality. That person was merely speculating. The difference between speculation and investment is that the former is concerned with large returns over the short term period while the latter is concerned with gaining reasonable returns over a long period of time. Unfortunately, most people are neither good at speculating nor investing.

As a professional investment adviser, I advocate investment as the method of gaining good returns (I don’t think there is a speculation adviser.) I list three reasons why people are not doing well with their investments.

PROBLEM NUMBER 1: TIMING THE MARKET

Attempting to time the market is one of the most serious mistakes an investor can make. Many investors attempt to do this unknowingly, due to emotions such as fear or greed. Questions such as “Is this the best time to enter the market?” or “Should I sell my investment today?” or “Is market valuation cheap?” are

PHOTO WWW.123RF.COM

symptoms of the market-timing syndrome. Consider this argument: if I hear that today is a good day to enter the market, thousands or millions of others would have already heard this before me. Before I could enter the market, those who had heard earlier would have bought on the news. Market price would have been corrected before I could act. This means it will be too late to enter the market. A similar argument goes for selling an investment. The market price would have been corrected before I could sell.

Whenever we see the market going up, it is inherent in human nature to chase after it. Whenever we see the market going down, it is also human nature to run away from the market due to fear. Using the MSCI World Free Net (US$) from 1970 to August 2006, for every month with a positive return, there was a 63.24 per cent chance of another positive return the following month. Also, for every negative month, there was a 60.48 per cent chance of a positive return the following month. These statistics show that the odds are against the investor staying away from the market. In fact, cashing out is associated with high opportunity cost.

For the past few years, we have witnessed a bull run in the world stock market. The MSCI World Free Net index has been up 10.02 per cent per annum for the past five years. Yet the chart above shows disastrous consequences of missing out on the biggest days during this period. By missing out on the 40 best days, its return becomes a disastrous -8.73 per cent per annum. I suspect that most investors' returns are closer to the latter rather than the former.

PROBLEM NUMBER TWO: MISUNDERSTANDING INVESTMENT RISKS

There are three misunderstandings with regard to risks. The first is equating risk with permanent losses. Technically, investment risk has to do with the fluctuation of one's investment portfolio and is often measured as standard deviation. For the lay investor, it is sufficient to know that such risk is associated with the worst-case annual return. Such loss is usually not permanent.

The second misunderstanding is that a person's risk appetite is static. Risk appetite is a measurement of a person's ability to take risks. My experience is that risk appetite actually changes according to the investment climate. A person might rate himself as an "aggressive" investor during the bull market but could very well rate himself a "conservative" investor during a bear market. As an adviser, I am more concerned with the person's risk appetite during the bear market. If a person is unable to stomach losses during a bear market, it means he will attempt to cash out of an investment, thereby attempting to time the market. As we have seen from the first problem, attempting to time the market has disastrous consequences. Here lies the flaw of the risk appetite scoring system. Such a system captures the risk appetite of a person at a particular moment. However, this risk appetite could differ considerably during market fluctuation.

The third misunderstanding is that high risk means high return. This assumption is true for market risks but not for non-systematic risks such as fraud, mismanagement and insider trading. These non-systematic risks are particularly prevalent in individual stocks and bonds. A person could very well suffer a permanent loss over a single stock or bond. Recent examples of companies going into bankruptcy due to these problems are testimony to the fact that not all risk equates with higher returns.

PROBLEM NUMBER THREE: BUY AND HOLD IS THE ONLY STRATEGY USED

Someone tells me this predicament: "Why is it that whenever I invest, the market will go down the following day? Why is it that whenever I sell, the market goes up the next day?" What this person is really seeing is that the market moves in random fashion on a short-term basis. However, most markets move upwards in the long term. Investment has to do with taking advantage of the long-term upward trend while ignoring short-term random movements. Let me introduce other strategies that take advantage of short-term trends.

Consider the Asian markets. The crash of July 1997 was popularly named the Asia Financial Crisis. If you had invested a lump sum at the beginning of 1997 in the Asian market and "held" it, you would have had to wait till end of 2004 before you could break even. This represents eight years of waiting! This is what we call regional risk. To mitigate regional risk, it is prudent to diversify into more regions. While the Asian market returned -34.20 per cent and -4.42 per cent in the years 1997 and 1998 respectively (as represented by MSCI AC Asia Pacific ex Japan US$), the US market returned 33.6 per cent and 28.58 per cent in those two years! A diversified portfolio could possibly have been in the black during the Asia Financial Crisis. However, most people suffered severely due to lack of diversification.

> **"The difference between speculation and investment is that the former is concerned with large returns over the short term period while the latter is concerned with gaining reasonable returns over a long period of time. Unfortunately, most people are neither good at speculating or investing."**

Another strategy is to use dollar cost averaging. While it took eight years to break even for a lump sum investment made at the beginning of 1997 in the Asian market, a person who had invested a fixed sum on a monthly basis in the same market for the same eight-year period would have reaped an absolute profit of 37.16 per cent. The reason why dollar cost averaging works is because it forces investors to buy more during market lows. **SI**

Wilfred Ling is an adviser with Promiseland Independent. He is licensed by the Monetary Authority of Singapore to provide investment advice to individuals. The author can be reached at wilfred.ling@promiseland.com.sg or 91710940.