Summer 2019

Two common errors investors make... and how to overcome them

Understanding compounding and portfolio rebalancing could have helped investors overcome emotion-driven decisions during a turbulent six months for stock markets. Duncan Lamont shares why.

The past six months have highlighted two common errors that investors frequently make - misunderstanding the way investments compound over time and letting emotions cloud our judgement. With the right knowledge, both can be remedied relatively easily.

The impact of compounding

The US stock market fell by 13.7% in the fourth quarter of 2018 but has since rallied by 13.9% this year so far (as of 12 April 2019). 13.9 is more than 13.7 so that means investors are up overall, right? Wrong. Investors are actually down by 1.7% over this period.

A 13.9% return on $100 would indeed lead to a gain of $13.90, if the investment was made at the start of 2019. But, in this situation, a $100 investment made at start of October 2018 has fallen by 13.7% by the year end, to $86.30. As a result, you have less capital to earn that 13.9% return on. Instead you only make back $12.00 (13.9% x 86.30). This takes your final amount to $98.30.

While this may seem a bit abstract, understanding the difference between arithmetic returns (i.e. adding them together) and geometric returns (i.e. compounding them together over multiple periods) is key in preparing yourself to make informed decisions.

Keeping your investments balanced

The end of 2018 was a difficult time to be investing in the stock market.

Stocks fell sharply, sentiment was rock bottom and the immediate emotional response would have been to sell.

However, during this time earnings-based measures of valuations had fallen to their cheapest levels for several years and markets rallied sharply from that low.

With hindsight, it would have been a great time to invest. But, we are hard-wired as emotional beings so overcoming the urge to sell is not easy. One way

tileawealth
financial services

Tilea Wealth Financial Services
Unit 4, 633 Logan Road
Greenslopes QLD 4120
PO Box 162
Carina QLD 4152
T 07 3160 2600
W tileawealth.com.au

to take emotion out of the equation entirely is to follow a rebalancing policy.

Rebalancing starts with deciding what percentage of your investments you want in the stockmarket, bonds, cash etc. If one asset class outperforms the others, its weight in the portfolio will rise. A rebalanced portfolio would then sell some of the specific winner, to bring its weight back to where it was initially intended it to be and reinvesting the gains in assets that have under-performed.

Remember to speak to your financial adviser before deciding if this is right for you. This is essentially "buy low- sell high" in practice.

Source : Schroders

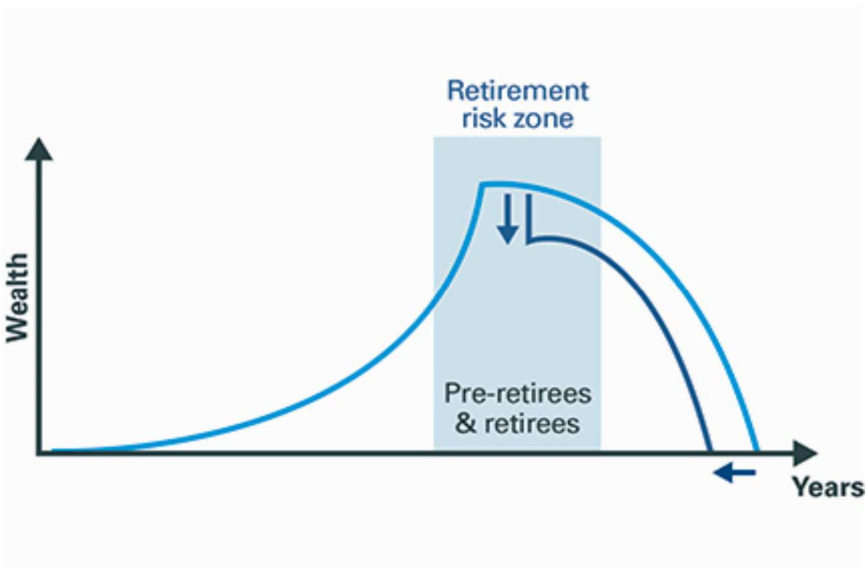
Be conscious of how you invest in equities during the 'retirement risk zone'

In the years just before and after you retirement is a period known as the retirement risk zone. It's a decade when your nest egg is likely to be at its highest.

There is probably no other time when your financial wellbeing is at risk to a sudden decline in value of your nest egg – simply because it's at its peak balance.

This is known as sequencing risk. A 5% decline in equity markets during this zone is not uncommon, and it can have a huge impact and shave years off a retirement portfolio, simply due to bad timing. Put it this way, it's worse having a bad performing year when you have more money, than when you have less.

This period is shown in the chart to the right.



It is during the years in this retirement risk zone that financial advice offers its greatest value.

And this period demonstrates why portfolio strategy for retirees is more about protecting capital as much as possible (and that still means investing in equities), and less about shooting the lights out with total return performance.

How do you get your equities?

There seems to be three broad camps when it comes equity investing:

- Direct equities
- Accumulation strategies
- Equity income

Direct equities

A direct holding means an investor holds shares in their own name, most likely via a broker or even a Separately Managed Account.

Accumulation strategies (active or index funds)

The accumulation strategy describes traditional Australian equity approaches designed for pre-retirees that seek to maximise total return and capital growth. In pursuit of wealth, accumulation investors are generally happy to accept a reasonable level of risk volatility in their capital, because they have time to recover and wages can help top up any shortfall.

Even a strong performing accumulation equity fund can still be highly volatile.

And it may not provide adequate refuge from sequencing risk during a decline when it hurts most – the retirement risk zone years when a super balance is highest.

Equity Income

Equity income funds are designed to provide a lower level of risk than accumulation strategies and provide a higher amount of their return as dividend income. Generally, you would expect an equity income to have lower capital volatility than an accumulation fund, and higher income at the same time.

The trade-off is that equity income funds tend to have lower long-term capital growth potential.

Source: Challenger

Gross Domestic Product (GDP) - What does it mean?

What does Gross Domestic Product (GDP) mean? Well, it depends who you ask. If you ask the renowned artist Banksy, it is a means by which trademarks can be registered.

His store of the same name in London exists so that he has a physical address with which to trademark his artworks, without needing to also register (and hence reveal) his true identity. The store stocks an eclectic mix of the most 'gross' homewares the country has to offer.

If you ask an economist, however, the answer to the question is more prosaic! GDP is the main summary measure of the national accounts as compiled, in Australia, by the Australian Bureau of Statistics (ABS). It seeks to quantify local production – this is the 'D' in GDP. Taking the June quarter numbers as an example, they highlight three key points:

1. The value of production: this is the 'P' in GDP. The value of the goods and services used in the production process are deducted so as to avoid double counting, and in the 2nd quarter of 2019 the value of this production was $496bn.

2. The income generated by this production. Australia's gross disposable income in the year to September 2019 was $482bn, and the shortfall with the figure above is mainly due to income paid to foreigners.

3. Of the $482bn of income generated by the Australian economy over the quarter, $368bn was spent on final consumption. After allowing for depreciation of fixed assets of $85bn, this left net saving of $29bn.

Why is Gross Domestic Product measured, rather than simply 'Domestic Product'? The 'G' of course does not correspond with Banksy's definition! Rather, it signifies that the gradual using up of fixed assets like buildings (i.e. depreciation) is excluded. In fact, one criticism of GDP as a concept is that is excludes much more than this. As a result,

GDP measures attract criticism from many in society. The national accounts were, however, never designed to be a fully comprehensive measure of well-being. They cannot measure things like the cost of excess pollution, for example. Nonetheless, GDP is the most comprehensive measure we have for now and despite its shortcomings, it does present wealth of interesting information about Australia's current economic performance.

Source: Perennial

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