

Larry Jacobson



Strategic Investing

This article has been written with the permission of Keith Matthews, author of *The Empowered Investor*.

I recommend each reader purchase that book. To obtain more information on *The Empowered Investor*, please visit www.empoweredinvestor.ca.

Before we can understand the strategy of investing, we must understand the most common mistakes made by investors. Thanks to work in behavioural science, many recent papers have been written on this phenomenon. The most common errors investors make are as follows.

- Lack of an investment plan
- Not aligning their investments with their personal objectives
- Miscalculating, or not calculating at all, their investment time horizon
- Trying to profit by timing the market
- Buying high and selling low
- Lack of proper diversification
- Building portfolios based on bold predictions
- Letting behavioural biases get in the way

1. A solid investment plan, simply stated, is an individual's own Investment Policy Statement, commonly referred to as an IPS. This is where your investment philosophy and your time horizon are outlined. The IPS can be as simple as a one-page statement or it can be as long as desired.

The most important thrust of your IPS is the statement it makes about where your investments are leading you and how and why investment decisions are made.

Timing the market is generally for losers.

Simply stated, a good investment plan maps out risks associated with your personal plan, personal longterm investment objectives, time horizons, diversification decisions, tax consequences, and finally investment philosophy.

The obvious is that the document must be read periodically and updated to reflect life-related events or changes to personal goals.

2. One of the most common pitfalls is failure to align time horizons with personal objectives (be consistent). The IPS helps overcome this common error.

For example, if one of the main goals is to have enough funds available in 5 years to pay for a child's education, those funds should not be put into nonliquid investments such as real estate or equity-driven vehicles, because there is a likelihood of needing the funds at a time when the market may be depressed.

Therefore, a more likely scenario is to invest those funds in a portfolio of bonds or other fixed-income vehicles that can be liquid in the timeframe when the child is in university.

On the other hand, if the time horizon is long term—with a goal of buying a cabin 20 years hence, there is the flexibility of utilizing investments that have more volatility and risk, such as equities.

3. Miscalculating your time horizons is a common pitfall. We all have the notion of Freedom 55, but is it realistic? A good method of planning for the "golden" years is to try to juxtapose a budget when you retire, keeping in mind you probably won't be saving but spending.

Once you know how much annual income you will need, you can quantify your longtime capital requirements.

4. Timing the market is generally for losers. The evidence to support that is overwhelming. There have been so many studies done on investors who chase returns versus investors who maintain their positions over the long term.

Unquestionably, most studies conclude that trying to pick the bottoms and the tops just does not work. I often quote the Dalbar study (see my article in the Winter 2008 *Scrivener*), which suggested that during an 18-year period from 1987 to 2005, for the average investor who timed the market the portfolio grew about 3.53 percent.

This type of investor would be buying and selling based on headlines. In contrast, for those who invested for the long term, the portfolio had about a 9 percent annual return. Don't chase returns. Allow returns to come to you.

5. Many investors lack proper diversification. While highly concentrated portfolios can lead to significant gains when everything works, they also can expose us to significant losses. People are human; we generally concentrate far too much on gains and far too little on losses. Therefore, like gamblers, investors who (endeavour to) time the market are looking for the next "big hit."

A more constructive approach would be to diversify.

Diversification strategy does require effort and thought.

- How much of the portfolio should be in fixed income?
- How much should be in cash?
- How much should be in equities?
- Should we buy a portfolio of stocks or a managed portfolio by way of a mutual fund?

All those questions do require some concentrated study, and this is where it may be useful to retain a Registered Financial

Planner (RFP) trained and experienced in leading investors through the maze of options and opportunities. For more information on Registered Financial Planners, go to www.iafp.ca.

6. We've all seen it. Through slick marketing campaigns, the brokerage and financial advisory businesses have positioned themselves as experts in predicting returns.

SmartMoney.com tracked the forecasts of Wall Street equity market experts during the bull and bear markets of 1997 to 2002. In looking at the 12 experts quoted in their study and examining their batting averages, not one would make the major leagues. What does this mean to the average investor?

Many investors lack proper diversification.

7. Choose where you want exposure in the market, then choose the easiest way to garner that exposure.

A method *The Empowered Investor* recommends is to utilize an index based-type mutual fund. The portfolio, if desired, can be tilted in any way, that is, more value, less value, more growth, less growth, large caps, small caps, and so on.

Again, this goes back to the Investment Policy Statement. As an aside, *The Empowered Investor* gives a good example of how to find and implement this strategy.

8. Finally, behavioural bias. Emotions like fear or greed often cloud our judgment and lead us to do things with portfolios that we will later regret. Money is a very emotional subject.

Choices we make in the wake of an exciting stock tip or plummeting portfolio affect our investment results in real and often damaging ways.

Successful investors are aware of the impact that emotions can have on portfolio decisions. Warren Buffet writes, "Success in investing doesn't correlate with IQ. Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble investing." Not a bad mantra by which to live.

Empower yourself. Become aware. Awareness pays off and knowledge is king.

To summarize, if you follow the Four Golden Rules, you should be able to achieve better returns.

1. Become aware of the pitfalls that can endanger your longterm investment success.
2. Educate yourself on capital markets and how they work, the relationship between risk and return, and the strategies to avoid getting trapped in traditional investment mistakes.
3. Build investment plans using time-tested strategies based on diversification and longterm asset allocation.
4. Execute and maintain your chosen investment plan with discipline. ▲

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