Financial Tips for College Graduates

U.S. News offers 10 financial tips for young adults.

Actually, financial advice for anyone starting out in the work world. Or even for those who have been working for awhile and now want to begin investing.

Good advice. A few comments from my side.

I shan't cover all the points, but do want to make a few observations.

Start Saving From Day One

Good investors save, invest, and grow their funds.

Enroll immediately in a plan where money is automatically deducted from your pay each period. Company plan, personal tax-deferred investment account, etc.

You did not have any income yesterday. Missing $50 or $100 per pay period will not be felt. But if you wait and get used to the extra cash in your chequing account, it will be more difficult to lose it later on.

Invest for the Long Term

How you invest should, in large part, reflect your phase in the life cycle.

Presumably you are young. With 40 plus years until you need to access your retirement funds. Starting out in the world, you hopefully are entering an accumulation stage of life.

With a long time horizon, you can handle some volatility in your portfolio. That means you should consider relatively riskier assets when you are young.

No, not betting double zero on the casino roulette wheel. Nor even putting half your money in corn futures. This is speculation. I am talking investment risk. Based on your personal risk tolerance and individual circumstances. For a typical young investor, that often means a well-diversified portfolio with an emphasis on equities.

Do not shun risk at a young age. Risk can be an asset for young investors. Just make sure it is well considered, prudent investment risk.

As your time horizon decreases and your personal circumstances change, then you can slowly move to a lesser risk portfolio.

Maintain an Emergency Reserve

Last in, First out (LIFO). An inventory term in accounting.

But also a reality for young employees who lack seniority within a company. If things go sour, new employees often suffer.

Start investing on day one. But also start accumulating an emergency reserve in case you suffer a loss of employment income. The amount should be based on various factors. A good benchmark is often 3 to 6 months of living expenses.

Don’t Live Like a King

Or queen. Or my nephew.

Yes, it is nice to finally get out of your parents’ basement and begin earning real money. But live within, or even below, your means.

Try to keep life frugal and invest any spare cash. Take advantage of your youth and the power of compound returns. Yes, you may enjoy that week in the Dominican Republic. But investing the money and watching its compound growth over time will allow for many more weeks vacation down the road.

3 Essential Investment Rules

StreetAuthority looks at three essential investment rules of master investor, Peter Lynch.

Excellent investment advice for those wishing to invest in individual equities.

Unfortunately, I do not know any non-professional investors who could actually follow two of the three keys. Ah, the joys of investment advice.

Only Invest in What you Understand

A good point. But what does the average investor understand?

First, most investors should avoid complex investments such as options, futures, forwards, commodities, etc. Stick to traditional fixed income and equities to go with cash balances.

But what about equities? The normal investor should have a well-diversified portfolio. That means small, medium, and large cap stocks, in a variety of industries, throughout multiple geographic locations.

If you are only supposed to stick with things you know, how can a Canadian investor add Russian, Australian, or Japanese stocks to the portfolio? Or the British investor may know something about Coca-Cola, Bank America, and McDonald's, but has he ever heard of smaller companies like Rush Enterprises, Sonic Automotive, and CommVault Systems? I haven't.

In this era of globalized markets, I am not sure one can stick only to investments that you understand. Even with traditional fixed income and equities, if you only invest in what you

know, it will be difficult (impossible) to create a well-diversified and effective portfolio.

Understanding the Fundamentals of a Company is Key

Also a good point.

If you analyze companies as part of your investment process you do need to look at fundamentals. The "quants and the quals" if you want to talk sexy and impress my nephew.

But how many amateur investors understand ratios including, percentage of sales or price/earnings to growth? I am not even certain the article's author fully understands percentage of sales, as he states:

> *Be certain the item or service that first attracted you to the company makes up a significant portion of its sales.*

What is "significant portion"? 20%, 40%, 80%?

What about if you were attracted to Blackberry products, then Apple comes along with the iPhone and eats RIMs lunch (and dinner)? The "eggs in one basket" thing can be a problem.

What about having a single client that purchases a significant of the company's product? Is that good? Hint: no.

With price/earnings to growth (PEG):

> *When the PEG hits two or higher, it may mean future growth is already built into the stock price.*

It "may mean"? Is this a rule you should carve in stone? Nope.

> *It's important to note that the PEG ratio is best suited for non-dividend paying stocks, since it does not take dividend returns into consideration.*

That is good to know. I am glad that not many companies pay dividends. Oh wait. Lots of companies pay dividends?

You also want a company with a:

> *Strong cash position, little debt*

As stated in the article, important for dividend paying companies (that is, the ones that are not suited for PEG calculations). What the …?

This cash to debt is another ratio that might be a positive, but is often a negative. For example, how do companies grow? They use internal cash flow, raise capital, or borrow money to invest in their business. Research and development of new products, marketing existing services, buying new equipment and plants, expanding operations into new regions, etc. If you are sitting on a pile of cash, are you likely growing your company (which usually means higher share prices as profitability also grows)? Probably not.

Yes, investors do need to analyze the fundamentals. But it sure helps if you have the technical knowledge and experience to comprehend the numbers.

For a thoughts on a few common ratios, check out price-earnings, price-book, dividend yield, and growth premiums.

Also recommended, a comparison of investing for growth versus value investing.

Invest for the Long Haul

A third good point. One I can actually agree on without an asterisk.

Take a long-term perspective. Do not sweat the short-term volatility.

I would be a little cautious on taking a long-term strategy

for individual stocks. Yes, some companies have dominated for many years. But technology and other variables can change very quickly. Be very careful employing a buy and hold strategy for individual stocks. You may miss out on the next Apple while holding on to Eastman Kodak.

What Should You Do?

Focus on your investor profile and the resulting target asset allocation. The process is more important to long-term investment success than the actual individual holdings.

Invest consistently in low-cost, well-diversified investments. That means passively managed index exchange traded or open ended mutual funds.

The nature of index funds is such that as the quality of the underlying holdings change, weaker stocks are deleted from the index and up and comers added. While you may not be buying at the best time nor selling at the peak, you do get some protection and benefit from the index adjustments over time.

As an added bonus, by investing in well-diversified funds, you do not have to analyze the fundamentals or completely understand the individual holdings. Your focus will be on your target asset allocation, not on the underlying components.

For a refresher on what you should do, please read my "Summary on How to Invest".

Invest Better Than the Pros?

In "Want to Invest Like a Pro?" we looked at attributes of successful professional investors.

I definitely believe one can learn a lot by watching how the pros invest. Nevertheless, I stated that following the professionals was “maybe a good plan, maybe not.”

This example nicely sums up that statement.

According to this article from The Guardian, a cat has managed to outperform a team of professional investors in a stock picking challenge.

Now to be completely fair to the professional investors, it was a cat and not a dog. And the professionals did manage to beat a group of high school students in the same challenge. So I give them part marks!

Lest you think this a huge anomaly, there are many other examples out there. Not all involving smart cats either.

Chimps seem to do well. Perhaps something to do with vodka and bankers. And I do know a British banker with identical suspenders.

Even the trusty old dart board beats investors.

Why I Like These Stories

One, further evidence that stock picking is tricky. It is difficult to separate winners from losers over the short term. Even for professionals, with years of training, access to the best available research tools and data, and who analyze investments as a full-time occupation.

Two, I am not quite a Random Walk guy, but I do believe that efficient markets negate quantitative analysis to a large degree. Not entirely and definitely not in less efficient market segments, so financial analysis can still add value in the long run. But when you factor in transaction costs, management, marketing, commissions, administrations fees, etc., it makes it that much harder to beat the benchmarks.

Three, cats continue to prove that they are smarter than investment professionals. As someone who has spent time with both groups, very easy to believe.

Finally, these tales provide me with much amusement. I sent the story on Orlando the cat to my nephew (who is currently studying to become a financial analyst). Now he is spending more time hanging out with Simba and Blossom than reading his finance texts.

I love it! Of course, his mother is mad at me for all the extra hairballs littering their home.

What Do These Stories Mean?

Maybe nothing, maybe something.

Limited Time Frames Mean Little

A very limited investment time frame tells us little about longer term strategies.

I see this a lot with the various investment challenges out there. Especially in universities (where I kind of shake my head). Investment challenges with a 6 to 9 month time horizon. Where the winner (or top three) get a prize and there are no consequences for finishing last.

There are always a few groups investing everything in one asset. Something leveraged, a derivative, non-diversified, etc. If they bet correctly once, they win. If not, no problem. Sort of like playing roulette in Las Vegas with house money. Why not just take the $100,000 and invest in lottery tickets?

If they really wanted to teach students how to invest (versus speculate, purely gamble), assign grades to the various quartiles at completion. Finish in the bottom 5%, get an F (or shot). Maybe have the students put in real money. Nothing like a little skin in the game to alter one’s risk approach.

Or run a simulation over multiple years based on historic data. That way investors will experience more realistic results. You might pick the right horse in one race. But to do so consistently over many races is much different.

If you are ever part of an investment challenge, two recommendations.

Bet on a non-diversified, highly leveraged, speculative single investment. You may win some money or accolades. Or you may finish last with no consequences.

Alternatively, realize that you have little real shot at winning (depending on the rules and number of participants who choose option one) and concentrate on the process. Learning how investing works may add some value in the long run.

Publicity Alters Behaviour

Publicity changes behaviour. Just watch any reality show on television. How people act in their own lives changes when it is open to public scrutiny.

I guarantee that the UK professionals did not want to lose money. So they took less potential upside to prevent an embarassing capital loss. And it worked, they came out ahead.

Had they taken on additional risk, perhaps they would have beat the cat. Or perhaps they would have lost money and been embarrassed nationally. Better to play it safe than become the brunt of jokes.

As we know, cats have no concept of shame. Win, lose, or draw, Orlando will continue to treat the human race with feline disdain.

So in the sense of time horizon and publicity potentially altering behaviour, I am not sure these type of contests tell us much about long term investing strategies.

Active Versus Passive Management

That said, it does add some fuel to the fire on active versus passive investing.

Over the course of the year, the professionals earned a paper profit of £176, a 3.52% return for calendar 2012. Good, bad, who knows? Lost to Orlando the cat, but how did the pros do versus the market as a whole?

According to the December 31, 2012 FTSE Factsheet, the FTSE All-Share Index returned 12.3% for 2012. That even beats Orlando's 10.84% return. The other FTSE indices also had strong returns over 2012. Two smaller indices had returns greater than 25%.

Over this one year period, the professional investors significantly underperformed their benchmarks. That does not even factor in any fees the professionals would charge for their stock-picking expertise. And you had better believe they would be charging the same fees regardless of the actual results. In only very rare cases, some hedge funds come to mind, do mutual funds adjust their fee schedule to reflect performance (always upwards).

If the high school students had simply purchased an exchange traded fund on one of the available UK indices, they would have easily won the investment challenge. No effort on their part. Just find a broad index like the All-Share, invest on January 1, head off to the cricket pitch, then come back December 31 and collect their winnings.

Of course, if they passively invested in an index fund they would not have learned anything about the benefits of analyzing individual stocks and the investment process.

Or maybe they would. Did you?

And to my nephew, less time in the litter box, more in the

textbooks, and a strong daily dose of castor oil. That will best get you ready for June.

Planning to Start Investing?

Just starting to invest?

Perhaps you just graduated from school, got your first real job, and now want to start saving money and building wealth.

Or maybe you are older but personal issues precluded you from beginning to seriously invest for future retirement. Student debt, home mortgages, and children, are just a few things that greatly impact the ability to invest for individuals in their late 20s and 30s. But now you have decided to focus on wealth accumulation.

Regardless of where you are in the life cycle, today some good tips for those beginning to invest.

The Wall Street Journal offers four simple recommendations to new investors. I have covered them myself, but they do bear repeating.

Start Early

The sooner you start investing, the better your long term wealth accumulation. This is due to the power of compound returns.

> *"A study by Maria Bruno, a financial planner with Vanguard Group, illustrates why: No matter how conservative or aggressive the hypothetical portfolio, projected median portfolio balances at age 65 are significantly higher for*

> *investors who started saving at an early age than for investors who began saving at older ages."*

It is incredible how beginning to [invest early in life has such an impact on capital growth] over time. If you are in your 20s, this is great news. Hopefully it will spur you to sacrifice a little now when money is tight, because the lon-term benefit is so high.

Now if you are in your 40s, it is all right to groan a bit at this realization. But what is past is prologue. You did not save in your 20s and we cannot turn back the clock.

On the positive side, not too many people do begin saving in their 20s and early 30s. Not the best approach, but the common one among adults. So if you have yet to start seriously saving, you have plenty of company.

Today is the first day of the rest of your life. Or, as another old saying goes, the longest journey begins with but a single footstep.

The power of compound returns works at any age. The sooner you start investing, the better the results. But you need to make that first step and then continue onwards.

Starting at 25 is better than 35, but so too is starting at 45 better than starting at 46. Additionally, life expectancy today may be between the ages of 80 and 85. Even at 45, you have ample time to allow your wealth to accumulate over time. But every day delayed negatively impacts wealth building.

So assess your financial situation today. See where you can make some modifications in spending and come up with money to invest.

Save Often

> *"Ms. Bruno found that the amount of money someone ended up*

> *with at retirement was more influenced by how much money was saved than by how that money was invested."*

How often and how much you save is more important than what you invest in.

Obviously, this refers to a well-diversified portfolio of assets and not investing everything in the next Apple. Nor placing all your money in a term-deposit of savings account.

But the point still stands. Timing and amount are more crucial to long-term wealth accumulation than the individual assets invested in.

Invest Early and Often

> *"The two levers an investor can directly control—savings time horizon and savings rate— will generally provide a higher probability of success, rather than relying on the possibility for higher portfolio returns."*

I wanted to highlight this statement.

Asset growth over time is a function of three variables. The rate of net return, time horizon, and invested capital.

If you are 25 years of age and invest $4000 annually for 40 years earning 8% per year, your ending capital is about $1,119,000. If you wait until 35 to begin, you will have to contribute $9150 annually at 5% to reach your goal. Perhaps that is doable. But if you wait until age 45, you will need to find $22,650 annually to reach $1,119,000. Perhaps not so doable.

Within limits, you can control when you begin investing and how much you invest over time.

However, your actual investment returns are out of your control. It is difficult to consistently identify individual

assets that will outperform the market. That is why active asset management does not normally beat a passive approach.

You can control your asset allocation and that does affect your portfolio’s risk-return profile. For example, by adding higher risk (with higher expected returns) assets to your portfolio. But asset allocation and adding assets with greater return potential can only go so far.

In our above example, say you waited until age 55 to start saving. At the 8% return, you would need to invest $71,500 annually over 10 years to reach $1,119,00 by age 65. Not very likely.

Even projecting higher annual returns may not help that much. Say you manage 16% per annum, you will still need to invest about $45,500 annually to hit $1,119,000. Or you get 24% (triple our original figure which means a lot of added risk), you still must contribute $28,500 each year. A fair bit of free money to find beneath the sofa cushions.

Focus on the two controllable factors (timing and amount) as they are more important to long run success than relying on riskier investments to provide higher returns.

Invest Frugally

> *“Investment costs are another, often overlooked variable that investors can typically control and that can have a big impact on a portfolio’s longterm performance.”*

Often-overlooked variable? Well not if you read this blog!

Transaction costs, commissions, management fees, operating costs, and taxes eat away at your gross returns and greatly damage your long-term growth. Every dollar that you pay to someone else – fund manager, brokerage house, tax agency – is one less dollar that will compound over time on your behalf.

Put your money to work for you. Minimize your costs to the greatest practical extent possible.

Divide and Conquer

Okay, you want to start investing, but you have debts and other needs that also must be met.

> *"Mr. Ritter suggests young adults tackle these major goals simultaneously. "Put a bit of money toward each goal," he says, "and work toward being able to do more over time." "Once one goal is reached—for example, after debt has been paid off—you can redirect money toward another goal, such as building an emergency fund. And once that is fully funded, with around six months of living expenses, you can save more toward retirement. Even if your contributions are small and come from a parttime or lowpaying job, Mr. Ritter says, they will pay big dividends in years to come. Remember, it's the little steps that count."*

I agree with this approach to some extent. It gets you on the investing path. It promotes a consistent and disciplined investing style, which is important for long-term success.

Also, investing a little is better than nothing. And, as your debts are paid off, you can indeed reallocate your cash and invest more over time.

Finally, I like the psychological impact that comes from seeing your investments actually grow. Even if you still have student loans outstanding, it is reassuring to see your investment account growing every month.

So I like this approach.

That said, I tend to see debt as a negative investment. And I prefer to invest my capital where I get the most return for my money.

Say I have $1,000 in cash on hand, owe $5000 on my Visa at 18% per annum, and want to invest monthly in a balanced fund expected to return about 6% annually. Now does it really make sense to split that $1,000 50-50 between my Visa and the investment fund? No. At an 18% non-deductible interest rate, I want to get rid of that balance as quickly as possible. So while I agree with the recommendation (especially getting people started on the investment process), you do need to assess your own situation.

While I think you should start saving and investing as soon as possible (and then consistently investing over time), you also need to be aware of your debts and the interest payable on them. If the interest payable on debt exceeds what you can earn on your capital, you may want to pay off your debt first.

And make certain you factor in the tax consequences. Interest payable on debt is often non-deductible for tax purposes while interest income, dividends received, and capital gains are usually taxed to some extent. So ensure when you do your calculations you consider the after-tax amounts, not the gross.

Vanguard 2012 Economic Outlook

As we move through 2012, uncertainty exists over global economic and financial markets.

Which countries' economies will prosper? Or maybe the better question is, which countries' economies will not completely crater in 2012? Which equity markets should investors consider? What should I do about all the market volatility?

There are many concerns out there for investors.

Vanguard considers these questions in, [“Vanguard’s Long-term Outlook for Stocks and the Economy”]. A short article, but one that contains some decent commentary. For example:

Will the U.S. recovery stay on track in 2012?

> *I think the recent data have been upbeat, which is a testament to the resiliency of the U.S. private sector. That’s why we think the recovery will continue to endure, more likely than not, although there’s no guarantee.*

Not carved in stone confidence, but positive about the U.S. economy.

I am less bullish on the U.S. currently.

There is still extreme uncertainty on the upcoming U.S. presidential election. I believe a Romney win will be better for the economy than if Obama is re-elected. That said, while Republicans talk a good game about fiscal responsibility and lowering the U.S. national debt, their actions are not representative of their talk. It took more than Obama and his crew to get the U.S. deficits and debt to where they are today. And Romney is not known as a huge fiscal conservative.

Unless people get real about the level of debt – if for no other reason than the sheer amount of tax revenues that must finance interest payments and not grow the economy – the U.S. will continue to stumble along. And I just do not see that happening anytime soon.

Should investors be worried about high market volatility?

> *The markets have been volatile, but it’s easy to forget that markets always go through volatile periods.*
>
> *But I think we’re all more sensitive now after the global*

financial crisis of a few years ago. This may be hard to believe, but in the last nine years, the U.S. stock market finished in negative territory in only one year, 2008. So it can be helpful to keep the longer-term perspective and remember that the reason we look for higher returns in equities is because the markets are volatile. Over time, investors have been compensated for the risks that they take in stocks. So we try to coach people to expect short-term volatility and to not overreact to it.

Very good point to keep in mind. The level of attention by the public to equity markets is very high. And I think that people remember that bad news more than the good. The media definitely contributes with its “if it bleeds it leads” mentality.

Volatility is risk as measured by the standard deviation of an asset’s returns. The more volatile an investment, the greater the risk. But the greater the risk, the higher the expected return. Investing 101 in a nutshell.

If you wish to achieve higher long-term performance, you need to take on risk (to some degree). That is why younger investors should look at (relatively) riskier asset classes as opposed to older investors. Young investors have a longer time horizon to withstand short and medium term volatility.

What about the sovereign-debt problems here and in Europe?

The fear of contagion has subsided lately, as it looks more likely that Europe will muddle through.

I am much less positive on Europe. They talk, they plan, they make cosmetic changes. But never seem to address the core problems that have created this problem in the first place.

And if you do think Europe is serious about getting their fiscal house in order, I give you the new French

President, Francois Hollande. His idea of fiscal responsibility is to lower the retirement age for certain workers from 62 to 60. That should go over well with the Germans (who have a retirement age of 67), Poland (67), Sweden (increasing to 69), Britain (increasing to 66), and even Italy (increasing to 66 for males, 62 for females).

What's Vanguard's longer-term outlook for stocks?

> *But again, we can't predict what's going to happen in the next year. So if you're saving to spend on something a year from now, you shouldn't be in the stock market. But if you're saving for a child's education 15 years from now, or for retirement 20 years from now, what asset class do you think is going to provide the highest rate of return?*

Again, this reflects the link between an investor's time horizon and their investment objectives. The longer the time horizon, the greater the investment risk that can be assumed.

But remember that all investors – even the young- have short and medium term objectives.

Maybe you are 25 and want to retire at age 65. You have a 40 year time horizon for retirement investing. Long term. Assets with higher volatility probably makes sense.

But maybe you want to buy a new car next year and will need $20,000 cash for that purchase. A short term objective. You probably do not want an investment that may swing 50% each year in case it is down over the next year when you need funds to buy that car. Same if you plan on buying a home in 5 years.

You always need to match your investment objectives to your specific investments. And all of you will have short, medium, and longer term objectives and constraints, regardless of age.

With negative headlines and volatility, should investors change their strategy?

> *To us, that means stepping back and asking yourself what is the best long-term asset mix for your situation. And once you figure that out, maybe with an advisor's help, then I think you put a plan in place to get to your allocation of stocks and bonds. That's what's going to drive your portfolio's returns.*
>
> *Then you don't have to continually second-guess yourself, wondering, for example, if you should sell a bond fund if you think interest rates are going to go up. Even if that happens, your stock portfolio can help to offset the decline in bonds. That's the advantage of diversification. You have one asset class that can support the other. You keep both because you don't know which one needs to support the other over the next year or two.*

Very good advice. Take a long term approach. Focus on asset allocation and diversification.

> *I encourage our clients to try to minimize the attention they pay to economic news, because I think that can actually lead to the pitfall of wanting to react. The market can discount economic news very quickly—I mean in a matter of seconds. So, while it's good to be well-versed on the economy, we have to guard against overreacting to it, because there's much more to investing and seeking long-term returns than analyzing the latest economic news.*

Avoid getting caught up in the flavour of the day. If you have followed the FaceBook public offering you know what I mean. Before the issue, the focus was on how to get shares and be part of the FaceBook phenomena. Now it seems to be, how bad an investment is FaceBook and should (former wonder-boy) Zuckerberg be sued?

> *market volatility presents an opportunity to be proactive by doing things like rebalancing. That can be a powerful*

> *antidote to the volatility, because if stocks or bonds fall, you can rebalance to your target allocation. "Buy and hold"—an approach we endorse—doesn't mean "set it and forget it."*

Something I strongly believe. Utilize a buy and hold strategy for long run success. But always make sure that you periodically review and rebalance as necessary. Buy and hold does not mean buy and forget.

I would also add that market volatility also allows for discount purchasing. If you utilize dollar cost averaging, volatility aids in buying higher volumes when prices are depressed and relatively less when valuations are running high.

Recession Babies?

Younger investors should be willing to take on the most investment risk.

This is due to the classic risk-return tradeoff from Investing 101. The greater the risk assumed, the higher the expected return over time.

However, young investors today are shying away from risk in their portfolios.

Why is this the case?

Is it because young investors were "recession babies"?

Recession Babies

A good term, possibly coined by Bill Finnegan in this [Wall Street Journal article].

> *"We had Depression babies," says Bill Finnegan, a senior managing director with MFS Investment Management, a Boston-based asset manager. "Now I think we have recession babies."*

Given the tough economic conditions and volatile markets over the last decade plus, many young investors have no memory of bull markets and strong economic growth. All they see is high unemployment, a tough job market, and high student loans. Maybe their parents are out of work. Perhaps these young investors still live at home due to a lack of money.

Fully understandable that these "recession babies" are risk averse.

And for any aged investor, I normally recommend maintaining a 3 to 6 month emergency reserve in cash to protect against tough times and unforeseen circumstances.

Better to Earn Little in Safety, Than Nothing at All

Recent market history reinforces this low risk approach. As the article states,

> *A 27-year-old who started investing right out of college has seen a 0.5% annualized gain from a Standard & Poor's 500-stock index mutual fund—less than the 1.85% returns of an ultrasafe money-market fund.*

As a result of poor equity market returns, young investors have moved into very low risk assets.

> *According to a June MFS survey, investors in their 20s held 30% of their non-401(k) portfolios in cash—four percentage points higher than the average for all investors. The survey found that 40% of investors in their 20s agreed with the*

> *statement: “I will never feel comfortable investing in the stock market.”*
>
> *An October MFS survey showed that young investors held 33% in cash, six points higher than the overall average, while 52% agreed that they would never feel comfortable investing in stocks.*

So in mid to late 2011, young investors had 33% of their capital in cash equivalents. A much, much higher percentage allocation than any standard asset allocation model would recommend for investors in their 20s.

And roughly 50% of young investors “will never feel comfortable investing in stocks.” This compares with an average of 29% for all investors polled. A marked variance.

But is this Wise?

No.

A hard one to explain, especially given the equity market returns over the last few years.

Modern portfolio theory is based in large part on the relationship between risk and expected return. Under the Capital Asset Pricing Model, expected return is a function of risk. Yes, there are times when it is not perfect but I think the principles hold.

I shall not get into the theory – the linked Investopedia article does a good job – but it should be intuitive to anyone reading this. When faced with two scenarios, you will require a higher return for the riskier venture.

Consider Nicole and Matt

For example, my niece and nephew come to me needing a $10,000 loan each.

Nicole will spend the money on a car to get to and from her new job. She has borrowed money from me before and always paid off her debt in full and on time. Further, she will use the car as signed collateral on the loan.

Matt, on the other hand, is like most Matts. He just lost his last job as a landscaper (who knew that sod did not go in grass side down?) and plans to use the money to finance a trip to Ibiza. His repayment history has been poor and the only collateral he has is a broken down ski-doo.

Now would you expect that I would charge each the same interest rate? Especially bearing in mind that they are my niece and nephew, so naturally I like neither.

No, I would desire a higher return to take a chance on the deadbeat, Matt. The probability is much higher that I will have difficulty collecting the debt from him versus Nicole.

You would do exactly the same.

In any aspect of life, the greater the risk you must assume, the greater the return you want.

This Holds For Investments

This risk-return relationship has held over time in the capital markets.

Cash pays less interest than investment grade bonds. And investment grade bonds pay less than riskier speculative (i.e., junk) bonds.

And the relationship between low risk cash, higher risk bonds, and highest risk (of the three asset classes) equities also holds over the long run.

If you take a quick look at the linked chart you will easily see that over the long run, higher risk assets (small and large company stocks) outperformed moderate risk assets

(government bonds) which in turn outperformed risk-free assets (Treasury bills).

But note that in many short periods (1930s, 1970s, etc.) riskier assets underperformed the risk-free asset. So during shorter terms, risky assets may not always outperform. A crucial point to always bear in mind.

Perhaps an argument can be made as to whether this long-term risk-return tradeoff will continue. Even I have some concerns due primarily to demographic shifts (a topic for another day). But I think the majority of experienced investors do see the risk-return relationship holding into the future.

The Key is Youth

In the short term risky assets may underperform. But over the long run, the tradeoff works.

How does that impact investors?

The key to utilizing the risk-return relationship is the investment time horizon.

The longer the investment time frame, the more likely that the risk-return tradeoff will hold true. Investors with long time horizons can ride out short term volatility and still prosper.

If you are 30 years of age with a 40 year investment horizon, you can invest in riskier assets knowing that the long term trend is positive. But if you are 65 and only have a few years before needing your capital to live on, you cannot afford to be caught up in a shorter term bear market.

My Advice to Young and Middle Age Investors?

The 50% of young adults who “will never feel comfortable investing in stocks” need to reassess that viewpoint. Equities are not to be feared. And for the younger investor, stocks have proven to be the best of friends over time.

For most young and middle age investors, a 33% asset allocation to cash is probably excessive. I suspect a large portion of cash could easily be allocated to equities.

As for the exact asset allocation, creating a comprehensive Investor Profile will help determine the correct mix for each person. Part of this reflects an investor's time horizon, personal risk tolerance, and phase in one's life cycle.

Investors must take a more rational approach to their risk aversion. Take a long term perspective and tune out the short term hysteria and unpleasantness. Young and middle age investors have the time to ride out the periodic ups and downs. Use time to your advantage.

The phase in one's life cycle plays a significant role in the asset allocation of common stock. Make certain you understand where you are in life. Then take an investment approach that takes advantage of your personal situation.

One comment that I may expand on in a subsequent post. When I refer to risky assets, I refer to them in a traditional investment sense. Shorting stocks, playing the futures' markets, writing naked call options, are all high risk investment tactics. But I would never recommend their use by non-expert investors even though I believe high risk assets outperform lower risk assets over time. The potential exposure is great enough that a short term negative movement could cause irreparable harm.

And be aware that even within traditional investments, there may be different risk-return profiles within asset subclasses.

Use some common sense when investing to reduce portfolio risk. Focus on mutual and exchange traded funds (bearing in mind that risk-return can also fluctuate within these groups). Employ proper investment techniques including adequate diversification, long term buy and hold strategies, and dollar cost averaging to create strong portfolios.

Do Financial Smarts Erode With Age?

As you get older, does your financial knowledge decrease?

Good question.

I do not think financial smarts necessarily fall with age. I know a lot of very smart investors of advanced years. However, a new study has come out that finds investing intelligence does decrease over time.

A scary thought. Especially for my 20 something nephew – nephew by marriage I like to point out, definitely not the same gene pool – who seems to already be lagging in this area.

This article from MarketWatch nicely summarizes the study's conclusions.

Increasing Age, Decreasing Financial Acumen

The key finding:

> *"The scores on a test measuring knowledge of investments, insurance, credit and money basics fell about 2% each year starting after age 60, falling from about 59% correct – hardly a passing grade – for those in their 60s to a dismal 30% for those 80 and older …"*

Now 59% is not a great score, but 30% is very worrisome.

But Increasing Age, Increasing Financial Confidence

Compounding the problem of diminishing financial intelligence

over time is that the study determined:

> *"Our confidence in our financial decision-making abilities rises with age. We are not older and wiser. Rather, we are older, less smart and overconfident."*

Not a winning combination for a successful retirement.

If you want to read the paper itself, you may download Old Age and the Decline in Financial Literacy at this link.

Why These Results?

My first thought was that the questions were skewed for younger investors. But I reviewed the test and they were fair. Maybe one or two questions that might stump an elderly individual who has not dealt (extensively) with tax deferred investment accounts. But overall, not much that should cause difficulties simply because of age.

The MarketWatch article provides 10 of the questions in their own internal quiz, if you want to see how well you do. The linked study provides all the questions. Note that as it is a U.S. study, some questions have an American slant.

Some argue that cognitive ability decreases in general as one ages. Another study found that "financial mistakes follow a U-shaped pattern, with the cost-minimizing performance occurring around age 53". As one gets older, there is an increasing level of financial errors made by individuals, on average.

While I do think the study questions were fair for all age groups, I also believe that new financial products, tax schemes, and regulations all add complexity to investment decisions. Unless investors maintain their knowledge level in new investment related developments they will quickly become out of date in their skills.

What to Do

The linked MarketWatch article provides some good ideas for investors on dealing with declining financial acumen over time.

The general point is to be prepared ahead of time.

Get your investment game plan ready before your financial smarts start to erode. If you stay sharp and not overconfident, great. But if you slip you will still be in good shape.

For me, an Investment Policy Statement (IPP) is the best method of developing a proper game plan.

Prepare one now and fine tune it over time to cover your changing objectives, constraints, and personal circumstances. A written IPP will help keep you on the straight and narrow over your investment life.

An IPP will assist in making the optimal investment decisions for your individual situation. It will temper any propensity for overconfidence and aid in reducing investment mistakes.

If you lack the competency to create or monitor an IPP, get professional advice.

While I recommend a low cost approach to investing, obtaining professional assistance may be money well spent. Even for those who think they know how to invest, a second set of truly objective eyes may provide excellent value for the cost.

Protection From Volatile Markets

A potentially legitimate concern about buy and hold investing is that it underperforms active management during fluctuating and bear markets.

Today we will review how to protect your wealth during periods of market volatility when using buy and hold.

A few points come from my general long-term investment philosophy. One that attempts to build such safeguards automatically into one's portfolio.

A few other thoughts will involve tweaks to the traditional buy and hold methodology. Tweaks that hopefully will improve on its performance.

Long Time Horizon

One's investment horizon should be long-term.

Certainly if you look at 3-5 year periods, you can find numerous examples where active management is better. But I think investing should take a longer time frame.

In last post's NASDAQ example, we saw that it took about 7.5 years for the market to recover from the decreases subsequent to December, 1972.

Active management may have performed better. I say "may" because who knows. Would you have bought and sold at the right times? Or would you have compounded your losses through even worse timed trading?

What I do know is that if you took a longer term perspective, a buy and hold strategy would have shown positive returns. Had you held until April 1990, your annual return would have been

6.8%. Until April 2000, annual returns of 13.0%. Until April 2011, annual returns of about 8.2%.

Perhaps an active approach would have brought better results. Perhaps not.

I prefer avoiding "perhaps."

Asset Allocation

Now some of you reading this are thinking, "Hey, I don't have 20 or 30 years to invest. What can I do?"

If you recall our discussions on investor profiles and investment policy statements, you realize that your asset allocation is geared, in part, to the phase in your life cycle.

Over the course of your life cycle and ever evolving investor profile, the amounts that you allocate to cash, fixed income, and common shares will change. As you near retirement, you will be shifting more of your wealth into lower risk (i.e., less volatile) assets.

This will also address problems with general market volatility.

Diversified Portfolios

I have previously recommended investing in diversified portfolios.

A diversified portfolio prevents you from having all your eggs in one basket. Whether that be a specific asset within a market or an individual market within the whole spectrum of investment options.

If you have 50% of your wealth in shares of Credit Suisse, your portfolio returns will reflect the results from Credit Suisse to a significant degree.

Or if you have invested 80% of your assets in the U.S. equity markets, your portfolio will mirror the ups and downs of the U.S. equity markets.

Either of these may generate positive returns during bull markets, but they will create problems during down periods.

However, by diversifying throughout various asset classes, you can spread the risk of any one market throughout multiple asset classes.

Not Just Diversified, But Well-Diversified

A diversified portfolio is a collection of different assets.

A well-diversified portfolio reflects a proper mix of assets, such that you minimize asset correlations.

If you recall our discussions on asset correlations, holding assets with low or negative correlations will provide some built in protection against market volatility. As the value of one asset rises, the value of a negatively correlated asset should decline.

While you may give up some potential return by never being fully invested in rising markets, you will also never be fully exposed to falling markets.

This offers a defence against market downturns.

Dollar Cost Averaging

Another strategy I have espoused is dollar cost averaging (DCA).

I think this also provides some protection against market volatility.

If you believe over the long run that appreciating assets do, in fact, appreciate, then down markets provide buying opportunities.

Yes, it took the NASDAQ until April 1980 to fully recover from the crashes of the 1970s. But it did recover and subsequently thrive in the 1980s. Had you continued to accumulate holdings in the NASDAQ under DCA, you would have done very well over time.

We have covered the above points previously in detail. I reiterate them here to show how we have already take steps to protect our portfolios from legitimate potential problems with employing a buy and hold strategy.

Nest time, we will look at tactics we have not previously discussed.

Legitimate Buy and Hold Concerns

In our last post, we looked at a few commonly perceived negatives on the buy and hold investment strategy.

Some of the minor complaints.

Today we will review more legitimate concerns.

Buy and Hold May Not Provide Maximum Possible Returns

A buy and hold strategy is essentially as it states, you acquire an asset and hold it throughout the investment horizon.

Investment theory indicates that over time, on average, appreciating assets (such as equities) will increase in value.

Granted, it may be a long time, but historically this has held true.

However, over the short and medium periods, there may be large price fluctuations in an asset. The greater an asset’s risk level, the greater the potential price swings.

If an investor can properly time the peaks and valleys of short or intermediate price fluctuations, the investor can sell high, then repurchase the same asset when it falls. This ensures the same position at the end of the investment time frame, but by selling and buying back the investor can profit on price fluctuations.

In short, the belief is that active management can outperform passive investing.

I would say that this is a legitimate issue for a buy and hold strategy.

Buy and Hold Does Not Protect in Down Markets

Markets, and the assets within a market, go through down cycles. Depending on the length of time, this may be called a crash, market correction, or possibly a bear market.

A buy and hold strategy sees investors sit tight during market descents. With some bear markets, this can wipe out previous accumulated gains and/or create portfolio losses.

Smart investors shift their assets in down markets into defensive positions or alternative asset classes that protect their capital.

Again, active management can protect portfolios during down cycles.

Another legitimate concern.

Buy and Hold Only Works if You Are Immortal

If you adhere to modern portfolio theory, you believe that in the long run, appreciating assets increase in value based on certain factors.

But that may require an extremely long holding period. One not all investors can maintain.

Many investors do not seriously begin to invest until they are in their early 40s. If they need to liquidate at 65, 20 years may not be a long enough time frame. Had you invested in the Dow Jones Industrial Average at its peak in 1929, it would have taken 25 years for the Average to recover after its losses in the early 1930s.

So one’s investment time frame is relevant to the potential success of a buy and hold strategy.

These three concerns are common when you read articles on buy and hold investing.

These concerns suggest that active management is better than passive.

But is it really?

We will consider the question more fully in my next post.

IPS – Keys to the Investor Profile

In creating an Investment Policy Statement (IPS), you need to conduct a comprehensive investor profile. Who you are as an investor and what you want to achieve.

Part of this requires assessing your current financial situation, as well as investment related objectives and constraints.

But it is also important to factor into your analysis three key variables. These are: investment time horizon; current phase of life-cycle; risk tolerance level.

Let us take a look at these crucial areas .

Time Horizon

We reviewed time as it relates to investing in our compound return discussion.

Longer Time Frame, Greater the Risk and Return

The longer the investment time frame, the greater the potential volatility (i.e. investment risk) that can be accepted in a specific asset.

And from the relationship between risk and returns we saw that the more volatility that an asset has, the higher the expected return that should be associated with the investment.

If your objectives are far in the future, you can afford to take on additional risk in the expectation of higher returns. This is because you can ride out the up and down swings over long periods and average out the higher expected return over time.

If you have near-term goals, then you want increased certainty as to the result. You do not want to be caught in a down swing during the initial period when you require the funds. So you willingly accept higher certainty in a lower return investment as an acceptable trade-off.

This is why it is commonly recommended that younger investors invest in higher proportions of equities than in fixed income or cash. And for seniors that require a consistent and

constant cash flow to finance their retirements, it is usually recommended that they have most of their assets in fixed income or cash instruments.

Longer Time Frame, Less Capital Needed

The longer you have to invest, the less you need to invest.

Both on a periodic basis, as well as in total.

For example, a 25 year old with a 40 year investment horizon only needs to contribute $315 per month at 10% to accumulate $2 million at age 65. If that same person delays investing until 30, he will need to invest $525 per month at the same 10% return. Wait until age 40 to start investing and he will need to contribute $1500 per month at 10%.

A significant difference in money needed to fund the account each month.

The earlier one starts to invest, the less of a problem it is to find the necessary cash.

As a further incentive to start investing, look at the actual aggregate contributions made by individuals at each age. The 25 year old contributes $151,200 over 40 years to amass $2 million. The 40 year old has to contribute $450,000 over 25 years to accumulate the same $2 million. Again, the power of compounding has a tremendous impact on wealth accumulation.

Fortunately, many people reading this post are relatively young. That means time is less of a potential constraint. It also means that with compound returns, by starting to invest now you will need to find less cash monthly, and in aggregate, to accumulate wealth over the long-term.

Phase of Life-Cycle

We have also previously reviewed the life-cycle view of wealth accumulation.

Usually Correlated to Age

The phase in one's life-cycle is normally linked to age.

When you are young, you are just starting out in the world. Income is relatively low, costs are high. As you get older you begin to accumulate wealth, but costs are still high. As income continues to rise and costs begin to fall (mortgage paid off, no car loans, etc.), wealth accumulation takes off. Then you retire and income falls, requiring the use of savings to make up the shortfall between income and costs.

But Not Always

While this may still be normal for most people, times have changed somewhat.

Increased unemployment may alter one's progression through income increases over time. More individuals are becoming entrepreneurs which also impacts the normal progression between life and income.

As well, people are getting married later in life and having fewer children. Interest rates on debt are relatively low. Housing prices in many areas are extremely depressed. So there may be less costs for younger adults than in previous decades.

And these are just a few quick examples as to how things are changing.

Do not simply assume your investment time horizon and life-cycle phase are connected.

Look at both areas separately when assessing your investment objectives and constraints.

Risk Tolerance

Risk tolerance is another area we have previously reviewed.

The greater one's risk tolerance, the greater the potential

for higher expected returns over extended time periods.

That is not to say, head to Las Vegas and “invest” your money in the casinos. But I am saying that a properly structured investment portfolio should achieve higher expected returns over the long run than the same money being invested in Treasury bills or term deposits.

I understand though that risk tolerance differs from investor to investor. If you are more comfortable in lower risk assets, that is fine. Just realize that you may need to invest more, for longer periods, to achieve your goals.

In our example above, you can see the potential results from investing in a safer portfolio with lower expected returns.

Investor Profile Drives the Actual Investing Process

An investor’s objectives, constraints, investment time horizon, phase of the life-cycle, and risk tolerance define an individual’s investor profile.

It is important that you clearly understand your own profile. If you do, I think you will make smarter investment choices when managing your own wealth.

It is also imperative that any financial advisor who manages your money also clearly understands your profile. That is why it needs to be discussed and agreed upon in writing, so as to eliminate as much ambiguity as possible.

Your profile will serve to drive the rest of the investment process.

What asset classes you include or exclude. The asset allocation that you choose. The investment styles, strategies, and tactics that you use. So the investor profile is crucial if you want success in your investment plans.

Next, we will start a look at asset allocation.