Avoiding common investor mistakes

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Financial Planning Fact Sheet 04

Every investment carries some degree of risk. The important thing is to understand the nature of risk so that you can manage it and use it to your advantage. Risk doesn't necessarily mean losing your capital. Provided you do your research properly (or get a good Financial Planner to do it for you), the main risk you will be concerned with is 'volatility' – the fact that all investments move in cycles. So how do you minimise risk?

1. Seek professional advice

A professional Financial Planner can help you determine an appropriate strategy to help you achieve your goals and objectives.

Professional advice can also assist you in understanding changes to legislation. Superannuation legislation changes frequently and social security regulations are constantly being reviewed as the Government grapples with the cost of providing for an ageing population.

With the flood of information available these days, how do you siphon out the parts that are important to you?

More so than ever before, having a regular review of your financial plan is becoming as essential as having regular health checks. And relying on friends could prove to be a mistake – Financial Planning is a very complicated area and what suits one person may prove disastrous for another.

2. Buy quality

Always buy the best quality investments you can. In the long run, it won't cost that much more. Quality investments will always have a value, whereas speculative investments can become worthless overnight.

For example, in the 1987 share market crash, the value of many of our leading companies fell by around 25%, but recovered quickly and had moved past their pre-crash levels within 9 to 12 months. At the other end of the scale, the high-flying and high-borrowing companies fell by 50% to 90% and took years to recover.

3. Diversify

There are 5 basic investment alternatives:

- **Cash** – at call savings; very secure, but low returns.
- **Fixed Interest** – term deposits, Government and corporate bonds, debentures, mortgages.
- **Property** – whilst bricks and mortar are generally regarded as safe and secure, the property market goes through cycles and values can fall as well as rise.
- **Shares** – the share market has traditionally been regarded as 'risky', however quality well-researched shares have a history of outperforming the above investments over the longer-term.
- **International** – international investments have generated above average return over many years but are more volatile due to the effect of changes in the exchange rate.

By investing in all of the above asset classes, you should achieve more consistent returns.

Investing all of your money in cash investments may appear to be the safest option due to the lower level of risk. However cash investments provide interest payments only and the capital value does not usually grow. Combine this with the effects of inflation and tax and there is the real risk that your money will lose value over the long term.

4. Dollar cost averaging

You can minimise the effects of volatility in the markets by investing small amounts on a regular basis. In this way you are able to take advantage of any downturns in the markets. In fact, the more volatile the market, the greater the potential for profits.

Managing your money

Don't rely on blind faith

Whilst you need good advice to navigate through the myriad of jargon, media hype, changing markets, trends and analyses etc, don't abrogate your responsibility to have a broad understanding of where your money is invested and why.

When it comes to investing your money, you should always be the one to sign the documents to invest, sell or change any of your investments. The investments should always be in your name.

Seek advice from a trusted source and always try to cross check the information you are given.

Pay yourself first

Most of us put our jobs, children, parents and everybody else ahead of ourselves. If there's any money left at the end of the month, we might get around to investing some of it. Wrong! The secret is to pay yourself first (by investing some of your salary into superannuation, managed funds etc), and you will quickly learn to live on what you have available. Most of us are guilty of not budgeting properly, and our living expenses tend to rise to match the amount of income available.

Remember: it's not how much you earn, it's how much you keep.

Good Debt vs Bad Debt (borrowing to invest)

As a general principle, you should pay off your personal debts as fast as you can. Try to borrow only for investment purposes. Why? Because the interest on the loan is then tax deductible.

Negative gearing can be a very effective way to magnify your investment returns, but remember that negative gearing can magnify your losses as well as magnifying your profits.

Investing versus speculating

Many investors baulk at paying what they perceive to be a high price for an investment. Their logic is that it is a lot easier to double their money on a low priced investment than it is on a high priced one.

Example:

ABC Company – current share price is $0.10

XYZ Company – current share price is $1.00

The argument is that it is easier for ABC to double their price than it is for XYZ.

The reality is that, all things being equal, it is just as hard for ABC to double their value from $0.10 to $0.20 as it is for XYZ to increase from $1.00 to $2.00. An increase of 100% produces the same profit return, regardless of the price.

The critical element to consider is the value of the company, not the value of the shares. For example, ABC may have issued 1 million shares at $0.10 each, whilst XYZ only issued 100,000 shares at $1.00 each. The companies have exactly the same value.

You will seldom double your money quickly by investing in quality (blue chip) shares. But do you wish to invest or speculate? There is a vast difference. Speculators can make a lot of money quickly, but they can lose it even faster.

Are you a saver or an investor?

Saving is the passive lending of money to an investor in exchange for a set rate of interest. Investing is the active use of money to purchase an asset in the expectation of making a profit.

Unless your sole objective is to preserve your capital, at least some of your savings should be invested.

Investing is a slow process. It takes time, at least 3-5 years, to see the results. Successful investing is a matter of keeping your WITS about you:

Whipsaw

This is the common mistake made by new investors. 'Whipsaw' occurs when you make an investment only to find that the market has peaked and the value of your investment starts to fall – sometimes quite dramatically. You then panic and switch to more 'secure' and comfortable assets such as savings accounts or term deposits, only to see the market rebound without you. You take the loss on the way down but miss out on the profits from the recovery.

Inflation

The effect of inflation reduces the real returns on your investment by slowly eating away at the purchasing power of the dollar.

For instance, if inflation continues at 3% p.a. an item that costs $100 today will cost you $135 in 10 years' time. That's alright if you receive pay rises to offset inflation, but once you are retired you may have a problem.

Tax

Did you know that tax can significantly reduce your income and investment returns? If you earn $37,001 - $87,000 p.a. you may lose 34.5% of every extra dollar you earn in tax and medicare levy. If you earn between $87,001 and $180,000, it rises to 39%.

An investor on a rate of 34.5% needs to earn at least 4.58% on their savings just to keep up with inflation. The following table illustrates the impact of tax and inflation on savings of $10,000.

	Investment income on $10,000	Capital Value
Income	$458	$10,458
Less tax 34.5% p.a.	($158)	($158)
Net income	$300	$10,300
Less inflation 3% p.a.	($300)	($300)
Net real value	Nil	$10,000

If you are serious about saving for the future, you need to earn over 4.58% per year if you want to see the value of your savings increase in real terms.

Strategy

An experienced financial planner can help you achieve that by explaining the likely outcomes of the many options that you are invariably faced with. You need a strategy if you are going to be a successful investor. This strategy should be based on what you need, not necessarily what you want.

Investment Tips

From the start, you need to have a strategy to guide future financial decisions and help you achieve your goals.

Here are some investment tips:

- Don't chase historical performance - don't take too much notice of past performance. It's like driving by looking into the rear vision mirror. You should be more interested in what is going to happen, not what has happened.
- Don't be paranoid about fees - fees are important, but you need to make sure you are getting value for money. The overall cost of investing in shares, managed funds, property etc is approximately the same. It's just that some fees may be upfront, some may be annual, others on redemption. Make sure you look at the net returns to you.
- Be patient - when you invest in quality growth assets, they are likely to fluctuate in value, on an upward trend, over the longer-term. Don't be too impatient and keep checking the value of your investments, expecting instant results.

Whether you are planning your retirement, investing for the future, or simply want to make the most of your current financial situation, Bank First's Financial Planners can provide relevant and comprehensive advice to help you achieve your financial goals. Unlike many other organisations, our Financial Planners do not receive commission or brokerage on any investments they recommend, guaranteeing that your interests are their only priority.

For further information or to arrange an appointment with a qualified Financial Planner, please call Financial Planning on **1300 654 193** or email **finplan@bankfirst.com.au**.

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