

ADVICE INSIGHT

Investing for greater certainty

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“Not to be absolutely certain is, I think, one of the essential things in rationality.”

- Bertrand Russell

We live in highly uncertain times. To be fair, we always have. Recently however, we have witnessed what will probably prove to be the most significant economic event of our lifetime.

The impact of the financial crisis is still being played out in thousands of households around the world. The loss of capital is troubling enough for those who are still of a working age. Albeit of little comfort for them, these people still have the capacity to earn and save their way to a better position. Those in retirement have fewer options available. They either need to learn to get by on less or to take the high stakes game on gambling their remaining capital in the hope the stakes will favour them. This option is highly risky and likely to end in more losses.

Many of those who invested in debentures or bonds have come to realise that the ‘certainty’ they interpreted in the advertised yield or coupon was not much more than a facade. This was most evident in finance companies where investors saw their investments placed unceremoniously in the hands of the receivers and their dollar invested turning overnight to 10 or 20 cents.

So how do we align peoples’ desire for certainty in how they can live their lives with the uncertain investment markets into which they must invest to fund their retirement?

We all value predictability, order and certainty. It is a key part of the human make-up. It is also the reason we hang off the predictions of weather forecasters and economists. Often these predictions just highlight how difficult it is to forecast what will happen next. Like the weather, investment markets are inherently uncertain. We gain greater predictability over long periods but over the short to medium term, where most people frame their decisions, no one really knows what will happen next.

It may give investors comfort to know that Warren Buffet has no interest in attempting to forecast the direction of the market. Author Robert G Hagstrom (The Warren Buffet Portfolio: Mastering the power of the focus investment

strategy) points out that Warren Buffet’s position on forecasting is clear - don’t waste your time. Whether in regard to the economy, the markets or individual stock prices, Buffet firmly believes that forecasting has no place in investments. For over 40 years, he has achieved great wealth and an enviable performance track record by investing in good companies while avoiding the short term distractions that occur when investors become obsessed with guessing the future direction of markets.

So it is clear that certainty in investing can’t reliably be created. What then is the solution for the average New Zealand investor looking for certainty in the lifestyle they can enjoy in retirement?

Behavioural finance offers a solution. It is a field of finance that recognises the impact of investor behaviours on investment outcomes. It recognises that more often than not investor actions are driven by emotions, most often either fear or greed, and that these actions fuelled by the inherent uncertainty of investment markets can have a significantly erosive effect on investor wealth.

“Investing is not a game where the guy with the 160 IQ beats the guy with the 130 IQ... once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing...”

- Warren Buffet

Buffet has a point but the problem is very few people can conquer these emotions. A more appropriate approach is to develop a tailored written financial plan for the investor based on their individual needs and to invest in a series of portfolios each tailored to meet a specific and defined goal. For example a cash portfolio to provide for known spending needs in the very near term, a portfolio focused on maintaining capital to provide for future spending needs by protecting capital from the corrosive effects of inflation and a growth portfolio to grow capital to meet future spending needs.

As their descriptions imply, each category aims to meet quite different needs. Similarly, the amount each client will define as necessary to meet each of the needs will vary considerably, depending on their age, stage, plans and aspirations. The outcome is unique to each individual.

This approach provides investors with a degree of certainty that is absent from the traditional approach. By defining a set of needs, and then in effect forward-funding those needs in the first few years, the investor can plan their expenditure with greater certainty. This allows the client to genuinely view their medium and long term portfolios in that context without being concerned that share market volatility in their long term portfolio will imperil their ability to visit their grandchildren next year. Capital protection strategies deployed across these portfolios further help reduce the likelihood the investor will be overwhelmed by the emotional roller coaster of traditional investing.

This framework, which overlays human behaviour onto traditional investment theory, provides the basis for an advice and portfolio conversation in which the investor plays the central role.

So if investors build their portfolios around their various spending needs over time they can invest with certainty to enable a lifestyle they can commit to in the short to medium term, enabling the remainder of their portfolio to focus on capital growth and the protection of future spending power.

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