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The 5 Golden Principles of Investing

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1. Diversify

Having a balanced portfolio, which means spreading your investments across different asset classes such as cash, bonds, property and shares, is one of the foundations of prudent investing.

Within each asset class you should also be diversified. For example, in property you can invest in a fund which will own a range of listed property companies, and in shares you can own a fund which will own a number of different shares, in companies from across different industries and countries.

Diversification helps reduce risk in two ways. First, diversification is a 'safety in numbers approach'. Having a spread of investments limits your portfolio's exposure to any particular investment or market. Secondly, by combining a range of investments from different asset classes, diversification can reduce the volatility of returns because asset classes often perform better at different times.

Diversification is also an important strategy to ensure your portfolio benefits from the gains in markets. It is difficult to predict which markets or shares will do best and it is prudent to own a wide range of companies across many markets.

2. Set goals

Investing with a purpose and having clear objectives provides direction and helps keep us on track during our investing journey. Goals can include saving to buy a house, education, or saving for retirement. Your goals, along with your circumstances, risk profile, diversification and any unique preferences you have, should underpin your investment decisions. Fees and tax are also important considerations, but they should not drive investment decisions.

3. Time, not timing

Markets can be volatile. They are in perpetual motion and move both up and down. Investing a lump sum means you invest at a point in time, exposing you to what is called 'market-timing risk' – the risk that the market falls not long after you invest.

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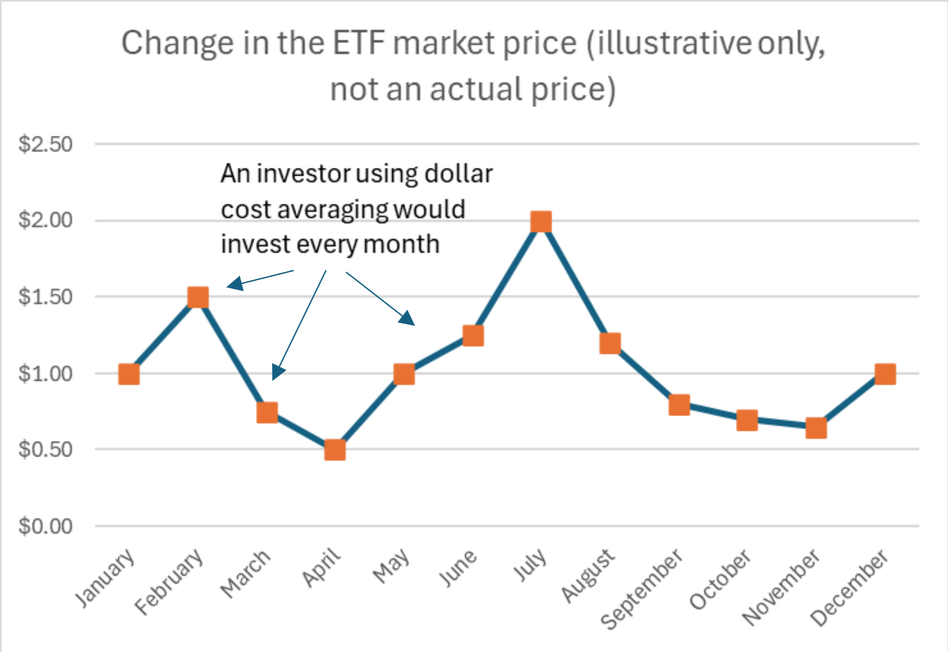
People who invest in regular instalments over time can actually benefit from this market volatility. If the market falls, they may be able to invest at lower prices which means their investment buys more shares. This reduces their average purchase price. This strategy is called dollar cost averaging.

Investing on autopilot with regular instalments is a great way to build up savings without having to lift a finger, and it also removes the emotion from your investment decisions – which is usually a good thing.

How Dollar Cost Averaging works

	Using dollar cost averaging				Investing a lump sum		
	Investing $100 per month	**ETF market price (illustrative only)**	**Shares purchased**		**Investing $1,200 lump sum**	**ETF market price (illustrative only)**	**Shares purchased**
January	$100	$1.00	100		$1,200	$1.00	1,200
February	$100	$1.50	67				
March	$100	$0.75	133				
April	$100	$0.50	200				
May	$100	$1.00	100				
June	$100	$1.25	80				
July	$100	$2.00	50				
August	$100	$1.20	83				
September	$100	$0.80	125				
October	$100	$0.70	143				
November	$100	$0.65	154				
December	$100	$1.00	100				
	Amount invested	**Average cost**	**Total shares bought**		**Amount invested**	**Average cost**	**Total shares bought**
	$1,200	**$0.90**	**1,335**		**$1,200**	**$1.00**	**1,200**
End value (Dec)			**$1,335**				**$1,200**



Our example is hypothetical only. For clarity, it does not use actual prices and ignores brokerage.

Our example shows how a regular investor using dollar cost averaging may benefit from price declines, which mean they can invest at a lower entry price and therefore buy more shares, thus enhancing their long-term return.

The benefit of starting early is that you will be investing for a longer time, and time is the fuel for arguably the most powerful force in investing, compounding.

Compounding is the process of earning returns on returns. If you invest $1,000 and earn a return of 5% your portfolio will grow by $50 and the value of your investment at the end of the year will be $1,050. Over the second year, if your portfolio again gains 5% your return will be $52.50. The return is $2.50 higher because you earn the return not only on your original $1,000 but also on the $50 you earned last year (5% on $50 is $2.50). The power of compounding becomes more obvious over the long term. After 10 years the original investment would be worth $1,629, after 20 years $2,653.

Regular savers can benefit from compounding. Someone who can save $200 a month ($2,400 a year) for 20 years will have invested $48,000. Using an illustrative annual return of 5% (after tax and fees), their end value would be $81,161, meaning 41% of the end value will have come from compounded returns.

If this person invests for 30 years instead of 20, they will invest $72,000 and their end value would be $163,075, which means over half (56%) of their end value would have come from compounded returns.

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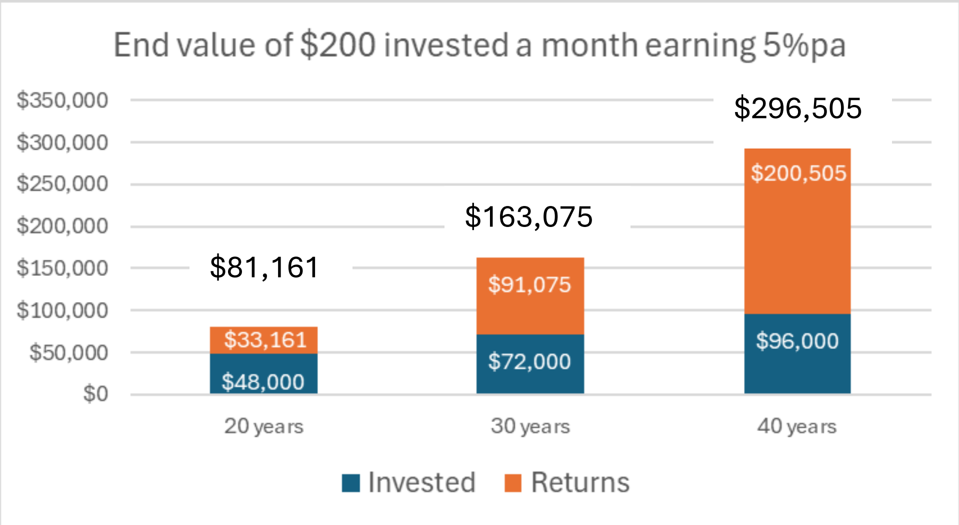
Do the same exercise for 40 years and they will invest $96,000 and their end value will be $296,505, meaning two-thirds (68%) of their end value would have come from compounded returns.

It was with good reason that Albert Einstein once called compounding “the eighth wonder of the world”.

An illustration of how compounding works



4. Pass the “sleep test”

Your investments should not keep you awake at night. There is a golden rule of investing called “the sleep test” which says your portfolio should have a mix of low and higher risk assets which aligns with your tolerance for risk. While it has a feel-good factor – who needs extra stress in their lives - there is also a serious angle to this maxim.

Having a balanced mix of assets means people are more likely to be able to ride out declines in markets and not sell after markets have fallen. Doing so locks-in their loss and can mean they miss the inevitable rebound in markets. As well, at the other end of the spectrum, having some of the portfolio invested in growth assets, like shares, helps mitigate our concerns that our savings will not grow adequately over the long term.

5. Take a ‘core and niche’ approach

It is important to maintain a well-diversified balanced portfolio. At the same time, many of us may like to make more active, higher-risk investments. A ‘core and niche’ approach is a way of both protecting your balanced portfolio while also providing an avenue to take more active positions.

Your ‘core’ portfolio is your key long-term investments. This may be a balanced fund, or a combination of ETFs providing diversified exposure to each asset class. Conversely, ‘niche’ investments are smaller, more active positions. They may be a sector-specific ETF, or any other range of investments. The key principle is that ‘niche’ and ‘core’ investments are like oil and water, they should never mix.

To ensure your core portfolio holdings, and your long-term goals, are not compromised by a niche investment which might perform poorly, any ‘niche’ investments should be kept separate from the ‘core’ portfolio.

A ‘core and niche’ approach is a great way of giving us scope to make some active investments, without risking our core portfolio and long-term investing goals.
