AMP CAPITAL

SEVEN KEYS TO SUCCESSFUL INVESTING

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KEY POINTS...

- Compound interest and regular investments can make a significant difference over 20-year plus timeframes.
- If an investment looks too good to be true in terms of the return and/ or riskiness on offer, then it probably is.
- Certain biases affect our investment choices, and explain why some investors make irrational decisions that are contrary to the available empirical evidence.
- While volatility can be disconcerting, high levels of market volatility can often indicate investment opportunities.
- Diversification is an effective way to reduce risk as not all types of investments perform well at the same time.
- Avoid emotional biases by being aware of these biases and taking a disciplined approach to minimise their influence.
- Over the long-term those who remain fully invested are best placed to reap the rewards from the market's positive years.

It requires discipline to stay invested through volatile times and capture the long-term performance of the market. Investor behaviour often deviates from logic and reason, and investors display many biases that influence their investment decision-making. This article sets out seven key strategies to help 'cut through the noise' and emotional biases, and help you invest more successfully over the long-term.

1. START INVESTING AS EARLY AS POSSIBLE

It's never too early to start investing. Investing early will help develop positive spending habits and teaches important lessons about budgeting, spending, and saving. Those who invest early on are less likely to overspend or be careless with their money in the long run. In addition, the earlier you start, the greater the power of compound interest.

Compound interest is interest that is paid on both the principal and also on any interest from past years. It's often used when someone reinvests any interest they gained back into the original investment. For example, if I receive 15% interest on my $1000 investment, the first year and I reinvest that money back into the original investment, then in the second year, I would receive 15% interest on $1000 and the $150 I reinvested. Over time, compound interest will make much more money than simple interest.

2. INVEST IN WHAT YOU UNDERSTAND

There have been lots of investments over the decades that have been sold on promises of high returns or low risk. Many were underpinned by hope based on hot air, eg the dot com stocks in the 1990s, or financial alchemy where rubbish was supposedly turned into AAA yield generators, such as the sub-prime CDOs of last decade. If an investment looks too good to be true in terms of the return and/or riskiness on offer, then it probably is.

The key is that if it looks dodgy, hard to understand, or has to be based on obscure valuation measures to stack up, then it's best to stay away. By contrast, assets that generate sustainable cash flows (profits, rents, interest payments) and don't rely on excessive gearing or financial engineering are more likely to deliver.

3. AVOID EMOTIONAL BIASES

In recent times investors have become more aware of how their behaviours affect the way they invest. This behaviour affects prices and returns, creating market inefficiencies as investors under or over-react to events or information.

One of the reasons our access to so much information is affecting our investment choices is our tendency to be overly influenced by our emotional responses, often unconsciously. No matter how disciplined you may think you are in your investment strategies, behavioural bias has been shown to have a significant influence on investment decisions. This is particularly true when we are bombarded with a high volume of information and communication 'noise' that affects our emotional responses.

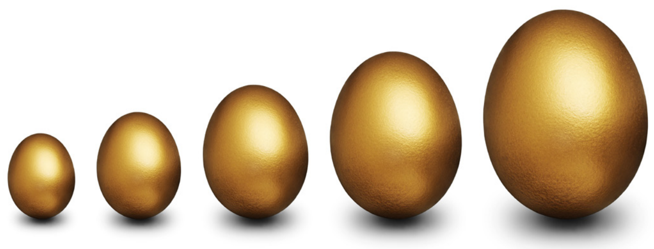
Being aware of these biases and taking a disciplined approach can help to reduce any potential negative impact they may have. The key is to get a long-term plan that suits your level of wealth, age, risk tolerance etc, and stick to it.

4. VOLATILITY IS NORMAL

Volatility in investing refers to the degree to which an asset's value fluctuates. It's always disconcerting watching the value of assets rise and fall. However, you can't avoid volatility in financial markets – it's simply a fact of life.

An important aspect to successful long-term investment is understanding that economic conditions fluctuate over time. Historically, investment markets – be it bonds, shares, property, infrastructure, etc – go through cyclical phases of good times and bad. Some are short-term, such as normal business cycles that result in three to five year cyclical swings. Some are longer, such as the secular swings seen over 10 to 20 year periods in shares. However, history also shows returns tend to be relatively smooth over long periods.

With heightened volatility an ongoing feature of investment markets, it's important to recognise that volatility is not necessarily the same as risk and to adopt strategies to avoid emotional responses. In volatile times the key is to avoid the emotional investing driving the crowd, look for the opportunities that volatility provides and stick to a long-term investment strategy.



5. DIVERSIFY YOUR INVESTMENTS

Diversification is one of the most important concepts in financial markets. Its purpose is to protect investors when markets are volatile or on a downward trajectory. The theory behind a diversified portfolio is that asset prices do not move perfectly together so as one asset classes rises, another generally falls, allowing the portfolio to ride out market cycles.

There are many ways of being diversified and new thinking has emerged around sources of diversification. For instance, it was once thought certain asset classes such as shares and bonds were uncorrelated. The assumption here is that when one asset class, for instance, shares, falls, another one, for instance bonds, will rise. But during periods of market dislocation, often the values of different asset classes fall in tandem. Therefore, it's important to identify other sources of diversification beyond asset classes. For instance, it's important to look for sources of diversification within the same asset class. Within the equities asset class, for example, it's possible to be diversified across industry sector and type of business (growth and value).

Overall, a truly diversified portfolio would ensure no more than 15% to 20% of the fund's assets are held in a single asset class.

6. TURN DOWN THE NOISE

Once you have worked out a strategy that is right for you, it's important to turn down the noise on the information flow surrounding investment markets, ie consume less of it. The past couple of decades have seen an explosion in the volume and ease of access to information surrounding economies, investment markets and individual investments. While in some ways it is positive, there is little evidence that it's helping investors make better decisions and hence earn better returns.

The ease with which information on returns can be accessed also reinforces shorter and shorter investment horizons for investors. By turning down the news volume you can refocus on your long-term strategy rather than lurch from one crisis to the next.

This also involves keeping your investment strategy relatively simple. Lots of time can be wasted on fretting over individual investments or type of managed fund – which is just a distraction from making sure you have the right asset mix, as it's your asset allocation that will mainly drive the return you will get.

7. INVEST FOR THE LONG-TERM

The best way to avoid losing at investments is to invest for the long-term. While it can be tempting to sell out of your investments when they are underperforming, investors who attempt to time the market can miss out on some of the biggest market bounces. Time in the market rather than timing the market can help to manage risk and improve the outcome of your portfolio over the long-term.

It takes courage to leave your investments where they are when there is a major event that causes a drop in their value. But it is important to remember that over time markets invariably recover. If you over react and sell when prices are low you will likely lose money and will not benefit from the upturn. Leaving the investment to recover over time will invariably reward you with better returns in the long-term.

[Source: Dr Shane Oliver, Head of Investment Strategy and Chief Economist, AMP Capital Australia]

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