

ten
GOLDEN
RULES of
investment



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The traditional financial planning model states the following incontrovertible truths: markets are efficient and can't be predicted, bubbles don't exist, equities always outperform in the long run, past returns are an excellent guide to the future and it's all about 'time in the market not timing the market'. This financial planning strategy can be loosely summarised as 'buy, hold, charge handsomely and go play golf'.

At Stanford Brown we believe that past returns are often a terrible guide to the future, that bubbles regularly form, that the madness of crowds is endemic, that predicting short term returns is strictly for fraudsters and economists, and knowing what your mates at the club have done can really hurt your returns!

We will at all times remember the wise words of Mark Twain about history rhyming, we will avoid overpriced markets, resist the urge to overly tinker with your portfolios and always maintain their robustness. We will think long term, remember that anything that cannot go

on forever will stop, and practice mean reversion. We offer no get-rich-schemes but take our responsibilities very seriously. We will never play Russian roulette with the funds you have entrusted to us, even if the metaphorical gun has 100 chambers and only one bullet.

However, to paraphrase JM Keynes, we are also well aware that assets can trade at the 'wrong' price far longer than we can remain employed or you, our clients, can remain happy.

Without any further ado, we proudly present our 10 Golden Rules of Portfolio Investment.



'The way to make money is to buy when blood is running in the streets.'

John D Rockeller

RULE 1

History doesn't repeat itself - but it does rhyme.

Whether recovering from the Great Depression of the 1930s, the oil shock of the 1970s or the market crash of 1987, the similarity of the equity cycle is remarkable. Why is this so?

Markets are the collective actions of humans, who nearly always respond in the same way. At the end of a crash, declarations are made never to buy shares ever again, followed by a dawning realisation that the bear market may be finally ending. Enthusiasm that shares are rising again gives way to greed as investors fear missing out on the 'next

big thing'. The cycle reaches its zenith with predictable delusional euphoria that 'this time it's different', followed swiftly by denial, capitulation and despair. This time it's not different. Our behavioural biases (heuristics) always conspire against our investment success. If something can't go on forever, it will stop.



"Everything should be made as simple as possible ...but no simpler."

Albert Einstein

RULE 2

Keep things as simple as possible ...but not too simple.

Most pithy sayings are attributed to one of Albert Einstein, Mark Twain or Winston Churchill. This trifecta of Wildean wit has been credited with 90% of all the great quotes.

History has credited Mr. Einstein with this maxim and Mr. Twain with our first Golden Rule, though it is highly doubtful whether either actually said it.

The future return on any asset class is the sum of three different factors; the income yield (dividends for shares, rent for property, and interest for cash and bonds) plus the forecast growth in that income plus the change in market sentiment as

denoted by the Price/Earnings ratio. This is just as true for property as it is for bonds and equities. Dividends and dividend growth are what matters in the long run not PE ratios.

Our 10 year return forecasts, which are published quarterly, are based on this simple and intuitive method. Structured products and derivatives rarely pass this test or Golden Rule V.



RULE 3

The long term is easier to predict than the short term.

Don't ask us where we think the market is going this year. We don't know.

Nor does anyone else, though it doesn't stop most market commenters from offering their 'expert' opinion. However, do ask us for our 10 year projections. The probability of us being right will be vastly

improved. Why are ten-year forecasts so much more accurate? We refer you, dear reader, back to Golden Rule I – markets rhyme and people are predictable.

'There are two kinds of forecasters: those who don't know, and those who don't know they don't know.'

JK Galbraith



'Indeed, the evidence is compelling that when decade-long real stock returns are inordinately high by historical standards, returns in subsequent decades are likely to tumble; when past returns are exceptionally low, future returns are apt to rise. What it's all about, it seems, is reversion to the mean.'

The legendary founder of Vanguard, John Bogle

RULE 4

Valuations almost always mean revert.

Also known as 'what goes up, must come down'. One of the most golden of all the rules. Trouble is, you rarely know when.

Our role at Stanford Brown is to reduce our clients' holdings of assets demonstrating bubble-like tendencies. We'd rather be six months early than six minutes late.

Asset classes (for example equities and property) demonstrate mean reversion. The Price/Earnings (PE) ratio of the

Australian equity market has averaged about 16 times for the past hundred years. A PE ratio substantially above this is likely to act as a long term headwind to share prices, and vice versa.

The performance of a typical fund manager also mean reverts. Last year's top performers are often next year's dogs.



'There is only one difference between the tax collector and the taxidermist - the taxidermist leaves the hide.'

M Chaplin
Former director of the Inland Revenue Service.
And clearly a very smart man.

RULE 5

Keep fees & taxes to a minimum.

Financial advisers are paid by clients to provide advice. Apologies if this seems obvious.

One of the best ways your friendly-neighbourhood adviser can justify his fees is to do something; sell a share, buy another, find a new fund, etc etc. However more often than not, this activity simply eats away at the portfolio's value and merely generates trading fees for the adviser and other intermediaries. We at Stanford Brown are in the business of building robust, diversified portfolios built for the long term. We will make changes, but we will keep them to a minimum. The reason is the overwhelming evidence that excessive trading reduces portfolio returns. Pay us to be lazy. Let us bask in our indolence. In fact, our portfolio philosophy

closely resembles Warren Buffet's – 'lethargy bordering on sloth remains the cornerstone of our investment style' (he actually did say this).

We have no hidden fees, nor do any fund managers pay us to promote their product. Using Fund Managers introduces more fees for clients. Sometimes these additional fees are justified; but these occasions are becoming rarer. We assume that all other things being equal, tracker funds are better than managed funds. We do use the latter sparingly but only when the fees are reasonable and only when they have a long track record of success.



'A great company is not a great investment if you pay too much for the stock.'

Benjamin Braham,
father of value investing and Warren Buffet's teacher.

RULE 6

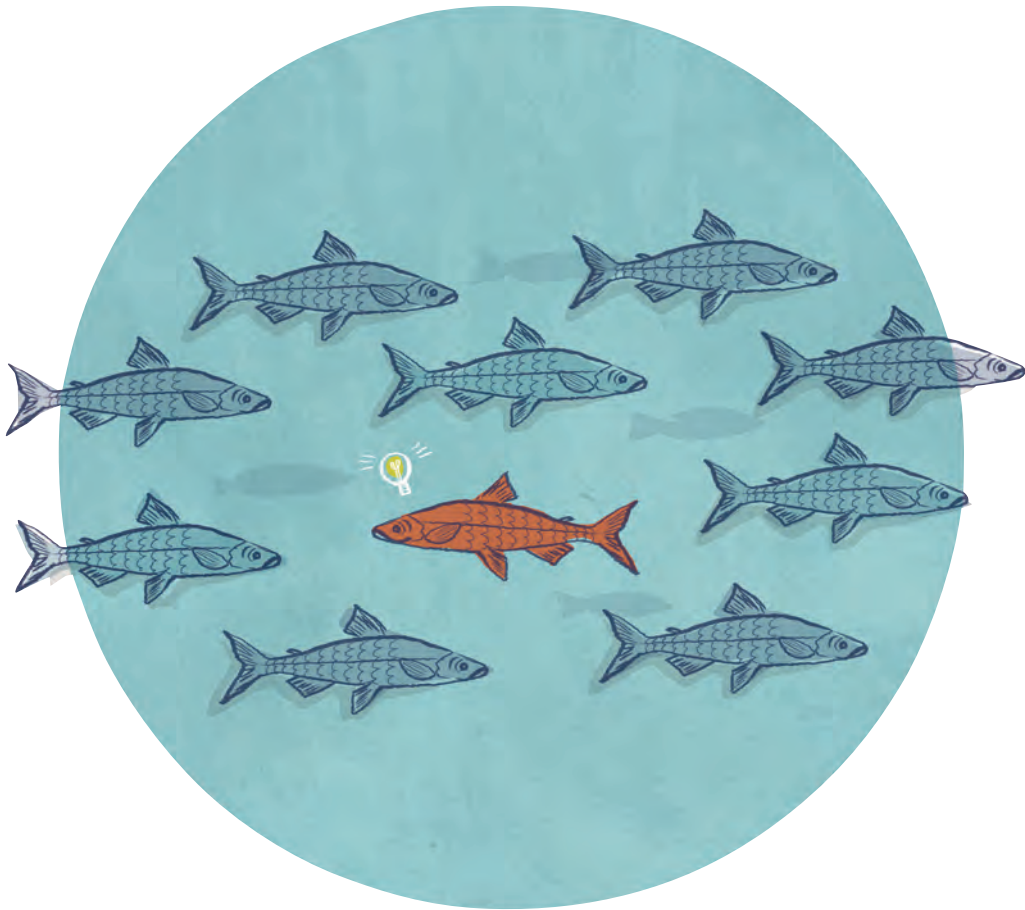
Things are not always as they seem.

The investment industry likes to label assets as either 'defensive' or 'growth'. In other words, look for income and safety from the former, and growth but risk from the latter.

This may be nice and simple, but it's grossly misleading. The reality is that there are no such things as 'defensive' assets and 'growth' assets – there is a line stretching from government guaranteed bank deposits to speculative penny stocks, and every asset sits somewhere on that line.

Crucially, as the price of any asset class

climbs, not only does its future return diminish but it also becomes more risky. Howard Marks, boss of Oaktree Capital, put it more succinctly, declaring that 'the current price of an asset is the principle determinant of its future return.' Not an intuitive concept at all – but profound nonetheless.



*'If all mankind minus one were of one opinion,
and only one person were of the contrary opinion,
mankind would be no more justified in silencing that
one person, than he, if he had that power, would be
justified in silencing mankind'*

John S Mill, On Liberty

RULE 7

Be the devil's advocate not his friend.

Most financial advice practices run almost identical investment processes.

They keep their clients' money invested in the same portfolios using the same expensive fund managers throughout the cycle, regardless of expected return or risk. At Stanford Brown, we do things a little differently. If we believe an asset class has a poor future return profile, we will remove it from your portfolios. Even if the benchmarks and the asset consultants insist we shouldn't.

We are, by nature, contrarian investors, forever scanning markets for unloved assets where all the bad news is fully priced in. This may lead to periods of underperformance (more likely in roaring bull markets) but has in the past has produced more stable portfolios over the cycle.



RULE 8

Don't copy your mates at the golf club.

We all know him – the guy who insists on telling you about his latest biotech stock purchase that tripled in value last week alone. What we also know is that he is omitting to tell you about all the dreadful trades he has made.

The now very famous Dalbar Study revealed that the average American retail investor underperformed the stock market by a whopping 8% each year over a 20 year period. Why?

See Golden Rule I - investors rarely get greedy when others are fearful; nor do they worry when others are greedy. Don't copy your mates at the golf club – it can seriously damage your wealth.

'Our comforting conviction that the world makes sense rests on a secure foundation: our almost unlimited ability to ignore our ignorance.'

Dan Kahneman, author of *Thinking, Fast & Slow*, one of the greatest books ever written



'Stock prices will always be far more volatile than cash-equivalent holdings. Over the long term, however, currency-denominated instruments [cash] are riskier investments – far riskier investments – than widely-diversified stock portfolios.'

Warren Buffett

RULE 9

Cash will destroy your wealth in the long term.

About 100 years after the birth of Jesus, Roman Senator and historian, Tacitus, observed that 'the desire for safety stands in the way of every noble enterprise'. That desire for safety is pervasive throughout many investment portfolios, and comes at great cost.

In 1979, Bruce invested \$100,000 in shares whilst Kylie preferred the safety of term deposits. Fast forward to 2013, and Bruce is now sitting on a portfolio worth over \$1 million earning an annual dividend income

stream of some \$50,000. Poor Kylie. Her portfolio is still worth \$100k but her annual income has dropped to just \$3,500. Safety stands in the way of success.



'My ventures are not in one bottom trusted, nor to one place; nor is my whole estate. Upon the fortune of this present year.'

Antonio reassuring Salarino in *The Merchant of Venice* and in the process giving one of the earliest lectures on *diversification*.

RULE 10

If all your eggs are in one basket, watch the basket.

Far too much attention is placed solely on the returns achieved by a portfolio; few notice the route taken to achieve those returns.

At Stanford Brown, we focus on risk-adjusted returns. In other words, the maximisation of portfolio return for a given level of risk. We build conservative, diversified portfolios that are designed to hold up in even the most turbulent of times. We search for assets that not only deliver an acceptable rate of return, but that also perform differently (correlation)

under various market conditions. Risk is as important as return. Most of our clients' baskets are the result of a life time's work. We offer no get-rich-schemes but take our responsibilities very seriously. We will never play Russian roulette with the funds you have entrusted to us, even if the metaphorical gun has 100 chambers and only one bullet.

Disclaimer

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