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IPC's Intelligent Investor

The Four Principles of Investing

During these times of uncertainty – oil prices fluctuating, slowdown in the economy, interest rate confusion, investors may be encouraged to make changes to their well-structured investments. It is always prudent to re-visit your investment plans within the scope of your financial objectives. But changing your plans based on recent events, news items, or forecasts is not a prudent approach to investment management.

Remember these principles of sound management when investing:

1. No one can predict the future

Yes, it's true – NOBODY knows the future. We don't even know what will happen tomorrow. People want to believe that it is possible to predict events and outcomes. Unfortunately, not even that renowned investor, Warren Buffet, can foresee the future. Some people make lucky guesses or constantly predict calamities. Famed investment analyst Elaine Gazarelli predicted (guessed) to the exact date that there would be a crash on October 19, 1987, yet her track record after that prediction has been miserable.

If every day you say it's going to rain, eventually you will be right.

Yet some events have a level of certainty. The sun has a record of rising every day – sure, clouds block it some days – but it still shines. You know that in winter it will most likely snow in most cities in Canada. You also recognize that the winter will end, followed by spring and summer.

Another comfort is that the vast majority of companies make profits – if they didn't they would go bankrupt, and other companies would take their place. Dividends tend to be regular, and bond interest has a good track record of payments. This means that the investment market does go up over time.

Even within the unpredictability of future events there are some probabilities. But they will remain whether there is a bombing, a war, an oil crisis, a budget deficit or a housing crash.

If we accept that nobody can predict the future, why should we waste our time trying to do so?

2. Nothing Works all the Time

Investors want to believe there is some magic investment asset out there that will succeed all the time. They are looking for the ideal investment with no volatility and high returns, but that's about as realistic as the Tooth Fairy!

No single investment is successful all the time, for example:

Gold

Think about the price drop from $800 to the $200s. People in the early 80s thought gold could never go down. They bought so much at $800 because someone predicted that it would go to $1,000.

Real Estate

You think that your house is the best investment you ever made, but that's not usually the case. Yet, it probably is the best leveraged investment you've made. Look back to 1989 when house prices were shooting up and everyone was flipping real estate. Then real estate crashed in 1990-1991 and house prices plummeted! People left their keys at the bank's doors because the mortgage was more than the value of the house.

Could this take place again? If it happened once, it can happen again. And it took ten years for house prices to get back to levels reached before the drop! House prices historically tend to increase slightly higher than inflation. When they exceed this standard you can expect a significant underperformance against the historical average. This is called "return to the mean".

Bonds

Those guarantees from the Government of Canada didn't do to well in 1994, when interest rates shot up dramatically, or in 1997 when we had the Asian flu.

Stocks

We can all remember 1987 Black Monday, the Tech Wreck of year 2000, Nortel at $120 per share, Bre-X, etc. Even the legendary Warren Buffet has had tough times. In June 1998, Berkshire Hathaway was trading at $78,000 and in February 2000 it fell to $44,000 - a 43 per cent drop, and didn't recover to $78,000 until October 2003, 5 years later.

Hedge Funds

Last week's Amaranth $6 Billion drop, Norshields, Portus and the Nobel winning Long Term Capital guys that helped collapse the markets in 1997.

Thus no single investment is always successful no matter what "someone says".

3. We live in the Short Term

People are focused on the short term; they think that the events of today will affect their long-term objectives. This attitude has been intensified by the media, and the abundance of nonsense available from Internet chat rooms and commentaries.

The panic of today is terrorism, much as the scare of past years was a nuclear attack from Russia, a missile crisis with Cuba, the Vietnam War or presidents being shot.

Corporations tend to manage their businesses on five-year programs, without getting bogged down in the events of the day. They maintain a steady stream of profits that they protect through good management.

Changing your portfolio based on short-term events such as an oil crisis, war in Iraq, hurricanes in the US, or a terrorist attack in Indonesia is hazardous to the achievement of your financial objectives. These events have as much impact on your long-term goals as Paris Hilton dumping another boyfriend! What matters is that the investments in your portfolio continue to maintain and enhance their profit centres.

Forget about the short term and turn your emotions off. Put down the paper and use it for what it is – entertainment. Turn off CNBC and the talking heads, because they are no better than Hulk Hogan and the WWE.

4. The pain of loss is greater than the pleasure of gain

The pain of losing 10 percent is greater than the pleasure of gaining 10 percent. When you lose, you have to almost double the return just to get even.

Because of the natural cycles of business management, losses are unavoidable in the markets. People buy cars in spring and summer, but not so many in the winter. This is a natural sales cycle.

A good investment program is based on the understanding that risk management is key. This may mean accepting a lower return when it seems that the rest of the world is making higher returns, but do you want to take the risk they are taking? Many investors examine their statements and say, "*Why didn't I do as well as other people?*" or "*Why don't I have as many energy stocks?*" Most of the time, it is because the risks were too high, and the potential of loss too great.

Remember those investors who were sitting on the sidelines with lower returns when technology was having a field day in the 2000s. Their risk management saw them through to superior long-term returns. Lower returns can be the safest course of action when the rest of the world has succumbed to greed. For when the pendulum swings from greed to fear, the rational investing approach will enable you to attain your financial objectives.

Diversify your portfolio

Nothing always works, but a portfolio made up of different assets ensures that at least one component is always earning. A varied portfolio, built with risk management in mind, is a better manager of loss than one with a narrow focus.

The keys to a well-diversified portfolio are:

- Excellence in independent management, investment specialists who maintain discipline and have triumphed over multiple market cycles.
- Due diligence and monitoring these investment specialists. Keeping an eye on their transactions and ensuring that they are not straying from their disciplined approach.
- Structuring to reduce risk. Including bonds reduces the risk of the market. The risk of an investment style is lessened by the introduction of an opposing investment style - value versus growth. The risk of a geographic region is reduced by adding other regions, and the risk of large companies decreased by including smaller companies
- Rebalancing to ensure that the time honored investment maxim "Buy Low – Sell High" is always in your favour and that your investment mix stays true to your objectives.

If you keep these principles in mind when managing your investments, you have a better chance of accomplishing your long-term goals.

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