The lessons learnt in half a century of investing

- DON STAMMER
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Investing is about preparing for the future. Investors take a view on prospective investment returns and on future risks and uncertainties.

Nonetheless, it may be interesting from time to time to look to the past, and at what investors with long experience have learnt. Now that I've been around for 32.6 per cent of the European settlement of Australia, and have a half-century of involvement with investing, perhaps I could be seen as experienced. Anyway, here are my offerings.

1. Benefit from compound interest and compounding capital gains. Compounding occurs where income from investments is reinvested and when gains from appreciating growth assets are left to bear additional fruit. Compounding is magic — notably for investors who make an early start and are patient.

In Australia, the long-run average rates of returns on shares and on houses, after inflation and before taxes, have been around 7 per cent a year. Compounding means their real value has, on average, doubled over 10 years, quadrupled over 20 years, and risen eightfold over 30 years.

2. Try to distinguish between the trend, cycle and volatility in investment returns.

The trend is the average of what happens to investment returns over a run of years; cycles are the somewhat rhythmical swings around the trend, and volatility describes the sudden and sharp moves that hit investment markets from time to time. Significant changes in trend returns from investments resulted from each of the float of the Australian dollar in 1983, our introduction of franked dividends in 1987, and the collapse of inflation in 1991. But trend rates of return don't change with the frequency that's suggested by the oft-made claims "it's a new era" or "it's a new paradigm".

3. Allow for the cycles in investment returns. Cycles occur because sentiment in investment markets swings from optimism to gloom; because governments and central banks sometimes change economic policies "by too much and too late"; and because of the big swings we see in the credit flows. Cycles vary widely in width and duration; no two cycles are ever the same; but cycles will always be with us.

Investors can cope with — and even profit from — cyclical swings in investment returns by:

● Holding a sensible diversification — and one that suit their risk tolerance — across the main asset classes. This should include holding enough safe and liquid assets so they won't have to sell off quality growth assets in depressed markets.

● Combining the themes of "time in the market" and "timing the market" — because both can help to improve returns. An element of market timing might be achieved by the investor holding multi-asset funds where the managers make occasional shifts in asset allocation. The investor might also use the regular meetings with his or her adviser to ask for a tactical change in asset allocation warranted by one or other asset class being seriously overbought or oversold.

4. As we’ve seen in recent weeks, occasional bursts of volatility are a feature of investment markets. Investors need to ask: is the volatility just a short-term wobble that soon will be reversed and forgotten, or is it the beginning of a major cyclical swing in investment returns. I’d guess, from experience, that the ratio of wobbles to the beginnings of something serious is about five to one.

5. Investors should think in terms of the after-inflation (or real) returns on their investments — and be aware of how changes in inflation affect investment markets.

Over the long term, inflation in Australia has averaged 2.75 per cent a year. In the 1970s and 1980s, however, inflation averaged 8 per cent a year — and was highly volatile.

Share investors usually do well for a while when inflation re-emerges; they do badly when inflation reaches high levels; and they benefit when inflation slows. High inflation causes price-earning multiples to shrink; cashflow considerations are given less attention; and speculative investments are favoured. Nominal interest rates take a while to adjust to changes in inflation. Investors in longer-dated bonds and longer-dated term deposits lose when inflation takes off, but gain as inflation falls.

6. Over the long term, shares and housing have delivered broadly similar average rates of return. But the cycle in returns on shares is wide; average house prices move in a steplike way.

Since the late 1980s, the timing and the duration of cycle in sharemarkets and the steplike moves in house prices have often been out of synch.

7. On some asset classes, returns are largely determined by overseas influences.

Our sharemarket usually moves in lock-step with US shares. Also, yields on long-dated Australian government bonds often move broadly in line with those on US bonds, though the correlation isn’t as close as with shares. But the Australian cash rate depends mainly on Australian influences — and our house prices follow a uniquely Australian path.

8. Investors need to be careful in the use of debt. Debt can be the investors’ friend, by enabling the investor to have a larger holding of assets than otherwise would be possible. But excessive debt adds to risks and vulnerability.

Experience suggests investors proposing to use debt to extend their investment portfolios should borrow modestly and be counter-cyclical in their timing: the worst time to increase debt is when borrowing is easy and assets are expensive.

Don Stammer chairs QV Equities, is a director of IPE, and is an adviser to the Third Link Growth Fund and Altius Asset Management. The views expressed are his alone.