If You Only Know 5 Things About Investing, Make It These

Description

I own one finance textbook, and I occasionally open it to remind myself how little I know about finance. It's packed with formulas on complex option pricing, the Gaussian copula function, and a chapter titled, "Assessment of Confidence Limits of Selected Values of Complex-Valued Models." I have literally no idea what that means.

Should it bother me that there's so much about finance I don't know? I don't think so. As John Reed writes in his book *Succeeding*:

When you first start to study a field, it seems like you have to memorize a zillion things. You don't. What you need is to identify the core principles — generally three to twelve of them — that govern the field. The million things you thought you had to memorize are simply various combinations of the core principles.

Evolution tells you a lot about biology. A handful of cognitive biases explain most of psychology. Likewise, there are a few core principles that explain most of what we need to know about investing.

Here are five that come to mind.

1. Compound interest is what will make you rich. *And it takes time.*
Warren Buffett is a great investor, but what makes him rich is that he's been a great investor for two thirds of a century. Of his current $60 billion net worth, $59.7 billion was added after his 50th birthday, and $57 billion came after his 60th. If Buffett started saving in his 30s and retired in his 60s, you would have never heard of him. His secret is time.

Most people don't start saving in meaningful amounts until a decade or two before retirement, which severely limits the power of compounding. That's unfortunate, and there's no way to fix it retroactively. It's a good reminder of how important it is to teach young people to start saving as soon as possible.

2. The single largest variable that affects returns is valuations — and you have no idea what they'll do

Future market returns will equal the dividend yield + earnings growth +/- change in the earnings multiple (valuations). That's really all there is to it.

The dividend yield we know: It's currently 2%. A reasonable guess of future earnings growth is 5% per year.

What about the change in earnings multiples? That's totally unknowable.

Earnings multiples reflect people's feelings about the future. And there's just no way to know what people are going to think about the future *in* the future. How could you?

If someone said, "I think most people will be in a 10% better mood in the year 2023," we'd call them delusional. When someone does the same thing by projecting 10-year market returns, we call them analysts.

3. Simple is usually better than smart
Someone who bought an S&P/TSX Composite index fund at the beginning of 2003 earned a 88% return (dividends and fees not included) by the end of 2012. That's great! And they didn't need to know a thing about portfolio management, technical analysis, or suffer through a single segment of Cramer's "The Lighting Round."

Meanwhile, the average equity market neutral fancy-pants hedge fund lost 4.7% of its value over the same period, according to data from Dow Jones Credit Suisse Hedge Fund Indices. The average long-short equity hedge fund produced a 96% total return — slightly better than the Canadian index and short of the 97% that the S&P 500 gained over this period.

Investing is not like a computer: Simple and basic can be more powerful than complex and cutting-edge. And it's not like golf: The spectators have a pretty good chance of humbling the pros.

4. The odds of the stock market experiencing high volatility are 100%
Most investors understand that stocks produce superior long-term returns, but at the cost of higher volatility.

Yet every time — every single time — there's even a hint of volatility, the same cry is heard from the investing public: *"What is going on?!"*

Nine times out of ten, the correct answer is the same: Nothing is going on. This is just what stocks do.

Since 1971 the **S&P/TSX Composite** (INDEX:^GSPTSE) has returned about 6.5% per year, but the average difference between any year's highest and lowest close is 29.6%. Perhaps more astoundingly, the widest difference between the annual high and low close was 95% in 2008. The smallest difference of "just" 11.1% occurred in 1977. Remember this the next time someone tries to explain why the market is up or down by a few percentage points. They are basically trying to explain why summer came after spring.

Someone once asked J.P. Morgan what the market will do. "It will fluctuate," he allegedly said. Truer words have never been spoken.

5. The industry is dominated by cranks, charlatans, and salesman.

- The vast majority of financial products are sold by people whose only interest in your wealth is the amount of fees they can sucker you out of.
- You need no experience, credentials, or even common sense to be a financial pundit. Sadly, the louder and more bombastic a pundit is, the more attention he'll receive, even though it makes him more likely to be wrong.

This is perhaps the most important theory in finance. Until it is understood you stand a high chance of being bamboozled and misled at every corner.

Even though the S&P/TSX Composite Index has posted a great return over the past 10 years, it's structurally flawed. It's overweight in resource and financial stocks means index investors lack proper diversification.

We have created an exclusive free report detailing "5 Stocks That Should Replace Your Canadian Index Fund," designed as an easy-to-implement strategy for market-beating returns. To download a copy of this FREE report, simply click here right now.

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CATEGORY

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