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14 steps to investing success in 2014

Chris Dillow

How can we get rich in 2014? We can't, at least not without luck. Markets are largely unpredictable, and our efforts to make quick profits are undermined by countless errors of judgment. What we can do, though, is tweak the odds of success in our favour by following a few principles, most of which don't so much help to make money as stop us losing it in the stupidest ways. Here are 14 rules for 2014.

Minimize taxes. It's a cliché because it's true; the first rule of investing is not to hand money to the tax man unnecessarily. This doesn't mean investing in fancy tax-dodging investments. It just means taking advantage of the allowances you have. You can invest £11,520 this year in an Isa, and if you're a basic rate tax-payer, the government will put £25 into your pension pot for every £100 you put in - and more if you're a higher-rate payer. Outside of these, you can get £10,900 a year before having to pay capital gains tax. Make the most of these breaks.

Remember tracker funds. It's not just the tax-man you should avoid giving money to. You should also not hand money over to fund managers without good reason. If you want exposure to equities, your default position should be a low-cost equity tracker fund. Only depart from this if you have good reason to do so. And remember that, very often, investors don't have good reason. Research suggests that demand for actively managed funds is inflated by cognitive biases such as overconfidence, naïve diversification and an under-appreciation of how badly charges erode wealth over time.

I know - tracker funds are boring. But lots of things are boring if done well: Geoffrey Boycott was a boring batsman, but England could use his sort now.

Simplify. Don't over-diversify. Surprisingly few investors are heavy owners of tracker funds. Many more, however, have wandered into expensive and unwieldy tracker funds unwittingly. This is because of the downside of diversification – spreading the risk of individual shares means your portfolio soon resembles a tracker.

Let's do some maths. Say you have 30 shares, and that the chances of one beating the market are independent of another doing so. And let's say each has a one-in-six chance of out- or –under-performing the market by 30 percentage points; this is true for middling FTSE 100 stocks or more staid FTSE 250 ones. It then follows that there's a two-thirds chance that your portfolio's annual return will be within 5.5 percentage points of the market's.

If you hold funds, the chances of ending up with a closet tracker are even higher. This is because – as I've just shown – any basket of stocks will tend to rise and fall as the market rises and falls. If you hold baskets of baskets, therefore you will quickly have something like a tracker – except with higher fees.

One solution to this is a core-satellite approach. Own a tracker for general market exposure, and add a few ideas to it.

Diversify across assets – including cash. Although you can't easily spread risk by diversifying across shares, you can do so across assets. Over the last 20 years, monthly returns on gilts and gold (in sterling) have had zero correlation with equities, which means that if shares fall there's a 50-50 chance that either gold or gilts will rise.

Correlations, however, vary with macroeconomic conditions. It's possible that these will become positively correlated if or when investors come to fear a serious tightening of monetary policy.

One asset that protects you from this correlation risk is cash. Which is one reason why it's worth holding some, even at negative real returns.

Don't be a noise trader. One of the strongest findings in economic research is that people who trade a lot end up poorer for it. One reason for this is that they are overconfident about their ability to pick winners. Another reason, says David Navon at the University of Haifa, is that we're prone to egocentric framing. We think only from our point of view. An easy antidote to this is to ask before buying a stock: "why is someone willing to sell me this?"

There is, though, a third reason for over-trading: we fail to appreciate that a lot of news is just noise, which conveys no signal about future returns; funnily enough, journalists rarely tell you this. There's a danger that the reaction against the efficient market hypothesis (which says that all news is immediately embedded in share prices) has gone too far, and some people now believe that nothing is in the price.

There is, though, a mid-point here. There are a very few systematic departures from market efficiency – general principles which pay off on average over the long-run. These are the tendencies for quality (profitable, growing companies), defensive and momentum stocks to do well. If you buy a stock outside these categories, you might do well – but you're fishing in more barren waters.

Respect the seasons. One of the strongest facts about stock markets is that they are seasonal. Returns are significantly higher from Halloween to May Day than they are from May Day to Halloween, especially for Aim and smaller shares.

This doesn't necessarily mean you should "sell in May", unless you can do so at no cost as many unit-linked pension schemes permit. But it does mean you should be wary of investing in smaller speculative stocks in the spring, as this is when investors' sentiment is apt to be high and so such stocks are more likely to be over-priced.

Don't follow old wives' tales. "Sell in May" is an old saying that has massive empirical support. But the same is not true for the other half of the saying – "buy on St Leger day". On average, share prices do poorly in September, perhaps because the longer nights reduce our appetite for risk.

This is not the only old saying that's wrong. So too might be the conventional advice to hold plenty of equities when you are young and fewer as you get older. Javier Estrada at IESE Business School in Barcelona has shown that this strategy often gives you lower retirement wealth than the opposite – investing more in shares as you age – or simply keeping the same proportion in equities throughout your life.

So, how can we distinguish between bad rules and good ones? Simple. Just remember that investing is a science and ask: what is the evidence base? For some rules – such as "sell in May" or "prefer defensives" – this base is strong. For others, it's just the received wisdom of empty suits.

Don't be one of the herd. "Thou shalt not follow a multitude to do evil" says the Book of Exodus. This is good advice for investors, because recent economic research shows that we are easily persuaded to follow a multitude, and in doing so, we do evil to our financial plans.

Hans Hvide of the University of Aberdeen and Per Ostberg at the University of Zurich have found that retail investors' share-holdings quite closely resemble those of their colleagues, suggesting that our stock-picks are subject to peer effects. This would be no bad thing if our colleagues gave us useful information. But they don't. Messrs Hvide and Ostberg found that shares bought under peer pressure do no better than other stocks, and can leave us with too risky a portfolio, to the extent that such stocks are disproportionately likely to be in the industries we work in.

Theirs is not the only evidence for peer pressure. Matteo Ploner at the University of Trento ran an experiment in which subjects were asked to choose between safe investments and riskier ones. He found that when people were told of others' choices, their own decisions resembled others' more closely than they did when they were not informed what others had done. In particular, people who had made cautious choices made riskier ones when they learned that others were more adventurous than them. "Social effects play a fundamental role in investment choices," he concludes.

This is very dangerous. It suggests that we are apt to buy shares at the top of the market – when others are taking risks – and to sell at the bottom, when others are cautious.

It's not just our investments that are prone to peer pressure, though. There's increasing evidence that our spending decisions are too; we spend more if our neighbours do. Such pressures can lead us to save too little. This matters, because the biggest influence upon our retirement wealth isn't so much how we invest (unless we do something very odd), but how much.

The message here is simple: don't follow others. This, though, is easier said than done. As Tom Waits said, "you must be strong if you're to go it alone". This leads us to...

Be disciplined. What makes a successful investor? The answer is: discipline, according to a paper by Lasse Pedersen and colleagues at AQR Capital Management. They show that the key to Warren Buffett's success is not so much great stock-picking as the will-power to stick with the strategy of holding defensive, quality stocks even in times when they did badly, such as during the tech bubble. This discipline means he's been able to profit enormously when good long-term principles come back into favour. Finding a few good rules and sticking to them is better than hyperactivity.

Be aware of the subconscious influences upon your investments. Recently, economists have discovered that our investment choices are shaped by factors beyond our control. These factors might be genetic, or our experiences in our formative years; people who experienced hard times in their youth are likely to hold fewer shares than those who enjoyed good times, and what shares they do hold are more likely to be value than growth ones.

Another big influence upon our investments can be our emotions. Psychologists at Harvard and Columbia Universities have found that people who are sad tend to save less than others. And Claudia Nardi of the University of Verona has found that people who are happy or angry are apt to take more risk than those in a neutral mood. Such emotional ups and downs can be expensive. Tilburg University's Charles Noussair has found that traders who maintain neutral emotional states during market gyrations make more profits than those who are more emotional.

Frequent trading is generally a bad idea. But it's an especially bad one if you are the passionate, temperamental type.

Avoid wishful thinking. I mean this in three senses.

First, don't have inflated expectations for long-run returns. If you're assuming long-run returns on equities after inflation will be more than around 5 per cent a year, you might well be disappointed. Low long-term interest rates are a sign that we live in a world of low returns. Those who believe we are doomed to secular stagnation might be too gloomy – but you shouldn't ignore them completely.

Secondly, don't bet that you can beat the market. Warren Buffett owes his success to the right general strategy and to cheap leverage rather than to good stock-picking. And research shows that fund managers typically have no more than a handful of good ideas; their other stockholdings merely dilute the returns on these. Why should you think you're any better? A belief in your own ability can be positively dangerous, as it can tempt you to trade too much, and to buy high-cost funds in the mistaken belief that you can spot good fund managers.

Thirdly, be very wary of stocks that seem to offer lots of upside potential. There's plenty of evidence that lottery-type stocks under-perform on average, because investors pay too much for the slim chance of big and quick returns.

Be wary of Aim stocks, but not yet. Herein lies a reason why Aim has under-performed bigger stocks; since its inception in December 1995, the Aim index has fallen 17 per cent whilst the FTSE 100 has risen 80 per cent. Aim stocks tend to be more speculative than bigger ones, and so are (on average) over-priced.

You might think this is a reason to reduce your Aim holdings. It is, in principle. However, Aim stocks are highly seasonal and tend to do well at the turn of the year. This is a case for holding onto them for a while longer – and especially onto past risers which might (on average) benefit from momentum effects. History and theory, however, warn us against holding them over the summer.

Get rich slow. If stocks with the small chance of quick, big gains are over-priced on average relative to the market, some others must be under-priced. Those others are generally defensive and quality stocks. These, however, won't make you rich overnight. Instead, many years of slight out-performance add up nicely over the long-term.

There's another way to get rich slow – to start saving early. Doing so has two virtues. One is that it takes advantage of the power of compounding; if you put £1,000 into a pension fund and can get a real return of 4 per cent a year, that £1,000 will grow to over £4,000 in

30 years' time. And – depending on what happens to your lifetime earnings - it might well be easier to save £1,000 in your 20s than £4,000 in your 50s. Perhaps even more importantly, though, saving early gets you into the savings habit. Just as it's easier to lose weight slowly, so it's easier to gradually save more rather than reach one's 50s and then try to save a lot.

Granted, it's possible to save too much – to deprive yourself of consumption capital in your youth and have excess wealth in your old age – but you can mitigate this problem by living it large in your middle years.

Be comfortable. Perhaps the main point of having money is that it gives you freedom from worry. If you have lots of savings – and remember that half of households in their 50s have financial wealth of less than £100,000 – and are still worrying you are therefore doing something wrong. There are two things to avoid here.

One is a mismatch between your investments and your risk tolerance; if you're worrying about stock market moves, you've probably got too much in equities. We can, roughly, quantify this. If we assume average real returns of five per cent a year and annual volatility of 20 per cent, then there is a roughly one-in-four chance of shares losing money in real terms over a five year period. Can you take this risk? The more you can, the more you can afford to invest in shares.

Although this is ultimately a matter of taste, one important consideration here is the margins of adjustment you have. For example: are you willing and able to work longer and postpone retirement? Could you release home equity by moving to a cheaper house? Are you willing to reduce the amount you leave to your family? If the answer to questions such as these is "yes", you're in a better position to take equity risk than others.

Your asset allocation should be based upon your personal circumstances and tolerance of risk. It should not be based upon idle futurological speculation on where the market's heading. That's just the road to worry.

Secondly, we should avoid a mismatch between our wealth and our spending habits: champagne tastes on a beer income are a bad idea. Sure, one way to a comfortable retirement is to save a lot and get a high return. But a more feasible way might be to cultivate cheaper tastes: if you enjoy reading and playing the guitar you need a lower income than if you like fast cars and fine wine. Yes, financial planning matters – but so too does character planning.