

InvestWell with Financial Lifestyle Managers

“THE MARKETS ARE MERELY A RELOCATION CENTRE: THEY RELOCATE THE WEALTH FROM THE IMPATIENT TO THE PATIENT”

Warren Buffet (Greatest investor of our lifetime).

Following on from this we thought we would look at why people act the way they do in relation to their investments. In the following article, Felix Stephen, Senior Manager Strategy & Research, Advance Asset Management, attempts to answer the question: **Are markets 'economically rational' or 'partially rational', or even 'irrational'?** and has provided a brief insight to why investors behave the way they do.

Being rational in an irrational market

What drives economies and markets?

Economic forecasting is more of an 'art' than a 'science'. Dr Greenspan agrees with this hypothesis in his book *"The Age of Turbulence"*. Dr Greenspan has also recently commented, "if confidence in the future improves and equity values go up, economic activity will also improve".

Global economic success or failure largely depends on a series of complex factors. Some of these factors crucially depend on policy biases and policy implementation by governments and bureaucrats, and the behavioural patterns of individual consumers and businesses, followed by the collective behaviour of a community, country or the global village at large.

Success is based on the level of confidence about:

- the future,
- attitudes towards risk taking,
- the approach towards wealth creation or savings accumulation,
- the legal and regulatory framework under which decisions relating to the future are made,
- demographics,
- macroeconomic and geopolitical trends, and

- the prevailing or expected environment under which individual or corporate objectives can be met and achieved.

But this list is not exhaustive. There's a lot of other factors that ultimately help us analyse and grasp key economic and financial market trends.

Paul Ormerod (Christ College Cambridge, St Catherine's College Oxford, National Institute of Economic and Social Research) in his book *"The Death of Economics"* argues that conventional economics offers a misleading view of how the world operates, and how futile and wasteful economic forecasting has become.

This is particularly evident after a major shock, because belief in the world's tendency to settle back to the previous regular behavioural pattern may be misplaced.

While the author does not imply that the study of economics is not of great importance, he uses a multidisciplinary approach, applying biology, mathematics, statistics and psychology to economics.

We have a similar bias and approach to our future economic and asset class trend assumptions.

What makes the task of economic forecasting or asset class trends more challenging?

Financial excesses followed by financial collapse are a sad artefact of economic history. While such events are often linked with innovation – railroads in the 19th century, automobiles and the radio in the 1920s and the Internet more recently - they are also a sad reflection of the irrationality of human decision making.

Behavioural economists and psychologists have uncovered a raft of decision-making practices that diverge from rationality. Financial market participants tend to condition their expectations on recent market trends, which reinforce price increases or decreases. Such expectations are slow to change, even when events undermine their assumptions.

Over time investors tend to become wedded to their views so only stark events finally shift them from their stance or biases.

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**You don't need to be wealthy to invest.
You need to Invest Well to be wealthy.**

Being rational in an irrational market *cont.* . .

Understanding this frailty of human judgement is crucial to understanding micro or macro global economic trends. It is important to bear in mind that this ‘frailty’ has been at the very core of past financial market turmoil, global economic booms and collapses, and most likely future booms and busts in global financial markets and economies.

Human frailty – our weakness

Stocks and bonds have been traded for well over 400 years. The Amsterdam Stock Exchange is believed to be the oldest organised exchange in the world and was established by the Dutch East India Company in 1602. However, what has not changed over the past 400 years, and is not likely to change over the next 400 years, is “human frailty” and the almost inexplicable behaviour of investors making similar errors of judgement over and over again.

We suspect that although there have been remarkable changes to our physiological and intellectual abilities throughout history, our psychological and rational

evolution has been less dramatic.

Given that on average there are minor financial market disruptions every 10 years and major disruptions once every 50 years, you would imagine that at present there are many more ‘battle scarred’ investors whose behavioural pattern is likely to be more cautious and circumspect. This is likely to have a major impact on the short to medium term global economic and financial market landscape.

Tactical view – financial asset market outlook looking better for ‘growth’ assets

We favour growth assets as opposed to defensive assets over the one-year investment horizon and believe that a re-pricing of risk is currently underway, which will help normalise over-priced and under-priced assets towards their “fair value” or “equilibrium” levels. However, this will lead to most liquid asset classes reaching an equilibrium level quicker than less liquid assets. ✱

Market update

ALWAYS LOOK ON THE BRIGHT SIDE OF LIFE

When it comes to the GFC, many feared a few short months ago that financial markets were about to draw their terminal breath. ("Crucifixion? No, they said I could go off and live on a tropical island somewhere." "Oh, good for you then. Off you go"). It seems to me that most people have found religion.

Unfortunately, once again people are confusing the real economy with financial markets.

This time around, though, everyone seems to see upside around every corner. Previously it was difficult to convince people that equity markets would rally well ahead of any pick-up in economic activity.

Now that the equity market has bounced 30-odd per cent, apparently all is right with the world. Indeed, Mr Rudd and Mr Stevens appear concerned about a spike in housing and an outbreak in inflation.

Right . . .

Well, it is certainly true that governments around the world are debasing their currencies by printing money like it is going out of style (particularly the US). It is also true that this is no solution. If it were, Zimbabwe would be a super power. But a serious bout of inflation, particularly in Australia: I just can't see it.

For a start, there remains a lot of excess capacity in the economy. The up-tick in housing largely reflects a pull forward in activity from the artificial stimulus of first home

owners' grants and stamp duty holidays. When the oxygen is turned off, it will be very interesting to see the results at the cheaper end of the market.

Meanwhile, news stories about the plight of small business seem to have sunk without a trace. Remember those little firms who still employ about half Australia's workforce?

A recent survey by JP Morgan & Fujitsu Consulting found that on average it now took over 50 days for trade debtors to pay up. Finance from the banks is also harder to get and over one third of small-to-medium-enterprises surveyed were paying in excess of 8 per cent for it.

Unsurprisingly, over half of the respondents expected to cut overtime and lay off staff during the next six months. Doesn't strike me as a particularly high inflation environment . . .

Will the financial markets continue to improve? Yes, but most of the easy gains have been seen.

Likewise, the real economy is on the mend, but let's not delude ourselves. There are still big issues to work through. Anything approaching reasonable levels of economic growth in the US and many parts of Europe will be hard to come by in the next 12 months. Even in Australia growth will be softer than in a normal recovery as the Government stimulus is wound back and lower export prices begin to bite. ✱

Frank Blundell

Enrol in a get rich slowly scheme

The power of compounding interest to help people obtain financial security.

Time for your investments to grow

Get rich quick schemes are everywhere. Unfortunately these schemes tend to make their promoters rich quickly — often at the expense of investors.

Like most things in life that are worthwhile, investing takes time: time to grow (compounding) and time to recover from downturns (volatility).

Compounding

Albert Einstein is said to have called it the most powerful force in the universe, and John D Rockefeller named it the eighth wonder of the world. We call it **compound interest**.

Why do people regard compound interest so highly? Most of us studied compound interest at school, so we know how it works. But it's not until you start looking at practical examples that you realise how powerful it can be.

31. At 31, you put aside \$5,000 and add another \$1,000 each year until you turn 65. Remember, you are reinvesting income, inflation is zero and you're getting that 8% pa average return.

You figure you will more than make up for lost time by saving harder — ie for 35 years rather than 10 years.

Which is the better strategy?

The **ten-year saving plan**, in which you will have invested a mere \$14,000 (a \$5,000 initial contribution then \$1,000 a year for nine years) will reap **\$332,413**.

The **35-year plan**, in which you will have invested \$39,000 — nearly three times as much — earns you considerably less: **\$227,077**.

Here are the hard numbers for you to check. The return, remember, is a constant 8% pa. ✱

The Power of Compounding – an example

This will fascinate you, or infuriate you, or both. It will also present you with a paradox – by proving that a person who decides to stop saving can save considerably more than someone who decides to save diligently all the way to age 65.

Imagine you are 21. You decide to invest \$5,000 and then add to it at the rate of \$1,000 a year — until you turn 30. Then you stop saving altogether and leave your nest egg alone until you turn 65.

Let's assume you earn an average return of 8% pa (after fees and taxes) which you always reinvest. And for simplicity let's say inflation is zero (so your real return is a healthy 8%).

Now imagine an alternative scenario

In this version you don't start saving until you turn

Years of age	Example 1 (\$)	Example 2 (\$)	Years of age	Example 1 (\$)	Example 2 (\$)
21	5,000	–	44	66,036	35,093
22	6,400	–	45	71,319	38,901
23	7,912	–	46	77,024	43,013
24	9,545	–	47	83,186	47,454
25	11,309	–	48	89,841	52,250
26	13,213	–	49	97,028	57,430
27	15,270	–	50	104,790	63,025
28	17,492	–	51	113,174	69,067
29	19,891	–	52	122,227	75,592
30	22,483	–	53	132,006	82,639
31	24,281	5,000	54	142,566	90,251
32	26,224	6,400	55	153,971	98,471
33	28,322	7,912	56	166,289	107,348
34	30,587	9,545	57	179,592	116,936
35	33,034	11,309	58	193,960	127,291
36	35,677	13,213	59	209,476	138,474
37	38,531	15,270	60	226,234	150,552
38	41,614	17,492	61	244,333	163,596
39	44,943	19,891	62	263,880	177,684
40	48,538	22,483	63	284,990	192,899
41	52,421	25,281	64	307,790	209,331
42	56,615	28,304	65	332,413	227,077
43	61,144	31,568			

Food for thought

WHERE WILL YOU BE AT AGE 65?

Millions of Australians earned over \$100,000 over the past 5 years, but at 65 only 10 in every 100 people are wealthy, financially independent, or still working.

So why don't more of us start saving sooner? And where do we spend our money?

- Over a quarter is spent on food, clothing, health and household items.
- About a quarter or more is paid in taxes.
- About a fifth to a quarter is spent on housing.
- And large amounts are spent on education, car, entertainment, and luxuries such as overseas trips or a new boat.

Invariably, it's a conflict between essential and discretionary spendings, which most of us don't differentiate between, and we cut into our lifetime earnings without thinking about our future needs.

You have a regular, disciplined plan to pay your taxes and your mortgage or rent. So doesn't it make sense to be just as committed to plan to meet your additional personal goals as well?



Rich



Independent



Working



Dead



Dead Broke



Dependent on Government or Charity

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