

# Four rules for investing success

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- The rollercoaster ride in investment markets over the past two years highlights the need for investors to have a disciplined approach to investing.
- Economic and investment forecasts are often seen as central to investing, but while they can be useful, they should be treated with caution and are no substitute for having a disciplined approach to investing.
- There are four key rules to successful investing. First, respect the market. Second, have a disciplined process. Third, be flexible. And fourth, know yourself.

The past two years have been tough for investors. Since 2007 shares have been on a roller coaster ride, first having their worst bear market in generations only to be followed by a rapid 50% or so rebound. And most other assets – bar government bonds and cash – have been on a similar ride. Trying to time any of that has been particularly challenging. What's more, there is no end of experts with widely differing opinions of where things are going. Some think that the next 'great depression' is still just around the corner and that the recovery we have seen over the past six months is nothing more than a bear market rally. Others, myself included, are of the view we have begun a new cyclical bull market with more upside to go. So what should investors do? At a more general level in undertaking investing there are several high-level rules worth following. These are particularly pertinent in the current environment.

**Treat forecasts with caution**  
The first thing to note is there is no easy way to predict where markets will go. If there was a foolproof method then I wouldn't be writing this and you

wouldn't be reading it! The difficulty in forecasting is highlighted by the experience of economic forecasters. Surveys of economic forecasts are regularly compiled and published in the media. It is well known that when the consensus (or average) forecast is compared to the actual outcome, it is often wide of the mark. This is particularly the case when there has been a major change in direction for the variable being forecast, as has been all too obvious over the past two years. The difficulty with forecasting applies not only to economists' forecasts for economic variables, but also to equity strategists' share market forecasts and share analysts' forecasts for company profits. Of course, this problematic track record has led to plenty of jokes about economists: Economists were invented to make astrologers look good; an economist will know tomorrow why the things he or she predicted yesterday didn't happen; economists have predicted five of the last two recessions, and so on. There are numerous examples of gurus using grand economic or financial theories which usually result in forecasts of 'new eras', 'great booms ahead' or, as is more fashionable at the moment, 'great depressions ahead'. These gurus may get their time in the sun but also usually spend years either before, or after, losing money for those who follow their grand calls. For example, the guru who foresaw a 'new era' based on the IT revolution in the late 1990s looked crazy in the bear market earlier this decade. And sure, some did get it 'right' in terms of the global financial crisis last year, but as former Reserve Bank of Australia Governor Ian Macfarlane observed; "Everyone who predicted what has happened [in 2008] has been predicting it for 10 years". And that's not a great track record. There is no guru or expert who will get it right all of the time. Prognosticators of doom can be particularly alluring. Firstly, because it is easier to sound logical and inquiring when painting a bearish picture regarding the outlook rather than a bullish one. As J.K. Galbraith once observed "we can all agree that pessimism is a mark of a superior intellect". Secondly, numerous studies show most investors are far more worried about a loss than a gain. This



natural wariness on the part of investors probably explains why historically share markets in stable countries have provided a higher return premium over safe assets such as bonds and cash than can theoretically be justified.

### The trouble with forecasting

Forecasts for economic and investment indicators can be useful but need to be treated with care. Forecasters are not immune from psychological biases such as the tendency to assume that the current state of the world will continue into the future; the tendency to look for evidence that confirms one's views as opposed to evidence that contradicts them; the tendency to only slowly adjust forecasts to new information and overconfidence in their ability to foresee the future.

### Precise point forecasts

For example, that the US S&P 500 will be at 1400 on December 31, 2010 conveys no information regarding the risks of the forecast. They are also conditional on information available when the forecast was made. As new information appears, the forecast should change. A yearly investment strategy based on forecasts at the start of the year and making no adjustment on new information is often a great way to lose money. Economic forecasts can also be self defeating. For example, economists' forecasts for a recession in Australia this year were in a large part headed off by fiscal and monetary stimuli, which themselves were a response to forecasts for a recession. In investment management, what counts is the relative direction of one investment alternative versus others – for example, that shares outperform bonds. Exactly where they end up is of secondary importance. Forecasting market variables is made harder by the need to work out what is already factored into markets, and rules of logic often don't apply. Value investing advocate, Benjamin Graham, coined the term 'Mr Market' as a metaphor to explain the share market. Sometimes Mr Market sets

sensible share prices based on economic and business developments. At other times he is emotionally unstable, swinging from years of euphoria to years of pessimism. Mr Market is also highly seductive – sucking in investors (and forecasters) in good times with dreams of riches and spitting them out in bad times. Precise forecasts can be useful but they have limitations. My view is that there are several rules worth following.

### No. 1: Respect the market

Markets are not always rational, but investors often lose because they thought they were better than the market. You may have a view that ultimately turns out to be right, but could end up losing a lot of money if you get the timing wrong. There is a well known story of a wealthy Australian investor who in the mid-1980s (rightly) thought shares were heading for a fall, but lost a fortune because he shorted the market too early. By the time he had to buy the shares back they had actually gone up further in value. Of course a little while later we had the 1987 sharemarket crash. In the 1970s, a US investor named Charles Ellis likened share market investing to playing a 'loser's game', where bad play by the loser determines the victor. Amateur tennis or boxing after several rounds are loser's games. The trick is not to try to win but to avoid making stupid mistakes and thereby win by not losing. Markets are fickle, sometimes rational but sometimes far from it, and highly seductive, and thus are a classic loser's game in which winners win by simply not making stupid mistakes. For many, this means the best approach is to adopt and religiously follow a long-term strategy consistent with one's objectives.

### No. 2: Have a disciplined process

This is absolutely essential for investors who want to move away from a long-term strategy and become more actively involved in timing investments into and out of markets or stocks. This should ideally rely on indicators including valuation

measures (whether markets are expensive or cheap); economic cycle indicators; measures of liquidity (or some guide to the funds available to come into markets); technical readings based on historic price patterns for the share market, exchange rate, etc; and measures of market sentiment (the crowd is often wrong – so if everyone is bearish that is likely to be a good sign and if everyone is bullish that is likely to be a bad sign). The key to a disciplined process is to stick to it and let it filter all the information that swirls around financial markets so you are not distracted by the day-to-day soap opera. The huge flow of information is often just noise anyway. A disciplined process can be costly and time consuming.

### No. 3: Remain open-minded and flexible

Markets regularly prove even the best investors wrong. One should constantly consider contrary views and test them against your own. Have some form of 'stop loss'. In the past I have ridden losing positions too long based on arrogant confidence that I will be right (because a forecast says so). A stop loss, either in the form of a formal sell order to reduce/cut a position if the market goes through a particular level contrary to your own position or just a trigger for a review, is useful in forcing investors.

### No. 4: Know yourself and check your ego

Smart investors have an awareness of their psychological weaknesses and seek to manage them. Examples of these include overconfidence, the tendency to overreact to the current state of the world, the tendency to look for confirming evidence, and any innate bias towards optimism or pessimism. A key to successful investing is to leave your ego at the door. You can't expect to always be better than the millions of investors who make up the market.

### Conclusion

It is tempting to think that it is easy to outperform the market or perfectly time moves over time. But it is never that easy. For most investors the best approach is to respect the market and have a long-term strategy and stick to it. Those who want active management of their investments must have a disciplined process, remain flexible and know and control your psychological weaknesses. – *Dr Shane Oliver, Head of Investment Strategy and Chief Economist, AMP Capital Investors.*

1. This note is an update of "Making money versus being right in the loser's game", Oliver's Insights, September 2006. Important note: While every care has been taken in the preparation of this document, AMP Capital Investors Limited (ABN 59 001 777 591) (AFSL 232497) makes no representation or warranty as to the accuracy or completeness of any statement in it including, without limitation, any forecasts. Past performance is not a reliable indicator of future performance. This document has been prepared for the purpose of providing general information, without taking account of any particular investor's objectives, financial situation or needs. An investor should, before making any investment decisions, consider the appropriateness of the information in this document, and seek professional advice, having regard to the investor's objectives, financial situation and needs. This document is solely for the use of the party to whom it is provided. This information has been provided to AustSafe Super through its relationship with AMP Capital. AustSafe Pty Ltd ABN 96 010 528 597 AFSL 314183 RSE Licence L0002035 is the Trustee of AustSafe Super ABN 92 398 191 503 RSE Registration R1005509 SFN 147 555 940 SPIN ASF001AU.



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