Building wealth

- the golden principles

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The principles for investing successfully, in terms of maintaining security and capturing returns, are little different from the general principles of life. Recognise that the world is uncertain, don't rely on luck or the impossible happening and don't trust strangers and friends. The principles, for most people, translate into 12 simple rules.

RULE #1	Understand that your employment is the main source of your real wealth
RULE #2	Recognise that speculating is not investing
RULE #3	Don't invest on the basis of a guess about the future
RULE #4	Be wary of others making decisions for you
RULE #5	No system or model works as well in the future as it did in the past
RULE #6	Don't borrow to invest
RULE #7	Don't buy things until you understand
RULE #8	Don't become dependent on one thing outside your control, diversification works
RULE #9	Create a portfolio that stands the test of time designed to achieve your purpose
RULE #10	Have some assets outside the country in which you live
RULE #11	Beware of tax-avoidance schemes
RULE #12	When in doubt, think safety. Sleeping at night is important.

RULE #1 Understand that your employment is the main source of your real wealth

Don't assume that wealth can be rebuilt.

For most people, their wealth comes from their savings that are then invested. While a few people will make a fortune through investment, most people make a lot more money from their job. Managing your investments is important, as the investment return can be significant but your wealth stems from what you save from your salary/wages. Therefore, your investment plan should focus on protecting what you have built up for when you need it, ie protecting it from permanent loss and the consequences of government interventions.

Given that what people have, was previously earned they should not assume that they could earn it again, if they lost it. Some, a few, can but most will struggle. Most people should treat what they have saved as if they could not save it again and not take chances with their wealth on the assumption that it could always be rebuilt.

RULE #2 Recognise that speculating is not investing

Don't take all your savings to the amusement park.

When people invest, they should accept and be happy with the general return the markets pay investors that is appropriate for their time horizon. When people speculate, they attempt to beat this return, ie to do better than other investors, by timing, forecasting (guessing), share picks or manager choice. There is an implied belief by speculators that they are smarter than most other investors. There's nothing wrong with speculating – provided it is done with money that they can afford to be lost. But the money that's important shouldn't be risked on the chance of getting an exceptional return and beating other investors.

If you want to try to beat the market, set up a second and separate portfolio with which you can speculate with to your heart's content. But make sure this portfolio contains no more than you can afford to lose. You can lose only the money you've already decided isn't absolutely critical.

Note: *The analysis and comments in this article, are of a general nature only. They do not take account of your specific circumstances. If you require personalised financial advice, you should seek advice from an appropriately experienced Financial Adviser.*

RULE #3 Don't invest on the basis of a guess about the future

No one can predict the future.

What happens in the economy and the investment markets, flows from the decisions and actions of millions of different people in different situations with different goals and abilities. Economists, analysts, advisers and individuals, have no more ability to predict (guess) the future actions of human beings than magicians, psychics and fortune tellers. Events rarely unfold as a particular person is certain they will but will unfold as someone somewhere has guessed. Someone will make a correct guess the question is who? People need to ensure that they are not seduced by the success of one person's guess and believe it will happen again.

No one can consistently predict what shares, interest rates, inflation or exchange rates will do next year, or how the economy will perform.

Investment advisers can provide valuable assistance. A good adviser helps people understand how to do things that they need to do, to achieve their purpose. They focus attention on the potential risks that may have been overlooked and identify alternate strategies. But no one can guarantee to always get it right at the right time and, trying to do so, is fatal to a portfolio for most (but not all). Bad things will happen and so always have access to an emergency fund for when they do.

RULE #4 Be wary of others making decisions for you

Don't trust strangers.

Many people lose money because they give someone (eg a financial adviser, a relative, an accountant, a lawyer, a friend) the authority to make decisions for them. The adviser may take too many chances, to chase returns, be dishonest, or simply be incompetent. Few advisers can be expected to treat other people's money with the same respect they would for their own. In practice, investors don't need a financial adviser to look at their portfolio more than once every few years. Investing becomes complicated and difficult to understand, but only if the investors try to beat the market. You can protect what you have with minimum understanding of investing. Therefore, never give anyone total authority over money that's precious to you.

RULE #5 No system or model works as well in the future as it did in the past

There are many models that seem to have signalled correctly where to invest money in past periods. The models, however, rarely are as good for the next period as the previous. Trading systems are also self-defeating. When a system works, everyone will start using it and that will cause prices to move until all advantages are cancelled out. Alternatively, the market will behave differently making it less affective. No model can allow for the randomness of political decisions and interference.

RULE #6 Don't borrow to invest

History shows that when someone loses their wealth, it's almost always because they used borrowed money. In some cases, they borrow money directly. In other cases, they borrow indirectly, as the investment was leveraged. Buying investments with borrowed money (debt) puts the investor at risk of losing more than their original capital. If all investments are made without debt, and the principle of diversification is followed, it's almost impossible to lose everything.

RULE #7 Don't buy things until you understand

If all your friends drove off a cliff, would you have to do it, too?

Don't invest in any asset or product that you don't understand. If you do, you may find something happens you were unaware of and not expected. This is particularly true for complex products and investments based on the latest fads and financial engineering.

RULE #8 Don't become dependent on one thing

Most investments have good years and poor years as they move around the average. No investment is good in all periods. Even government bonds can lose real value during times of inflation. Also don't rely on any single organisation to protect your money. All companies are subject to being taken over, merged or failing. The company you think will keep your money safe might not be there when you're ready to withdraw your savings. It is best to have choices.

Don't put all your eggs in one basket.

RULE #9 Create a portfolio that stands the test of time designed to achieve your purpose

For the money you need to take care of you for the rest of your life, set up a simple, well-diversified portfolio. The portfolio should align the return characteristics of the investments with your expenditure needs – we call this the bucket approach[1]. You then only need to rearrange the investment mix, even if your view on the investment outlook changes, when your expected expenditure changes. This portfolio should protect your expenditure no matter what the future brings, including an event that could be devastating to an individual element within the portfolio.

RULE #10 Have some assets outside the country in which you live

Don't put everything you own to be where the government's policies can significantly influence it. By having something outside the immediate impact of your government, you will be less vulnerable to change in the government policy direction. Also, a key need of an investor is often inflation protection and typically half of inflation is imported. Having some overseas investments will help manage the consequences of imported inflation.

RULE #11 Beware of tax-avoidance schemes

Any investment that relies on tax to make it competitive, poses greater risks than appear on the surface. Where tax is involved, there will always be regulatory change to protect the tax base and managers and advisers often charge higher fees. A great deal of money has been lost by people who looked to beat the tax system. The losses came from investments that provided special tax advantages but didn't make economic sense and therefore were unsustainable.

RULE #12 When in doubt, think safety

If you don't invest in one successful investment, don't worry, another investment will come along. It is better to be safe than sorry and good investments do not cease to be good investments, so it is always better to wait until you are comfortable. Remember, if you lose your savings, you may never get a chance to replace them.

Don't get into a situation that you can't get out of.

The rules of safe investing are little different from the rules of life: we live in an uncertain world, the impossible doesn't happen, and never trust strangers. If you apply to your investments the same attitude that produced your present savings, you needn't fear that you'll go broke.

[1] Details of the bucket approach to investing are explained in the article "The bucket approach" on the MCA website.

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