Investing in shares

- what most investors should do

December 2022

If you invest in shares, there will be times when you see the value of your investments go down, and sometimes go down significantly. This most recently began in January 2022 reflecting the consequences of the spike in inflation and the 'cost of living crisis' but it has also happened in February/March 2020, reflecting the immediate impact of the coronavirus COVID-19, in 2007/2009, with the GFC (global financial crisis) and in 2000/2003 with the bursting of the "tech" bubble. When you invest in shares, you invest with the belief that shares will provide the highest long-term average return and the knowledge that the return over the immediate future may not be positive and may be lower than the return from "money in the bank".

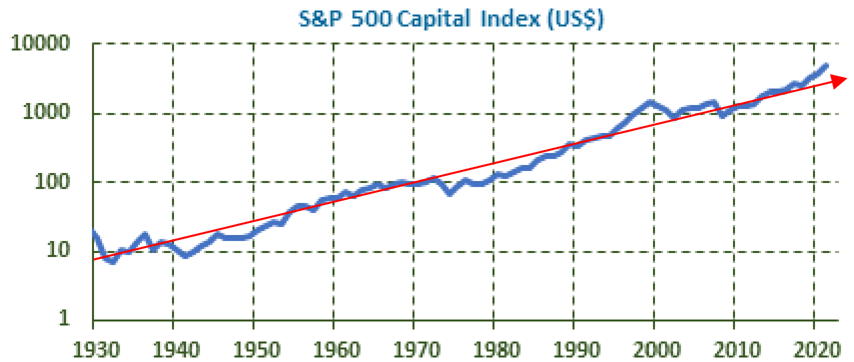
Typically, the share markets halve in value (ie $100 becomes $50) a couple of times every generation, before they then go on to new highs. Over shorter periods, say over a 12-month period, negative returns happen a couple of times every six to eight years. Investing in the share market, therefore, should not be a 1-year investment. This is because of the risk of loss if you need to sell the shares for your immediate expenditure. Investing in shares should be for expenditure at least ten years away. This lets you have a level of confidence that you will capture sufficient good years to make up for the inevitable bad years.

When the market goes down, it can be tempting to sell and wait for the crisis to pass and then reinvest. For most people however, this is not a good idea. While it is alarming to see the value of your investments decline and see negative news in the media with no apparent end in sight, it is normally better to ride it out. This is particularly relevant if the shares were bought to help meet expenditure that is in more than 10 years' time.

Investing in the share markets requires a plan to get you through the bad times that will inevitably arise. For most people, that plan need not be complicated or require an "expert" to implement or monitor. But the plan requires assumptions and beliefs about the future - about how the markets behave and therefore how best to invest and achieve the goals. A suggested plan is attached, though this will not be suitable for all investors; just most.

Investment beliefs

The chart shows the S&P 500's performance since 1930 on a logarithmic scale. The S&P 500 tracks the performance of the 500 biggest companies in America and is the main indicator of the average return of US shares.

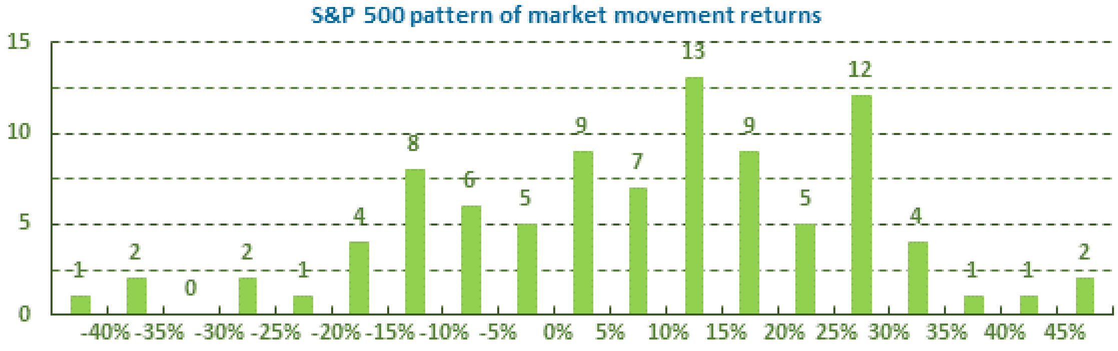


Belief 1:
The share markets will continue to trend up but go up and down around the trend, and always recover with time.

What is observed, is that the share markets trend upwards, but returns are not positive each year.

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.*

The pattern of the market movement returns over individual years is:



Source: S&P Dow Jones

Note, of the 92 years since 1930, for 7 years the market movement fell between 5% and 10%. The average annual return was 7.7%. Of the 92 years 29 years were negative (32% of all years, ie 1 in 3).

Despite the downs, the overall trend is that the share market rises, even though some of the downs are large and sometimes last for extended periods of time. Therefore, despite the severe events like wars, terrorist attacks, economic downturns, changes in governments and pandemics, share markets have trended upwards. The plan therefore has to involve not having to sell shares to meet immediate expenditure, when they are down in value and being able to wait for the eventual recovery.

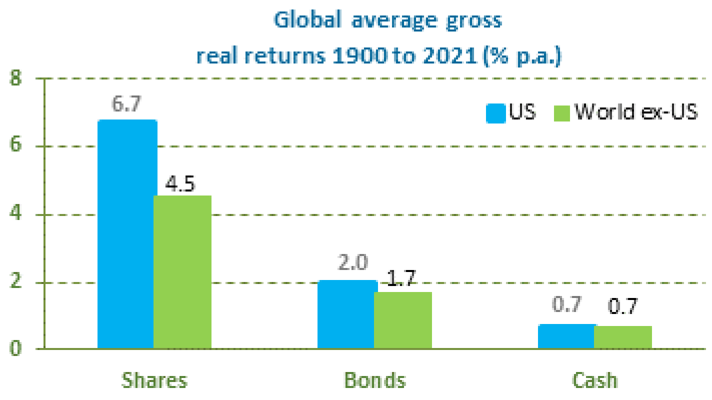
The ups and downs of the share market have an element of randomness. Because of the randomness, it is virtually impossible for the average investor to predict (guess) whether the market will go up or down over the next day, week, month, quarter or year (ie over the short-term). You may get an insight from the news, company announcements, analysing charts and using investment analytic tools, but unless you have inside information (which is illegal to use) or have significant research capability to understand what is important, the likelihood that your guess might be wrong is high. What is important will include the economy, the investment markets, what governments and central banks are about to do, and the likelihood and imminence of unrelated shocks (foot and mouth outbreaks, viruses, earthquakes etc).

Belief 2: The immediate returns from the share markets are unknown - many (most) experts get it wrong.

Also, mastering all the technical chart strategies and obtaining an understanding of the wider macro and micro information, still doesn't guarantee that you will get it right. According to S&P Dow Jones SPIVA analysis 2022[1], the S&P 500 index returned more than 83.07% of the US share managers over the 10 years to 31 December 2021. By definition this means that 16.93% of US share managers did outperform the S&P 500 index and therefore a few investors may have regularly outperformed the market. But as a whole, the past returns of the "professional" investors highlight that the share market is unpredictable, and most have a hard time getting it right consistently. Over the 20-year period to 31 December 2021, the S&P 500 index returned more than 94.12% of the US share managers. The risk management plan has to allow for the randomness of the share market as not all information is known.

Also, even though the share markets have trended up and produced positive returns, to invest in shares an investor needs to expect that the returns will remain higher on average, or more appropriate relative to the liabilities, than the returns from alternative investments, such as cash and bonds.

The average annual returns from the global markets, before tax and expenses but after inflation, of cash, bonds and shares over the last 122 years have been:



Belief 3:
Over the long-term, the average return from shares will continue to be higher than the average return from cash and bonds, over the period relevant to the investor.

Source: Global Investment Returns Year Book 2022 based on the work of Elroy Dimson, Paul Marsh and Mike Staunton and published by Credit Suisse in conjunction with the London Business School.

Note: the returns for individual countries and in individual years will vary around the average.

Understanding the share markets

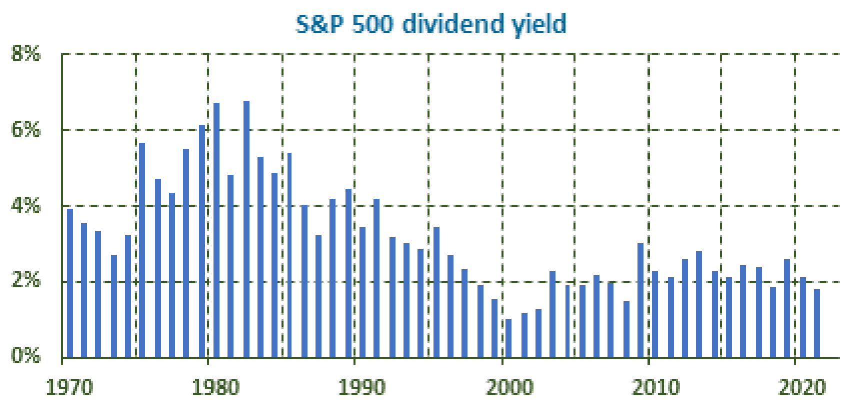
. . . but the share market is not the same as an individual share

Also, while the market is made up of individual shares, the market is not and does not behave like an individual share. The S&P 500 graph does not tell anything about individual shares. In fact, most companies (individual shares) eventually cease to exist, unless they continually innovate and reinvent themselves, to the ever-changing environment, or become part of a company that does. A successful plan for most investors, therefore, involves diversifying by buying many shares and not a few.

Belief 4:
Diversification helps manage the risk of individual shares.

. . . share markets also produce income (dividends)

While the market goes up and down, even when it is down and down for an extended period of time, investors receive dividends which can be spent if required or reinvested. The annual dividend yield of the S&P 500 since 1970 has been:



Source: S&P Dow Jones

Shares provide part of their return as cash dividends

Given the beliefs, it is therefore better, for the average investor, to stay away from short-term share market investing and focus on the long-term rising market and the receipt of dividends each year.

[1] S&P Dow Jones SPIVA Scorecard for 31 December 2021

A solution for most

This article looks primarily at the share portion of your portfolio. It does not look at the cash, bond and property part of your portfolio. Most investors will have an overall investment plan that involves a mix of cash, bonds, property and shares (an investment strategy). In determining the investment strategy, the focus should be about making sure that when you come to spend money, the money is there to be spent. Therefore, the money that you will spend in the near future is probably best invested in cash (and bonds), irrespective of where interest rates are. This means that when the share market goes down, you are not forced to sell shares, to help fund your immediate expenditure. This lets you take a long-term approach to your share investments and capture the higher average return they are expected to provide.

While no approach for managing shares will be best for everyone, for most people the optimal plan will have common features. If you believe that the share market will continue to go up and down around a rising long-term trend, that it will continue to be impossible to always guess right short-term and the returns from shares will be higher, on average, than cash and bonds, an effective plan for the share portion of your investment strategy is:

1. Invest regularly

The best strategy is to invest regularly according to a plan and not try and time the market ie (try to pick the highs and lows) or react and sell when the market goes down. Each pay day or month, save part of your income. This is what most people do with KiwiSaver or their superannuation scheme. In doing this, sometimes you'll buy when the market is high and sometimes when it is low. This does not matter if you are investing for the long-term and not just for the next few weeks or months.

Of your savings, allocate the amount that you are likely to spend in the next 10 years that will not be met by dividends and interest, to cash and bonds, with the balance to property and shares.

2. Buy market index funds and do not trade (ie buy and sell)

Index funds are portfolios of shares that follow the market as a whole. When you buy one share in a listed index fund, often referred to as an ETF (exchange traded fund) or a unit in an unlisted index fund, you are essentially buying a portfolio of shares that make up the whole market. This gives you the market return, less fees, and means that your investment will go up and down with the market short-term. This strategy means that you will capture the long-term average return. Therefore, you are unlikely to become an overnight millionaire or wake up and discover that you have lost everything. You are however, expected to get an above average return after fees long-term.

Index funds can also work for bonds, for the average investor, because of their low fees. It is important that any index fund you buy has 'low' total fees and low tax slippage.

3. Don't check too often

Whether or not the markets drop in value tomorrow, the drop and the reason why they dropped is irrelevant, because you can be confident that it will go up at some point over the next few decades.

4. Sell down when you are likely to need the money for expenditure in the next 10 years

When you get to within 10 years of needing the capital to spend, start to look for opportunities to sell. If it has gone down, defer the sale. If the market has gone up, sell. Sell because you will need to the money to spend and avoid the temptation to hold on for a little longer looking for extra returns.

Most people should set up a plan to save regularly, invest (ie put) their money in index funds and let it work. Yes, occasionally check that the plan (savings level and investment strategy) is on track to achieve the goals, but do not react to short-term market events. This has been proven to work historically.
It also means that as long as society does not collapse, you will make money long-term and do not need to worry about the health of the economy or speculate about what a particular company is about to do.

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