'Lars Kroijer takes a refreshing look at how everyday people can improve their fortunes by taking some simple investing steps.'
DR DAVID KUO, THE MOTLEY FOOL

LARS KROIJER

INVESTING DEMYSTIFIED

HOW TO CREATE THE BEST INVESTMENT PORTFOLIO WHATEVER YOUR RISK LEVEL

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Investing Demystified

How to create the best investment portfolio whatever your risk level

Second edition

Lars Kroijer

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successful geographical area does not mean that things will be like that in future.

Imagine if you were an investor in the Russian stock markets or government bonds just before the 1917 revolution. You would have lost everything without hope or recourse. Likewise, there have been many instances of large-scale and irrevocable losses for investors. When studying the charts above there may be a dangerous tendency to believe that 'it may take a while, but equity markets will always come back'. They may not.

The disadvantage with the view that markets will always bounce back is that some investors will want to 'average in' to falling markets, i.e. buy on weaknesses, dips, etc. After all, if markets always bounce back, the reasoning goes, you will eventually be fine. That thinking is akin to a gambler going to a casino, betting on red and keeping on doubling down whenever he loses. That strategy works really well until the one time when it really, really doesn't work and you run out of money.

Some may view the rebound from the 2008 financial crisis as evidence that markets do always bounce back, and that historical instances of complete and 'un-rebounded' losses are exactly that: history. To those I would say, look at Japan.

In Figure 6.4 the main Nikkei index is trading at an approximate 50% discount to its peak in the early to mid-1990s, despite rebounding more than 100% from the worst point (so 20 years after investing, some investors were still down 75% in Japan). When I was studying economics at university in the early 1990s, I remember how often we considered the Japanese miracle. We were told how special characteristics like lifetime employment and superior production techniques had led to Japan's spectacular rise and the implication was clear: Japan would continue to prosper. But already as I headed to business school in 1996–98 there were few mentions of the Japanese economic miracle, other than the odd case on auto production techniques.

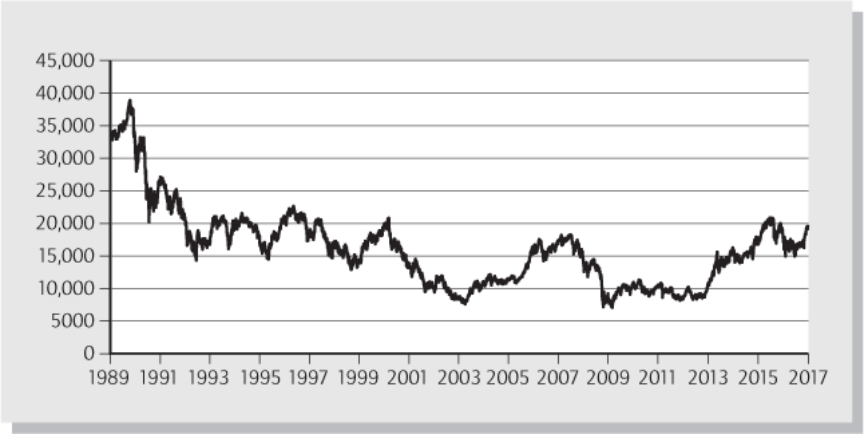

Figure 6.4 The Nikkei index since its peak

Even if the Nikkei does recovery fully it is entirely possible that this will be so far into the future as to be irrelevant for many current readers' financial lives. From the vantage point of 1990 many would have predicted the chart shown in Figure 6.4 to apply to leading European or US markets, not Japan. So don't exclude the possibility that this can happen in your local equity markets or even the wider world equity markets.

We don't know what is to come, but it's dangerous to extrapolate too much from historical data alone. We don't know what we don't know, and it is hard to incorporate this factor. Over the next year, decade or century we could be blessed with peace and prosperity, or some completely unpredictable calamity. Looking at how the US stock market reacted to the dire events in the twentieth century may give us an indication of how the world stock markets will react in future, but it's also quite possible that future losses will look very different.

Diversification and the false sense of security

Although correlations between various national stock markets have generally increased over the past decades, the benefits from

diversification are still clear. Local companies, in general, are more dependent on the global markets than they were decades ago, but there are still unique characteristics to national economies. The latter operate in different legal and political climates and while they may be dependent on local factors such as access to commodities, skilled labour, tourism, etc. they are also influenced by natural disasters (as in Japan) or political upheaval (as in the Middle East, Brazil, etc.). Diversifying away from such exposures in one region or country makes a lot of sense.

The main problem with higher correlation in down markets is that we are not always afforded the protection of diversification when we really need it. We are probably less concerned that the volatility of our monthly returns is slightly higher because correlations are higher than expected if this happens in a market where we are up 10% a year (see Figure 6.5). But if we are down 40% because of high correlations between our different investments then we care a lot. If we believe that the correlation between investments is more or less a constant number we would have understated our portfolio risk in bad markets and be more exposed to losses than we thought. Increased correlation was a factor that affected a lot of investors in the 2008 crash, when not only did various international stock markets correlate, but also several supposedly uncorrelated asset classes did so as well. (Certain government bonds were a notable exception, being the safety asset in the turbulence.)

A major selling point of the US sub-prime investment proposals was that there had never been a case where all housing markets in the US had declined at the same time. This diversification was supposed to provide great investment security and was a major driver of the high ratings and attractiveness. In simple terms, investors did not believe that the housing markets in Miami, Las Vegas and Dallas would all collapse at the same time and were therefore willing to provide more debt at a low cost. During the crash, correlations between the various housing markets shot up to the point at which they acted like one market instead of providing diversification against a location-specific decline. The resulting

eggs of embarrassment on the face of the financial community and huge monetary losses became all too obvious.

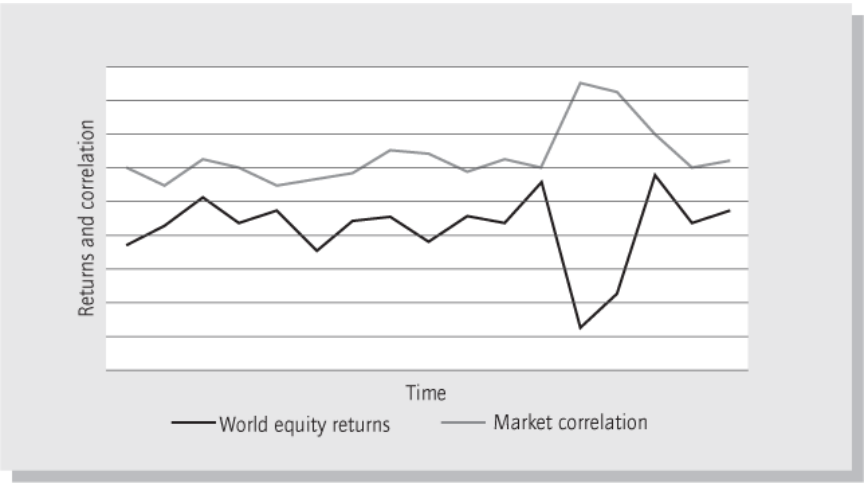

Figure 6.5 World equity returns and correlation between markets (illustration only)

Some people look back at historical market declines that used to be more geographically contained and wish they had had the chance then to diversify internationally. Now they can diversify, but correlations are up. You can't have it all. Over time, as cross-border capital flows to foreign equity markets increase and the world generally becomes more interconnected because of trade or information flows, correlations will probably increase even further. Higher correlation means that we would be fooling ourselves if we think diversification alone protected us against bad things and we accepted higher risk in our portfolio as a result.

Risk rethought

To some, standard deviations or skew might sound like an archaic finance-related term that will get us all in trouble. What I'm suggesting is not to use this as an exact science, but rather as a tool that gives a general idea of what the perceived risk of investing in

equities will be in the future. The next step is to figure out how to use that in understanding the risk of our portfolio.

Other than basing things on a gut feel or what we glean from newspapers, we can get a more accurate sense of where things stand. A future market standard deviation of 20% is clearly not the same as one of 40%: the market is expecting far less risk. Similarly, you can't just assume that future returns are distributed like the neat bell curve of the standard deviation – they are not. Understanding that there is skew helps to explain this; it makes more sense that really bad events can and probably will happen on occasion despite the standard deviation suggesting that it is as unlikely as being hit by a meteor.

This chapter has been less about giving answers than about informing the gut feel that investors probably already have about the equity markets. In the long run we can expect good returns from equities, but this is not without risks, and those risks can be unpredictable and severe. We'd better plan for that.

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1 For those willing to engage in some complex maths there is a better way to predict the future volatility of stock markets. When looking at the price of an option on a stock market index the only variable that is not readily observable is the expected volatility (the other inputs are: the strike price of the option, the current price of the index, time to maturity and the interest rate). Using the Black-Scholes option pricing formula we can obtain the implied volatility. Looking at the implied volatility for options with various maturities we can see how volatile traders expect the market to be in future. In the past, the implied volatility of index options have been better predictors of future market volatility than using the historical volatility of the stock market. For the S&P 500 index you can look at the VIX index, which gives the implied volatility for that market for the coming month, but expect the implied volatility to be very different depending on the market, maturity and strike price you are looking at.

Chapter 7

Adding other government and corporate bonds

The main focus of this book has been on creating a simple, yet powerful and robust portfolio for the rational investor. The message is hopefully clear: if you want no risk, pick the minimal risk asset; if you want a lot of risk, pick a broad-based equity portfolio. If you want a risk profile in between the two, you allocate between the two. And do this in a cheap and tax-efficient way. Simple. If you do this and read no further, in my view you are already doing better than the vast majority of investors, private or institutional.

If you ignore this chapter and stick with the simple minimum risk/world equity portfolio you are still doing very well. Only add other government and corporate bonds if you are comfortable with extra complexity of the portfolio – the benefits may not be worth it otherwise.