ASSET ALLOCATION IS KEY

The theory behind successful investing is simple to understand but not easy to implement. If you are going to be a successful investor over the long term, you will have to develop the ability to ignore the noise (or hysteria) created by the financial media. Their job is to create hype so that people will notice them every day, unfortunately, what they report is often not going to help you as an investor. Your investment decisions must be taken with a long term view and daily news is not going to help you – you need to create your own parameters for making decisions. The decision about how much capital to allocate to different types of investments i.e. shares, property, cash and bonds is more important than any other investment decision. This should be the guiding principle for all your future decisions and should occupy the bulk of your initial attention when you invest. Unfortunately, most investors spend too little time on this critical factor which leads to poor investment returns over the long term.

SHARES ARE THE BEST ASSET CLASS OF ALL

History shows us that there is no better long term investment than the stock market unless you are prepared to invest in your own business. The table below shows the long term real return of the main categories of South African investments – also known as asset classes. The table includes the 2008/09 calendar years when the stock market fell by more than 30% in 12 months. Even after this drop, we see that shares outperform all the other asset classes. The table also shows that cash is a very poor investment. It is clear that you don't need to be a genius to get great returns, simply buying the index will provide great long term growth.

TABLE A: ASSET CLASS RETURNS FROM 1900 TO 2010

Asset Class	**Indicator**	**3 years***	**5 years***	**Long term average above inflation ***
Shares	All Share Index	-1.7%	13.6%	7.6%**
Residential Property	ABSA House Price Index	4.43%	10.8%	2.1%****
Listed Property	SA Listed Property^	3.1%	10.9%	5.9%***
Bonds	All Bond Index	-1.7%	7.1%	1.9%
Cash	STefI Call	1.4%	1.9%	1.0%
^Prior to 2006 this was SA Real Estate Index	* Annualised **Updated annually since 1900	*** Since 1983	**** Since 1966	

Compiled by Galileo Capital: Source ABSA, Nedgroup Investments, I-Net

Asset Allocation is important

If you decide that you don't like the roller coaster ride of investing in shares, and would prefer to keep your money in cash, you should know that you will probably not achieve financial independence. Shares are very volatile but they will reward patient investors with excellent capital growth over time. A portfolio of high quality shares will always recover after a market crash even if

one or two shares collapse – so you should always try to have some exposure to shares. If you accept this principle then the real question is how much of your capital to invest and what to do with the rest.

Table A shows us that bonds only generate 2% per annum above inflation but one needs to remember that they are very low cost investments and are significantly less risky than shares or property. For investors who want to be relatively certain that their capital will be securely invested and still beat inflation, they should have the bulk of their capital in bonds with at least 25% in shares. The shares will ensure that your overall capital growth beats inflation whilst the bonds will provide some growth but mainly capital protection. For investors who want high levels of capital growth, you should have the bulk of your capital invested in shares and only a small portion in bonds - no more than 25%.

Cash should be used as an insurance policy only - you should have a maximum long term holding of 6 months' worth of expenses in cash. If you have cash lump sums to invest and are nervous about the markets, you could phase your money in over 3 – 9 months to limit your initial losses if the market falls in the next few months.

Market timing is pointless

The All Share Top 40 Index has averaged 14.68% per year from Dec 2005 to end Dec 2010. These are great returns and were achieved during a time when the market lost more than 30% over 12 months. It shows that you don't need to be a market timer to get good returns, you can simply buy and hold. People who predicted the market crash in 2008 (there were a few) almost certainly did not re-invest their capital in November 2008 and/or March 2009 when the market was at its lows. The explanation for this is simple, it is much easier to know when to get out and far more difficult to get back in again. Usually people wait far too long and miss the great returns offered by the early rebounds. Most people wait for the markets to "stabilize" which is a mistake. Stable markets usually occur at the top of the market just before the next market crash! The lesson from this is that you should not focus too much on the short term movements of the stock market.

In summary, having the right combination of asset classes is the most important decision to make, getting this step right will have a massive impact on your long term success. All your other decisions should lead from this first step.

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