THE ELEMENTS OF INVESTING – the one book you should read this year

CAPE TOWN: I cannot count the number of investment books, articles and publications that I have read since I started financial planning in 1996. In that time I have read a few great books that I believe everyone with an interest in money should read. Recently I read another great book that I wish I could send to all the people who email me on a weekly basis asking how they should invest their money – after reading this book, I think they would have most of their answers.

THE ELEMENTS OF INVESTING

The book is called The Elements of Investing, the authors (Malkiel & Ellis) tried to distil all the investment/financial knowledge that they have jointly accumulated over very long and successful careers in the investment or related industries. This is the book I wish I had written because I think they provide a fantastic investing blueprint that covers all the main principles we need to know about investments and saving. More importantly, their style is so simple and easy to read that the book can be given to anyone who wants to start saving and investing. If you are a really slow reader, it will probably take you one week to read the book while most people would finish it in a day.

DIVERSIFICATION

The authors explain that there are three aspects to Diversification: across asset classes, within asset classes and over time. Most people would be aware of diversification within specific asset classes (e.g. invest in a range of different shares and not just one share) and also across different asset classes (e.g. shares, bonds, cash and property) but; most people don't understand the importance of diversification over time. If you want to invest in shares, especially if it is a lump sum, phase your money into the market over a period of months. For example, those who invested in the US market in the year 2000 would probably still not have recovered their losses 11 years later. However if you had invested over a 12 month period starting in June 2000, you would probably have made a healthy profit in subsequent years and you would certainly be in the money now.

This same principle applies when investing in bad times; we cannot determine when the market has bottomed so it makes sense to phase in your purchases over a period of months. You will never be exactly right in the timing of your purchases but at least you will have some capital committed before the inevitable recovery. You cannot simply "wait for things to get better" as this means you will never participate in the recovery. In 2008/9, the JSE dropped to around 18,000 and if you had waited "for things to get better" you would still be sitting in cash (because the financial system is still a mess) whilst the JSE has recovered beyond the 30,000 level.

WHAT IS RISK

Most investors perceive market volatility as risk however; it is only hazardous for traders or speculators because of the limited duration of their investment horizon. If you are a long term investor, volatility presents a great opportunity for you to buy great shares at a discount when others are panicking. To me, the impact of inflation on your assets is a far greater risk than volatility. Inflation destroys the value of your money incrementally on a daily basis so there is no major event that alerts you to the danger. Normally, you will only realise the impact of inflation once it is already too late and your capital is no longer able to sustain your lifestyle. The only safe way to beat inflation is to invest in growth assets like shares which are by their nature, volatile. People who don't understand this concept often suffer in retirement because they avoid volatility at the expense of inflation protection.

ASSET ALLOCATION

The authors also provide some guidelines for investors to determine their appropriate allocation to shares and bonds. Whilst I do not completely agree with their guidelines, because they make them age related only, I think they are worth considering if you have no other basis for determining your ideal asset allocation. In essence, most people should have a range of 35% to 75% of their investment capital in shares. If you have less than 35% in shares with the balance in cash and bonds, there is little chance that your capital will outpace inflation over the long term. More than 75% invested in shares is classified as a high risk strategy, especially if you require income from your capital.

CONCLUSION

The theory behind the investing business is actually quite simple and easy for anyone to implement over time. Unfortunately, a successful investing career also requires patience and discipline which is why most people do not make a success of their investment careers.