STRANGE MONEY

Money is such an important part of modern life that it is surprising how little we know about the workings of money. I don't believe that we should spend all our time focused on our money, there are (apparently) more important things in life but we really should be well informed about how our money works. Here are some pointers that are worth knowing.

Successful fund managers often become unsuccessful because of their success
The most money flows into a unit trust or hedge fund *after* the fund has already done well, especially if it wins an award as the best performing fund over a 12-month period. At the same time, a fund that is not doing well compared to other funds will see investors selling out in droves. You might think this is not a bad thing, why would you *avoid* investing in a fund that has done well and more importantly – why would anyone keep money in a fund that is doing poorly?

A fund that did well over 12 months could simply have been lucky or the fund manager took excessive risks to win an award. Investors who pile into these "top" funds expect the fantastic growth to continue. This is normally where the problems start. When a fund is small, it is easier for the manager with a few good investment ideas to grow the value of the entire fund. If the fund does so well that it tops the performance rankings, it will attract massive inflows – great for the fund but potentially not great for investors. The fund manager now has a lot more money to manage and therefore needs many more great investment ideas to grow the large pool of money. This is a bit like taking a small racing car and expecting it to continue winning when you double the weight of the car.

It is no coincidence that many "top" funds slide to the bottom of the performance rankings two or three years after reaching a top ranking. Ironically, when the fund starts nearing the bottom of the rankings and everyone else is selling, you should probably keep your money in the fund. It will now be smaller and if the fund manager still has a few great investment ideas, the fund might start "racing" again.

WHAT SHOULD YOU DO: don't chase funds that have already performed well, rather be patient with your capital. If your current fund is underperforming, try to understand why and consider remaining invested. If you are considering a new fund, find out if the manager is prepared to limit the size of the fund. This is a great indicator that the manager knows his limitations and is most interested in providing long-term consistent performance for investors. In South Africa, some very large funds have become concerned about their size and are finding ways to expand their potential pool of investment ideas. They do this by adding international shares to the portfolio or increasing the universe of companies that they can select for the portfolio. This has the effect of making the fund a smaller fish in a bigger pond. I would prefer that they limit the size of their funds too.

Most investors become excited about investing money at the wrong time
When the stock markets are booming and share prices start breaching new highs, we see massive inflows into unit trusts. Most of the money will flow into higher risk funds, especially those with a large allocation to shares. Similarly when the markets are falling, money flows out of higher risk funds into money market funds. This pattern repeats itself as consistently as any cycle in nature. The only surprise is that we have not learnt from the past. Humans are generally at their most intelligent when they operate in small, diverse teams or on their own. Unfortunately, in larger crowds, they become much less intelligent. Stock markets are simply large crowds and the advent of instant information has had the effect of making irrational crowd behaviour worse.

WHAT SHOULD YOU DO: when the markets are falling, try to avoid the mass hysteria created by the general media. It is a sure sign of the start of irrational crowd behaviour when the lead articles in the general news outlets are about the stock markets. I am always sceptical of the information value of a financial article written by someone who wrote about global warming yesterday and politicians the day before. Rather limit your news intake to respected financial media. Don't assume that because a global news channel interviews someone about markets, they are worth listening to. The global news channels are competing with reality shows for airtime and therefore they aim to provide more drama than a soap opera.

If your cost of trading an investment reduces, your performance will probably drop
Numerous studies have been done at large stock broking firms around that show how the reduction in trading costs have actually resulted in *worse* performance by investors. Lower trading costs make it easier for people to trade more regularly. If your trading costs are high, you will tend to think more about trades and take longer to make decisions. Essentially, higher trading costs create a barrier to transacting and it has been proven that private investors perform better when they trade less.

WHAT SHOULD YOU DO: Any transaction cost is a friction on potential growth; you should always try to find the lowest cost trading platforms. However, once you have selected your platform, you need to train yourself to trade less. Try to limit yourself to six transactions or less per year.

The time to invest is when you are in your 20's but you only really earn enough money to invest in your 40's & 50's
The best investment advantage that we have when investing in riskier assets (e.g. property or shares) is the power of compound growth. If you buy a good business that loses value over 2 or 3 years, you need to be able to continue holding the business (if it is still a good business) so that it can recover and then start to grow. Most people only start investing when they are at their peak earning potential e.g. age 45 onwards. Unfortunately this limits the amount of time they can invest the money before they need to use it for retirement. Younger people have much more time but naturally have less money to put away.

WHAT SHOULD YOU DO: Younger investors should start saving as early as possible. Even if the amounts are small, the power of compounding will ensure that they have a real advantage later in life. If you are already in your 40’s or 50’s, start investing as much as you can and try to leave your capital for as long as possible. This means you might need to plan to work a bit longer or look for part time work once you have retired. This will allow you to draw less from your capital so that it can continue to work for you.