



Paul Clitheroe's

**TOP
TEN**

**keys to successful
investing**



TOP TEN TIPS

my keys to successful investing

1. invest in something you understand
2. consider mainstream assets first
3. understand that risk equals return
4. look for an investment that stands on its own merit
5. diversify
6. don't try to 'time' the market
7. try 'dollar cost averaging'
8. invest in growth assets for the long term
9. take advice if necessary
10. take action!

How often have you had one of those great moments where you notice a detail that really says it all? I remember having one such flash at Warwick Farm Racecourse some years ago as I was walking into the racetrack past the car parks. There was a large parking area for the public – the punters – and another smaller one for the bookmakers, and what really struck me was the stark difference in the types of cars in each.

One was filled with clapped out bombs, the other with gleaming BMWs, Mercs and the odd Rolls Royce. There are no prizes for guessing which cars belonged to the bookies and which to the punters, and the huge difference between their cars spoke volumes about who makes most money at the track. In fact, on noticing this, I really should have stopped, turned right around and walked straight out of the place!

Why is it that over time the bookies always seem to win? What do they do right that the punters do wrong?

Well, apart from having a better idea than the punters about which horses are good and which are not, what they do is spread their risks, while the punters concentrate theirs. And, over time, the racecourse car parks scream at you which is the better strategy.



A bookie spreads risks by continually changing the odds in such a way as to encourage punters to back as many different horses as possible in each race – ideally, every horse in the race. If,

despite this technique of encouraging a wide spread of bets, one particular horse is very heavily backed, the bookie then minimises exposure by backing it with other bookmakers. This way, no matter which horse wins, the bookie will have a mix of wins and losses. If bookies spread their risks well, wins should outweigh losses.

The punter takes the opposite tack. He doesn't spread risk at all. He concentrates it all on one or two horses in each race without knowing too much about them and, if he has my luck, they usually run backwards. At the end of the day, pockets empty, he limps home in his battered old Datsun.

What punters do at the track is lay bets against horses that generally have a low chance of winning. They punt, bet or speculate. Call it what you will, they gamble – looking for a spectacular, instant gain. They take a chance on something performing well. If it does, they're rewarded handsomely; if it doesn't, they lose the lot. Not only that, the more they do it, the more they increase their chances of losing.

This is not what I call 'investing'. In my book investing means putting your money into something that has a good chance of winning in the short to medium term, and an even better, if not dead certain, chance of winning in the long term. The wonderful thing is, there are money-making vehicles that fit this description, and they are the classic assets of quality shares, property, fixed interest securities and cash deposits.



To strengthen your returns from these assets you should, ideally, invest a little in all of them, not a lot in one. Investors call this ‘diversification’, bookies call it ‘hedging their bets’. They both mean the same thing; namely, not putting all your eggs in the one basket.



Let's take a look at my ten keys to successful investing. Ignore them at your peril because they represent a combination of everything I have learnt – from all the books on investment I've read, from the professional investors I have spoken with over the years, from the real-life experience obtained from my own clients and from the many people who write to me.

**TIP
ONE**

**invest in something you understand
– the simple things are often the best**

After 30 years as a financial adviser I have seen all manner of investments being offered to the public. They have ranged from the outstanding to the downright outlandish, and experience has taught me that, in both life and investing, the simple things are often the best. If you look at some of the most successful companies in the world, you'll see that most of them have a fundamentally simple product. Like the giant American company Microsoft, whose user-friendly software finally made personal computers easy for anyone to use, Coca-Cola, and closer to

home anyone who has a bank account or shops at Woollies can pretty quickly see these are necessary and solid businesses.

On the other hand, I regularly receive prospectuses inviting myself or my clients to hand over our hard-earned cash into some scheme or other that is so complex no reasonable person could be expected to understand it. Trying to explain what you have sunk your money into may make for impressive dinner party conversation, but it always sets my alarm bells ringing when an investment is so complex that I have to make a serious effort just to come to terms with the basics of how you can make money from it.

It's not terribly hard to get a good grasp of how a business like, say, Woolworths works, and we are all familiar with how the banks make money. But how many ordinary investors, many of whom had their fingers burnt, really understood the underlying business behind many of the so-called dotcom companies in 2000, or from the impossible to understand business models of Allco or Babcock and Brown.



Just because something is complex, it doesn't necessarily follow that it's good. I've often found that the more complicated something is, the more opportunities there are for things to go wrong. If you are just starting out investing, I reckon a good test of whether or not something is unnecessarily convoluted is if you can explain how the investment works to a spouse or a mate. If you can't, then you don't properly understand the investment

and you'd have to be a mug to put your money into it. When you think about it, if you can't understand how your investment works, how can you expect to recognise the pitfalls that may be associated with it?

I am certainly not the only one who thinks that being able to understand your investments is one of the keys to successful investing – it's a sentiment shared by Warren Buffett, one of the world's most renowned investors. Warren Buffett enjoys something of a cult status among many American investors, and while his company Berkshire Hathaway has suffered setbacks from time to time, its long-term shareholders have little to complain about.

Yet, you won't find Warren Buffett flogging 'secrets to instant wealth'. His investment approach is simple, perhaps even old-fashioned. He ignores economic issues like interest rate and currency fluctuations and stock market trends. Instead he looks for decent businesses whose shares are sensibly priced, that have low overheads, high growth potential and a strong market share. There's nothing flashy about the approach, in fact he has a number of sayings that are equally homely but very sensible.



My favourite Buffet saying is, 'If you don't understand it, don't buy it'.

TIP TWO

consider mainstream assets first

For anyone just starting out investing, it may seem that there is a baffling range of investment opportunities to choose from. Many investments are marketed under a variety of names, and often with very slick presentations, but most mainstream investments fall into one of three categories: cash (which includes fixed interest securities), property and shares. Unless you regard yourself as an experienced investor, I reckon you are better off sticking with one of these mainstream investments rather than something more exotic like, say, ostrich farms or feature films.

That's not to say mainstream assets are failsafe – far from it. It's just that these three investment classes are generally a more proven way of generating wealth. And there is plenty of information available so you can compare returns over a long period of time and make a reasonable investment decision.

Certainly there are other investments you may have heard of that fall outside these classifications, but these tend to represent a smaller slice of the total investment pie. And as I have mentioned, unless you are a seasoned investor, it's not a bad idea to stick to the mainstream options, which are complex enough!

Mainstream assets aren't failsafe – but generally have proven ways of generating wealth.



There are two main types of assets: 'income' assets and 'growth' assets.

income assets

Income assets are generally lower in risk unless of course they promise higher than average returns, then you may well find yourself with some dud US subprime mortgages or something similar. They include term deposits, cash management trusts and other interest-bearing securities and usually pay investors a specified income on a regular basis. This lets you budget more easily, and because they are reasonably secure you are unlikely to lose too much sleep over them. However, there are downsides to these investments. Firstly, the returns are taxable and secondly the returns are lower because there is less likelihood of losing your money.

The other concern is that income assets generally offer no capital growth. And that is a serious consideration when you are talking about long-term investing.

Now, that's not to say income assets are not worth having, far from it, they certainly have a place in most portfolios for the security and regularity of income they offer. What you need to consider is how much of your money you should invest in this type of asset.

growth assets

Growth assets include property, shares, both international and Australian, and units in managed funds that invest in these

assets. These investments offer ongoing income in the form of rent, dividends and distributions, but they also offer capital growth and some tax breaks. It's important to remember though that these investments carry more risk. The capital growth is by no means guaranteed and while there will be periods when the market goes gangbusters (the boffins call this a 'bull' market), there will also be periods when the market dips (a 'bear' market).



There is no doubt it can be enormously rewarding to see the value of your investment climb – in some cases daily when you are talking about shares. But the converse is that you need to be able to withstand a fall in the value of your investment, as we have seen in 2007 and 2008, which is far from fun and can be extremely stressful.

Even though they are often classified as growth assets, shares and property can also be good sources of ongoing income. And unlike income assets, the return on growth assets can be more tax effective. Dividends offer franking credits to offset against the income tax you pay, and property can give you depreciation and other allowances that can be claimed as a tax deduction and help lower your tax bill.

An important point to bear in mind about growth assets is that their stated returns usually include both capital growth and ongoing income, but the capital growth is only accessible if you sell the asset.



KEY THOUGHT

The appropriate mix of income and growth assets will vary from person to person, depending on your stage in life and your investment goals.

property

If property is your thing (and it is for many Australians), the expression 'location, location, location' always holds true. Just as shareholders should look for quality shares, so too should you aim for the best-located real estate that your money can buy. I reckon it's important to pick a property and a location that will appeal to the ageing baby boomers that are making up an increasing proportion of our population. Set to number around 5 million by the year 2031, the over 65s have certainly got the numbers, and they've got the money.

As the population ages, the baby boomers (people born between 1945 and the mid-1960s) will increasingly move from their homes in the suburbs to smaller dwellings, such as townhouses, closer to the city or to coastal retirement enclaves. Generally the dwellings will need to be: low-maintenance with little or no gardens; made of good quality materials; well positioned and close to all amenities, and preferably a level stroll to shops and transport.

If you want to invest in residential property, I recommend you buy something that fits those parameters as it's more likely to show a stronger price and rental growth than other types of properties.



shares

As a general rule it pays to remember that when you buy shares, you are buying into a business. So in addition to monitoring the share's performance on the Australian Stock Exchange (ASX), some of the other things you should look for in a publicly-listed company include:

- ~ whether or not the underlying business is a good one
- ~ whether the management team is experienced with a good track record
- ~ whether the product has good growth potential.

The company's Annual Report provides a lot of information but it can be a bit overwhelming – sometimes running to a few hundred pages. This is when the advice of a competent financial adviser can be very useful. Alternatively, the ASX runs courses designed to give investors a better understanding of shares, which I do recommend as a good starting point.

TIP

THREE

understand that risk equals return

Etch the words 'risk equals return' into your bathroom mirror so you can see them every morning. Taking excessive risk in looking for a big return is the number one reason why investors lose their money. They get too greedy – and investment salespeople know this.

The only way you can circumvent the classic relationship between risk and return is to obtain information that is not widely known. With shares it's called 'insider trading', and the penalties are high if you get caught. With property, inside knowledge about things like rezoning can be very valuable but, unfortunately, over the years a number of people have abused their position of trust on such matters. For most of us, inside knowledge isn't available and we must invest on the premise that the return we get will be related to the risk we take.

If you see an investment offering a high return, don't say 'Oh good', ask 'Why?'. Examples such as Estate Mortgage, Pyramid Building Society and more recently Fincorp and Westpoint, spring to mind. To attract money they offered higher rates of interest than their competitors. To pay this higher rate they lent the money on more risky projects. The result? Investors lost most of their money when it all collapsed.

Now, I'm not saying risk is to be avoided. If you take no risk, you get no return. Everything has some risk, but you must be aware of risk. The real trick is to consider how much risk you can take and still sleep at night, and to invest accordingly.

A young person may be willing to not only invest in property or sharers, but to borrow money to do so. Sure, this means more risk, but if his or her gearing is appropriate to their situation and job security, with a long term view this strategy could give our young investor the highest return over the decades. And if he or she makes 40% in one year and loses 20% the next, it isn't as problematic as it would be to an older person, like a retiree

who cannot easily recoup the lost money and who relies on the investment as a source of income. With their working life ahead of them, younger Australians can afford to take on more risk.

On the other hand, at my age of 55 I would not invest all my money in share markets or property and I avoid gearing because of the higher risk, but with a life expectancy of around 30 years, it still makes sense for me to hold a majority of my money in growth assets.

Be aware of risk. Ask questions and understand the true nature of risk in any investment before you do anything.



As I age, my attitude to risk will change. I'll be more concerned with protecting my wealth, not growing it, so I will gradually switch to lower risk investments such as cash, fixed interest and more blue chip shares.

The trick to managing risk is to consider how much risk you can tolerate given your personal situation, and then to build a portfolio of assets that suits you.

Put simply, a youngster with \$500 may be happy to take a very high risk. This would see a 100% exposure to shares. A middle-aged person may want to be moderately aggressive and invest in a mix of medium- and high-risk investments. A retiree is likely to take a low-risk approach and invest mainly in low-risk assets like cash and fixed interest with a smaller exposure to higher risk investments such as shares.

TIP FOUR

look for an investment that stands on its own merits

There is no doubt that at present it's a tough market for many organisations selling financial products. And this can lead to sales techniques that play heavily on your emotions rather than delivering cold, hard facts, or to marketing methods that seem more suitable for selling household items than long-term investments. I have come across advertisements where investors were offered a free music CD if they bought units in a particular managed fund. I've seen ads from several financial institutions offering bonus deposits to anyone opening a new savings account.

There is nothing wrong with these offers and in this sense they are all above board. But what does concern me is that, in some cases, these offers may encourage investors to choose a long-term investment vehicle, like a managed fund or a home loan, based on a short-term gain.

We all like to get something for nothing and the burgeoning growth of customer loyalty programs is testimony to that. But when it comes to investing our hard-earned money, it pays to stay focused on the fundamentals and these rarely involve selecting an investment based on the best available 'freebie'. If you are planning to invest for five or more years, take a moment to think about how important the new CD (or other freebies) will be some way down the track.



High-pressure sales tactics of the ‘free flight to Queensland’ variety or other marketing gimmicks only distract investors from the main game, which is the performance and security of your money.

We all have the potential to be successful investors and it doesn’t take a huge sum of money to achieve financial independence, but what it does take is a level head and a bit of research. The person who cares most about your money is you, so when it comes to investing don’t be baffled by big talk, broad statements or bad gimmicks. When you are looking around at different investment options, make sure you opt for one that you feel confident with, and that suits your long-term objectives. Don’t be tempted to go with a particular investment, lender or financial institution simply because you get a sweetener on the side. Marketing gimmicks may be fine if you are choosing a new set of golf clubs, but they shouldn’t form the basis of a long-term investment decision.

A picture may be worth a thousand words – but not when it comes to investing.

A study by the University of Michigan has shown that companies can still attract investors, even when they perform badly, by dressing up their annual reports with the right photographs.

According to the survey, investors can be almost twice as likely to invest in a company whose reports have lots of colourful graphics, even if the company’s had a dog of a year. And given the number of annual reports and prospectuses that regularly

come across my desk full of images completely unrelated to the company or its product, I'd say there's every likelihood the same principle applies in Australia.



The bottom line is to disregard the glitzy presentation and focus on the important stuff – what the company aims to achieve, what it invests in, who runs it, what the fees are, and what its long-term performance has been. That's what matters.

**TIP
FIVE**

diversify

In broad terms, I recommend that you have a plan to create three pools of wealth – your home, your superannuation and other investments. This is based on a simple view about diversification. This strategy gives you exposure to property (your home), shares and fixed interest (through your super) and other investments you buy yourself. These might be shares, money in the bank or an investment property.

It also gives you diversification from a tax and legislative perspective. Super is a highly regulated area, and the main reason I would not rely solely on super is another type of risk – the risk of changing legislation.

How you diversify depends upon your age, income, family and so on. The younger you are the less diversification you are likely to have, but as you get older you will diversify more as your wealth grows and you want to reduce the amount of risk you are taking.

A young person may concentrate their investments with a high weighting to growth assets and sensible use of debt. My retired clients on the other hand have a very diversified portfolio because they are trying to minimise risks.

You can take diversification into an even narrower context. For example, with a share portfolio you should diversify by choosing different sectors within the market. You might invest in the following areas:

- ~ banking and finance
- ~ building and construction
- ~ media
- ~ health
- ~ resources

Inside, say, the banking and finance sector you might further diversify by choosing several shares such as Westpac, National Australia Bank and CBA.

No one knows the future. Don't gamble yours by relying on one type of investment only.



**TIP
SIX****don't try to 'time' the market**

It's pretty obvious that you should buy when things are cheap and sell when they are expensive. It sounds so delightfully simple, but guess what most investors tend to do? When the news is good and investments are expensive, they buy, and when the news is bad and investments have fallen in value, they sell. It's a recipe for financial ruin.

'Good market timing' is all about buying at the bottom and selling at the top, and being a 'market timer' means trying to do just that. But no market timer I know consistently gets their timing right year after year, as no one has yet worked out how to read the future.

Punting (and it is punting) on trying to move in and out of the markets at optimal times is a mug's game. Even the maths is against punters. As the following sums demonstrate, the damage caused by losing a dollar is greater than the gain achieved by earning a dollar.

A gambler's lament – the cost of losing is greater than the gain of winning.

Invest \$1 and lose 50%. You now have 50 cents.

Invest that 50 cents and earn 50%. You now have 75 cents, 25 cents less than you started with.

Try it the other way around...

Invest \$1 and earn 50%. You now have \$1.50.

Invest that \$1.50 and lose 50%. You're back to 75 cents again, still 25 cents less than what you started with.

As the 'gambler's lament' shows, in percentage terms, if you make a loss, you will need to make an even greater gain to compensate for it. Furthermore, in the context of investing, this is before you pay any commission, stamp duty or brokerage. In general terms therefore, you need to be right with your investment timing decisions around two-thirds of the time just to break even – and that's all too hard.

I'm not saying you shouldn't use research to guide you to better investment areas. But when it comes down to it, determining how much risk you can live with and then buying investments that suit your risk profile and monitoring these is a better strategy than switching from one investment area to another on a regular basis. The only winner in this is the broker or salesperson who is doing the buying and selling – or the Stamp Duties Office!

TIP
SEVEN

try 'dollar cost averaging'

This is a great tip, simply because it works so well. In 'Don't try to 'time' the market' Except with hindsight, to picking the right

investment is nearly impossible.. Well, 'dollar cost averaging' makes things very easy. All you have to do is simply decide how much and how often you are going to invest. You may decide to invest on a monthly, six monthly or yearly basis – it really doesn't matter what the frequency is.

Let's imagine you decide to invest \$1,000 twice a year into a particular share. Its price, like all shares, rises and falls over time. This is what could happen.

Share price

Number of shares you get

1 January 2005

\$1.00

1,000

1 July 2006

\$1.00

1,000

1 July 2005

\$1.20

833

1 January 2007

\$1.40

714

1 January 2006

\$0.80

1,250

1 July 2007

\$1.30

769

Look at when you bought the most shares – in January 2006, when our imaginary share's price was 80 cents. When did you buy the least? In January 2007, when the share price was \$1.40.

Human nature tends to lead us to sell when things are cheap (times are bad) and buy when they are expensive (things are good). Dollar cost averaging forces you to buy most shares when they are cheapest, and buy the least when they are the most expensive. This is a discipline worth using.



TIP
EIGHT

invest in growth assets for the long term

Remember, a growth asset is simply something that grows in capital value as well as producing income. To maintain your standard of living once you stop work, you need your income to grow with inflation. Growth assets such as property and shares will help to do this. Property rentals increase over time, as do share dividends on good companies.

Be careful about being seduced by high (and fully taxable!) income returns on bank deposits or other such investments. Let me try to highlight this with an imaginary investor who has \$10,000 to invest for her future. She is 40 years old and wants to stop work at age 55.

If the \$10,000 is invested in, say, a term deposit at 5%, it will generate an annual return of \$500. Depending on our investor's total income, up to 46% of this \$500 could be lost to tax. And if

whatever's left over gets spent – as is often the case – 15 years down the track our investor will still have the \$10,000 (with its value much eroded by inflation) and that's about all.

By investing the \$10,000 into growth assets like shares, our investor would probably (though not necessarily) earn less income today than the term-deposit investor. However, the share investment would most likely grow in value over the years. Let's say three shares were purchased with the money: BHP, National Australia Bank and Woolworths. (You'll note I've chosen shares from three different sectors and, incidentally, investing in a managed share trust would do the job equally well.)



Now, our share investment would generate income of around 4%. Much of this would be in the form of fully franked dividends with tax already having been paid on them at the company tax rate of 30%, but let's compare apples with apples and assume this income is also spent.

Let's assume that the shares would grow (in price) on average at around 6% pa (before inflation) and that inflation would average around 4% for the period. With these assumptions the shares would be worth around \$24,000 in 15 years. So at retirement at 55, our investor would have \$24,000 worth of shares earning 4% income (\$960), and this \$960 would have had tax paid on it at 30% (assuming the dividends were fully franked).

Compare this income to that provided by the \$10,000 still sitting there in the term deposit (and getting eaten by inflation). It's still only earning 5% (\$500) and this \$500 is fully taxable.

If the investor's effective tax rate was 30%, the shares would provide an after-tax income of \$960, and the term deposit an after-tax income of \$350.

In 15 years' time, would you rather have \$500 of fully taxable income or \$960 of income after 30% tax has been paid on it?

Sure, growth assets are far more risky in the short term, but over 10 to 15 years, quality growth assets will tend to grow in value, and so will the income they generate for you.

Growth assets increase in value, have tax advantages and, therefore, generate more income as time goes by.



**TIP
NINE**

take advice if necessary

I'm the first to argue that the more you know about your money, the better off you are. But there are some things you don't need to know nor, unless you have a huge amount of spare time, will you be able to know. It's like your health – you don't have the time or training to be able to self-diagnose and treat your own health problems. When necessary you go to see a doctor. With

money matters you go to a financial adviser. But if you thought finding a good doctor was a challenge, finding a good financial adviser is even harder.

The reason is that the whole field of professional financial advice is reasonably new. Commissioned salespeople have been around for years, but it has only been in the last 20 years or so that qualified, professional advisers have started to appear in reasonable numbers. Finding one requires a bit of work. You could contact the FPA and get a list of qualified advisers near you, but I'd also be talking to my friends, colleagues and your super fund may also be able to help you.



**TIP
TEN**

take action!

Anyone can be a successful investor rather than a losing punter by following a pretty simple prescription – spreading risk over a diversified range of assets, and hanging on to these assets for the long term, through the good and the bad times.

And yes, there is something else – taking action. No one ever got rich by doing nothing (unless you're lucky enough to inherit a fortune). You generate wealth by doing something. This might seem like a statement of the bleeding obvious for some, but for others it needs to be said.

All the main investment classes produce reasonable returns over time. And even if you only invest in one or two of the poorer performing ones, this is still far, far better than not having invested at all. Yes, I know I say that diversifying across all the main asset classes is the best investment strategy, but let's say you only invest in residential property, well, good, at least you have invested in one viable asset class. In fact, in the end it doesn't really make an enormous amount of difference which quality assets you invest in, be they shares, property, cash or fixed interest, just so long as you do invest!



These are what I reckon are ten of the key building blocks for successful investing, but they certainly are not the only steps successful investors take. Once you have mastered the

basics, you can start to take on board some of the key steps that more seasoned investors follow.

If you would like more detailed information, I suggest you get hold of a copy of my book *Making Money*.



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