BLU

How to Manage your Money Effectively

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Forget all the technical analysis, the fundamental valuations or the current macroeconomic situation. The only thing we control when it comes to our investments, is how much of our capital we put at risk. Everything else is random, and the evidence for how bad we are at predicting things is staggering, especially when it comes to the future. The key to the successful management of our money is *focus*, but let's take it one step at a time.

The Investment Universe

In the beginning, there are equities. With historical average annual returns at somewhere between eight and ten percent, including dividends, there is much to like about the stock market. We can try and skew our allocation to certain regions, sectors, or even individual companies. That may or may not enable us to beat the market averages, but the main thing we have learned in the last hundred years, is that long-term investing into a globally diversified portfolio of stocks works.

Although there is little to suggest this trend is over, there is a reason that we get paid so much money. Historically, crashes happen about once a decade, and markets have gone down more than 35% on average and as much as 56% in the Great Financial Crisis of 2008. Important to note is that when these events happen, all stocks go down, even ones that were allegedly "safe". It just has to do with herd mentality and everyone running to the door at the same time. That's the risk we take with equities.

Never fear, that's why we have bonds - so called *fixed income instruments,* where the most we should hope to get back is our capital with a little interest on top. We take credit risk, in that the borrower may have trouble paying us back. As such, there are also ways to skew our allocations to either the riskier or higher-grade part of the market. We can also lend short term or for many years, and we receive yields accordingly. Historically, bonds have been a good addition to a portfolio consisting of stocks, because they tend not to go down as much in times of market adversity. Government bonds have usually even gone up when stocks sell off.

The so called "60/40" portfolio, consisting of a combination of stocks and bonds has been a stalwart in most wealth management models for a very long time. However, in 2022, it has lost more than 20% for a number of reasons. As such, it would be good to have a third type of risk when looking to spread our eggs into different baskets. That's where the aptly called *alternatives* come in, and it includes everything from property, hedge funds, private equity, gold and even digital assets.

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Rebalances

It may seem obvious, but in looking to invest into something other than stocks and bonds, we need to make sure that whatever we do, it does not move like stocks or bonds. One must carefully choose investments and strategies accordingly. We must also decide how quickly we want access to our money. My father always said, your house is where you live, it is not an investment and we would not sell our home, because we saw an opportunity in the Nasdaq.

Markets don't move up or down in straight lines. The whole idea in creating three different buckets of risk, is that we want to be able to move between them, depending on market circumstances. We may not be able to predict what happens in the future, but we can rebalance, selling one bucket which has outperformed on a relative basis, whilst buying the other. That is usually where the best opportunity lay, getting into investments when everyone else is (forced) selling.

Currencies

It is often underestimated how much of our investment returns come from our positioning relative to our base currency, e.g., the one in which we live and pay our bills. If you are a Sterling investor and bought the US stock market at the beginning of 2022, you would have lost 20% year to date. However, the US$ is also up 20% against Sterling during this period, which means we break even. Of course, this can also work the other way, and pity the US based investor who bought the UK. Therefore, it is recommended to maintain at least half of our exposure to the currency we need the money in the most. That way, we can at least cut this risk in half.

Allocations

So here we are, we have three different buckets of risk, stocks, bonds and alternatives and we have neutralised our currency exposure (as best as we can). Now we have to decide how much to put into each category of risk.

Into equities we can only put in half of what we are prepared to lose. In other words, if we invest £1,000,000, we need to accept that we may only get £500,000 back when we need it. Obviously, the longer we are invested and the markets have a chance to go up, this risk diminishes on an absolute basis. However, timing remains a very difficult thing, and anything is possible, just ask those that bought Japan prior to 1987 (note the Nikkei is still down versus the high it achieved that year).

Bonds are relatively easy to figure out, as the yield gives us a fairly good indication of how much we can earn for the risks we take. Up until the beginning of this year, you must have been mad to buy bonds with zero yields bearing huge upside risk (note, long term bonds are down as much as 35% in 2022). The situation is now much different with short term bonds particularly attractive on a historical basis. As such, bonds are no guarantee of a safe haven, but they do serve a purpose and if anything, all we need is for them to act differently relative to equities.

The rest goes into the alternatives. For most balanced portfolios at the moment, a 50/25/25 allocation seems about right. Of course, this can change from week to week, and this is where the most important aspect of any investment management strategy lies.

Rather than spending time looking for the perfect investment or trying to make sense of the prevailing market environment, all we need to do is focus on our allocation to the different risk buckets. When equities are down, we buy more. When bonds are up, we sell. Whereas alternatives by their very design create a different return stream entirely. Very simply: when our allocations have moved significantly relative to one another, we rebalance to bring them back to our chosen profile. All we can control is the risk we take on and the costs and fees we have to pay. There are exchange fees, custody charges, admin fees, compliance costs, stamp duty, banking charges and we do well to understand each and every one of these before we start investing.

Intelligent implementation is the key

Wealth management may be very simple when broken down into its components, but it is in the implementation where most of our money can get lost. Most important is to stop wasting any time thinking we can predict the unpredictable, or worse paying someone to get lucky. We need to spread our money into different types of investments and rebalance when they have moved too much against one another on a relative basis. We also need to keep a keen eye on our currency exposure, for it is the biggest risk we take. Finally, we should not compare apples with oranges when looking at the costs. Sometimes the cheapest offering isn't all that it seems, and the most expensive can be good value. We need to understand *where* the fees are being spent. The less on pontifications, and the more on systems and processes the better.

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