Cuffelinks
Connecting investors with ideas

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This Week's Top Articles

My 10 biggest investment management lessons

Chris Cuffe

(Editor's introduction. There are valuable lessons to learn from Chris Cuffe's experience with the Third Link Growth Fund. The Fund's managers are selected by Chris in a 'fund of funds' structure, and all fees paid by investors go to charities. The Fund has outperformed its benchmark over seven years by 4.5% pa compound, and 5.3% pa compound in the last three years. According to research house Zenith, it ranks 3rd out of 108 comparable funds since its inception (to 31 May 2015), with a lower volatility than the median manager or the benchmark. How is such performance achieved?)

Although the Third Link Growth Fund has been a success, if I'm honest with myself, after seven years and with one of the best track records in the market, you would expect it to be bigger than its $85 million. I'm proud of the pioneering structure, where the fund managers provide their services for free, enabling us currently to give more than $100,000 a month to charities. That's obviously a great story, but why has more money not flowed in? Answering this question highlights some big lessons about investment management.

1. Financial services are sold not bought

In commerce generally, the consumer finds the best products in the market, especially with such an open system as the internet. But financial services is an industry where products are sold not bought. There are a lot of middle men and women doing the selling. Across most businesses consumers generally can easily find the best products, but not so in the world of investing.

If a fund does not have active sellers and marketers, it doesn't get much support and that's how it's worked out. Listed Investment Companies (LICs) have broker networks that work their clients intensely in the offer period, while dealer groups have advisers who tell their clients where to invest.

In the pre-FOFA time when this Fund was launched, it paid no commissions, and most advisers were commission-based. We're not really long into the post-FOFA environment, but I don't think advisers scour the earth looking for the best products. They have to do the right thing by their clients, but that does not mean finding the very best. It's more what's on their radar screens.

2. Joe Average doesn't have a clue where to invest

In financial services, with most aspects of investing, Joe Average does not have a clue where to start to find the best products. To DIY in financial services is tough for the average person. I can DIY in my back yard by going to the hardware store, work out how to pave a path or tile a wall, but you can't do that easily in financial services.

3. The environment and structure must be right for the product

Third Link does not have sales support other than me telling the story (and I do this pro bono and have limited time given my other activities) and the occasional bit of press coverage, and it lost some of its initial impetus due to the impact of the GFC. The environment must be right for the product. My Fund was more suited to a one-off big bang, a press event, a launch with a room full of people, sell it and close it quickly on the back of a heap of publicity. I don't think it suits a slow burn of continuous fund raising over many years. Whether you like it or not, a slow burn means being on the major platforms, financial planner support and a sales force of business development managers. And stockbrokers don't support managed funds.

Third Link is only rated by the Zenith Group and it's only on one platform (the BT platform) to allow people to have a superannuation version. Platforms create administrative work and everyone helping out with Third Link is doing this pro bono, so I have not sought to have it on other platforms.

4. Blending styles is a waste of effort

In my view, professionals blend managers in multi manager funds in exactly the way that gives a mediocre result. Typically, they will blend value managers, growth managers, large managers, small managers, etc and then wonder why they achieve the index less their fee. The results of these blended funds have never been great.

I am not the slightest bit interested in blending styles and so some people are put off Third Link because there is no formal scientific process. My process is called experience – one of finding competent, proven managers who will swing the bat and have a go. I do watch for concentration risk but I'm mainly interested in the willingness of managers to pick stocks ignoring the index. In fact, I like to see a high tracking error which is the opposite of most professionals.

5. Past performance is the best guide to future success

Every offer document in the country says something like 'Past performance is no guide to future performance' or similar. That is exactly the opposite of how I think. It's the best guide to knowing what a manager is really like over a long period. Past performance is extremely important and a great guide to the future.

Only long-term results are relevant. The managers I use are selected for the long term. I have no interest in their short-term results. If it looks like a manager is struggling (which I would only conclude after rolling 3 year periods), I would only exit after say a poor rolling five-year result.

6. Never buy a bad stock because the price is low

I don't like 'deep value' investing where a manager is willing to buy a poor quality stock because the price is so cheap. I don't like people saying a bad stock priced cheap is low risk. I would hate to see any of the stocks held by my managers fall over.

Managers need to buy quality stocks. Adding that to a good track record and a high tracking error should mean my fund will do well in falling markets (which it does) which is a sign of a good portfolio.

7. Watch the level of funds under management

I do look at total funds under management in a manager and the types of stocks the manager buys. A small cap manager in Australia with more than $1 billion concerns me. And I am cautious about investing with a larger cap manager in Australia with more than $6 billion under management. At that level, I need more convincing. Size can get in the way of performance. It's no coincidence that most of my managers have performance fees, which enable them to remain smaller while making it economically viable to run their business.

Most managers talk about staying below capacity and refusing to take in more money but my experience is most don't do that, especially when there's an institutional owner. It's compelling to take more money. Boutiques are best at watching capacity as they can make a lot of money from performance fees if they are good.

8. Don't be afraid of performance fees

I believe managers deserve their high fees based on their performance. In my own personal investment portfolio I don't care about paying a 20% performance fee (as long as the right hurdle exists) if I'm getting 80%.

It's a great part of the Third Link structure that the managers kindly refund all the performance fees (as well as the management fees). It's the sizzle in the Fund. For most professionals who provide a fund-of-fund product the underlying fee of each manager is so crucial for their own economics that they cannot pay performance fees. But I'm agnostic to fees so I just look for the best managers.

I have not selected any of the managers based on their willingness to forgo their fees. I select on merit then ask if they will waive their fees. I will restrict the Fund's size to about $150 million so no one manager has more than about $20 million.

9. Active versus passive depends on the asset

The active versus passive debate is not a one-size-fits-all. It should be considered in the context of the asset class. In Australian equities, I'd never invest in a passive fund. You have to look at the index before you go passive. Why would you buy an index which is 30% in banks (mainly four stocks) and 15% in resources (mainly two companies)? Talk about a risky portfolio! It amazes me people would start with that. But internationally, say the MSCI World Index, index investing has merit. In Aussie small caps, you could invest in an index fund but I think there is no upside in having small resources because of their boom/bust track record. And I think the active managers of small cap industrials generally do way better than the industrials index because they can find small under-researched stocks. But there's nothing wrong with indexing in parts of the fixed interest asset class.

I hope some of the roboadvice models go into active management, especially in Australian equities, but I suspect they are unlikely to do so due to the cost.

10. Business risk guides a lot of investing

It's astounding in Australia the number of managers who won't risk being too different from the index. If they underperform for a short period due to departure from the index, they worry they will lose funds (and the particular portfolio manager may lose his job). If resources and banks are not doing well, a fund with managers that are index unaware should do very well. And guess what – the best three months of Third Link in its history have been the last three months as both these sectors fell.

I listened to an active Australian equity manager tell me how proud he was of being index-unaware, yet his financial exposure was 27%, not the 30% per the index. This is not an active position at all and the person is surely being driven by the index. I would think that a position of half or double or nil is more like an active view.

This benchmark risk (being the willingness to be different from a benchmark) has a lot to answer for in encouraging mediocre investing across the world. The dominance of these behaviours is far greater than anyone will admit. It drives many professionals to bizarre investing.

I don't have any business risk or career risk in selecting my managers. Third Link is not a business and I'm running only one fund.

The best investors I deal with are totally benchmark unaware, even as to what markets they invest into, local or overseas or cash or whatever.

Chris Cuffe is the co-founder of Cuffelinks and has a [wide portfolio of interests across commercial, social and charitable sectors.](#) More details on the Third Link Growth Fund are on www.thirdlink.com.au. How can we have a disclaimer after such firm opinions? Let's just say anyone should seek professional advice on how these lessons apply to them, as the circumstances for each investor are unique.

Where to from here for house prices?

Roger Montgomery

No rational valuation measure produces a number for local house prices that even remotely approximates what houses and real estate sell for in Australia. But does it follow that a bursting is the only route from here?

For decades residential housing has sold on gross yields of 2% to 5%. Inverting the yield – and remember we are talking 'gross' yield here, which does not count the cost of maintenance, taxes, interest payments or management fees – houses have frequently traded on multiples of 25 to 50 times the gross earnings. Let's agree houses aren't cheap.

What drives house prices?

In the very long run, it isn't demographics or interest rates or immigration or construction costs or any of those things that makes investing in your home a sensible decision. What makes residential real estate investment essentially a sensible decision is that you are effectively short the Australian dollar. Not against other currencies but against itself, its purchasing power.

Housing becomes worth more over long periods of time because the purchasing power of the dollar declines due to inflation. The house that was bought decades ago is worth more in dollar terms, especially based on the land value (so the argument is not as strong for densely-built apartments).

In Australia, home ownership is hailed as a worthy aspiration. Tax structures such as zero capital gains tax on the primary place of residence and the deductibility of interest costs against residential property income as well as legislated incentives such as the first home buyers grant, have contributed to the pursuit of real estate as a worthy investment. That feeds its popularity and Australians' predisposition to it.

Then add to the mix the accessibility of credit. With a deposit of 10% or less and low interest rates, and many properties become relatively attainable and even affordable.

What has happened to long term house prices?

If one believes that housing is a way to short the dollar, then it should be that house prices will generally follow inflation. The Herengracht Index is the longest study ever of house price changes - following house prices along the Herengracht canal in Amsterdam. Created by real estate finance professor Piet Eichholz of Maastricht University, the index goes back to the construction of the Herengracht in the 1620s and was first published from 1628 up to 1973, later extended to 2008.

The strip of homes in the index has always been some of Amsterdam's most favoured and attractive real estate. This stability renders the index a useful tool for understanding how inflation-adjusted real estate prices change over time.

It shows that between 1628 and 2008 – 380 years – house prices rose and fell but on average the real price merely doubled. This corresponds to an average annual real price increase of about 0.1%.

In Australia long term studies have also shown prices followed inflation but only until the 1970's when prices in Australia detached from their correlation with inflation and started to follow incomes, in particular the rising incomes of the baby boomers.

Demographics and immigration are supportive, on a net basis, for house prices in Australia. While individuals are studying longer and starting families and careers later, all cohorts from their early thirties onwards provide support to house prices.

Finally, in the shorter term, interest rates, employment, foreign investment and lender behaviour will have an impact on house prices as will changes to zoning and other government interferences.

When crowd psychology takes over

From time to time, these short-term influences combined with the mystery of crowd psychology corrupt an otherwise sound premise and an appropriate valuation.

In all bubbles the sound premise that once catalysed the favourable change in prices is forgotten and all that matters is that prices are expected to rise materially in the future as they have in the past. At some stage, if prices keep rising they become self-reinforcing. The mere fact that prices are rising confirms to the onlookers that the original premise remains sound. And those commentators who might warn of impending doom are discredited by the rising prices.

The price one pays always determines one's return, so the higher the price, the lower the return. There is also a difference that exists between investing and speculating. Investing is where funds are committed today in the expectation that more funds will be produced later from the operations of an asset.

Investing therefore doesn't care whether the stock market or property market is open or not. A sufficient return can be made from long-term operation or development of the business or the property. Speculation, on the other hand, cares less about the asset and more about the change in price.

Combining the concepts together produces some insight into the development of a bubble from otherwise more normal changes in price. When activity switches from being investment-like to speculative the risks of a bubble forming are heightened. And when speculation is justified by apparently rational arguments - such as the weight of money argument that Chinese investment in Australian property will keep house prices supported – the risks that the seeds of an even bigger bubble will germinate start to increase.

The role of banks

Those risks are also fuelled by profit-motivated financial institutions holding the keys to the cash register amid cheap credit. In the pursuit of growth and maintaining their competitive position, lenders can fuel the already speculative flames by loosening otherwise sound lending practices.

And this happened in Australia. Earlier this year, ASIC found 'troubling' flaws in credit standards in the interest-only mortgage market, which represents 37% of home loans held by banks, building societies and credit unions. Interest-only loans have grown by about 80% since 2012 and we now have low and no deposit loans, which leave the borrower with little or no margin of safety if their circumstances change. A pin awaits every bubble and how toxic the aftermath becomes is directly proportional to the level of gearing that fuelled the rise.

ASIC's review of 140 customer files held by banks and credit unions revealed that lenders incorrectly calculated how much time the borrower had to repay the principal when the interest-only period ended in 40% of cases. In about one-third of cases, ASIC found no evidence the institution had assessed the appropriateness of the product for the borrower and in more than 20% of cases, the lenders had not appropriately assessed the borrowers' living expenses.

When house prices compared to incomes are stretched and those incomes have been estimated incorrectly, the seeds for an ugly reckoning are planted. The question is whether they will germinate and mature, resulting in a bursting.

If in the US, a decade ago, Freddie Mac and Fannie Mae had been required by regulators to lend only based on 30% deposits, and to verify incomes and expenses, and to ensure loans were limited so that payments only amounted to one-third of incomes, the bubble in property prices that preceded the GFC might have been prevented.

The average house price in Sydney consumes more than 65% of the average income of a borrower geared to 80%. The reversal of the resource boom and the end of automotive manufacturing in Australia will leave holes in job prospects. We also know that throughout history prices for assets have risen spectacularly when interest rates are low.

The signs are changing

Unlike the US a decade ago, we have already seen regulatory changes to investment lending growth, lending practices and foreign investor permissions that may just be enough to prevent any bubble from inflating too fast or too far. The increase in bank capital charges for residential mortgages has already forced banks to increase their rates on investment loans, and last week, Westpac took the highly unusual step of increasing rates on owner-occupied variable rates out-of-cycle with a change in the cash rate. Other banks will follow.

Plus the banks are imposing quantitative limits on investment lending, and publishing postcode lists where they believe valuations are stretched and warrant extra deposit margins. Anyone who has tried to borrow to finance an apartment in the last few months has experienced a different attitude to a year ago. Auction clearance rates are now at their lowest level for three years.

All of this suggests some of the steam will come out of the housing market now. Of course asset prices never move in steady straight lines so a smooth transition to lower prices might not be possible. The oversupply in apartments currently under construction and the replacement of local bank lenders (who are baulking at oversupply and poorer developer standards) by Malay, Japanese and Chinese banks suggests the road could still be bumpy for investors who have overstretched.

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Many investors buy and then worry about a crash. Perhaps the solution is to wait for a crash, or at least a long pause, before buying and have a lot less to worry about.

Roger Montgomery is the Founder and Chief Investment Officer at The Montgomery Fund, and author of the bestseller 'Value.able'. This article is for general educational purposes and does not consider the specific needs of any individual.

Challenging a will: money or family

Adele Horin

Fights over wills provide an appalling insight into the bitterness, anger, and recrimination that can tear families apart. Even when quite small sums are at stake, adult children, ex-spouses, stepchildren and others will stop at nothing. It's enough to make a person turn in her grave.

A recent report shows why increasing numbers of Australians are challenging wills in court: they've a good chance of success. Judges and mediators are able, in effect, to re-write a person's will. They can even ignore a parent's written statement that explains why this ingrate daughter or that callous son is to get nothing.

The report called Having the Last Word? is the result of a major investigation under the aegis of the University of Queensland into will-making and contesting wills. (It's fascinating reading). It found 74% of cases challenged in court resulted in the will being changed, and 87% of those that went before a mediator. No wonder law firms appeal to would-be clients with advertisements that ask "Have you been left out of a will?"

The high level of contesting wills – particularly evident in NSW – can destroy family harmony forever and for generations, and whittle away the estate's value in costly legal fees. Many of you probably know this. The study found 18% of those involved in a dispute said family relations had been poor before the contents of the will were disclosed but this rose to 26% afterwards. The report's authors recommend measures to reduce the level of fights over wills. But the lawyers and others consulted were pessimistic.

"Some people have an unhealthy sense of entitlement and don't respect the wishes of the will maker," one told them. "You can't draft documents or legislation to change that."

Trawling through some cases that went before the NSW Supreme Court in recent years, I was mesmerised by the ghastly family dynamics on display. In one case a woman cut her stepdaughter out of her will, and explained in a statement: "I make no provision in my will for [DM] who claims to be a daughter of my late husband as she has ill-treated both myself and my late husband for many years and has made no attempt to contact or have anything to do with me."

In this case DM convinced the judge it was her father's and stepmother's conduct that had caused the rift. ["My stepmother] is a horrible person," DM said. "They [shut] the door in my face for 47 years." She was awarded $75,000. Her legal costs that came out of the estate were $55,000.

In another case two daughters were cut out of their father's will because, according to the statement he left, "they make no attempt to contact me either by telephone or in person. No cards are sent to me either at Christmas or my birthday… I do not feel obliged in any way to make any provision out of my estate for their benefit." The daughters were awarded $9,665 and $7,750 because the judge did not believe the father's complaints were valid. The father's friend, who was to inherit the small estate, spent $16,500 or 25% of its value, defending the action. This is madness.

It turns out we're not entirely free to give away the family silver to whomever we want. Our freedom is balanced by laws that allow courts to ensure family members (and others) who fit the criteria are adequately provided for out of the estate.

Irrational and punitive parents and spouses can treat family members unfairly in their will, or come under malign influences. But lawyers such as Lesa Bransgrove, of Bransgroves Lawyers, believe the balance has tilted too far against the will maker. "What we're seeing is a view in the courts that the responsibility of parents goes beyond the time when children are dependants," she said.

Judges had expressed a view that the community expected estates could be used to help adult children in retirement if they had no superannuation, provide them with a deposit on a home, or assist with the education of grandchildren.

The Queensland University study found a will is widely regarded as a means to distribute "family money". Not many Australians leave bequests to charity in their will (Muslims are the exception here); and if they do, charities report court challenges from family members are common. The view of wills as "family money" may be fostering a "sense of entitlement" by family members, and fuelling the challenges, the report says. There's some evidence "some family members are greedy rather than being in need."

Professor Linda Rosenman, one of the report's authors, said: "It's probably almost impossible to draw up a 'contest proof' will. It would be more useful to address the family dynamics at the time of making the will rather than leaving it for the family to 'fight out' after death."

Elder law specialist Rodney Lewis says he didn't believe it was too easy to contest a will and attributed the high success rate to lawyers having already screened out weak cases. To avoid feuds, Lewis urges will makers to communicate with their family. Where they're departing from equal distribution – or giving a motza to the dog home – make sure everyone understands the reasons. Writing a statement of explanation is not a total waste of effort in the event of court action, he says. "But any defects in logic or errors of fact will undermine its authority." So take care.

Adele Horin was the social issues journalist with the Sydney Morning Herald for 18 years prior to her 'retirement'. This article was first published on Adele's blog (adelehorin.com.au), and is reproduced with her permission. Adele is recovering from an operation for cancer and we wish her the best.

How safe is my super?

Noel Whittaker

How safe is my super from rule changes? What do you think the government has in store for us? The person who asked these questions is an executive in his early 50s who is busily trying to get his finances in shape to retire at age 65.

For a person of his age I am not overly concerned. There have been non-stop changes to the superannuation system since it became universal more than 25 years ago, but there has been no element of retrospectivity. Yes, there are many voices now saying the system is too generous, but they tend to be focusing on those few people who have more than $5 million in super, and who are certainly not representative of the majority.

So what can we expect? The present government has promised no changes in their present term but this has only a year to run at most. Opposition Leader Shorten has already announced Labor's intention to increase the contribution tax to 30% for people whose adjusted taxable incomes are in excess of $250,000 a year. This is not a huge leap from the present system where the 30% tax applies to people with incomes of over $300,000.

Under the present system, there is a 15% tax on earnings from superannuation funds in accumulation phase but this reduces to zero once the fund enters pension mode. Under the Gillard government there was a proposal to tax the income of a pension fund once fund income exceeded $100,000 a year per member. This was a fairly mild proposal because the 15% tax was only on the excess income over $100,000. But the predictable outcry ensued, and the proposal did not become law.

It is now Labor policy to reintroduce this tax but they have made it tougher – it will apply once income exceeds $75,000 a year. Given the failure of the last attempt, the chances of this getting through must be considered slim, but even if it did, it's probable only a few would be affected.

Think about a couple with $4 million in super, with a portfolio that is spread in a conventional manner between cash 30%, local shares 35%, international shares 25%, and listed property 10%. The income including franking credits would be around $73,000 each, which would still keep it under the threshold for Labor's new tax. I suspect when they start doing the numbers, they may come to the conclusion that the gain is not going to be worth the pain.

The Association of Superannuation Funds of Australia (ASFA) proposes that money in pension phase be capped at $2.5 million per member. It might be easy in theory but devilishly difficult in practice. Is the intention to take the balance at June 30 and simply switch the excess, if any, to accumulation mode? If the market has a sudden fall or rise, or if there is a big withdrawal, do you have to go through the whole process again? But once again we're talking about balances of $5 million and over, which is hardly likely to worry mums and dads.

Emails arrive continually from people who are concerned that the government will change the rules to prevent withdrawal of lump sums. I do think at some stage in the future the government of the day might decide to compel retirees to take part of their superannuation as an income stream, but that may be a long way off. It would be a brave government who would compel retirees to lock up part of their retirement funds in an annuity when interest rates are at historic lows.

Yes, more change is inevitable. In my view, the biggest risk for most retirees is an overemphasis on cash in their portfolio because they are averse to risk. Many retirees can now expect to live 25 years or more after they retire. For them, holding money in cash may be one of the riskiest strategies of all.

Noel Whittaker is the author of Making Money Made Simple and numerous other books on personal finance. His advice is general in nature and readers should seek their own professional advice before making any financial decisions. See www.noelwhittaker.com.au.

7 golden rules for SMSF investors

Shane Oliver

Investing during times of market stress and volatility can be difficult. It's useful for SMSF investors to keep a key set of rules in mind.

1. There is always a cycle

The historical experience of investment markets – be they bonds, shares, property or infrastructure – constantly reminds us they go through cyclical phases of good times and bad. Some are short term, such as occasional corrections. Some are medium term, such as those that relate to the three to five year business cycle. Some are longer, such as the secular swings seen over 10 to 20 year periods in shares. But all eventually contain the seeds of their own reversal. The trouble with cycles is that they can throw investors out of a well thought out investment strategy that aims to take advantage of long term returns and can cause problems for investors when they are in or close to retirement. In saying this, cycles can also create opportunities.

2. Invest for the long term

The best way for most investors to avoid losing at investments is to invest for the long term. Get a long term plan that suits your level of wealth, age and tolerance of volatility and stick to it. This may involve a high exposure to shares and property when you are young or have plenty of funds to invest when you are in retirement and still have your day to day needs covered. Alternatively if you can't afford to take a long term approach or can't tolerate short term volatility then it is worth considering investing in funds that use strategies like dynamic asset allocation to target a particular goal – be that in relation to a return level or cash flow. Such approaches are also worth considering if you want to try and take advantage of the opportunities that volatility in investment markets throws up.

3. Turn down the noise and focus on the right asset mix

The combination of too much information has turned investing into a daily soap opera as we go from worrying about one thing to another. Once you have worked out a strategy that is right for you, it's important to turn down the noise on the information flow surrounding investment markets. This also involves keeping your investment strategy relatively simple – lots of time can be wasted on fretting over individual shares or managed funds – which is just a distraction from making sure you have the right asset mix as it's your asset allocation that will mainly drive the return you will get.

4. Buy low, sell high

One reality of investing is that the price you pay for an investment or asset matters a lot in terms of the return you will get. It stands to reason that the cheaper you buy an asset the higher its prospective return will be and vice versa, all other things being equal. If you do have to trade or move your investments around then remember to buy when markets are down and sell when they are up.

5. Beware the crowd and a herd mentality

With crowds, eventually everyone who wants to buy will do so and then the only way is down (and vice versa during periods of panic). As Warren Buffet once said the key is to "Be fearful when others are greedy and greedy when others are fearful."

6. Diversify

Don't put all your eggs in one basket as the old saying goes. Unfortunately, plenty do. Through the last decade many questioned the value of holding global shares in their investment portfolios as Australian shares were doing so well. Interestingly, for the last five or so years global shares have been far better performers.

It appears that common approaches in SMSF funds are to have one or two high-yielding and popular shares and a term deposit. This could potentially leave an investor exposed to a very low return if something goes wrong in the high-yield share they're invested in. By the same token, don't over diversify with multiple – say greater than 30 – shares or managed funds as this may just add complexity without any real benefit.

7. Focus on sustainable cash flow

This is very important. There have been many investments over the decades sold on false promises of high returns or low risk (for example, many technological stocks in the 1990s, resource stocks periodically and the sub-prime asset-back securities of last decade). If it looks dodgy, hard to understand or has to be based on obscure valuation measures to stack up, then it's best to stay away. There is no such thing as a free lunch in investing. If an investment looks too good to be true in terms of the return and risk on offer, then it probably is. By contrast, assets that generate sustainable cash flows (profits, rents, interest payments) and don't rely on excessive gearing or financial engineering are more likely to deliver.

Final thoughts

Investing is not easy and given the psychological traps that we are all susceptible to – in particular the tendency to over-react to the current state of the markets – it might be best to simply seek the advice of a coach such as a financial adviser.

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The biggest rort of all

Marcus Padley

As a beginner investor there are a myriad of asset classes you can invest in and it must be a bit confusing knowing where to start. So let me give you an idiot's guide to rating investments from 'alpha' to 'beta'. Stick with me.

Alpha is an expression from the funds management world used to describe the 'excess return' of an investment relative to a benchmark. In the industry it is used as an expression to denote how much value someone is adding to your investment returns above the average. If funds management was a gladiatorial sport the fans would be chanting "Alpha, Alpha, Alpha, Alpha!".

Beta on the other hand represents how an investment performs relative to the market. All you need to know here is that a beta of 1 means an investment will move with the market and a low beta investment is something that moves less than the market. A beta of minus one, just to make it clear, is an investment that moves in exactly the opposite direction of the market and a beta of 2 is an investment that moves twice as much as the market when the market moves in a particular direction.

I like to think that alpha means 'Action' and beta is 'Boring'.

With that little definition in mind let's now look at the most common investments and rate them from high alpha, a lot of action, to low beta, no brain required. The first couple might surprise you but they should be on your list:

Building a business – This is a very high alpha investment, high activity, high risk but it is where all really wealthy people made their money, in business.

Your career – This is also massive alpha. Getting up, going to work, coming home for half your life. It is also just about the lowest risk investment you can make. In terms of risk and reward, investing in yourself is one of the best investments in the whole world.

Then we come to traditional investments that are high alpha. These include:

Direct investment in equities and property - I have put these on a par because if you manage your own property investment or equity investment they are both hard work for similar returns. Both are very involved and both require a skill set. Both are high alpha, high activity with significant risk. They only suit you if you can service the need for action, not pretend to. This also makes the point that when weighing up which asset class is the best the answer is the one you will enjoy the most, know the most about, are more suited to managing, because both are very different activities meaning it is not really which asset class is the best, its which asset class you want to expend your alpha on.

Then comes a big drop in alpha to the first of the **higher beta investments**. These include managed funds and listed investment companies. It also includes the large super and industry balanced funds. These are investments that are marketed as if the managers are 'adding alpha' but really, the majority of them are benchmarked to an index and the moment you benchmark a professional, even if they consider themselves an 'alpha adding' fund manager, they unavoidably start to 'hug the benchmark' trying to emulate the benchmark which makes it a lot harder for them to beat it. Their investments will also become diversified across a lot of individual investments and because of that diversification these funds will never set your hair on fire despite the marketing and despite the fees. Some funds like smaller companies funds, sector funds and special situations funds may be more volatile and appear alpha orientated but even they have their benchmarks and their alpha compared to those benchmarks is more of a beta in the end even if it is more exciting.

Beta investments are things like index funds and passively managed exchange traded funds. Investments that do what they say they'll do on the box, match an index, a market, a sector. They can be volatile, as volatile as the market they represent, but no-one is working them, they just represent an average, nothing else. And low fees.

Finally there are **lower beta investments**. These are investments that offer no value above the expected return. They are predictable, low risk and don't require you to sweat them to get a return. They can't be pushed. They include everything that offers no growth including hybrids, cash, term deposits and money under the mattress. I know a lot of people become highly concerned about the returns on these investments, but really, the main point is that you are taking very little if any risk and you are parking your money out of harm's way instead of driving your money. The returns used to be enough to live on but they're not anymore, pushing low risk investors into more risky investments.

The most common mistakes on this rating system are taking on a high alpha role yourself but not giving it the attention it requires and the second is the biggest rort in the investment industry, paying an alpha style fee when it's obvious from the structure you're only ever going to get a beta style return.

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