Understanding Investing

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financial independence

Before you start, there is a simple question.

Why should you have to "learn" about investing at all?

The obvious reply is "to make more money".

But there is another, more pervasive reason.

It is that changing times now make you an investor whether you like it or not.

Not too long ago life was simpler. For the most part you could get by — and even prosper — just by understanding the basics. You had dollars in your pocket, or your bank.

Perhaps you had a few investments — an interest-bearing deposit, government bonds, an endowment policy or even a unit trust.

Decisions were easy enough!

You needed simply to be prudent — to live within your income and to safeguard your savings for the future security of your family.

How changing times make everyone an investor

But then, with frightening speed, a revolution took place. The inflation of the 1970s and early 1980s cruelly eroded the wealth of many, especially those forced to live on fixed incomes such as pensions. And simultaneously it made fortunes for those lucky enough to be in investments that benefited, such as property or precious metals.

And then came an even more startling change. The so-called financial services industry was born. Money and all the places you could put it became something to be aggressively advertised, marketed and sold as "packaged products".

Even simple everyday decisions may now be a bewildering headache. How do you choose from the confusing array of accounts offered by your local bank or building society? How do you sort through the clamour of claims made by trusts. And what about fixed-rate mortgages, superannuation, insurance bonds, offset accounts and offshore investments?

And to cap it off, 95% of Australians fail to obtain wealth. "What's going wrong?"

The holders of equities, or ordinary shares, are the owners of a company. They receive dividends which are usually related to the profits of the company.

how changing times make everyone an investor

Additionally, you now have to be familiar with a series of new terms such as "dividend imputation", "capital gains tax", "fringe benefits tax", "endowment warrants", "approved deposit funds" and "GST".

And then there's the sharemarket itself as the Booming 1980s turned into the Nervous Nineties. You may wonder if the crash of October 1987 altered the sharemarket forever. (No, it didn't.)

Or if the mini-crash of October 1989, the decline in world sharemarkets during most of 1994, the Barings scandal in 1995, or scandals in the copper market in 1996 showed again that the market is no place for the "ordinary" person. Again – the answer is no, they didn't.

Or whether insider trading scandals and the takeover raiders now stack the odds against the individual investor. (No, they don't.) In fact investor protection, although still far from perfect, is better than ever.

What these events did show is that such dramatic swings may be emerging as a permanent feature of today's sharemarkets. The result – more risk for the unwary but increased opportunity for the knowledgeable.

Why good advice is often hard to get

If you're like most people you may have the idea that out there somewhere — if only you could find them — are friendly honest people who are going to give you sound and disinterested advice on what to do with your hard-earned ' money In short truly independent advisers who will act in your best interest.

Sadly, the people you're looking for may be hard to find. The truth is many so-called investment advisers are no more than commission salespeople who try to sell you products irrespective of whether they are suitable or not.

Many advisers, particularly in the insurance industry, are tied to one company's products. So there is no guarantee that you will get the best product available even if the adviser is recommending what is best for your needs and objectives.

Even "respectable' banks often prefer to recommend only their own products and often push them aggressively regardless of their suitability to your best interests.

All these developments may well have you asking yourself whether shares are still a good long-term bet. Yes, indeed they are. As you'll see, nothing beats the return on good quality shares over time, especially if you can pick the correct ones.

And then there are the extraordinary developments in the Communist world. Not to mention the increased integration of China into the world economy.

These – and many other exciting new developments – will almost certainly create new opportunities for trade and broader horizons for business in general. The result again: <u>wider range of choices for you as an investor – and more chances for profits</u>.

volatility is now the name of the game

Deregulation of financial markets has resulted in considerable volatility in interest rates, inflation, the $A, property prices and the sharemarket.

Interest rates moved in three distinct cycles in the 1980s. Short-term interest rates were around 20 per cent on three occasions. In early 1994 they fell to around five per cent and then began to rise — before stabilising in 1995 and falling significantly in the first half of 1997.

Volatility is the degree of uncertainty associated with any given investment – in other words, how much its value is likely to go up or down.

Inflation was over 10 per cent in 1982/83 and is expected to be around three per cent in 2000. While this is welcome news for the Australian economy it means that you need to reassess your investment strategy — a financial plan geared to a high inflation environment may prove inappropriate when inflation drops.

If the $A falls in value against other currencies it results in a rise in the value of assets held outside Australia. So you should consider the merits of having some of your assets invested overseas.

After rising rapidly between 1986 and 1988, residential property prices slumped dramatically and commercial property prices also fell sharply. Residential prices in many areas began to rise again as interest rates fell in 1996 and the first half of 1997.

Even the sharemarket has become more volatile. The sharemarket moves in cycles, but these days the cycles seem to be shorter and involve greater fluctuations.

A 20 or 30 point daily rise or fall in the All Ordinaries Index, which measures the movement of the sharemarket's largest companies, is now considered commonplace. In the 1960s and 1970s, such movements were the exception rather than the rule.

Despite what real estate agents say, property prices go down as well as up.

Increased volatility in financial markets means that you must constantly review your investment strategy. A strategy which works well in one year may be inappropriate the next year.

<u>When volatility increases timing becomes an essential ingredient in your investment strategy</u>. It is no longer possible to invest money in a particular financial product and simply wait for your capital to accumulate.

You can do as well as your own investment adviser

Over time most professional money managers do a consistently poor job investing their clients' money. Incredible as it may seem, extensive academic research shows you can beat most professional fund managers – including unit trusts – by simply throwing a dart at the sharemarket pages in your newspaper.

how tax changes affect your investment plan

Personal income tax rates have generally declined – as have company tax rates. There are now taxes on capital gains, fringe benefits and the taxing of superannuation has changed several times. In addition, there have been changes to the way in which friendly society and insurance bonds are taxed.

Aiming to be as "tax- efficient" as possible is a key aspect of successful investing. There is no point in making money if you end up handing over more to the taxman than you need to. Tax minimisation is a priority of the rich.

Investing versus speculation

Investing is the seeking of long- term growth in capital and income with the emphasis on safety of capital. Your decisions should always be made on the basis of overall market conditions and the fundamental value of the assets you are buying.

If you are careful and stick to the basic rules you should always succeed in attaining your investment objectives. Investing is a serious business designed to build long-term wealth.

Speculating, in contrast, involves short-term timing and taking advantage of market fluctuations. It will usually also involve gearing or leverage, the use of borrowed funds to increase potential risk and return.

You will usually be dealing with factors over which you have little or no control and which are difficult to analyse. In speculation you must expect to be wrong much of the time. You must cut losses quickly and you will count on a minority of successful moves to finance your failures. Speculation should be a "fun" business designed to give your capital a quick boost.

How the new knowledge gives you the ground rules for success

So the key to success, now more than ever, is having knowledge – knowing how this new world of money really works and knowing the "tricks of the trade" that lead to success.

But where can you get this knowledge? You do not learn investing and money management at school, or university. Newspapers and magazines give you fragmentary advice and information. But they do not give you the whole picture, starting at the basics and moving logically to the more advanced techniques. And when you see how the press relies on financial advertising you may wonder just how objective their views really are.

why creating real wealth requires a "total plan"

Financial success invariably comes from not only mastering the sharemarket but from applying skill and knowledge to all aspects of how you deploy your assets and income.

Retirement planning, tax strategies, property, managing your home loan, government bonds and life insurance "alternative" investments such as art, antiques and precious metals — all have a role to play.

These lessons sort out the confusion by helping you define, and then act on, your own highly personal plan for financial success. You will learn to exploit your own special strengths and to work to a timetable based on what is right for you and you alone.

Starting with basics, will swiftly lead you on to more sophisticated strategies. You will learn how first to protect, then multiply profits to build wealth even faster.

Underlying all successful investing, you will find certain basic principles — the timeless ground rules that apply equally to the simple and the more advanced moves you make.

seven ground rules for successful investing

Be your own investment manager. No “adviser” or broker can do it for you. Only you know your own real needs and temperament. And only you are motivated by your own best interests and not by the chance of earning a sales commission.

Don’t wait for “things to get better” before you start investing. If the sharemarket is filled with gloom it may be the time to buy bargains. The time to get going is now. Always invest regularly regardless of market conditions. This way you’ll take advantage of the mathematical phenomenon known as “dollar cost averaging” — or even better, variable ratio averaging

Exploit the powerful money-building effect of compounding at all times. As you’ll see, it is one of the single most effective keys to creating real wealth.

Make good quality shares the core of your investment strategy. And choose them by following the time-tested rules of value investing.

Use diversification (sometimes called “asset allocation”) to reduce risk — to keep your money as well as growing.

Cultivate a “contrarian” turn of mind. As you’ll see, history shows that the public is emotional and usually wrong. Watch what the herd is doing. And then do the opposite.

And finally — be tax-efficient. Remember it starts off being your money, not the taxman’s. Use today’s wide range of legal tax-minimisation strategies to the full. And train yourself to think in terms of after-tax return.

Another key to investing success – don’t become mesmerised by daily twists of the market. Think and act longer-term.

knowing yourself as an investor

If you ask an experienced financial adviser to describe the single most common failing in clients, the chances are you would get a two-word reply:

“Unrealistic expectations”.

Studies show that risk-taking has nothing to do with intelligence. Single males tend to like risk the most... and for some reason, extremely conservative investors are likely to be first-born in their family.

Stockbrokers, particularly, see it again and again. Investors plunge in with a “get-rich-quick” mentality hoping to find instant wealth just around the corner. Such people are in fact not investors at all but speculators.

In contrast, experienced investors study carefully the factors underlying any given investment, then choose only those that promise a satisfactory level of return at any given level of risk.

You are now about to learn a key concept in successful investing:

How to ensure that you act as an investor (and not as a speculator) by using the appropriate techniques to maximise return and minimise risk.

investor or speculator?

the concept of risk — and the basic techniques to minimise it

Keeping your money in a bank account may not earn you an exciting return. But at least you know your money is relatively safe.

Suppose you decide now you want to earn a higher return. So... you take your money out of the bank and buy some shares.

Ordinary shares outperformed other investment sectors over the last five years. These figures also highlight how well fixed-interest investments — such as government bonds — can perform in periods when interest rates are falling.

The performance of shares over the last 10 years was adversely affected by the previous sharemarket crash, but shares still performed well compared with other investments.

These figures highlight that different investments usually offer substantially different rates of return — and the benefits of having a diversified investment portfolio.
But there is another side to the coin: the question of risk.

Higher return is closely linked to higher risk.

This is not to say that higher risk automatically ensures higher return. Far from it. Even in a "bull" (rising) sharemarket you might pick the wrong shares and lose money. You would have opted for the riskier investment but still failed to get a higher return — even though other investors might have succeeded.

Risk and return are always intimately linked. The whole art and science of investing is the use of techniques for minimising risk while maximising return.

General market risk is reckoned to be from 30 per cent to 50 per cent of all risk from buying shares.

what makes investments risky

Usually when you use the term "risk" you are talking about the chances of loss. In the world of investing the word has a slightly different meaning. It refers to the <u>deviation from your expected return</u>. If you expect a return of 20 per cent and actually get only 15 per cent, the difference between the two reflects risk.

Total risk at the top of the diagram is all the risk associated with an investment. It is divided into:

<u>Systematic risk or market risk</u> is risk that affects all shares in the same manner, for example, changing economic or political circumstances. Even ext diversification will often not help you reduce this type of risk.

<u>Unsystematic risk</u> is a specific event that affects an individual company — a strike, perhaps, or a fire or flood.

You can now break risk down further into:

<u>Interest rate risk</u> — the risk that a fixed-income investment such as a government bond will decrease in value if interest rates rise.

<u>Purchasing power risk</u> or inflation which will decrease the buying power of your capital or interest income.

<u>Business or financial risk</u> - the chance that an individual company may fail due to bad management or changes in consumer demand or market share.

<u>Political or social risk</u> — the chance that changes in government policy may adversely affect your investment or, in the case of an overseas investment, the chance of a major political upheaval such as a revolution.

<u>Currency risk</u> — changes in relative values of currencies that may affect import or export driven companies, or which may result in an unfavourable rate of exchange when you wish to sell a foreign investment.

what makes investments risky

Risk rating of investments

The following is a snapshot of the risk profile of popular forms of investment. It should be recognised that within many categories there are lower and higher quality alternatives which may justify a slightly better or lesser ranking.

Risk Category	*Investment*
Negligible	Bank deposits Bank bills Government bonds Semi-government bonds
Very low	Credit union deposits Building society deposits Cash management trusts
Low	Capital-guaranteed insurance bonds Capital-guaranteed friendly society bonds Bank-backed finance company debentures First mortgages Mortgage trusts Prime real estate (ungeared)
Medium	Commercial and industrial property Unlisted property trusts Second-ranking residential property Unit-linked insurance bonds Unit-linked friendly society bonds Balanced equity trusts Bond trusts Non-bank finance company debentures
Medium-High	Shares Specialist property trusts Convertible notes Specialist share trusts Unsecured notes Listed property trusts Overseas share trusts Vacant land Second mortgages Endowment warrants
High	Options; Warrants Currency futures; Commodity futures Share futures; Share ratios Films Agricultural investment schemes Commodities; Gold Collectibles — antiques, paintings, stamps

the ranking of risk

As you have seen, the risk involved in investing in the sharemarket is much greater than the near-zero risk involved in having money in a bank account.

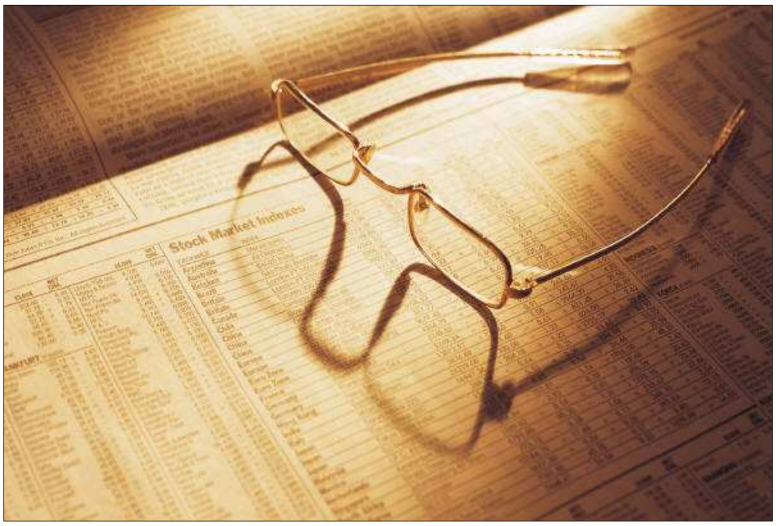
How Benjamin Graham made a fortune by imagining he had a neurotic business partner

Benjamin Graham was a British-born American investor who is often referred to as the father of modem investing — and in particular what has come to be known as “value investing”.

With Professor David Dodd in 1934 he wrote *Security Analysis* and in 1949 a more popular book *The Intelligent Investor*. Both books are regarded as classics and widely read by serious investors.

Graham taught a celebrated course in share analysis at Columbia University. He always urged his disciples to imagine the share market as a partner with them in a private business. This partner is an amiable fellow. But sadly he is also extremely neurotic.

Every day he names a price at which he will happily sell you his share of your business or buy your share from you. Due to his unstable personality this price will fluctuate widely from day to day and week to week — even though the underlying value of the business remains much the same.



Some days he is feeling irrationally “high”. He sees only the favourable factors affecting the business. He names an unnaturally high price. Other days he is all doom and gloom. So he names an unbelievably low price.

But regardless of whether he is feeling high or low, he never cares if you take up his offer to buy or sell. Remember, he’s an amiable fellow. He never gives up and always comes back the next day with another offer.

Having the market as a partner is just fine as long as you remember that it is emotion ally unstable. By knowing its moods, you can learn to take advantage of its excesses in optimism and pessimism. You thus allow it unwittingly to serve your own ends. But you must never, ever, let the market lead you. As long as you keep your head you can always put a truer value on your shares than it can. Not allowing yourself to be swept away by excessive optimism or pessimism is a key investing skill — and the basis on which most investing for tunes have been built.

one solution to risk: diversification

Specific techniques to hedge (protect) against risk, such as options, fixed-interest loans, and futures. But right now let's examine the most basic way to protect against risk.

Your objective is to lower your risk without — at the same time — lowering the size of your potential return. The first way to do tills is through diversification or, as it is sometimes called, portfolio balance.

For example, if you are investing in shares, you could buy into a range of sectors such as mining, retail, engineering, building, leisure, media, banks, and so on.

Alternatively, you can diversify geographically by investing overseas in the US, Japan or Europe. Or you can combine these by putting your money into different sectors in different parts of the world.

The key point is to ensure that you are protected by diversification and that you do not put all your eggs into one basket.

Again, balance is critical. You will always aim to strike the right relationship between over- and under-diversification.

Over-diversification is having too many different investments. The result is that each holding becomes insignificant. Suppose you have $10,000 to invest and you put equal amounts into 25 different shares. If only one of the shares doubles, the effect on your total portfolio is negligible. The impact of your one winner was dragged down by the 24 that did not do so well. Too many shares also increases your brokerage costs and makes it virtually impossible for you to follow them all in detail.

Under-diversification is putting too high a percentage of your holdings into too few investments. It can happen if you have too much money in the shares of one company or if you are too heavily invested in just one market sector or one industry. Or if you have put all your financial eggs into just one type of investment basket, such as property.

Over- and under-diversification are two of the most common and dangerous investing errors.

just how risky various types of investment are and what makes them that way

For a start, let's look now at the main types of investments available to you and see what it is about each that determines its degree of risk.

Investments can be broken down into five main groups:

Shares — representing ownership of a company.

Bonds, fixed-term deposits and debentures — where you receive interest income.

Managed investments — unit trusts, property trusts, insurance bonds and superannuation funds where you pay a fund manager to invest on your behalf.

Options — puts, calls and warrants which are contracts to sell or buy shares and represent potential ownership.

Futures contracts — contracts to buy or sell commodities such as wheat or gold, shares in a particular company, or even the sharemarket index itself.

It is essential to review the balance of your portfolio regularly.

shares

Let's start with the most commonly known investment — ordinary shares.

Ordinary shares: High risk linked to high return. As an ordinary shareholder you are a part-owner of the company in which you have invested. If a company has a million shares outstanding and you own 1,000 shares, quite simply you own one thousandth of that company. You will share proportionately in any rise or fall in the company's fortunes. And that, of course, is what makes ordinary shares so exciting.

Take, for example, a company you've probably heard of called Coca-Cola Amatil. In June 1995 its share price was $7.75, and in November 1996 it bad risen to over $18 only to drop to $11 in early 1997.

This indeed is the nail-biting action that draws many investors into the world of ordinary shares. So let's look at how they really score against what will become your major criteria for evaluating investments: safety, inflation hedge, capital growth, income, ease of management, after-tax return and liquidity (how easily you can turn an asset into cash).

Safety. When you own ordinary shares in a company you own a piece of that company. Your reward is a share in the profits. But your risk is that if anything goes wrong you will be at the end of the queue waiting to get paid.

Degrees of risk

It is easy to assume that investments of the same kind carry the same degree of risk. This is certainly true in some cases. For example, one bank account carries the same near-zero risk as almost any other. But in the sharemarket it is far from true.

Suppose you buy shares in a company such as Coles Myer Ltd. It is possible that the value of those shares will decline. But the chances of Coles Myer Ltd, the company, going out of business altogether, making your investment worthless, are extremely low.

In the sharemarket, an investment in the shares of a company like this a solid, established company that is highly unlikely to fail — is a relatively safe investment. In the jargon of the market, these shares are described as “blue-chip”.

Of course, the Stock Exchange includes many listed companies whose shares are much riskier. These are the relatively small, or ‘junior”, companies that could go out of business if something went radically wrong. For example, a small company could attempt a major expansion only to find that it runs into problems that create a serious drain on its resources. It could then face a cash flow crisis and be forced by its creditors into bankruptcy.

Moreover, as the last few years have shown, many large companies, such as Bond Corporation and Hooker Corporation, can run into financial difficulties.

And finally in all companies, regardless of size, management is a key consideration. Is the company run by a tyrant? Has he or she hired family members as senior executives? Do the senior managers come and go as if they are in a revolving door? Does management pay itself too lavishly — do they always appear to be off on unnecessary trips to exotic destinations?

Later you will learn in more detail how to evaluate management, a vital factor in judging a company’s potential.

What is left after all debts have been paid by a company is called “equity” – it is what the ordinary shareholders actually own.

The order in which companies must pay off their debts in the event of being wound up is:

- Expenses of preserving, realising or getting in the property of the company.
- If a court order has been required, then the costs of applying for the court order.
- Special cases, eg. disbursements laid down by other sections of the Corporations Law.
- Costs of the liquidation.
- Additional special provisions.
- Wages of employees, superannuation, amounts arising by way of compensation, holiday pay and retrenchments.
- Secured creditors.
- Unsecured creditors, including the Australian Tax Office.
- Preference shareholders.
- Ordinary shareholders.

- This is known as the "seniority" of debt, and as you can see the ordinary shareholders are the least senior. So ordinary shares are risky. To compensate for this risk there are two ways you can be rewarded:
- By dividends which the company may pay to you as a distribution of its profits.
- By a capital gain if you sell your shares to another investor who pays you a higher price than you paid originally.
- Capital gain — or growth — is of course the main reason most investors buy shares.

One simple way to beat the professionals — by being your own market analyst

Aside from investing skills there's another element that distinguishes successful investors. It is a constant alertness for opportunities that arise from everyday observations. If you think this sounds simpleminded, take a tip from Peter Lynch formerly head of the $9 billion US Fidelity Magellan Fund and a man generally regarded as one of the world's most successful money managers.

In the 1970s Lynch made a fortune by investing in a little known hosiery company called Hanes. His wife had raved about a new type of panty hose she'd just bought named L'eggs. He investigated the company and bought heavily. Sure enough L'eggs became a marketing success story and Hanes' shares soared.

In his book (*One Up on Wall Street*, Simon and Schuster) Lynch says he remains continually aware that giant companies are researched to death by armies of analysts IBM, for example is covered by more than 50 full-time broker analysts on Wall Street alone. The same is true in Australia where stockbrokers concentrate their research on the largest 50 companies on the share market. The result is a herd mentality where no analyst wants to risk going against the trend of the moment. The chances of gaining an edge are remote.

Highly paid and "professional" would consider it ridiculously unsophisticated to spend time looking into supermarket trolleys to pick up buying trends. Yet that is where you may well find your best leads on up-and-coming companies.

So — is your partner enthusing about a new household product they've just discovered? If so who makes it? What are local teenagers doing with their money? What's "in" and what's "out" with them, which shops do they patronise and which do they shun? Where did you last get efficient and cheerful service in hotels restaurant chains or in other day-to-day transactions? Keep your investing mind alert and you may well spot a winner long before the analysts cloistered around their computers.

As an alert individual investor, you have a real edge over professional analysts if you keep your eyes and ears open for little-known shares likely to benefit from new products and trends in the day-to-day world.

Takeover lever gives you one of the best chances of profits in the Australian market

Periodic bouts of takeover fever sweep the Australian Stock Exchange — each of which provides good opportunities for alert investors.

Later you'll learn the key factors that affect takeovers — and how to use a set of simple criteria to spot the likeliest next targets.

You'll see how increasingly it's the large institutions such as superannuation funds which determine the final outcome of hostile bids — and how it often pays to be patient and do nothing in response to the initial bid.

You'll learn how understanding the legal timetable that governs takeovers is the key for getting the timing of your own decisions right.

Takeovers can be one of the most profitable events in your investing life. But — as always — it's essential that you understand the special rules and terminology in order to reap the maximum rewards.

Now let's see how ordinary shares compare according to your other criteria:

Inflation hedge. Historically, shares have kept pace with inflation — although high rates of inflation often depress sharemarkets.

Capital growth. Overall, the potential is good to excellent.

Income. Variable. It depends on the shares you buy. Some shares pay dividends that are relatively secure; others pay no dividends at all, offering only the potential of capital gain.

Ease of management. Poor. To invest successfully in shares, you need to know exactly what you are doing and keep a careful watch on the sharemarket.

After-tax return. In some instances the after-tax return you get from shares, through both "franked" dividends (more on this later) and capital gains adjusted for inflation, makes them attractive compared with fixed-interest investments.

Liquidity. Excellent if you buy leading shares — not so good if you buy second-rank companies.

Preference shares. Preference shares differ from ordinary shares in two important ways:

They are safer, since they rank ahead of ordinary shares should the company go out of business.
They usually pay fixed and often higher dividends that tend to make their prices more stable.

Convertible preference shares. These are a specific kind of preference share. They are a hybrid, in that they let you convert your investment into a certain number of ordinary shares — at a fixed price and within a specified period of time.

They allow you to benefit from any rise in the value of the ordinary shares but they involve less risk than ordinary shares.

Redeemable preference shares. These shares come with an option for the company to buy them back at a stated price. Companies are likely to do this only if they have an excess of cash or are able to raise money cheaply elsewhere.

Cumulative redeemable preference shares. These give you an extra degree of security: if the company misses a dividend payment one year the dividend owed is carried forward to the next year and so on until it is eventually paid.

Now let's look at the terms used to categorise shares by the type of underlying business rather than the technical description of the share itself.

"Franked "dividends means that the company has already paid some tax on your benefit.

At the top are:

Blue-Chips. These are the biggest and safest companies, household names such as Blue Scope Steel or Coles Myer. By and large the blue-chips are the same as the 20 Leaders Index, a category invented by the Stock Exchange to describe the 20 largest companies on the sharemarket. Roughly speaking any company valued by the market at more than $2 billion could be considered a blue-chip.

You can still lose money investing in blue-chip shares

Next come:

Second liners and recovery shares. These are shares trading below their stated asset backing and which investors believe have the potential to recover. They include cyclical shares suffering from downturns in economic cycles, shares in companies that have suffered some specific misfortune and former glamour companies working their way back into a state of grace.

Growth shares. These are shares in rapidly expanding companies. Since the fastest way for a company to expand is through acquiring other companies, the term "growth stock" is frequently applied to companies with reputations for making aggressive takeovers. Growth, however, is one thing but profitable growth is another, making the choice of growth shares trickier than it sounds.

Penny shares. At the bottom of the investor's totem pole, penny shares are defined merely by their price which should usually be under 20 to truly qualify. Penny shares often appeal to novice investors because they are "cheap" and because you can buy thousands of shares rather than hundreds. Both assumptions are wrong. When you invest $,000 you invest exactly the same amount of money whether you buy thousands of penny shares or just one hundred blue- chip shares.

A share is "cheap" or "dear" according to its true value — not its price. Despite much-publicised exceptions, most penny shares are junk, their share certificates are usually fit only for wall-papering your spare bedroom.

How "asset allocation" becomes the name of the game in uncertain markets

Finding the best-balanced mixture of assets to diversify away as much risk as possible is called "asset allocation". In uncertain or defensive markets this process of trying to find the right mixture to preserve capital and yet achieve maximum growth becomes a fine art.

Owning a dozen shares, for example, can diversify away 90 per cent of all risk. But to cut your exposure on the remaining 10 per cent, you would have to own a further 100 or so shares — clearly impossible for most investors.

In addition, each industry group has its own "correlation" to each type of risk. Inflation risk, for example, will hit building industry shares badly but may be good for "wealth in the ground" shares such as gold mines. If you mix two such groups in your portfolio the result will be a "weak" correlation to inflation. The two groups will offset each other's vulnerability.

Be careful about investing too heavily in the industry or business in which you work. Your job already represents a major investment in the fortunes of that particular sector. If it experiences a severe downturn you may lose two ways. You may suffer a reduction in income and bonuses or even lose your job altogether. And you may lose on your investments. So generally diversify away from the business in which you work.

Let's move now to the second major category of security — debt obligations.

Why fixed interest is far from boring — and far from "safe"

At the top of the debt tree are government bonds; this is where you lend money to the government and the government guarantees to pay you back. On one level it is the safest security available, because the Australian Government is not likely to go out of business and default on regular interest payments or the eventual repayment of your investment.

But on another level, bonds are a gamble. Why? Because the price of bonds varies according to prevailing interest rates — and the market's expectations of what those rates will be in the future. If you have to sell your bond before it matures there is no guarantee you will get back what you paid for it.

Here is how it works in simple terms. When interest rates rise, bond prices fall — and vice versa. Suppose you invest $100 in a bond paying 10 per cent. Interest rates then rise to 12 per cent. No one wants to pay as much as you did for your bond because they could earn more elsewhere. So the price of your bond is "discounted" by the market — its price is knocked down — to yield the equivalent of the prevailing rate.

Conversely, if interest rates fell, the market price of your bond would move up to where it would be yielding a rate equivalent to the lower market rate of interest.

This makes bonds an interest rate "play — a gamble on whether rates will go up or down. But even if you plan to hold your bond to redemption you must consider another key factor: the "real return" — that is, the bond's return minus inflation.

Historically this real return has not always been good. If you were on the highest income tax rate you would have lost money in real terms had you held on to a bond yielding 12 per cent with inflation at seven per cent — and inflation was much higher than that for most of the1980s.

Some preliminary rules for successful speculating

- Deal only through brokers or other investment advisers whom you know and trust. Never deal with telephone salesmen or overseas brokers.
- Realise that if a share or other investment is undervalued there is probably a good reason for it. Remember, sharemarkets fully reflect all rumours. You can be sure that you are not the first person to hear of "hot" news.
- Don't be greedy. Set a target and be ruthless in getting out when you've reached it. Possibly the most common error in speculating is "falling in love" with a share and holding it too long.
- Admit your mistakes. Cut losses quickly. Successful investors reckon to be wrong more times than they are right. So don't argue with the market if it proves you incorrect.
- When you have a winner sell half your shares when the share doubles. This way you cannot lose regardless of what happens.
- Don't speculate unless you have the time to be in touch with the market on a daily or even hourly basis. You can't make a speculative investment and then go away on holiday.

How bonds work

There are two ways you can buy government bonds — either directly from the Reserve Bank or a State Treasury (called the primary market) or from an existing holder of government bonds (known as the secondary market).

When you want to sell government bonds you can either sell directly back to the government or to another investor through a stockbroker.

Most Government bonds are easy to buy and sell.

Bonds are classified by their dates of redemption — the date on which the government has promised to repay the bond's face value.

The main classes are:

"Shorts", due to be redeemed within 12 months.

"Mediums", to be redeemed between two and five years.

"Longs", due to be redeemed between five and ten years or longer.

What distinguishes one bond from another is the information that comes after their names — the coupon or interest rate and the maturity year. These two factors make bonds a complex subject.

The two types of yields

All bonds have two yields — the interest (also called the "flat" or "running") yield and the redemption yield. The interest yield is simply the bond's coupon rate, or interest rate, divided by the price, multiplied by 100.

The redemption yield is the total return on the bond if held to maturity. This includes both the interest yield and the capital gain or loss when the bond is finally redeemed at its face value.

Let's take a quick look at why this is.

Now you have already seen how the price of bonds moves up or down to reflect current interest rates available elsewhere. Specifically, if you buy a government bond and interest rates move up, your bond will decline in value. But if interest rates drop, you are holding a capital gain on your bond.

This fact is not understood by many investors who mistakenly think you cannot get a capital gain from government bonds. But smart investors know this is not correct and are laughing all the way to the bank.

Your interest rate strategy

You should be buying government bonds when you expect interest rates to fall, and selling them if you think rates are on the rise.

You can buy and sell government bonds as easily as shares.

Another major consideration in choosing a bond is its redemption date. Should you buy long, short or medium term bonds? Each reacts to changes in interest rates in a different way. So the answer depends on matching your view of interest rates to the appropriate bond.

Historically, long bonds have been more volatile than short bonds because the shorts tend to move around their redemption value. But in recent years shorts have also tended to be volatile due to the wide short-term swings in interest rates.

Bonds can give better returns than shares

There are times when buying shares may not make much sense — and when bonds prove superior. In 1987, far instance, you would have done better staying out of the sharemarket and sticking to bonds which handily out-performed the sharemarket indexes.

The long bull market that ground to a halt in October 1987 awakened a new generation of investors to a fact all but forgotten except by a few grizzled veterans: bull markets do not go on forever and they are always followed by a bear market. When this happens bonds may be an ideal place to put your money — but much depends on how interest rates move.

From 1938 to 1952 and again from 1988 to 1992 making money in shares called for skill and judgement. Today more and more "small" investors are turning to bonds as an "ideal" component in their overall investing and tax strategy. That why you will be learning more about bonds and the techniques for evaluating them in later lessons.

Do bonds sound complicated? They aren't really, once they're explained. Remember, this is only a preliminary survey of the investment alternatives open to you. In other lesson you will be learning much more about bonds and looking in detail at strategies for investing in them.

You may be getting the idea that bonds may well have a place in your investment portfolio. Far from being just for the professionals, bonds can prove extremely attractive for individual investors – you can get the best of both worlds – a capital gain plus a Government guarantee.

Moving into the world of high risk

Exchange-traded options are fast becoming one of the hottest kinds of investment as more and more people realise how lucrative — and how volatile — they can be.

Options are not for everyone – but it pays to know how they work.

Typically, if a share price rises by, say, 20 per cent, then the price of an option giving the right to buy some of those shares may rise by several hundred per cent.

But if the price of the share falls the option could prove worthless — so you could lose your entire investment.

The pace of options trading is fast and furious — and thus they are a high-risk, high-return investment that often border on speculation.

The idea behind a traded option is simple. You are buying the right to buy or sell something at a pre-determined price on or before a specific date in the future.

So there are two basic types of traded options:

If you buy a "call" option you have the right to buy the underlying share at an agreed price, and

- If you buy a "put" option you have the right to sell the underlying share at an agreed price.

You may choose not to exercise your right or "option". If you do not exercise your option, it simply expires and you lose whatever you paid for it.

A key point about options is that they have a short lifetime. After that, they expire and become worthless.

You may lose all your money — this is what makes options so risky. On the other hand, you may have bought the options as "insurance" to hedge against risk on an underlying share which you own. In this case even if you lose your money on the options it may have been worthwhile — just as an insurance policy payment is worthwhile even if you do not make a claim.

You will be learning more on how options can be used to reduce risk in this way. But for now you're safe in regarding them as a high-risk investment that is often not an investment at all but a speculation

Options usually are a high-risk speculation. You need to have a thorough understanding of the options market before you contemplate getting involved. In a later lesson, you will learn the main strategies for trading in options — the ones that are most likely to lead to large profits. But until you understand those strategies, you should keep away from the options market It is, in most ways, a market for speculators not investors.

gearing

Going for even greater risk and reward.

Gearing is the use of borrowed money to greatly increase your risk and potential reward. It is a technique you will be returning to again and again. Properly used it can be one of the greatest keys to investment success. Frequently it is what distinguishes the professionals from the amateurs.

But have you ever thought that without actually knowing what this term meant you have already profited — probably spectacularly from gearing.

You did so if you borrowed money to buy your house. A mortgage is the most common form of gearing — and one of the best.

A quick example: Suppose some time ago you bought a house for $150,000. You contributed $30,000 yourself and arranged a $120,000 mortgage. A few years later you sold the house for $300,000 — a $150,000 profit.

You tell yourself that you have doubled your money. But in fact — thanks to gearing — you have done much, much better than that. Your actual return should be calculated on the profit — against the money you put up.

$150,000 (your profit) x 100 = 500%
$30,000 (your investment)

Of course, you would have had costs in carrying the mortgage and your real profit would be somewhat less. But what a spectacular return!

Thanks to the power of gearing you have made a large profit. All the capital benefit from the borrowed money went to you — not the lender. Later you will be learning how this power can be put to work in other investments. Right now, though, it is enough if you start to think of borrowing as gearing and not just debt.

Rights issues offer high percentage gains

A close relative of options are rights.

Rights issues are used by companies listed on the Stock Exchange to raise money by offering existing shareholders the “right” to buy further shares, usually at a discount price You may take up the rights and buy more shares, sell the rights on the market like options, or let the rights offer lapse.

Rights offer high gearing If a share currently trades at $1 and a rights issue is made at 95 cents, the rights would typically trade at the difference — five cents.

If the share price rises to $1.05 the price of the rights would double to 10 cents — a 100 per cent gain compared with a five per cent gain in the share price.

Note, however, that this process works equally well in reverse. If the shares fall to 95 cents the rights would be worthless.

futures

Making or losing it fast through high gearing

A futures contract differs from an option in that it is a binding contract to buy or sell a commodity — such as cattle or gold — at a fixed price on a fixed future date. The futures market allows manufacturers and producers to reduce risks due to fluctuations in commodity prices by selling "forward" — getting money now for future delivery. Speculators in futures assume the risk by gambling on what the future price will be.

Futures trading is a high-risk business because it offers high gearing. All trading is done on "margin" — usually you will have to put up only 10 per cent of a contract price. Profits and losses can be spectacular and fast. Small movements can wipe out your whole investment overnight or force you to pour good money after bad.

In a nutshell, futures are high risk. Invest only that portion of your money that you can afford to put at extreme risk. There is an entire lesson on futures later on.

unit trusts

Are they really all they claim to be

Let's move on now to look at unit trusts, an investment often described as providing an ideal solution to the problem of reducing risk through diversification, particularly for the beginning or smaller investor. Almost everybody thinks they understand unit trusts. But, as you will see, there is more to them than first meets the eye.

In the 1980s unit trusts were one of the most heavily promoted investments — a persuasive reason to ensure that you make your own decisions about whether unit trusts are a worthwhile investment and do not succumb to the optimistic claims of the marketers.

In time you will confidently do this across a wide range of investments. But first let's look at what unit trusts are, and how they work.

How to buy unit trusts

There are two types of unit trusts: listed and unlisted. A listed trust simply means that its units are traded on the Stock Exchange.

Buying and selling units in a listed unit trust is done through a stock broker in exactly the same way as shares. The price of a listed trust will go up or down according to the demand for it — just like a share. So it may sell for more or less than its true value.

Investments in unlisted trusts must be made through an application form contained in an up-to-date prospectus registered by the Australian Securities Commission. You can either send this form directly to the fund manager or go through an investment adviser.

You sell units in an unlisted trust back to the trust manager who calculates their price according to a formula contained in the trust deed.

How unit trusts work - and how to calculate the net asset value of the unlisted equity trust

Suppose you and 19 of your friends had $1,000 each to invest.

Instead of going off and buying shares in one company each, you decide to pool your money and turn it over to a professional manager. He then has $20,000 to invest and can buy, say, shares in 10 different companies. You and each of your friends will own one-twentieth of the pool.

So, instead of each having to bet on just one share, you each own an equal portion of the pool consisting of 10 different companies. You have achieved the objective of diversification (the spreading of risk) and — with any luck — found a professional manager to handle your money who will do a better job than you can.

This is exactly how unit trusts work. Now let's imagine that you and your friends have done well and the value of your holdings has increased to $30,000. Each of your shares in the pool is now worth $1,500.

Other friends have heard about your success and want to join in. Fine, you say, you are welcome to come on in. But of course each share will now cost, not the original $1,000, but $1,500. This is what is known as the NAV or net asset value. It is calculated by dividing the total number of shares outstanding into the total value of the trust's holdings. It will vary from day to day and week to week as the shares the trust owns go up or down. When you buy any unit trust this is what you pay, plus various dealing charges.

The cost of investing in unit trusts

Unit trust managers have a lot of expenses and, not unreasonably, they also like to make a profit for themselves. So you will pay in two basic ways:

With an initial charge taken off the top of your investment when you go in. Typically this charge ranges from 3.5 per cent to as much as 6 per cent or more. Most of this money goes to reward the investment adviser — all too often just a fancy name for a salesperson — who sells you the unit trust. But the managers also keep some to cover their costs, such as advertising. Buying directly from the manager will not usually save you any money. The managers simply keep the entire fee for themselves.

With an annual charge that typically is from 0.5 per cent up to 1.5 per cent of the sum you have invested.

Taken together these two charges are substantial. It may take quite a while before the price of the units rises to where you can get your initial investment back if you sell — one reason why unit trusts are often sold on the basis of being "long-term investments". But as the great economist (and investor) Lord Keynes said: "In the long run we are all dead!"

Which brings you to the next key fact:

How well do unit trusts really perform?

The short answer is: not as well as they would have you believe. In a rising sharemarket it is not difficult to boast of substantial gains. (You will be learning specific strategies for investing in unit trusts in a later lesson). Let's first look at how unit trusts fared against the broad measures of the market's overall performance, and especially the All Ordinaries Index.

Between June 1996 and June 1997, the All Ordinaries Price Index rose by around 20 per cent. That is to say that if you had simply bought shares which make up the All Ordinaries Index — something you don't need to pay a professional manager to do for you — you would have made 20 per cent — a pretty handsome return.

Most investors are drawn into unit trusts near market peaks, when cash-rich managers do the most advertising. Not a happy situation.

Astonishingly, most fund managers fail to equal the rise in the All Ordinaries Index, and many do a lot worse. Table 1.6 shows how much $1,000 invested in the sharemarket index would have risen. The majority of fund managers could not match this performance.

Ah, you say, surely I could have avoided the poor performers by looking at their past investment record.

Wrong — past performance is no guarantee for the future which is why this is always being stated in advertisements. In fact, extensive academic research has also supported the view that past performance is no help in evaluating a unit trust.

There is, in fact, considerable evidence that the opposite is true — that you would do best by buying the worst-performing unit trust within any roup in any given year.

Good Features

Unit trusts still fulfil their original purpose — to enable you to achieve diversification by buying units representing a far wider range of shares than you could possibly afford by yourself.

Unit trusts usually provide good liquidity (ease of selling). But in the late 1980s several unlisted property trusts received government permission to put a temporary freeze on redemptions.

Some unit trusts allow you to choose between capital growth and income, or a balance of the two.

They are easy to manage.

A frequent mistake made by unit trust buyers is to invest small amounts in numerous unit trusts. This increases costs and makes management more difficult.

Unit trusts also enable you to choose to invest in a specific market sector or geographical area. There are trusts specialising in Japan or the US, or in sectors such as commodities or property. Many unit trust groups offer inexpensive switching from one trust to another within the group.

Test yourself against these “ideal” asset allocation models

As you’ve already seen, asset allocation is the term used to describe the process of determining the best allocation of your resources among the many choices open to you.

Much depends on the current state of the market, and on interest rates in particular. But another constant component of successful asset allocation is your own position in the “stages of life”.

As you grow older you will want to move from higher risk, higher return types of investments such as equities towards a lower return, lower risk positioning.

The chart below gives you a rough guide as to how you might split your assets at various stages of your life.

These figures are a general guide only. Obviously much will depend on the extent of your resources and other commitments and on current market conditions. But they will give you a rough idea of whether your asset mix is where it should be for your age.

Make a quick inventory of your financial assets and see how you stand in relation to the asset allocations above. Monitor it from time to time to see if it is getting unduly skewed in favour of any one type of asset.

Poor Features

Performance of most funds is not as good as you may be led to believe by salespeople and lavish advertising brochures. Professional investment managers do not necessarily do better than average. (Indeed there is a now- widely-accepted academic theory; called the Efficient Market Theory which says that it is impossible for them to do so.

Upfront charges and annual fees can make unit trusts expensive.

There are now so many unit trusts to choose from that one of the initial reasons for their existence — to simplify investing — no longer exists. To invest wisely you may have to make almost as many choices as if you selected an individual share.

Unit trusts are often sold through seductive advertising or by salespeople who, in some instances, may be more concerned with making a quick commission than with really matching you up with the trust that best serves your interests. You could fall victim to an investment decision made impulsively or under pressure.

unit trusts

If all this leaves you a bit confused about unit trusts — don't despair. When you come to the lesson specifically on unit trusts you'll be learning the sophisticated techniques used by the professionals who invest in them — methods of rating trusts to ensure that the odds are in your favour of getting the best return.

You have learned that there is more to unit trusts than you are led to believe by all the marketing activity that surrounds them. Like other investment choices you may be considering, you must first gain the necessary knowledge to ensure that you make the right decision.

Studies show that most "small" investors buy unit trusts at market highs and sell them at market lows – not a good strategy for making money.

listed investment companies

As an alternative to buying units in unit trusts you could buy shares in investment companies which are listed on the share- market. Their main activity business is to buy shares of other listed companies.

The shares of investment companies move up and down according to the rules of supply and demand like any other share — and this is what makes them interesting. Like a unit trust, investment companies have an easily ascertained NAV — the value per share of their investment holdings.

You may find that your investment adviser specialises in unlisted unit trusts and knows little about listed investment companies. You may have to contact your stockbroker for information. Or you can approach the company directly and ask for a copy of their latest annual report.

Now for the key fact about investment companies: the shares frequently trade at a substantial discount to their NAV or what they are really worth. This discount is often 10% or more — that is, you could buy $1,000 worth of assets (usually shares in other companies) for $900.

Sounds like a bargain? It is. The snag is, of course, that you will not usually be able to capitalise on this when you sell — you will also have to unload your shares at a bargain price.

defining your objectives — the need to set goals

You are now about to learn the most fundamental of all investment principles — the need to set clear and specific goals The only way you will cut a profitable path through the jungle of investment choices is to set clear objectives — and stick to them. So let's start on the important task of narrowing down the overwhelming array of possible investments that you see when you survey the market place.

There are two ways you can do this:

You can do what many people do. You can alight on some specific investment and persuade yourself that it is a "good thing". An example of this is the "hot tip" from your brother-in-law.

Or you can ask yourself:

- Where am I now?
- Where do I want to get to?
- How am I going to get there and which investments will help me get there?

First, take a moment to consider where you stand in what are often referred to as the "stages of investment".

The "three stages of investment" — where are you?

The first factor to consider in narrowing down investment choices is simple: your age. Most people's investment lives can be divided into what could be called the "three stages of investment".

Between the ages of 20 and 30-35. The chances are that at this stage of your life you appear not to have much surplus money for investing. Your expenses will probably be high due to a mortgage and a young family. As a rule, your principal objective will probably be the safety of your investment capital - and the safe laying of the foundations for the future.

Between the ages of 35 and 55-65. Now the income from your job is probably nearing its peak and your expenses are beginning to fall — the mortgage may well have been paid off and your children will be leaving home. You can probably afford risks that earlier were out of the question. Capital growth in preparation for retirement can now be your top priority.

Above the age of 55-65. Your career has probably peaked and if not retired you are preparing to do so. Your objective will be income and security of capital.

Remember total return is what counts. Success is not just how much a share has gone up. It's also the value of the dividends you've received.

the "three stages of investment"

There are three key words used above that now enable you to take a further step towards defining your objectives. They are:

Capital Growth – the most common aim of many new investors – often referred to as capital gain the profit you make when you sell an investment at a higher price than you paid for it.

Income – expressed as yield the percentage rate your investment is earning you, or as return – the actual amount in cash.

Safety – usually a function of risk, as you learned earlier.

Avoid these two dangerous myths about retirement

Myth No 1: Preservation of capital should be your main goal in retirement.

Fact. It is spending power that counts — not preservation of capital. Even low inflation of 4.5 per cent annually will almost halve your buying power in ten years and reduce it to just 20 per cent in around 30 years. Your capital may be intact but it won't do you much good. If you plan to live off your savings the chart below shows you how long your money is likely to last. If you have, say, $150,000 invested at 8 per cent and withdraw $15,000 a year, your cash sum will last you 21 years. But remember that this doesn't allow for inflation reducing the real value of your annual withdrawals.

Myth No 2: You need only save for 10 to 15 years of retirement.

Fact. The chances are that if you retire in your early sixties you'll live a lot longer than the average lifespan of 75 or so. Around 20 per cent of all deaths take place before the age of 65. So if you make it to 65 the chances are that you'll do a lot better. If you're healthy at 65 you'll need to plan for much longer.

How long your money will last

Percent of original capital, withdrawn annually	Will last this many years, if invested at these interest rates:					
	4%	6%	8%	10%	12%	14%
6%	29	*	*	*	*	*
10%	14	16	21	*	*	*
14%	9	10	12	14	18	*
18%	7	7	8	9	10	12

*At this rate of withdrawal, the money will never be exhausted.

Source: Coopers & Lybrand

These are the three main investment objectives which you have to balance according to your specific requirements. To these you now add what you may call investment characteristics described earlier in this lesson to evaluate the different types of securities. These are:

Ease of management – the amount of time and energy the investment demands from you. Some people love to watch and worry about their investments every day. Others do not. Only you can decide how much day-to-day involvement you want.

After-tax return – a vital concept you will be returning to later which is often overlooked by new investors. It is easy to forget that the tax consequences of an investment may outweigh other considerations. A dull investment with favourable after-tax characteristics may well return more to you in real cash than a more glamourous investment that attracts a higher rate of tax.

Liquidity - the ease with which your investment may be turned back into cash without causing you a loss. Blue-chip shares, for example, are extremely liquid while property may prove extremely illiquid.

Using the criteria above you should now have some idea of your own investment objectives.

Owning good quality shares for income is one of the safest ways to guarantee your future. You may lose your job but no-one can “sack” you from owning income-producing shares of bonds.

Use the check-list below to spell this out to yourself.

Risk and Return	Check Yourself Degree of Importance: High	Medium		Low	
Safety	[ ]	[ ]		[ ]	
Inflation Hedge	[ ]	[ ]		[ ]	
Income	[ ]	[ ]		[ ]	
Capital Growth	[ ]	[ ]		[ ]	
Ease of Management	[ ]	[ ]		[ ]	
After-tax Return		[ ]	[ ]		[ ]
Liquidity	[ ]	[ ]		[ ]	

You will probably find that defining your objectives is not easy. Investing always involves trading off one objective against another. But at least you have now started to define and articulate your objectives. As you progress through the course you will learn increasingly how to reach the right balance – one of the critical skills in successful investing.

superannuation has attractive tax advantages but be aware of the costs

Superannuation today can be one of the most tax-effective ways to save for your retirement.

The reason: earnings in superannuation funds are only taxed at a maximum of 15 per cent — much lower than the rate which applies to other investments.

But — as many people have found out too late — the main beneficiary of your superannuation contributions could be the person who sells you the policy — or the insurance company which is man aging your money.

Average initial commissions on some superannuation products are as high as 60 per cent. Even worse, in some cases, over 90 per cent of your first two years' superannuation contributions are eaten up in agents' commissions and insurance company fees and charges.

The new superannuation surcharge announced in the August 1996 Budget will make superannuation less attractive for some people.

Fees, commissions and other charges reduce the long- term benefits you receive from superannuation. So, it is crucial that you find out the level of these charges before you join a super fund. Do not sign up for any superannuation policy before you are satisfied that the level of fees and charges is reasonable.

how to set your own goals - regardless of what the market is doing

There is an old saying that goes: "If you don't know where you want to go, the chances are you won't get there". As you'll learn throughout SPI, this is especially true of money management and investing. A vague or generalised desire to be "rich" is unlikely to result in a real increase in wealth. Like any good manager, you need tight control to ensure that you are continually on target towards reaching your goals and objectives.

Let's look at what "goals" and "objectives" mean in the context of successful investing.

Goals are where you want to arrive in the long-term. Do you want to retire and travel around the world? Are you aiming to accumulate enough money to start your own business? To send your children to an expensive school? Goals express your values — what is important for your happiness in the years ahead.

Objectives are the stepping stones towards achieving your goals. They are what you actually do to bring you closer to your goals.

Now let's look at how the "know yourself" rule combined with clear goal-setting will help you manage the psychological aspects of risk. By taking a simple step-by-step approach — and by being aware of where you stand in relation to the broader market cycles — you will see how it is indeed possible to stand aside from what has been referred to as the "madness of crowds".

All investment decisions involve a trade-off between capital gains on the one hand, and maximising income while preserving capital on the other.

It is essential to define your objectives before you start investing.

Only you know where you fall in the personality range between cautiousness and aggressiveness. Being clear in your own mind about this is one of the most vital investing skills.

You may believe that you are aggressive. But then you make your first market investment. Soon you find yourself anxiously reading the sharemarket pages each day and tossing and turning all night. You may have to make a radical reappraisal of yourself.

The chances are, though, that you will want to arrive at a "balance", trying to fine-tune your see-saw so you get the best of both worlds in the context of your own needs.

As you have now learned, much of the art of successful investing hangs on getting this balance right. In the lessons ahead you will be learning in detail how to do this using a wide range of techniques designed to help you objectives.

Four stepping stones to financial success

Acquire the necessary knowledge. Research shows that many would-be investors are intimidated by the "jargon" of the financial world. They believe learning to invest successfully must be a lengthy and difficult process, like studying advanced mathematics.

In fact, as you'll see, nothing could be further from the truth. Taken step-by-step, mastering the fundamentals of successful investing is as easy as following a simple recipe. But straightforward as it is, this knowledge is absolutely essential for success. Without it you are "shooting in the dark" — trusting on luck alone.

Set goals. An old saying has it that those who "fail to plan, plan to fail". Many would-be investors trust fate to somehow ensure that everything will turn out all right. But fate has nothing to do with successful investing in today's financial marketplaces. Success goes to those who act on a firm plan — not to the guessers and gamblers.

Develop a positive approach. Sports psychologists use a technique called "visualisation" to help athletes achieve peak performance. The athlete concentrates on building a mental image of winning — of actually seeing himself coming in ahead of the field.

The same is true in developing a successful investing program. It helps if you can "see" yourself as a winner. Visualise yourself enjoying the fruits of financial independence and you increase the chances of it actually happening.

Get started on your plan right now. In investing, procrastination is theft from yourself. However small your initial nest egg, not to put it to work all the time is to throw away the chance to build real wealth.

Opportunities are all around you, in good times and bad. The "miracle of compounding" alone will guarantee that your money will multiply astonishingly over time even in the most conservative investments.

Then, as you acquire the knowledge, more sophisticated opportunities will ensure that your money grows even faster, especially when you choose investing vehicles that allow your gains to accumulate tax-free. In investing, time is quite literally money. So the time to get started is right now.

"Farmers and miners" — Which should you be?

You can compare the two basic investing approaches to farming and mining.

A farmer ploughs away, slowly but surely making small gains until after many seasons of cultivation he achieves security and prosperity.

A prospecting miner takes higher risks. He may search or drill for long periods and find nothing. Then suddenly he may strike it rich — if he's lucky.

Research in the United States shows that when it comes to investing, "farmers" outperform "miners" every time.

Conservative long-term holding investing strategies beat speculative short-term trading strategies again and again.

Mark Hulbert edits a US newsletter The Hulbert Financial Digest which specialises in reporting to its readers on the performance of hundreds of financial newsletters and tipsheets.

Hulbert has found that newsletters that recommend portfolios less volatile than the indexes do better by far than those that play a more speculative game.

Similarly, the US Financial Traders Association runs a real- life money trading championship for its stockbroker members. Most are "miners". In seven years it found that only 22 per cent of the 3,500 stockbrokers who entered made a profit overall. If a similar contest were held in Australia there's no reason to think the results would be any different.

ReWealth4Lifeg modest gains and then compounding them over time is a far more profitable strategy than trying for the big hit. Speculating or gambling can be fun — but do it only with the small portion of your wealth that you can truly afford to put at risk. Don't count on it to make you rich.

The million dollar question:-

Young boy asks experienced trader "Will my stocks go up?"

Trader replies "If you think they will or you think they won't, you are probably right".

Exercise

Investing is both risky and forever changing . List 5 precautions you can do to hedge against loss

EG: Reading business news daily

1

2

3

4

5

Write down the name of your tax adviser

Do you have a written investment plan? Write down what a plan should consist of.

Exercise

Write down the name and address of your nearest ASX office and make an appointment to book in for some free investment courses about stocks and share investing.

Even blue chip stocks can lose money, list below 5 things you can do to hedge against loss of blue chip stocks.

1
2
3
4
5

Government bonds, stocks, insurance companies are all risky investments, explain what the value of the American green back can have as an adverse reaction if the USD falls.

Exercise

Explain what a unit trust is and explain 3 risks including costs of managing a unit trust.

1

2

3

FINAL REFLECTIONS

What have you learnt from this module?

Why?