KENNEDY BLACK
WEALTH MANAGEMENT

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Welcome to the latest Kennedy Black Private Client Newsletter.

While the government continues to make some significant changes to the pensions legislation, the biggest of which I have commented on via my blog, I thought I would move away from that and focus on other areas of importance. Rather than concentrate on topical subjects, I've tried to write some more theoretical pieces that I hope are a bit more interesting as we get towards the end of the calendar. I will, however, use January's newsletter to focus on some end-of-tax-year topics that should help focus the mind while there is still time.

BEHAVIOURAL FINANCE – WHY YOUR BIGGEST INVESTMENT ENEMY IS YOU

My experience of working in the financial markets has taught me a great deal, no more so than about human emotion – particularly my own.

Conventional economic theory suggests that finance is an exercise in efficiency and randomness involving purely rational beings. However, a new school of thought (known as Behavioural Finance) has emerged recently to demonstrate that individuals are not perfectly rational beings, far from it.

There are a number of psychological and emotional traits that humans have developed, often through natural selection rather than in spite of it, that make investing "simple but not easy," as Warren Buffet has put it. The hardest part is in handling the ups and downs and maintaining a rational and consistent thought process in challenging situations when your natural instincts are telling you to do the opposite.

Hence I attempt here to summarise three examples of characteristics that investors must learn to overcome. I hope that by helping identify them, you might be better placed to resist their destructive temptations.

Firstly, the two emotions that most famously move markets are fear and greed. However, I firmly believe that fear is the more powerful. To be more specific, it is the fear of loss that tends to make people act irrationally, since fear of losing typically outweighs the benefit of winning. A rational being ought not fear loss more than he derives pleasure from a corresponding win.

Secondly, 'empathy gaps' influence our judgment (i.e. the inability to appreciate how you would behave in a similar situation where the circumstances are different). For example, if you have just finished a massive meal, it is very difficult to empathise with your hungry self. Empathy gaps make consistent decision making very difficult. Shopping on an empty stomach is the surest way to buy too much food, just as buying stocks at the top of a bubble often looks completely irrational with hindsight.

Finally, a deluge of information does not necessarily breed better decisions, just over-confidence. Hence, even professional investors have been shown to be worse forecasters than weathermen, since weathermen appreciate their limits with relative accuracy. Investors fare all the worse because they often look at the extra information (and it doesn't matter whether it is positive or negative) as reinforcement of their original decision.

As topics go, I find this intensely fascinating and could go on all day. The above should give you a flavour of the human flaws that make investing such an interesting exercise. And these perennial truths should give you an idea why booms/busts are destined to repeat themselves. And with that in mind, I will conclude by repeating the four most dangerous words in investing: "This time it's different."

CAN AN ETF FAIL?

We have covered Exchange Traded Funds ("ETFs") in previous editions of this newsletter, in response to their growing popularity as a low cost, liquid investment tool. However, this is a relatively new market and there is still considerable misunderstanding of ETFs.

For example, a recent study from a small US research house, Bogan Associates, alleged that an ETF may collapse if there were too many investors selling short that ETF

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compared to the assets underlying. (Source: "Can an ETF collapse?" 15 September 2010) In effect, there could be a 'run on an ETF' (similar to a run on a bank) whereby the assets held by the fund operator are insufficient to meet redemptions. Bogan Associates speculated that retail investors could be left holding "defunct shares in a closed ETF."

Understandably, the ETF industry reacted quickly to these rather alarming accusations. The conclusion seems to be that, while short sellers clearly exist, an investor seeking to redeem its shares (i.e. cancelling them via the ETF operator) may have to prove that the shares have not been lent out. And the ETF Trust retains absolute discretion about exercising such redemption requests if there is any doubt. This is a right set out in the ETF's prospectus.

The point here is not necessarily about whether an ETF can collapse or not (although I personally agree with the view that they cannot, even so I tread very carefully around this sector), it is that there is a great deal of confusion among even the experts. This comes back to one of the classic rules of investing, which is that investors should always understand what they are buying. If you are in any doubt, Kennedy Black can assist you in negotiating some of these more technical areas of personal investments.

Core and Satellite

At Kennedy Black Wealth Management, we regularly recommend a "Core and Satellite" investment approach to our clients.

That is, a strategy that involves a 'Core' portfolio which is long-term, stable and should (largely) be left alone, alongside one or more 'Satellites' which might be alternative investments or more targeted investments. The choice is naturally vast and boils down to plenty of factors unique to every individual.

The exact make-up of the core will depend on the investor's attitude to risk but the principle is the same for all. The aim is to invest the lion's share of your portfolio in mainstream funds that can offer a diversified mix of asset classes and can provide stable returns with lower volatility.

What exactly these funds are will depend on your individual requirements, such as whether you are looking to take an income from the assets or whether you are looking to invest for long-term growth.

The core of the portfolio should be built using traditional asset allocation tools, with the appropriate exposure towards equities, bonds, commercial property, commodities and cash according to your risk profile.

This core can then be supplemented by a 'Satellite' strategy, typically the minority percentage. A Satellite portfolio can focus on more specialised areas, designed to increase overall returns while still keeping risk under control. For example, this could be a more regularly-traded share portfolio, or perhaps funds that target a specific sector or region (e.g. China). Alternatively, it could include assets that are typically uncorrelated to traditional markets (e.g. Private Equity, Hedge Funds). Or it could include investments that attract favourable tax advantages (e.g. Venture Capital Trusts, Enterprise Investment Schemes) or unique payout structures (e.g. Structured Products).

However, it is important that the combined portfolios should remain within your acceptable level of risk. And that means a degree of due diligence is required that most individual investors might struggle to undertake.

Investment Rule #4:

"Cut your losses and run your winners"

A classic investment mistake is to take profits too early while hanging on to losing positions in the vain hope that they might recover. It takes some effort to try to achieve the reverse, i.e. to run your winners will cutting losses early.

Taking profits too early comes back to the fact that fear of a loss outweighs the benefit of a gain. Hence, the natural reaction is to cash in your profits quickly in case the performance reverses.

Equally, it is all too easy to get depressed about a losing position and start to hope that it might bounce back.

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