logical financial management

Logical Thoughts

Build your future by 'investing' not 'speculating'

Gavin Shepherd
Portfolio Construction &
Investment Research Manager

It is paramount that you fully understand the difference between “speculating” and “investing” when making planning decisions about your wealth management and investment portfolios. If we fail to understand the difference it is highly likely that you will make poor investment and timing decisions that result in you failing to meet your financial objectives and, in some cases, leave you in a worse financial position.

Speculating

In our experience, “speculators” pay little attention to the fundamental value of a company or particular investment and adopt a shorter-term view of the price movements or invest with a view to make a large and often quick profit.

Timing the financial markets is fraught with risk. Companies and investments often deviate from their intrinsic value over short periods of time and determining when such investments will revert to their intrinsic value is virtually impossible to quantify. In some cases, companies and investments may trade at extreme valuations for prolonged periods of time. Even professional investors often get the timing of price movements wrong because price changes can be influenced by a range of factors such as political outcomes, investor confidence, weather, flow of funds, to name just a few.

In many cases, investors don't even understand what they are investing in or the factors and influences affecting the outcome for the investment. Rather, speculators attempt to trade shares for a short-term profit, rather than 'invest' in the company for the long term and most have little success.

Who can forget the push by investors into the technology sector in late 1999 and 2000. The USA technology market as measured by the NASDAQ index (majority of the index was made up of technology and communication companies) seemed unstoppable, rising from around 2,500 points in late November 1999 to just over 5,000 points at the beginning of March 2000. At its peak the NASDAQ was capitalised (total value of all companies) at over $5 trillion (US dollars).

Driving the index over this time was the speculation of strong future earnings growth, cost transformations associated with new technologies, productivity improvements enhancing profit opportunities and spurring of business investment. However, most companies had no actual earnings or profits.

As we all know the so called "new economy" bubble did burst, and at its low in early October 2002 the NASDAQ had fallen by 78% to a low of 1,114 points. At its peak, the price-earnings ratio of the Nasdaq had blown out to more than 175. That meant it would take more than 175 years at the company's existing rate of earnings for a share to generate enough earnings/profit to pay for itself.

An example of this tech boom was Cisco Systems. On March 27, 2000 Cisco had a market capitalisation of $US555 billion. It's market capitalisation by the end of March 2001 was $US145 billion representing a decline of 74%. To put this into perspective, the, fall in the company's market capitalisation over the year to the end of March 2001 was equal to roughly 5.5 times Australia's gross domestic product.

At Logical we were amazed that fund managers established sector specific technology funds in late 1999 and 2000. These so-called professional investors launched their strategies at a time when the technology sector was booming and at its peak. When that bubble burst, these funds reported total losses of between 40 to 50 percent. These professional investors had in effect turned into speculators.

It took almost 16.5 years for the NASDAQ to exceed the 2000 peak.

Investing

By contrast, at Logical we structure client portfolios and recommend investments to improve the financial position of our clients based on a view of "investing" rather than "speculating". Anton Tagliaferro, Investment Director at Investors Mutual described investing as follows:

"Investing…is about buying an asset that generates sustainable cash flows and where these cash flows can be used to either pay an income to the owner or used to grow the asset's value over time by reinvesting in the business. Investing in the share market is all about patiently accumulating a diversified portfolio of quality companies that can grow their profits over time and that can generate a sustainable and growing income stream".

It is important to recognise that we're all susceptible to having an emotional view to market trends and over-react by investing into companies that can take advantage of those market trends.

When you "speculate" it comes with a short-term focus and an intention of making a quick capital gain…it could be a fear of missing out…or just greed! Too often we have seen that this results in clients taking on higher risk of capital loss often without realising it and usually with little thought on the impact on their personal circumstances or achievement of their financial objectives.

If you "invest" in companies and investments that are relevant to your financial objectives (such as need for regular income or capital growth or a tolerance level for risk), then it is likely you'll be in a better financial and lifestyle position over the long term, including in retirement.

Final Thoughts

At Logical, we build bespoke investment portfolio strategies tailored to your circumstances and structured appropriately in line with your specific financial objectives that provide targeted **risk adjusted returns** based on the concepts of 'investing rather than 'speculating'.

Some of the things we may consider when structuring your portfolios include preservation of capital, growth of your portfolio, tax implications, planning to generate a certain level of regular investment income, to name a few. Other themes which may be incorporated into your portfolios include currency diversification, investment mandate flexibility, a focus on absolute returns and the inclusion of best of breed investment management with highly researched concentrated portfolios.

A common saying summarises the point: "Good things come to those who wait."

t 02 9328 3322
f 02 9328 3323
e team@lfma.com.au
w www.logicalfinancial.com.au

Suite 21, Level 2, 8 Hill Street,
Surry Hills NSW 2010
PO Box 103
Darlinghurst NSW 1300

DISCLAIMER: This newsletter contains information of a general nature only. The reader should not act on the information contained in this newsletter, but should seek professional advice tailored to their personal situation, needs and objectives. Whilst every care has been taken as to the accuracy of the contents published herein, no warranty is given, or liability accepted by Logical as to the correctness of the information.