



STEP JOURNAL

WEALTH STRUCTURING ANALYSIS FOR TRUST AND ESTATE PRACTITIONERS

Guerilla investing

F. Mark van Gelderen on understanding the true time value of investment money

ABOUT THE AUTHOR

F. Mark van Gelderen TEP is Branch Manager of Financial Resource Network, Jerusalem

A significant part of the investment process is counterintuitive because people overemphasise the investing process, instead of first understanding simple mathematics.

Compounding has been described as the eighth Wonder of the World. Most educated adults know the Rule of 72s – where you divide an interest or yield rate, or conversely an inflation rate into 72 to measure the increase or decrease in value.

Some applications of this include:

- a bank rate of 2 per cent means you double your money nominally in 36 years;
- an average return on a fund of 6 per cent means that you may be doubling your money every 12 years, however if inflation averages 3 per cent we see our purchasing power halved every 24 years;
- if bank rates average 2 per cent and inflation averages 3 per cent, we experience a 1 per cent negative growth annually, before taxes and management costs;
- if our investments are averaging 6 per cent a year and inflation is 3 per cent, our net, before taxes and costs, is 3 per cent.

Too often, the pursuit of safety, plus the client's fear of taxes, puts the financial advisor and his client in a slow-moving asset trap.

Achieving positive real results

Here is a minimal list of fees most investors will wind up paying beyond the internal management costs of the underlying bond, share, fund, etc: custodial related fees are typically around 1 per cent per year depending

on where held, total account size, etc; brokerage fees can vary from 10bps to over 2 per cent per trade, depending on where these are done and the greediness of intermediaries; churning means that there may be round trips (selling and buying) too often, decreasing after expenses yields tremendously; miscellaneous bank charges can also be a significant drag on the bottom line; and finally, the advisor needs to make sure s/he is paid – let's factor that in at 1 per cent. Now we have to pay taxes – not on the bottom line after all of the above, but on the nominal gross published yield of the underlying investment. To keep track of all this, we will need to pay an accountant a significant fee and perhaps every year or two get tax consulting or a legal opinion.

Given all this, there is no way that traditional conservative investing can have positive real results in today's low inflationary world.

Not only will the investor soon wake up to this self-defeating game, where everyone is getting their due except the owner of the assets; but the advisor will eventually lose their mandate and reputation.

Is there a mathematical or real-time solution? Yes, if at least part of the money can remain invested, undisturbed for five years or much longer.

Solution A

Let's play with some numbers. For instance, you have 50 Talents of Silver to invest long-term, ultra-conservatively. The maths works the same in all currencies. Portfolio A will contain only central government bonds from the main democracies, since they are generally considered the safest investment medium – safer than bank deposits.

Let's say, for arguments sake, that the bond market can give you 4 per cent, before costs, on a 20-year bond. Even with this amount of capital you must follow the first

and foremost investment rule: diversify, diversify, diversify.

Therefore you would buy perhaps 10 Talents worth of Japanese Yen Bonds, 10 Talents worth of German Euro Bonds, 10 Talents worth of Czech EuroDollar Bonds, 10 Talents worth of Canadian Bonds, and 10 Talents worth of Brazilian Real Bonds. 50 Talents worth of sovereign bonds in all, but diversified for currency, political and default risk, etc.

A simple compound table will tell you that if all was to be equal at the end of the 20-year cycle, each 10 Talents of bonds, growing at 4 per cent, would become 21.91 Talents; before inflation, taxes and the other costs already mentioned. Thus, our 50 original Talents might grow nominally to 109.55 Gross Returns.

But the net, bottom line, returns are problematic. Let's say inflation averages 2 per cent over this period (probably low based on historical records) and taxes are only 15 per cent (4 per cent taxed at 15 per cent means 0.6 per cent goes to the tax collector) and say overall management only costs an unbelievably low 0.4 per cent annually, including custodial costs, bookkeeping, accounting and legal fees. Then the entire cost structure comes to 3 per cent per year, giving us a theoretical net gain of 1 per cent. This means that this investor will double his money in 72 years. Very safe but hardly exciting – and probably impossible to attain in the real world as the internal costs given here are unrealistically low.

The rule of thumb with unmanaged sovereign bonds is that you rarely have positive real net gains; they generally are net losers, unless fixed interest bonds are bought at the top of the inflation cycle. Now, when interest rates can't go much lower than zero, the upside risk of higher inflation and having



to cash-out early means that high-grade, long-term bonds are truly risky investments!

Solution B

Let's look at another, radically different, solution for the long-term investor: Portfolio B.

Look in the *Financial Times*, *Wall Street Journal*, or any newspaper with a robust financial section. You will regularly find investments, even today, that indicate long-term records of 15 per cent or higher. The old adage that return is associated with higher risk seems to hold true. Risk, however, does not mean failure. Risk is more often interchangeable with volatility. Meaning more risky investments must be given more room, time, to do their thing. A highly volatile investment with a high average total return needs more holding time to prove it will perform similarly to the way it has in the past. New high prices may take years to happen, but when the investment gets going again it might quickly make up for lost time.

Let's go back to our investment example used for the bond portfolio. This time we will invest our 50 Talents into a portfolio of diverse high-yielding investments. We will again buy five, each with 10 Talents. This time the portfolio will include a leading managed commodities programme, a managed currency trading programme, two different hot-shot hedge funds, a venture capital partnership and an Energy Exploration limited partnership. Let's assume that we set as one of our basic criteria that each candidate investment show a long-term track of getting returns of 15 per cent or more.

Going back to the compound table, we will see that on paper, every 10 Talents, if meeting our minimum expectation would, over 20 years, become worth 163.66.

Let's bring this strategy back down to minimal outcomes and assume that risk really does mean failure. Let's postulate an unlikely outcome. Four out of the five investments completely disappear, become totally worthless. That means we invested 50, lost 40 completely, and with the 10 left got back 163.66 in total.

How does that compare with our first portfolio? Despite losing 80 per cent of capital, Portfolio B gets more than 65 per cent higher return. Not bad for using two simple concepts: diversification and a compounding table.

Real life

Most readers are probably thinking at this point, 'well that does not work in real life. How many people have 20 years to wait?' Before

answering that question, let's first do some maintenance.

If we are making 163 over 20 years, or 110, most of the underlying fundamentals, in terms of costs, don't change significantly. The only significant change is more taxes paid, because of a higher total return. That means that higher-return investments have the most chance of allowing the client a decent return at the end of the investment day. Time and higher yield can have dramatic bottom line results.

To get back to applying the more aggressive investment strategy for shorter periods of time, there are several variables that we can play with: time, yield and risk. When we are associating risk with volatility we are actually talking about a common investment statistic: standard deviation. If we look only at investments with more than a five-year track record with no questionable activities in the background (due diligence is an ongoing responsibility), then one can set criteria beyond just yield for a hypothetical portfolio. Some of the other metrics to be on the checklist include standard deviation, downside deviation, sharpe ratio, alpha and beta measures, etc.; plus to choose investments that have low correlations with each other.

Now let's look at what our two potential portfolios do with all the assumptions left the same, but the time horizons changed.

Length of time	Portfolio A	Portfolio B	Portfolio B2
5 years	63.45	20.11	40.22
10 years	74.01	40.45	80.90
15 years	90.04	81.37	162.74
20 years	109.55	163.66	327.32
25 years	133.29	329.82	659.64

Let's also look at portfolio B2. In this example, two out of the five investments deliver on target at 15 per cent. With a decent financial advisor halfway awake, keeping 40 per cent of investment capital meeting its goals should not be difficult. If we did a B3 scenario, with three out of five managers meeting their goals, the results are dramatically better. Portfolio B is definitely realistic: any good financial advisor should be able to name off the top of their head several well-known investments that would meet our 15 per cent yield requirements.

Let's look at the other easy variable to deal with, our minimum expected yield. If Portfolio B was based on standard 12 per cent yielding equity funds, of which thousands exist around the world and many are just about household names, let's look at the results in a 2 per cent

Length of time	Portfolio A	Portfolio B	Portfolio B2	Portfolio B3	Portfolio B4
5 years	63.45	17.62	35.24	52.86	70.48
10 years	74.01	31.05	62.10	93.15	124.20
15 years	90.04	54.73	109.46	164.19	218.92
20 years	109.55	96.46	196.92	289.38	385.84
25 years	133.29	169.99	339.98	509.97	679.96

successful portfolio, example B, as above: a 40 per cent successful portfolio, B2 as above, and B3 and B4 portfolios.

We could play with the variables interminably. There is no one perfect answer. For someone involved with investing, the assumptions given above, although hypothetical, are extremely conservative in terms of failure rates. All investments periodically fail, including governments and their bonds, Black Swan events. Imagine how radically different the above tables would be if we made the following additional assumption: that over a 20-year period at least one of the government bonds in Portfolio A would fail. This is realistic. Failure rates do not seem to rise as fast as returns, meaning 10 per cent investments don't have twice the failure rate as 5 per cent investments.

Final thoughts

A final thought on this general topic, regarding where one places their money and can still achieve a return: during the last time a Depression existed in the United States and Europe, there were two interesting and little-mentioned realities. It took 25 years for the major market indexes to nominally surpass their peak of 1929. Yes, 1954! Taking into account inflation and costs, the breakout point was probably around 1960. During the Depression, there was a higher failure rate among government bonds than among the bonds of the blue chip manufacturing firms.

For investment time periods of less than five years, the above alternative strategy should never be used. Going back to our discussion of costs, net bottom losses need to be contained. Costs should be more of worry than yields in this low interest environment. Look at long-term bank deposits, national government bonds (as opposed to local authorities that are not backed by the full credit of the central government), AA and above corporates: bond funds and exchange traded funds that specialise in these areas, are generally the best solution. Everything else is too expensive or risky. It is still far better to get 1 per cent at the bank that after all costs comes to a negative 1 per cent, or worse, than to bury your cash in the cellar. Look at the 1 per cent loss as the cost of insurance that your asset is publicly registered and can't be easily stolen or confiscated from you. ■