Investing Basics – Feb 26, 2021

What are your financial goals when investing your money?

The most appropriate questions to ask yourself when considering your personal investment options are 'what is the purpose of this capital?' and 'what are my investment objectives?' This may appear obvious and logical, but in reality, most people start not with an assessment of their financial goals, but instead by considering specific investments – putting the cart before the horse.

If you were planning a holiday, would your first priority be the type of aircraft in which you would like to fly? Most certainly not. You would likely consider whether it is a family holiday, a sightseeing holiday, a skiing or beach holiday, then narrow down your options, considering specific destinations, departure dates, length of stay, etc. You probably would not know anything about the airplane until you were on board.

In fact, most people spend more time planning their holidays than their personal investments. They choose holidays that reflect their specific interests, and may take different types of holidays depending on what interests are paramount at a given time.

Yet when people consider their investments, they usually seek to satisfy one objective only: to make a lot of money in a short period of time. This is not appropriate. You most likely have a variety of financial objectives which you should set out in an investment statement. This statement can help you in the planning process to achieve your financial goals.

Have you just sold a business and wish to invest the proceeds in order to have sufficient after-tax income to provide for current living expenses? Do you wish to make provisions for your children and grandchildren? Are you planning for an early retirement at a certain standard of living? Are you looking to fund a special project? The more clearly you define your objectives at the outset, the easier it will be to implement an investment plan.

The most important subjects to be addressed are: risk, returns, liquidity, time horizon, legal structure and taxes.

Risk

Risk must be approached from two perspectives: emotional and financial. From an emotional viewpoint, you must determine your tolerance for volatility, typically thought of as the variation in the value of an investment over time.

Will you be able to sleep well when the value of your investment drops 15 per cent in a few days? Most people like volatility when it earns them profits, but not when they suffer losses.

From a financial perspective, risk can simply be defined as not having money when you need it or want it. Can you risk losing your investment capital? On the other hand, another risk that many people do not recognise is inflation. Leaving money in a bank account may be risky if inflation erodes the value of your assets and income flows.

Returns

What rate of return will allow your investments to grow to your required level? Is it realistic and achievable? The MSCI World index has had a compounded annual growth rate of 9.9% over the ten years to December 2020; it would be unrealistic to expect, for example, 25% returns over a long period.

Investors often overlook the impact of compound returns on growth. Gains compounded, that is to say reinvested over many years, improve your investment returns exponentially.

Too often, investors seek to time individual investments, that is “buying low and selling high”. Even though gains in financial markets come in concentrated periods, they are difficult to time consistently so as to maximise gains. Thus, it is better to focus on an average annual return over three to five years rather than shorter periods of a year or months.

Liquidity

How quickly can your investment be converted into cash? Bank deposits are more liquid than a real estate investment. It may be important for you to have the ability to liquidate assets quickly to meet other financial obligations.

Time Horizon

When will the capital, or part of the capital be needed? This helps determine what asset allocation is best suited to you. Asset allocation is simply a determination of what proportion of your investments are held in different asset classes, such as cash, bonds, equity and real estate. You may have more than one time horizon. For example, in five years you may wish to buy a home, and 15 years later you may wish to live on the after-tax income generated through your investments.

Legal Structure and Taxes

Where your objective is to provide for future generations or where you want your investments to be confidential, you may wish to consider establishing a trust. If you have concerns about social and political uncertainties and the desire to minimise overall tax exposure, investing via a corporation in a tax haven is a possible option. Establishing a trust and an offshore corporation for your investment can be complementary. By first determining your investment goals, you will be better prepared to make available legal structures serve your purposes.

Statement of Objectives

Putting this all together into a statement of investment objectives will help you to formulate an investment plan, to choose an investment adviser and even to guide you to the investment vehicles best suited for you. You can develop your own statement of objectives on one or two pages and review it from time to time. It will prove to be a valuable tool to help you achieve better investment returns.

Formulating a Plan

Once you have determined your investment objectives, you can begin to formulate your investment plan. If you already have investments, you can compare how well your current investments match your objectives. You are now in a better position to choose the right investment professional (private banker, broker/dealer, discretionary fund manager) for your personal needs. Just as your holiday plans change over the years so will your investment objectives. Remember that fine tuning investment goals is a dynamic process which will change as your objectives change at different stages of your life.

A simple illustration will demonstrate how the process works. Let us examine possible changes in objectives that will occur in a couple now in their early 30s and then during their late 40s or early 50s. Personal characteristics such as risk tolerance will probably remain the same.

In the first stage, objectives may be heavily weighted towards capital appreciation as the investors have sufficient income to support their family and a 10 to 15-year time horizon for their investment goals. This would dictate that a greater proportion of their assets be allocated to diversified portfolio of stocks than to bonds and cash.

In their late 40s, they will likely shift their asset allocation more toward fixed income investments in the currency of the country where they will be setting up a second home. They will be better able to take advantage of the capital markets at that time because they will have the flexibility to alter their investments over a longer period to meet their new objectives, the mandate for their investment advisor will become much clearer.

In the longer term, when the investors reach their mid-50s, they may wish to have the financial ability to spend part of the year in another country where their children are attending university or working; to purchase a home, cars and golf club memberships there; and to travel extensively to Europe while only working part of the year.

With these clear objectives in mind, they will be able to better determine how their assets should be invested to provide them with the capital required to set up a second home as well as the capital base necessary to generate the after-tax annual income required to meet their living expenses, such as the cost of maintaining two homes, travel and university costs.

Conclusion

There is no guarantee for achieving financial success. However, establishing clear investment goals before you begin to invest, makes it more likely that you will be successful.

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