What Should I do with my Money?

By Robert Vinall, Kilchberg, 25 November 2011

When people learn that I am a money manager, they frequently ask: „What should I do with my money?“ The question elicits surprise and embarrassment in me in equal measure. Surprise, as everyone should have a clear idea of how to invest his or her savings - the way you invest is the most important determinant of how wealthy you become after your choice of career. Embarrassment, as I am no more inclined to discuss other people's financial affairs than I am my own. And so, to help alleviate your pain on the former and mine on the latter, I thought I would put a few thoughts down on the subject. I believe these points are relevant for most people whether they are wealthy or not-yet-wealthy, risk-averse or risk-seeking. They reflect precisely how I manage my own family's money.

1. **Steer clear of financial advisors** or, as I prefer to call them, financial products salespeople. Engagement with the vast majority of financial advisors works something like this: They visit you in your home, probably in the evening if you have a day job, and proceed to ask questions about your financial situation, such as how much you earn, how much you spend, what your savings are and how much money you owe. They then ask you to describe your dreams (a little house in Spain, college education for your kids, paying less tax) and your fears (death of the main breadwinner, running out of money in retirement). In short, you relate more about your financial situation and most deeply held hopes and fears than most people do to even their closest friends. The advisor then proceeds to propose some carefully selected securities to you, which, as luck would have it, pay him or her the highest commissions. Having born all to this near stranger and used up his or her valuable time in the evening, you find it very difficult to say no. You should though because the cost of the sales pitch you have just received in all probability far exceeds the value it provides. Allocating your capital is actually very simple. In this note, I will provide you with some pointers, which should allow you to do most of it yourself. They should save you money and help you to reach your financial goals.

2. **Always maintain sufficient levels of cash in your current account to cover near term expenditures**, both the expected ones (holidays, rent, etc.) and the unexpected (medical bills, car repairs, etc.). Any cash remaining after setting a sum aside for near term expenditures is available for investment. What should you do with it? In essence, there are three main income-producing asset classes, which are worthy of consideration for investment: real estate, fixed income, and equity. I will discuss all three in the following points. Please note that I do not include commodities, art, wine, etc. as they do not provide income; in fact they absorb income as you have to pay someone to store them for you. Income is crucial as it allows you to participate in the miracle of compounding, which I discuss in point 9. I also do not include cash, as it is almost certain to lose value in real terms due to the effects of inflation. Please note that the financial services industry has come up with a bewildering ray of products. All of these are derivatives of the three main investment alternatives I mention above. For most people, their complexity is likely to outweigh their benefit, and so I would ignore them.

3. **Own the house you live in**. Real estate has generally been a good investment over time and in most countries there are various tax benefits to owning your own house, which makes it even more attractive. Also, no matter what your situation 20 or more years from now, one of your fundamental needs will be shelter. Everyone should probably sleep better knowing that the risk of being homeless is off the table provided there is no war or revolution. I say "most people" as I don't think it is appropriate for people whose vocation most likely involves moving locations. Home prices can fall! This need not bother you if plan to live in the same town for much of your life, but could lead to substantial losses if you are forced to sell at an inopportune moment due to career reasons.

4. **Avoid owning real estate purely for investment purposes**, i.e. to rent out. This may seem to be a contradiction to my former point, but I think there are important differences. Renting real estate is a lot of work for relatively meagre returns. It is also far more risky than people generally assume. Prices can go down as well as up, as already mentioned. Also, tenants enjoy very strong protection in most countries which makes it difficult to get rid of them if they stop paying. As most people cannot buy a second home outright, it is normally partially financed with bank loans. I am very much against borrowing for investment purposes with the exception of buying your own home, as I will explain under point 10. Finally, real estate is an easy target for expropriation by cash-strapped governments. If the government imposes a 3% property tax on real estate and the rental income is 6%, then you have lost half of your investment. You may feel the house still belongs to you and indeed it does if it requires any repairs, but in effect you have a silent partner who owns 50%.

5. **Invest in the equity of a business**, either your own business or part of a business, which is traded on an organised exchange, i.e. stocks and shares. This is in my view the next best investment option after owning your own house. The standard reason for owning equities is studies showing that the best long-term returns are made in this asset class. I believe this is a valid argument, and clearly all of the great fortunes in the last centuries have been made through owning substantial stakes in successful businesses. However, as the saying goes: "Past performance is no guide to the future" and I think there is a more powerful argument to owning equities, which is forward looking. Based on current earnings power and moderate economic growth, the underlying return on equities in the coming years will almost certainly be far superior to the other investment alternatives. As I write this, there are any number of companies, many of which are amongst the largest in their respective countries, which have dividend yields of 4% or higher. Not only this, there are good reasons to believe that they can grow their earnings at 3% or higher, assuming modest price increases in line with inflation and some expansion in their markets. This should bring a return of 6-7%, which is in excess of most high grade bonds (the next alternative I will discuss). Please note that just because the value of a company's equity goes up, does not mean that its price will immediately. Price often disconnects from value for long periods of time, overshooting on the upside and undershooting on the downside. However, if you are patient and do not panic when the markets go through one of their regular gyrations, you will find the return of the investment matches the return of the business. Moreover, the frequent disconnect between price and value represents

an opportunity for the intelligent investor, which I will discuss under point 8.

6. **Only Invest in high grade bonds if you are not emotionally equipped to deal with the inevitable ups and downs of the stock market**. If you met with a financial advisor and ticked the box that you hate the idea of losing money (who doesn't?), you will have been pushed towards a higher allocation of your savings into bonds. This is not entirely bad advice as the bonds of high grade governments and companies have in the past generally made good on their promise to return principal with interest. This is not the complete story though. The promise to return principal has come at a high cost as the return on bonds is usually far lower than on equities. Moreover, the promise has not been worth much as equity holders have also had their principal returned to them over most 10 year periods (though not all). Furthermore, the risk with bonds is not just that principal is not returned, but that principal is returned in a debased currency. To put this differently, if you invest 1'000 EUR in a bond today, which would buy you 500 sausages, you will lose money in real terms if the 1'000 EUR are returned in 10 years time, but only buy you 250 sausages. Most companies, by contrast, generally have some ability to increase prices and so afford the investor a degree of protection against inflation. What all this means is that equities are a better investment most of the time than bonds, but it depends above all on the price paid. As I write this, the price of high grade bonds, i.e. those which are considered likely to return principal, is catastrophic. The yield on the 10 year German government bond is 2%. Inflation is currently well above 2% and for most of the last 50 years has been above 3%. This is an example of return-free risk.

7. **Be patient - the best time to start investing is not necessarily the present**. Most people have had some experience of the stock market and given that they are asking me for advice on what they should do with their money, I assume they found the experience unsatisfactory. The reason is usually some variation of the following: They felt a certain resistance to investing in the equity market as they have little knowledge of it other than a vague notion that it is "risky". This resistance was worn down over time through a rising market coupled with a rosy economic outlook and perhaps the dogged attentions of a financial sales person. Unable to bear the pressure anymore, they invested. Shortly after, there was some setback, which led to sharply falling prices. Cursing their stupidity, they sold, locking in substantial losses and swearing a solemn oath never to go near the stock market again. What they failed to understand is that planet earth is a pretty uncertain place. Wars, natural disasters, recessions and financial crises are not exceptions, but the rule. Despite all the setbacks though, the general path has been very firmly upwards on all meaningful measures (life expectancy, standard of living, etc.). This has two important implications for investing. Firstly, it is far better to invest at a time of pessimism expecting things to gradually get better than a time of optimism expecting things to continue indefinitely. Second, after investing, one should expect there to be major setbacks from time to time. Rather than sell on a low, it is far better to be patient, expecting things to improve some time or other. How do you know you are in a time of pessimism? This is easy: economic problems and declining stock markets are on the front pages of the popular press, i.e. Blick, Bildzeitung, The Sun, etc.

8. **Distinguish volatility from risk**. It is a fact of life that stock prices go up and down every day of the working year, sometimes substantially. Sometimes, a share price falls because a company's value is genuinely impaired, but more often than not this is not the case. A group of companies that provide services and products which will be needed years from now, have honest managers and reasonable valuations will almost certainly increase in value over time. Volatility may be high but the risk of losing money is low.

9. **Understand the miracle of compounding**. Although I had maths at school up until the age of 16 and learnt the calculation of compound interest at an early age, no one ever explained to me the implications of compound interest. In case you suffered a similar fate to me, here it is: Through the magic of compounding, small amounts of money become large amounts of money over very long periods of time, and: small differences in interest rate make an enormous difference in wealth over long periods of time. Thus, 10'000 EUR invested at 10% becomes 1'173'909 EUR after 50 years. Not bad, but compounded over 15%, it becomes 10'836'574 EUR.

10. **Never borrow money to invest with the exception of your own house**. There are many reasons to avoid borrowing, but here are just a few. 1) There is no need to borrow – through the miracle of compounding most people should be able to reach their financial goals even if starting with relatively modest amounts. 2) Markets periodically go through periods of tremendous upheaval. In such a phase even modest levels of debt can lead to a total loss of capital. 3) With debt, the magic of compounding becomes the nightmare of compounding.

11. **Never buy a product that promises tax savings**. Taxes are a fact of life and I have never seen a worthwhile product that helps you to legally avoid them unless it is specifically sponsored by the government to encourage a certain type of behaviour.

12. **Open a brokerage account and manage your investments directly**. All local banks offer brokerage accounts and in addition, there are pure online brokers. The lowest cost way to invest is to buy shares of companies directly. I also find this to be the most fun. For guidance on how to pick companies suitable for investment, I recommend you look at my investment letters under www.rvcapital.ch. The next best option is to buy low cost index tracker funds. They provide exposure to a basket of companies, e.g. the Dax© or the Eurostoxx©, at a low cost. This last piece of advice may come as a surprise as I advise an actively managed fund. However, actively managed funds have far higher costs and as a group do not provide superior returns. If you are a non-sophisticated investor (you are if anything you are reading here is new to you), you are unlikely to find the few outstanding investors amongst a sea of mediocrity. My fund is aimed at institutional investors who have a robust model of what constitutes a good investor coupled with the resources to identify exemplars, and to family, friends and friends of friends, who know me well enough to vouch for my character, if not my ability.