Creating an Investment Plan

Since I invest only in the stock market, I will confine my discussion to the creation of an investment plan to invest in the stock market. Nevertheless, the same principles may be readily adapted for other asset classes.

Why Create a Plan?

An investment plan is a document that sets out what we want to achieve from our investments and how we are going to try to make it happen. If we do not have such a plan then where we end up is likely to be largely outside our control. There is also a secondary reason for having a plan: to help us to know how we are going against the plan and to make changes where necessary. Thus, we must be able to measure how we are going against our plan.

When we begin investing it seems to be an overwhelmingly difficult task to formulate a formal plan. We do not even know where to start. Most of us will begin by winging it, hoping that we will learn as we go along. This is dodging the issue and just putting off the day when we need to start to formulate a plan. Moreover, diving in without a plan is a very expensive way to learn, because we will be instructed by the market. The fees the market charges are called losses. As well, there is the silent cost of opportunities not recognised and missed.

It is tempting to search for a guru with a good plan and just copy it. This is likely to fail because each of us is different in age, education, skills, experience and personality. Our plan can be adapted from a guru's plan, but it must fit our needs and be comfortable for who we are.

Our investment plan ***must*** be written down. This should be done in such a way that another person could audit our investments to confirm that what we have done with our investments is what we planned to do. However, the most significant benefit of committing a plan to writing is that the process will uncover the logical inconsistencies and gaps in it. A good rule is that the plan should set out all of our decision rules and guidelines, such that when undecided about what to do, we can pull out our plan and find the answer to the problem.

Plan Structure

There are many ways that we might structure a plan that will serve the purpose. Remembering that each of us is different and must do it the way that we find comfortable, I have personally found it to be useful if my plan has three logical sections:

1. Objective: What our plan aims to achieve.
2. Strategies: A broad outline of the means we will use to achieve our objective.
3. Tactics: The rules and guidelines through which we will execute our strategies.

Our objective will ideally take the form of the required level of saving and the rate of return on capital that we need to lead a comfortable life and retirement. Some key decisions will involve issues like whether we wish to leave our financial capital to our children, or will we use some of it up in retirement.

Our strategies might best be set out as the risks to be managed and the methods for doing so. In the stock market, the four key risks are the fluctuations in the economic cycle, specific risk in each investment, the overall financial risk in our portfolio, if debt is used, and liquidity risk in buying and selling the stocks we choose for our portfolio.

Our tactics might be set out as how we will select and manage the stocks we buy. In stock selection, the key ideas are the maximum and minimum level of diversification in the portfolio, our criteria in selecting stocks in terms of analysis and valuation methods and what timing models we will employ if any. In managing investments, the key idea is how we protect our capital against catastrophic loss by having a stop-loss for investments that do not work out and a protect-capital-loss decision rule for those that do work out well. This may be in the form of guidelines for how we build a position in a stock over time as well as for closing and switching investments if better opportunities emerge.

Setting an Objective

The ideal time to make our plan is when we first enter the workforce, but almost nobody does it then and many people do not even think of it until they near retirement. The longer we leave the task, the fewer options we may have because most saving and investing decisions will have already been made largely unconsciously. Everyone who has left it too late must live with the choices they have already made and hope that government pensions will get them through.

The right way to go about setting an objective is this: Estimate the level of income that we wish to have in retirement. Do this in today's dollars and don't forget that the final years of our life may involve very heavy medical and aged care expenses. These might be met by selling the family home and/or spending the kids' inheritance, so if we do not plan ahead these are uncomfortable choices we may have to make.

As an example, the calculation may look like this: $70,000 per year for a comfortable life and travel plus $200,000 for end of life medical, aged care and funeral costs. If you do it like this the huge risk that few people consider - that they may live well beyond their life expectancy – can be covered. Assuming an optimistic, but not unrealistic after tax real rate of return from stocks of 3%, the ***minimum*** amount of capital we will need at retirement is $70,000 ÷ 3% + $200,000 = $2,533,333. This might be reduced if we downsize our home at retirement, but increased if we have not yet paid off the mortgage.

In setting an objective, the major issues are that it be realistic, or failure is certain, and measurable so we can track our progress.

Risks to be Managed

The global financial crisis of 2008 and the ongoing aftermath will have reminded us that there is an economic cycle (if we have forgotten that lesson from 1974 and 1987). We must decide whether we will try to time the market and how we will do it. If we intend to buy and hold over the long term that does not remove the economic cycle risk, so a strategy must still be formulated.

No investor ever gets all of their stock selections right so we must have strategies for managing specific risk, which involves managing the underperformance or failure of some of the firms we invest in. If the investments are through derivatives, don't overlook counterparty risk.

Financial risk comes from borrowing money. If our investments fail to perform, our loss is magnified. This is called gearing or leverage and may be present at multiple levels: mortgages, margin loans, derivatives and debt within the companies in which we invest. Banks and finance companies are the most highly geared.

Liquidity risk is often overlooked and is worst in small and tightly-held stocks. It often does not become apparent until we need to sell in a crisis.

Stock Selection

Everyone starts by focussing on this, to the exclusion of all the other messy issues. However, the reality is often that selecting stocks is the easiest part to learn. The difficult, but arguably more important issue is managing our investments, something I will look at in the next section.

The single most important element in stock selection is diversification. This is how we deal best with specific risk. However, it does not necessarily work if we buy lots of small holdings in big stocks. Not only can blue chips fail, but spreading capital too thinly is likely to mean mediocre returns at best. Spend some time thinking this through.

The key concept in stock selection is to buy stocks with a margin of safety. This essentially means buying stocks that are not already relatively overvalued. Spend some time working out your parameters for a margin of safety bearing in mind that there are many ways to do it and no single way is objectively the best. There is a spectrum to deal with – at one end is absolute safety and low returns, while at the other end, is high risk with possible high returns. We need to find where we are comfortable along the spectrum.

The professional investors tell you not to time the market as a whole or in individual stocks. Yet even the best investors will not buy a stock at any price at any time. Everyone makes decisions that even unconsciously imply timing decisions. This is the area where charting can add value to security analysis.

Managing Investments

This is where the real money is made and large losses avoided. Risk can be mitigated by phasing into and out of stocks rather than always making all-or-nothing decisions. If things go well with a stock, build a position and if they go poorly, pull some money out and invest it in other stocks.

The pachyderm in the room is the ability to take a loss. Most people find it the most difficult thing of all, but not experienced investors, who have probably learned the hard way. If it helps, try not to focus on the loss, but see a sale of an underperforming stock as an exercise in switching to a better opportunity. There are always some investments that do not perform for us. This is how to deal with them:

1. Before we buy we should know clearly what we expect to happen.
2. Before going any further, we should define how we will know if our expectation is happening.
3. Turn that definition around and we can define when our expectation is not happening.
4. This is where we are wrong and should switch to a better opportunity (also known as a stop-loss).

Once we know where we would be wrong, we are able to keep control of specific risk. Suppose that we decide to risk $1,000 (another way is to use a percentage of total portfolio worth like 1%). Further suppose that we can buy a stock for $3.80. If where we think we would be wrong is if the stock falls to $3.10 our risk per share is $3.80 - $3.10 = 70¢ (assuming we act on our stop-loss without hesitation). This means that to risk losing no more than $1,000 we should buy $1,000 ÷ 0.70 = 1,429 shares.

In my experience this is the most difficult step for most beginners to come to terms with. Once we internalise that the primary single objective in investing is the preservation of capital, we come to the realisation that taking a small loss like this, when an investment fails to work out as we expected, is a good thing.

Refining the Plan

The final element in creating an investment plan is to recognise that it is a work-in-progress and is never final. There are always small improvements that are possible as we assess our performance against our plan. The key here is to keep good records of our thinking when we made an investment, so that we can go back to evaluate how our plan worked out in practice. From this we can make small adjustments that refine our plan through continual feedback.

From here it is all up to us. We have the game plan. Now each of us must to decide how committed we are to creating a great investment plan. From there we have only ourselves to blame if it does not work out well. Developing an investment plan will be the most difficult task in investing. The rewards for effort and persistence are very considerable.

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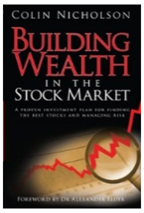

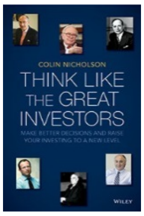

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