Part 1 of 10: An Epic, Final Post

Hello MFDI Friends,

I’m due to return to the US of A in a couple of days for my annual 2-month stay. I’m deliberately timing my stay so I can enjoy the Halloween and Thanksgiving festivities, as well as attending the AAII Investor Conference in Orlando. My subscription to DI is due to expire in a few days and I’ve decided not to renew for now. This will be my final, epic swan-song post.

Thank you to all who have followed by posts over the last 3 years. Your feedback and comments has been very useful, kind and much appreciated.

I’m going to finish with a helicopter summary on how I invest and structure a long-term investment portfolio. It’s the result of over 30 years of lessons as a long-term investor in the stock market (mostly NYSe and NASDAQ). It’s going to be a refresher for those who regularly read my posts.

Please note: the way I invest is a personal preference and may not suit everyone. I’ve always been upfront about my investment process in the sincere hope it may benefit others. Some may think “I like this style and I’ll adapt for my own purposes”. Others may think “I hate it, no no no, it won’t work for me”. Either way, my objective is achieved because I’ve provided value.

The Core-Satellite Portfolio

I find this paradigm to be the simplest and best construction methodology for a long-term stock portfolio. It’s based on the principle of simplicity and putting the probabilities firmly on your side. In the words of The Motley Fool on a Facebook post on 9 July 2019:

“*In investing, no points are awarded for difficulty or complexity. Simple strategies can lead to the most outstanding returns*”

The following long-term portfolio structure is essentially ALL that’s needed for an Australian investor:

The core portfolio is a low-fee, globally diversified portfolio , tilted to a home bias (60% allocation) to Australia. The home bias makes sense because most of us live here and will end up retiring in Australia. We can take advantage of the tax friendly dividend imputation scheme.

VGS provides global diversification. Investors must get some exposure and ownership to some of the largest, most successful companies on the planet.

This portfolio is a **hold-forever, never-sell** portfolio. Poorly performing companies will automatically drop off the fund, replaced by more successful growing companies. The individual investor only requires "sitting power" to stay the course and remain invested.

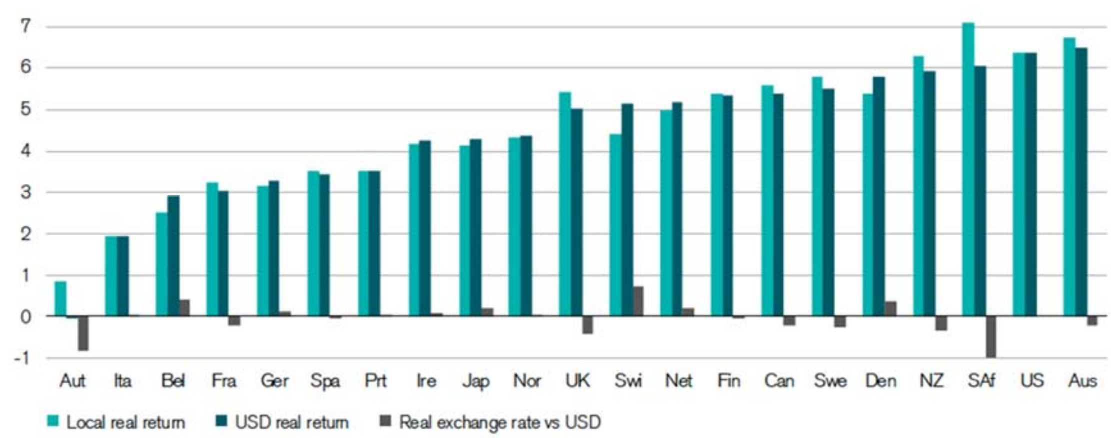
The Vanguard Australian Shares Index ETF (VAS) pays a dividend every quarter and that can provide a great source of passive income once the investment position grows significantly large. The yield on investment is currently around 4.2%.

The 60% VAS to 40% VGS allocation can be tailored to your own taste. Investors closer to retirement age should consider bumping up their allocation to VAS (maybe 80%) and take advantage of the tax-efficient income.

Part 2 of 10: Long-Term Returns of the Stock Market

We are lucky to live in Australia (or the US of A) because the stock market has historically performed extremely well compared to other stock markets around the globe. The following chart shows the real (after inflation) long-term total returns of the stock market (capital gain + reinvested dividends). Australia is top of the pops.

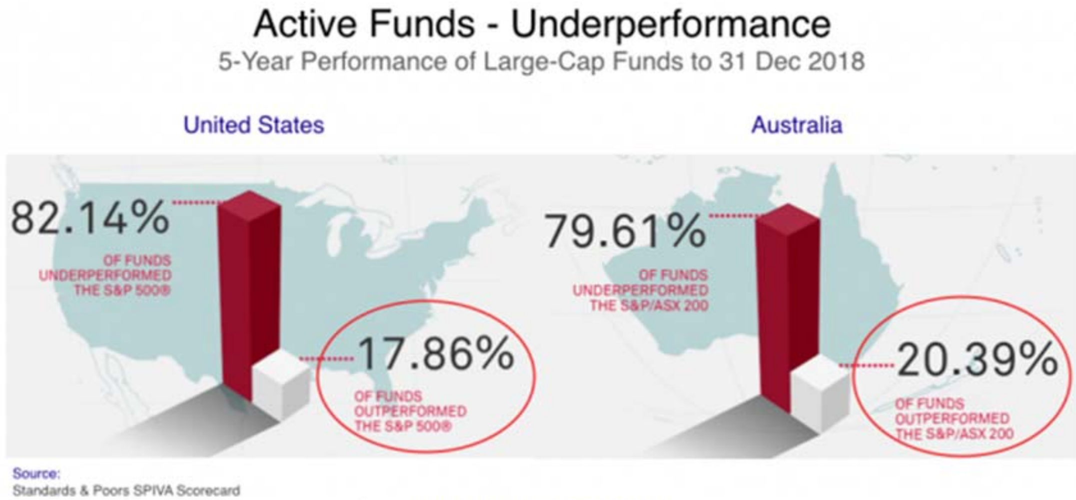
Figure 13: Real annualized equity returns (%) in local currency and US dollars, 1900–2018

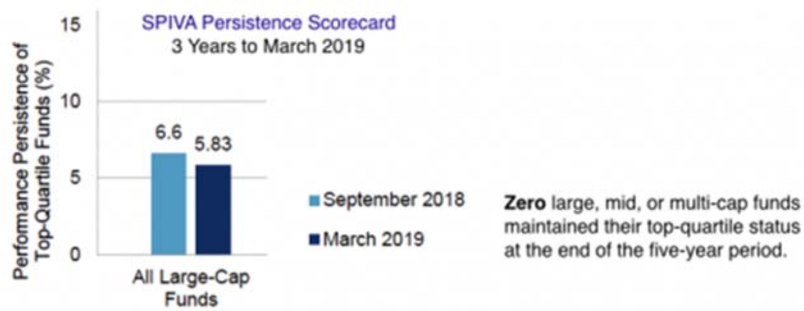


As long as Governments continue to pursue policies of economic growth and the population is given the freedom to provide innovative products and services in new and existing industries, there's no reason to doubt those past returns can't be repeated in the future (over the long-term).

Part 3 of 10: Why Invest in an Index Fund?

A common misconception about investing in an index fund is you are settling for average returns. This couldn't be further from the truth. In fact, an investment in an index fund will almost always land in the top 80th percentile of returns. The vast majority of professionally managed active funds underperform the market index over a 5 year period.





What about the active funds that beat the market index? The Standards and Poors Persistence Scorecard shows those funds fail to stay top performers in subsequent years as shown in the chart above. Only a small percentage of funds retain their top perfomance status, even across 2 quarters. Reversion to mean is real. In fact, there were no large, mid, or multi-cap active funds able to maintain their top-quartile status at the end of the five-year period.

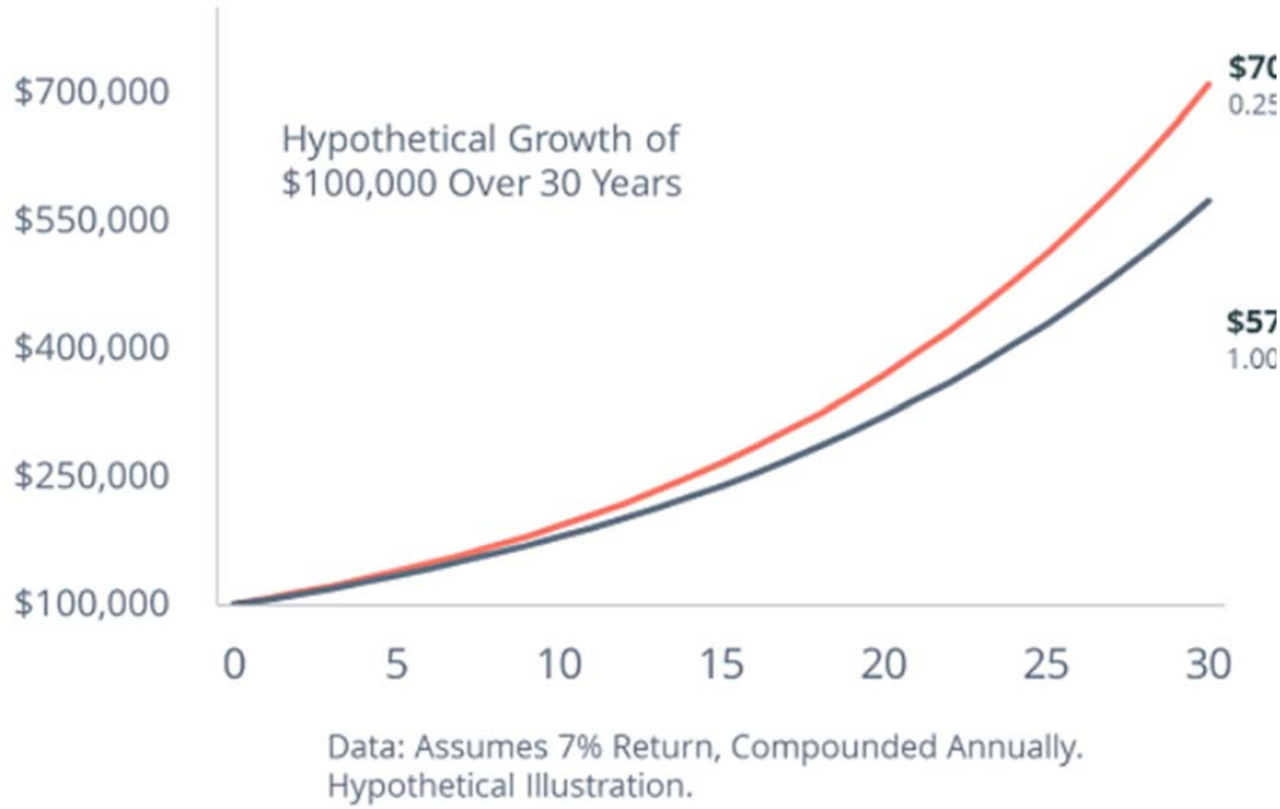
This means if you are able to choose an active fund that will outperform the market index over the upcoming year (31% chance), it's unlikely that the same fund will continue to outperform the index in future years. Fund performance is NOT persistent. Your chances of investing in an active managed fund that outperforms the market index year after year is extremely slim.

As master investors, we always want the known probabilities on our side. To take the lower probability bet would be non-optimal behaviour (I won't use the term irrational !).

Part 4 of 10: Why Do Professionally Managed Active Funds underperform?

Quite simply, professional fund managers are **unable to produce enough excess return to overcome their fee hurdle**. Index funds enjoy a low fee advantage. Fees matter.

The following graph illustrates the decaying effects of high fees over the long-term.



Here are the core investment principles for a successful stock portfolio:

- Invest for the long-term
- Keep fees low
- Diversify your stock portfolio, preferably using a low-fee index fund
- Invest regularly, regardless of what the market is doing (dollar-cost averaging)

This is the real secret to long-term investing. It's not possessing specialist knowledge that no one else knows or having an ability to predict the future. It's as simple as following a proven strategy consistently and unfailingly.

Simple works best, but don't take my word for it. Consider this statement from the foremost active investor in history:

"Over the years, I've often been asked for investment advice, and in the process of answering I've learned a good deal about human behaviour. My regular recommendation has been a low-cost S&P 500 index fund – Warren Buffett

And if the greatest investor of all time isn't enough to convince you about the wisdom of investing in an index fund, how about words form the infomercial king himself :

"When you own an index fund, you're also protected against all the downright dumb, mildly misguided or merely unlucky decisions that active fund managers are liable to make"

Tony Robbins

Sold ! Now where's my free set of steak knives??

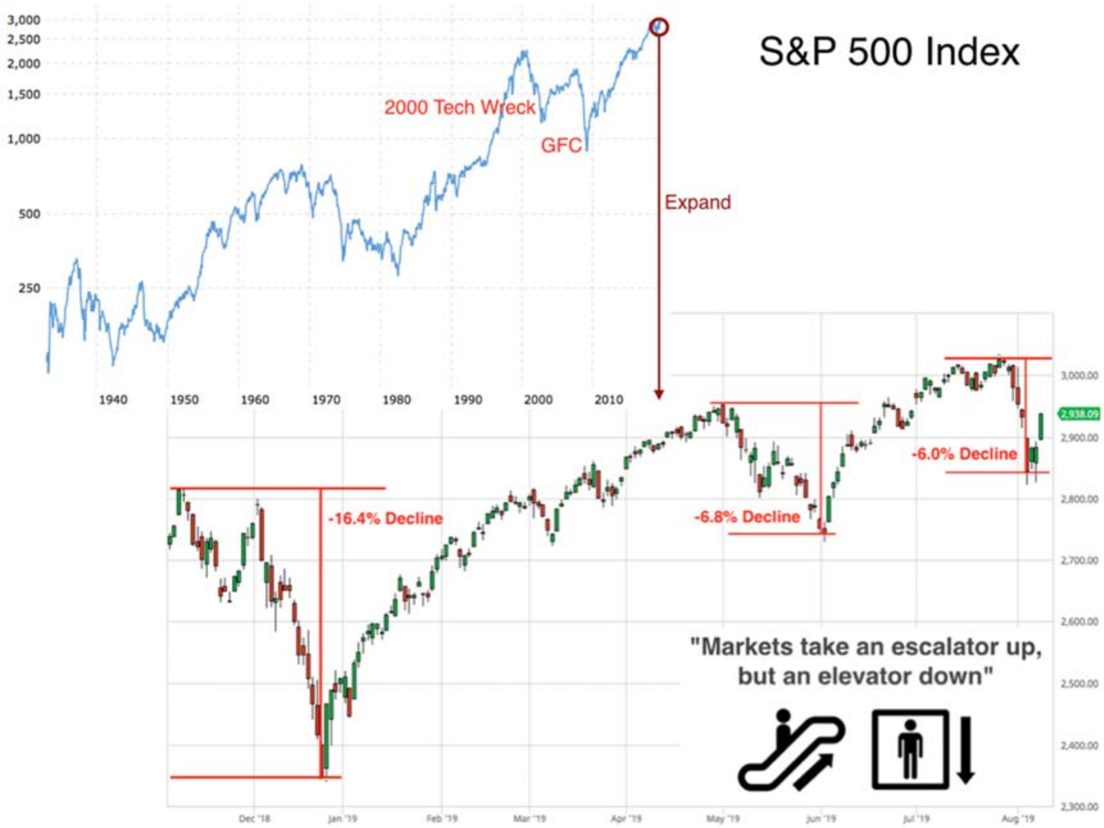
Part 5 of 10: Stock Market Investing is Simple, But Not Easy

The principles for a successful long-term stock portfolio are simple. But simple doesn't mean easy to do. Market volatility is the undoing of so many investors. The stock market doesn't rise in a straight line. We get "paid" to endure the price volatility (termed "equity premium") of our stocks and funds. Price discovery is instantaneous and we'll feel every single dip.

The emotional ride is the undoing of so many retail investors. Don't be one of them.

Part 6 of 10: How We Earn Our Reward

Over the long-term, the direction of the stock market is always up, but not without hiccup. When you look at a long-term multi-decade chart of a stock market index and drill in to one of the squiggles, you'll see violent swings on a monthly basis. The following shows the United States market over the last year. It's a tiny squiggle in the long-term chart, but wild swings on a day-to-day basis.



This is why stock market real returns have been higher than almost all other asset classes over the long-term. We need to be adequately compensated for the risk (as measured by price volatility) we take on board.

Part 7: of 10: What About Investing in Individual Stocks?

For the beginner investor, buying individual stocks is the riskiest way to invest in the stock market. Not only are you taking on board market risk, you also take on board a whole bunch of additional company specific risks.

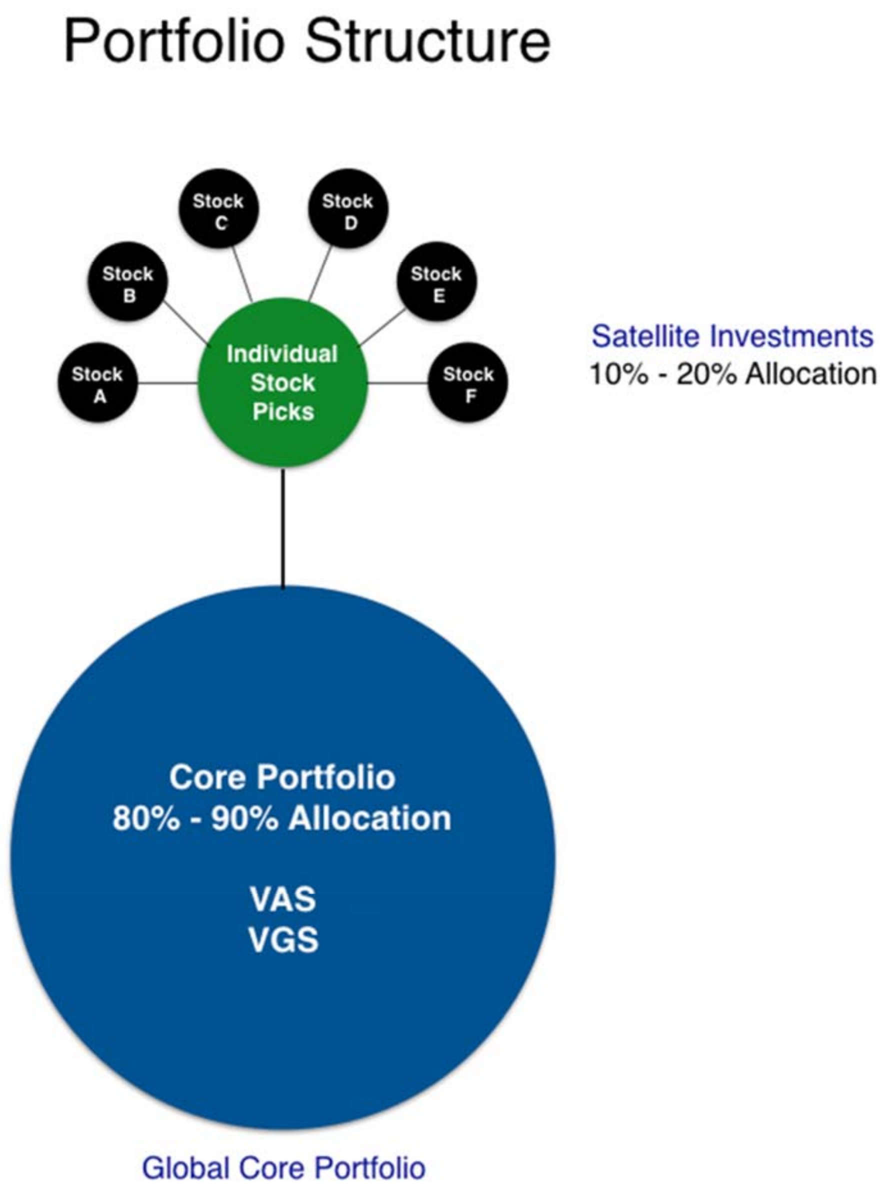
The temptation to invest in your favourite company is hard to resist. If you are successful in your chosen profession, it's easy to think that your competency is easily transferrable to stock picking. This is simply not true. Stock selection is a very difficult skill to learn and takes years to master. It's important not to confuse successful stock picking in a raging bull market with skill. As they say: only when the tide goes out do we find out who's swimming naked.

Professor Hendrik Bessembinder at Arizona State University performed a study of the returns of all stocks listed in the US stock exchange. Out of the 25,300 stocks listed in the Center for Research in Securities Prices (CRSP) database between 1926 to 2016, only slightly more than 4% (1092 top-performing stocks) account for all of the wealth creation. All the wealth generated by the stock market over a 90 year duration was created by a small 4% minority of stocks. Of course is this over the long, long term. But we have to acknowledge that empires rise and fall. You don't want to be holding when the secular decline of the business sets in.

An index fund ensures you at least have some exposure to these winners. If you only fill your portfolio with individual stocks, you can easily miss out on those long-term winners.

Part 8 of 10: Adding Individual Stocks in a Safe Way

If we want to invest in individual stocks, we must do it in a safe manner to account for the greater risks. We invest the bulk of our money (core portfolio) in index funds to ensure we at least capture market returns. We can allocate a smaller 10 – 15% of our total investment capital to individual stocks (tailor to preference). This is the basis of the core-satellite portfolio. The satellites can be individual stocks. This is a safe and judicious way of investing in individual stocks.



If you choose to buy an individual stock, you must know exactly what you are betting on. For example, if you are a dividend investor, you should look at any individusal stock purchase in relation to a no-effort investment in the Vanguard Australian Shares Index ETF (VAS). VAS currently yields around 4.2%. If you invest in an individual company stock yielding only 2%, that lower dividend return must be made up with a higher return somewhere else. Maybe you're betting the company stock will grow its earnings and dividends faster than the overall market. Maybe you believe the stock price will appreciate faster than the market index because it operates in a rapidly growing industry. Wither way, you must always think about your "total return" (price appreciation + dividend). What is the catalyst that will make the total return of this stock better than the overall marke

Master investors know exactly what they're betting on. They measure and monitor the progress of their bet so they know exactly when they're wrong and when to close the bet. It's OK to be wrong, it's not OK to continue on a wing and a prayer hoping things will magically come right. Take your lumps and move on.

Part 9 of 10: What About Trading Individual Stocks?

The short-term trading of individual stocks only compounds the difficulty of reaping a decent return out of the stock market. Studies show trader survival rates are extremely poor.

Trading individual stocks is a lower probability path to wealth generation and success. Master investors will always put the balance of probabilities on their side.

Choose to be patient and build up a core portfolio of one or more index funds. Stay invested for the long-term. If you are a beginner, resist the tempation to time the market and/or trade individual stocks. Your probability of a success is extremely low.

Short-term trading requires surgical precision and extreme discipline. It's not something that can be learned during a weekend seminar. Just like real-life hospital surgeons, it takes years of study, focus and experience. If you're interested in going down the trading pathway, make sure you remain humble and start small. Put 90 – 95% of your available capital into a low-fee index fund and commit the remaining 5 – 10% into your trading activity. This way, you won't go bust if it all goes right. Only ramp up your trading capital when you have a proven track record of success across all market conditions.

Part 10 of 10: Final Words

I sincerely wish every investor here all the very best for a successful investing journey.

If there's any takeaway from all my posts, it's recognising your greatest risk wil come your own behaviour. It's won't be due to poor timing and walking straight into a bear market. Bear markets always recover over time and rise to higher highs.

If you choose to be a long-term investor, make sure you stick to your guns and stay with the process. Suppress your natural action-bias and desire to control short-term outcomes. The stock market provides one of the highest returns across all asset classes because we are silly being paid to endure volatility and temporary paper losses. **There's no gain without suffering any pain. That is the immutable law of investing.**

I'll leave you with the wise words of Jim O'Shaughnessy, author of "What Works On Wall Street":

"*Presuming they're well diversified, the only point of failure that a passive investor faces is panicking near a market bottom and selling out of all of his or her index funds. That's really the only thing they have to worry about, because by definition they're getting the average return, they're getting low costs, they're getting a lot of really good things.* ***But, they do face that point of failure and sadly I have seen many, many people who swore that they would never ever to do such a thing, do exactly that***"

Godspeed everyone.