

Investment Perspectives for the 30s and 40s



Understand carefully what it means to be a Conservative or Aggressive Investor.

By Wilfred Ling

IN A RECENT survey by AIA and Singapore Press Holding, only 40 per cent of those surveyed say they are building a retirement fund of at least 10 times their annual income. I assumed that the remaining 60 per cent just leave their money in their saving or fixed deposit accounts.

Yet, when a person wants to build a reasonable retirement fund, many financial advisers advocate the use of various investment vehicles to obtain a higher return. However, this is easier said than done. Consider the following market news:

Market News Number 1:
New Century Financial Corp filed

for bankruptcy on April 2, 2007. Overwhelmed by rising borrowers' defaults, it became the largest sub-prime mortgage lender to fail. The housing problem of the US is old news but its problem appears in the media almost every other day.

Market News Number 2:

Back in February, China's stock plunged by 9 per cent due to rumors of Chinese government intervening to curb speculation. We then witnessed stock markets in United States, Paris, Frankfurt and Singapore plunging as well. Although China's "A" shares are not liquid to foreigners, why did the plunge of China's stock cause other

stock exchanges to react in similar fashion?

Market News Number 3:

On February 26, 2007, the former US Federal Reserve Chairman Alan Greenspan said that it was "possible" that the US economy would go into recession by the latter months of 2007. Strangely, he toned down his warning a few days later by saying such recession is not "probable." Why did Alan Greenspan change his tone?

Market News Number 4:

Computer glitches occurred at the New York Stock Exchange and Singapore Stock Exchange due to

overwhelming trading volume during the February correction.

Can everybody understand all the above market "news"? Everyday, the amount of news produced by the media is overwhelming. Trying to comprehend what each news means is difficult. Attempting to make an investment decision based on all these news is almost impossible. The question is — are these really news or noises? How is anyone to start a retirement fund with these market noises?

I like to demonstrate two simple ways of putting your money to work. None of them requires the understanding of market noises. One is for a conservative investor and another for the aggressive investor.

The Conservative Investment

The conservative investor is one who cannot afford to make a loss. His capital must be preserved. Returns on the investment must have a guaranteed amount. Anything extra is considered a bonus. Traditional asset classes such as bonds and equities cannot provide such guarantee. Equities are always subjected to market risk while bonds are subjected to reinvestment risk of its coupons. To illustrate that even bonds are unable to guarantee a return, let us consider the Singapore Government Securities (SGS). The SGS is the safest bond because the probability of default is almost nil. Currently the yield to maturity for a 20-year SGS bond is 3.29 per cent per annum. However, this rate of return is only true provided regular coupons payout by the bond is reinvested at the same rate as the yield to maturity. Since the interest rate at the point of reinvestment is not known in advance, the return for investing in SGS bond is also not known in advance.

Endowment Plan for Education Savings

Child: Son next age 1
Payer: Father, next age 30
* Annual premium \$29,289.60 for just 5 years

Payout at the end of age 20 years old	\$120,000 (guaranteed)
Payout at the end of age 21 years old	\$60,000 (guaranteed)
Payout at the end of age 22 years old	\$60,000 (guaranteed)
Payout at the end of age 23 years old	\$60,000 (guaranteed)
Payout at the end of age 24 years old	\$80,920 (non-guaranteed)
Total payout at maturity (guaranteed)	= \$300,000
Total premium paid (\$29,289.60 x 5)	= \$146,448
Guaranteed profit (\$300,000 - \$146,448)	= \$153,552

* Included is an enhanced payer benefit rider that waives all future premium on death, total and permanent disability or critical illness of the payer.

Non-Juvenile Endowment

Payer: Payer, non-smoker, next age 30
Annual premium \$8,768.40 for 20 years

Lump sum guaranteed payout at end of age 60	= \$390,000
Lump sum non-guaranteed payout at end of age 60	= \$104,354
Total premium paid (\$8,768.40 x 20)	= \$175,368
Guaranteed profit (\$390,000 - \$175,368)	= \$214,632

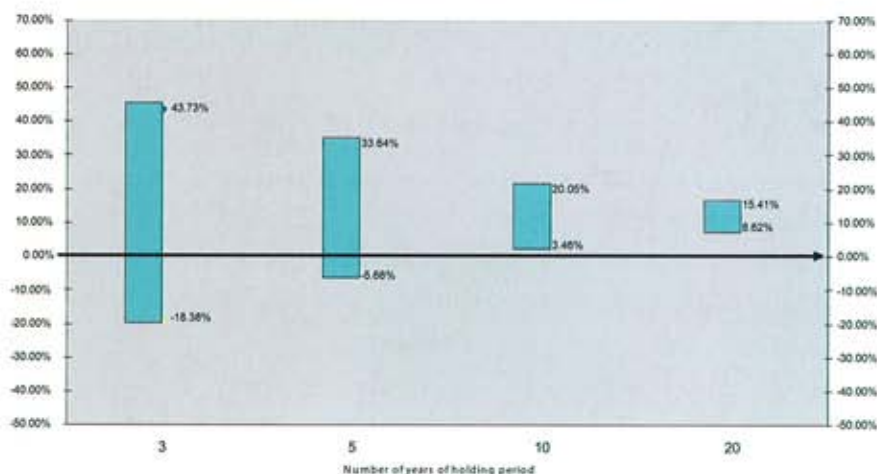
However, a carefully chosen endowment can provide such guarantee. When looking at endowment, it is of utmost importance to look at the guaranteed cash values at the end of maturity rather than the non-guaranteed cash values. Historically all insurers except one have cut bonuses. To avoid disappointment, it is best to plan based on the guaranteed payout. The guaranteed cash value must be much more than the accumulated premium paid for the policy. Here is an example of the best endowment in the industry

that can be used to help make your money work harder. In this example, it is an education endowment (refer to graph for Endowment Plan for Education Savings).

Note that premium is only to be paid for 5 years with the remaining 15 years to be premium free. The absolute return based on guaranteed payout is a whopping 105 per cent! In terms of annualized return this is 3.80 per cent per annum guaranteed.

It is possible to stretch the premium paying period exceeding 5 years at the

Annualized return of buy and hold strategy over different holding period
(based on MSCI World Net US\$ from Dec 1969 to September 2006)



expense of lower return but this is in exchange for a more affordable annual premium. Although this endowment is marketed to fund the child's tertiary education, the manner which the maturity benefit is to be spent is entirely up to the parent.

For those who dislike paying annual premium, it is possible to pay premium in one lump sum by obtaining a special quotation. In the above example, the discounted single premium is \$141,616.

However, not everyone has a child. Not to worry, the same product manufacturer offers an equivalent endowment for non-juvenile. Here is an example of an endowment for an adult (refer to graph for Non-Juvenile Endowment).

In the above non-juvenile endowment product, the payer gets his lump sum when he retires at the end of age 60. He only pays for 20 years with the remaining 10 years premium free. The absolute return based on guaranteed payout only is a whopping 122 per cent! In terms of annualized return, this is 3.86 per cent

per annum guaranteed.

The usage of endowment is suitable for the conservative investor. The return is known from the onset and there is no risk of capital lost provided the policy is held to maturity. There is only upside, no downside.

What then is the fine print? The fine print is that it is possible to have a much higher return for the aggressive investor. Having an absolute profit of 105 per cent or 122 per cent is considered low for the aggressive investor.

The Aggressive Investment

The aggressive investor is willing to accept the possibility of capital loss in exchange for the possibility of a much higher return. Should there be losses, the aggressive investor does not complain. Therefore, not everyone can consider themselves as aggressive investors.

The traditional asset that is most commonly used which offers the highest form of risk but in return for the highest potential return is the equity asset class. Two commonly used

techniques in equity investment are fundamental analysis and technical analysis. Fundamental analysis is concerned with valuations like price-earning (PE) ratios, price-book ratios and earnings growth. Technical analysis looks at the charts and interprets trends and indicators to predict future behavior of the security concerned. Both schools of thoughts have one thing in common — that history repeats itself. A market is considered "cheap" relative to history and history has demonstrated that investing in "cheap" market tends to reward the investor. Similarly, a technician interprets the chart as bullish due to certain formation because such formation has demonstrated to indicate a bullish outlook in most cases. However, fundamental analysis and technical analysis tend to be driven by market "noises". For example, in fundamental analysis, it is common to consider the estimated PE ratios of the future based on estimated earnings. The problem is who are the ones who provide these estimated earnings? Estimated earnings are not guaranteed and are often subjected to revisions whenever new market "noise" appears.

I like to propose equity investment from a more simplistic view. First, invest in the market rather than individual companies. In this way, there is no worrying about selecting the "wrong" company. Second, if you believe that the world economy is progressing, investing in the world market should yield positive return.

Is it a good assumption that the world economy should be an uptrend? Consider the case in which this is untrue. If the world economy is on a

perpetual downtrend, it implies that the world economy will eventually revert back to the stone-age era. The chances of this happening are slim because humans are known to seek improvements.

Now let's look at some hard data (refer to chart for Annualized Return of Buy and Hold Strategy Over Different Holding Period).

Based on MSCI World Net US\$ (an equity index proxy for the world's developed countries), a lump sum investment return ranges from -18.38 per cent per annum to 43.73 per cent per annum if the holding period was merely three years. However, if the investment was held for 20 years, the return ranges from 8.62 per cent per annum to 15.41 per cent per annum. Not forgetting that during the period under consideration was: 1973 first oil shock, 1980 second oil shock, 1987 Black Monday, 1990 Gulf War, 1998 Asian Financial Crisis, 2000 Technology bubble, 2001 "911" Twin Tower attack, SAR virus outbreak and

so on and so forth. Despite these events, the worst return was rather reasonable. In fact for 8 per cent per annum return over 20 years, the lump sum absolute return is 366 per cent!

Many people employ a regular saving plan (RSP) or dollar cost averaging

look like historically? (refer to chart for Monthly DCA Annualize Return). The chart looks similar to a lump sum investment. For a 20-year period, the annualized return for monthly RSP ranges from 6.15 per cent per annum to 14.25 per cent per annum.

"INVESTORS who use fundamental analysis and technical analysis intensely also have the belief that HISTORY REPEATS ITSELF but they are subjected to day-to-day noises and distractions which isn't very good for one's health."

(DCA) by investing a fixed sum of money every month. How does RSP

For the aggressive investor, making an investment decision can be quite easy. Just invest in a diversified portfolio and just wait. If you believe that history repeats itself, the returns will be good. Investors who use fundamental analysis and technical analysis intensely also have the belief that history repeats itself but they are subjected to day-to-day noises and distractions which isn't very good for one's health.

The only issue is how to construct a reasonably diversified portfolio. This is where the investment adviser comes in — but make sure you call one who knows more than you.

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Monthly DCA Annualized Return
(based on MSCI World Net US\$ from 1969 to 2006)

