Investment Philosophy

Why you should consider investing – Comet Wealth's Investment Planning Process and Philosophy

2) How to invest sensibly

Contents

1. Investing challenges and choices 2
2. Start by building your investment compass 3
3. Five lifelong principles 4
4. Five effective investment practices 14
5. In conclusion 21

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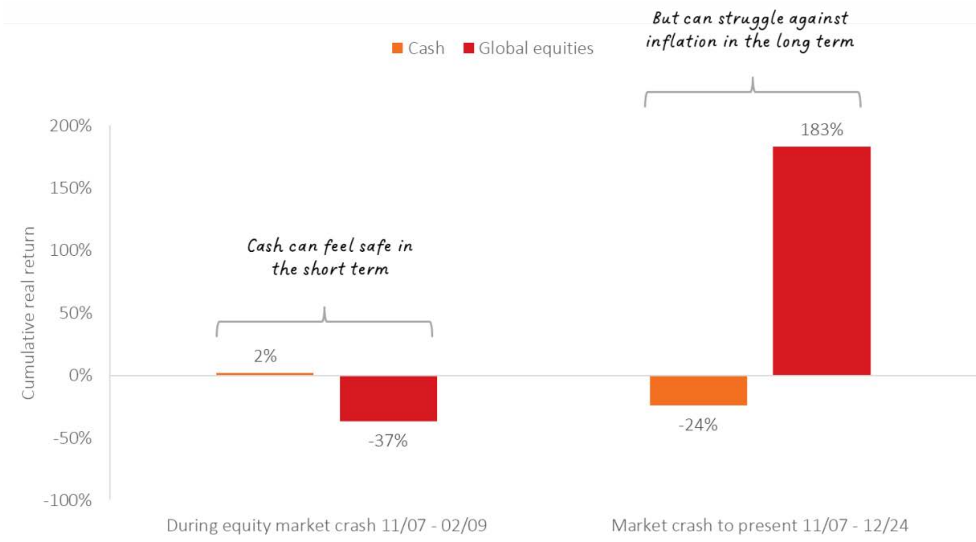
1. Investing challenges and choices

As the old saying goes, investing is simple but not easy. We would agree.

The first hurdle that people face is whether to invest at all. For those who are inexperienced investors, or who have suffered a bad initial foray into markets, it can be hard to step away from the sense of safety that a bank deposit provides. In the short term, cash can feel comfortable, but it has a terrible track record of maintaining or growing purchasing power – i.e. the amount of goods or services your money can buy – over time for investors. For us, that makes it a risky strategy. The chart below demonstrates how cash performed during the Global Financial Crisis (2007-2009) and how it has performed since then, compared to world equities (developed and emerging). Over the whole period, 24% of cash's purchasing power has been eroded, whilst the purchasing power of 'higher' risk equities more than doubled, even when measured from the height of the market before the fall.

Figure 1: Why we need to invest – Playing it 'safe' is not going to get you there



Source: Morningstar Direct © All rights reserved (see endnote). Indices: DB SONIA, MSCI ACWI. Adjusted by: UK CPI.

So, invest you must if you have long-term financial goals, as cash is not the answer.

It is simple enough to pick a few shares of well-known global companies to hold in an online brokerage account. It is also simple to avoid this task by engaging a professional investor – such as a stockbroker or fund manager – to manage your money for you. Yet it is not easy to know whether the portfolio you or they build is sensible, the manager you have chosen is worth his or her salt, or that your pool of investments will be able to meet the goals that you are aiming to achieve. It is certainly not easy to stay calm and rational when markets are soaring or in free-fall, as they inevitably will be from time to time.

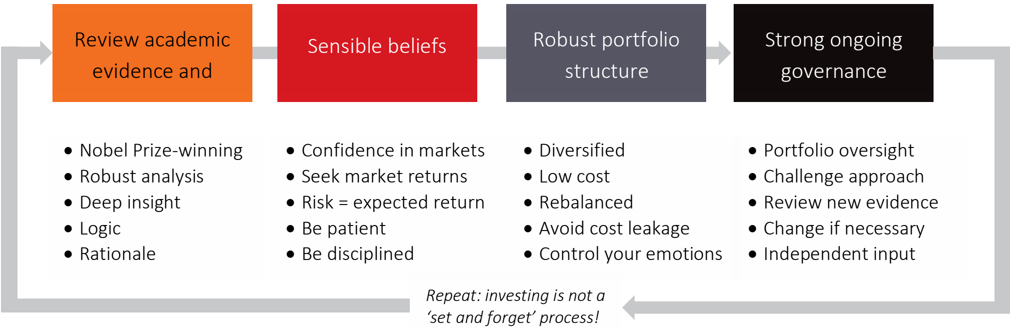
It is not surprising that many of the new clients who come to us do so with a great sense of unease about their existing investments. This may be due to a bad experience or poor advice in the past, a sense of fear of what might happen in the markets to their hard-earned money, or simply a lingering doubt that how they are invested currently may be less than optimal. In some ways they are the lucky ones, as they have realised that their investment strategy needs fixing, and we can help. Many others are not so fortunate, holding too much cash or taking risks they do not understand in their portfolios, suffering high costs on the investments they own, or chasing last year's best performing markets and funds, all of which is likely to be detrimental to their wealth. They are also likely to be disappointed by their investment experience, which is more than just a shame. It is unnecessary.

This detailed document seeks to provide you with a sense of what we believe to be a sensible and highly effective way to invest your money, helping you to build confidence in our approach. Investing may never be easy, but it can be far easier.

2. Start by building your investment compass

Investing money well requires a logical and robust framework on which to build a lifelong investment programme. It needs to be grounded in investment theory, supported by empirical evidence, and enhanced with an insight into the behavioural traps and pitfalls that all investors face, that can and do cost them dear. We have spent considerable time researching the theory and the evidence to come up with an investment programme that we, and you, can fully believe in.

Figure 2: Building a sensible way to invest



Source: Albion Strategic Consulting

While many investors tend to start the process by thinking about **what** they should invest in, the true starting point should be to focus on **how** to invest. To do that we need to spend some time establishing the guiding principles and good investment practices that will underpin all the investment decisions that we will make together, now and in the future. Investing is a journey, and these principles and practices act as a compass to steer us through the maze of choices, emotions, and challenges that investors will undoubtedly face in the coming years. We call this our investment philosophy.

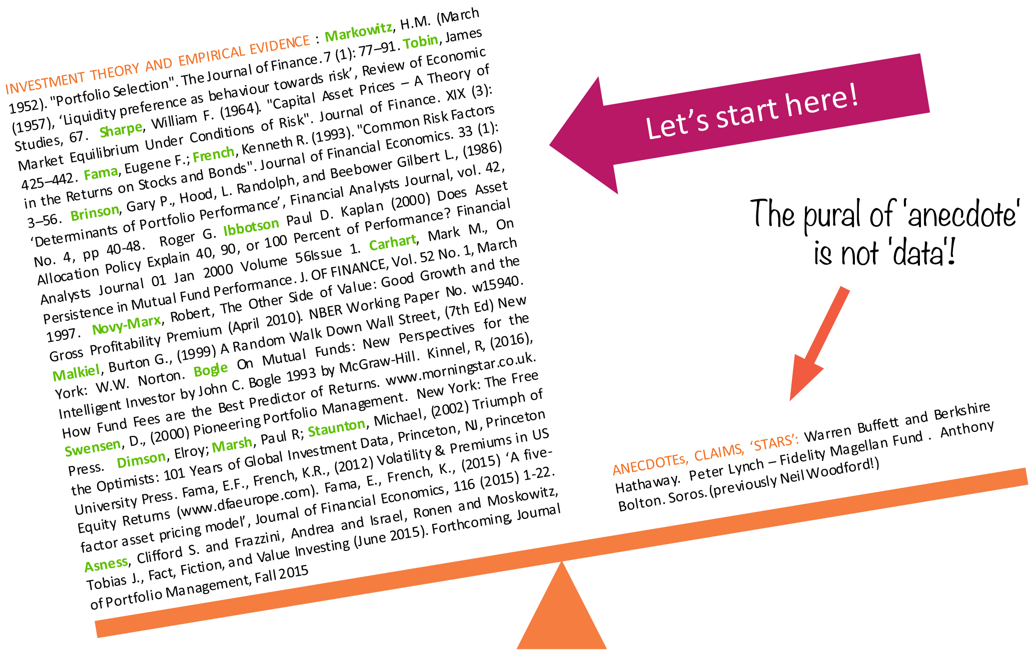
> ***Successful investors operate with a coherent investment philosophy that they apply consistently to all aspects of the portfolio management process. Philosophical principles represent time-tested insights into investment matters that rise to a level of enduring professional convictions.'***
>
> *David Swenson, former CIO, Yale University Endowment*

We explore our own investment philosophy below, which is supported by many eminent players in the investment arena, including Nobel Prize-winning academics, leading investment practitioners and members of the business community.

3. Five lifelong principles

We start by looking at five guiding principles that provide the backbone for **how** we should think about investing, rather than **what** we should invest in. They are principles that all investors would do well to adopt. It is also of immense value to remind oneself of them, from time to time, as they help to provide the confidence and calmness that is necessary to navigate your investment journey. This journey should be guided by the academic evidence and sound investment theory available to us.

Figure 3: Be guided by the evidence.



Source: Albion Strategic Consulting

Investment principle 1: Have faith in capitalism

It seems hard to remember the last time we had a roaring economy like we did in the early 2000s. The Global Financial Crisis (2008-9) and the ensuing turmoil in the markets, followed by economic recession, ballooning government deficits and austerity, Greece and the Euro crisis, Brexit and the COVID-19 pandemic are perhaps far fresher in most people's minds. It can sometimes feel that capitalism is struggling as a credible economic model. Yet it is an adaptive, robust economic system that has delivered incredible developments to the benefit of mankind.

There is much talk of the gap between rich and poor, evidenced by the fact that the richest 1% own almost half of the world's wealth, while the poorest half of the world own just 0.75%[1], but that to some extent misses an important point. Even in its inequitable raw form it has had an overwhelmingly positive impact on global humanity. The world we live in is better in many respects than ever before. Whilst unfortunately 659 million of the world's population live in poverty, this is down from 1.9 billion in 1990[2]. Global under-five mortality has dropped by 60%, and 2.1 billion people have gained access to safe drinking water since 2000[3]. These are remarkable numbers in a world of over eight billion people. Capitalism also drives incredible innovation, availability, and service. Examples include electric vehicles, cheap and fresh food in our supermarkets, and John Lewis' customer service. They are all a result of the ultimate desire to create wealth.

> ***It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest.***
>
> *Adam Smith – The Wealth of Nations (1776).*

Harnessing the power of capitalism as an investor

From an investment perspective, despite multiple significant world events, the global stock (or 'equity') markets have delivered strong returns for those who have participated in them.

As providers of capital, we can access the rewards of capitalism by becoming part-owners of companies (by owning shares), gaining the right to receive dividend payments and, hopefully, rises in the price of the shares we own. Alternatively we can lend capital to governments and companies (by owning bonds) in return for receiving interest on the money borrowed from us, with principal (the borrowed amount) returned at a maturity date in the future.

The rewards of equities are more uncertain than bonds, particularly in the shorter term, and equity owners rank below bond owners in any bankruptcy situation. As a result, equity investors should expect to receive a higher reward for taking on this uncertainty, otherwise they would simply invest in something less risky for the same return. On average, since 1926 US equities have delivered returns of around 7.5% above inflation per year, whereas government bonds and cash have delivered returns substantially below this at around 1.9% and 0.3% above inflation respectively to year end 2024[4]. To some, this may not sound substantial, but US$1 invested in each would now be worth around US$1,260, US$6.60, and US$1.40, respectively. That is the power of compounding market returns.

Figure 4: Global markets have delivered strong returns, despite world events

Source: Albion Strategic Consulting. Data: 60% Albion World Stock Market Index, 40% Albion Short Term Bond Index, 1928 to 2024. Annual rebalancing, in USD, adjusted for US CPI. See smartersuccess.net/indices for more information.

As investors, we need to keep faith in capitalism as a robust and resilient economic system that creates wealth and does good, sometimes in spite of itself. We also need to recognise and accept that the markets are a powerful mechanism for rewarding those who provide capital to those engaged in the pursuit of wealth creation.

Investment principle 2: Accept that risk and expected return go hand in hand

One of the inescapable truths of investing is that to achieve higher returns, you have to take on more risk[5]. That seems logical enough, but you would be surprised just how many investors seem to think that it is possible to get high returns with low risk. If you think about it, if this were possible, all investors would seek to own this investment driving prices up and expected returns down, eliminating the opportunity.

> ***If you want to earn high returns, be prepared to suffer grievous losses from time to time. And if you want perfect safety, resign yourself to low returns.***
>
> *William Bernstein, author of 'The Intelligent Asset Allocator'.*

Figure 5: Global bond and global stock portfolio mix characteristics, after inflation (01/72 - 12/24)

Portfolio mix	100% bonds 0% stocks	80% bonds 20% stocks	60% bonds 40% stocks	40% bonds 60% stocks	20% bonds 80% stocks	0% bonds 100% stocks
Annualised return	2.1%	3.0%	3.7%	4.4%	4.9%	5.2%
Annualised volatility	4%	4%	6%	9%	12%	15%
Growth of £1	£2.99	£4.73	£6.98	£9.62	£12.32	£14.60
Worst 1-year (p.a.)	-15%	-15%	-22%	-30%	-38%	-46%
Worst 5-year (p.a.)	-7%	-5%	-6%	-8%	-9%	-12%
Worst 10-year (p.a.)	-4%	-3%	-3%	-4%	-5%	-6%
Worst 20-year (p.a.)	-1%	1%	2%	3%	2%	2%

Source: Morningstar Direct © Inflation: UK RPI (31/01/88), UK CPI (thereafter). Equities: MSCI World (31/12/00), MSCI ACWI (thereafter). Bonds: UK 1M T Bills (31/12/75), FTSE UK <5Y Gilts (31/12/84), FTSE WGBI 1-5 GBP (thereafter). Returns in GBP.

A widely used measure of risk is the volatility of returns, yet this is a rather one-dimensional perspective. Risk is multi-faceted. Many other risks exist that need to be identified and managed appropriately, from the risk of not achieving your long-term financial goal to the risk of default on bonds, currency exchange risk, changes in interest rates or the risk of a company that you own shares in going bust. Yet risk should not be feared, because when sensible, well-understood and well-diversified risks are taken, they are the source of returns that investors seek to achieve their financial goals.

> ***Risk surrounds us and envelops us. Without understanding it, we risk everything and without capitalising on it, we gain nothing.***

Breakwell and Barnett[6].

The one thing we know for sure about risk is that if an investment looks too good to be true, it probably is. If you ever see such an opportunity, you need to establish what the hidden risk is as you have not yet spotted it! Risk and expected reward are always related.

▶ *Investment principle 3: Let the markets do the work*

When investing, there are two main sources of potential returns. The first is the return that comes from the markets and the second is the potential excess return – above the market return – generated through an investor's skill. Those less familiar with investing are prone to make a few understandable assumptions that simplify the choices and challenges that they face. Perhaps the least valid assumption often made is that it is easy for an investment professional to use their skill to predict what is going to happen in the markets and position a portfolio appropriately.

For example, it seems intuitively reasonable that a professional fund manager should be able to decide when to scale back equity exposure or which company shares to pick. Unfortunately, this is simply not the case. The broad and compelling empirical evidence highlighting the poor performance of the majority of professional fund managers tells us so, which we explore below.

> ***The idea that a bell rings to signal when investors should get into or out of the stock market is simply not credible. After nearly fifty years in this business, I do not know of anybody who has done it successfully and consistently. I don't even know anybody who knows anybody who has done it successfully and consistently. Yet market timing appears to be increasingly embraced by mutual fund investors and the professional managers of fund portfolios alike.***
>
> *John Bogle, Founder, Vanguard Group and the grandfather of index investing.*

› Accept that markets work well enough – 'its all in the price'

Many investors also make the mistake of confusing a great company with a good investment opportunity. The problem is that they are not the first person to recognise the great company. The market is full of very bright, diligent, experienced, hardworking participants that includes: individual investors, stockbrokers, professional fund managers, sovereign wealth funds, endowments, and other institutional investors.

Each investor forms their own view on the future prospects for a specific security, such as the price of Tesla or Apple shares. Some will like a company and others not. They cannot both be right. The market incorporates all these views into market prices via the trades that are made, settling on an equilibrium price for every security. In order for an investor to benefit from buying the great company's shares, it will therefore have to perform better than the market's current expectations of that 'greatness'. It may or may not. Prices will only move on the release of new information affecting these expectations which is, by definition, a random event. Second guessing randomness is a fool's errand. The same applies at the market level.

In investment parlance, accepting this premise is to consider the markets to be 'efficient' – a theory accredited to Nobel Prize in Economic Sciences winner, Professor Eugene Fama. He sums up the implications of his Efficient Market Hypothesis nicely:

> ***It's a model, so it's not completely true. No models are completely true. They are approximations to the world. The question is: "For what purposes are they good approximations?" As far as I'm concerned, they're good approximations for almost every purpose. I don't know any investors who shouldn't act as if markets are efficient.***
>
> *Professor Eugene Fama, Chicago Booth Review.*

We agree. For our purposes and those of nearly all investors accepting the premise that ***'it's all in the price'*** is a profoundly solid and useful starting point.

Given that markets work pretty well at incorporating information into prices, trying to beat the market – through either market timing or stock picking - is a tough game, with very few winners and, in our view, is not a game worth playing. We avoid trying to time markets (e.g. jumping in and out of equities) or picking individual stocks. We just let the markets do their work.

Figure 6 shows how few active professional managers actually manage to deliver on their promises to beat the market. The data are for the 20-year period to the end of 2024 for all US equity funds managed in the US, on a risk-adjusted basis.

Figure 6: Fund managers are poor at keeping their promises to beat the market

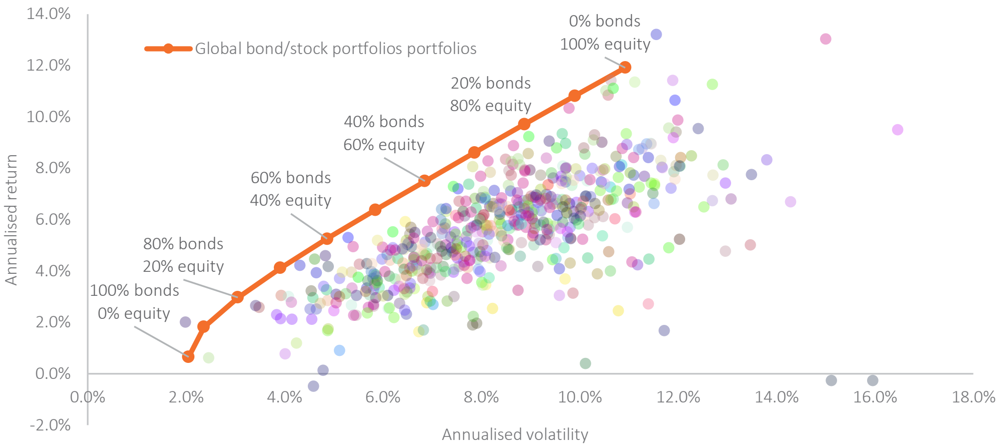
Source: SPIVA ® US year end 2024. Graphic: Albion Strategic Consulting

When you understand and accept that returns come from the markets, and rarely from human skill – which is extremely hard to identify without the benefit of hindsight – it is a big leap forward and materially changes the focus on **how** you should invest. In short, investors should identify market risks that are likely to deliver adequately compensated returns; combine them together sensibly in a portfolio to build a portfolio for all investment seasons; invest via low cost, highly diversified funds that capture market rewards in an effective manner; and make sure that the portfolio retains its structure over time, by periodically rebalancing it back to the original strategy. We call this a **systematic investment approach**.

Figure 7 illustrates the volatility and return of two market index funds combined – one bond and one equity – together in a portfolio against the surviving cohort of professionally managed multi-asset funds available for sale in the UK between 11/2011 and 12/2024. **About as many funds (579) failed to make it through as survived (539) the period.** It is evident that the professional fund managers have delivered underwhelming outcomes, relative to simple market investments.

Letting the markets do the heavy lifting on returns will take a great weight off your shoulders. You no longer need to worry about picking the right companies, the right manager, the right fund or deciding if you should be in or out of the markets.

Figure 7: Simple market combinations have beaten most UK managers



Source: Morningstar Direct © (see endnote). Albion © Multi-manager Comparison Tool (MMCT). Index funds: iShares MSCI ACWI, iShares UK Gilts 0-5yr. Period: 11/11 – 12/24. Single dots represent professionally managed funds. All funds are net of fund ongoing charges figure (OCF), but no other costs. Returns in GBP

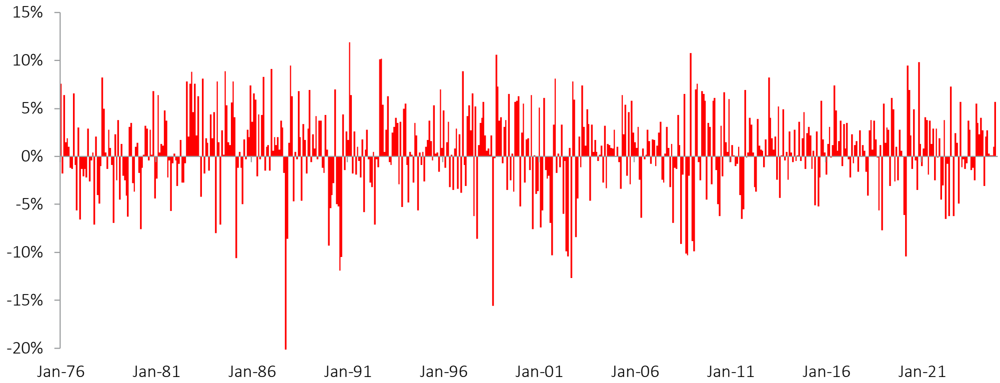
Investment principle 4: Be patient and think long-term

One of the great challenges that all investors face is that there is no easy or quick way to investment success. Aesop's fable of the tortoise and the hare is a useful metaphor. You have to use the time on your side – which could be over multiple decades – to capture the returns of the markets effectively, but slowly. In the short-term, market returns can be disappointing, and at times distressingly so – and on occasion exceptionally exciting – but always remember that you are playing a long-term game. It is time that allows the attributes that you seek to come to the fore. The longer you can hold for, the more likely the returns you will receive will be at worst survivable, and hopefully far more palatable. It is time that allows small percentage returns to compound into large financial differences for the patient investor.

Unfortunately, as investors, in this new digital age, we have immediate access to market commentary that focuses on short-term noise. We are bombarded with investment noise, such as *'£5 billion was wiped off the value of the FTSE 100 leading shares today'* which is a meaningless fact for a long-term investor. It is easy to become unnerved about having money invested in the markets. That creates stress and can lead to poor and unnecessary, emotionally driven decisions. The reality is that markets – in particular stock markets – go up and down with regular monotony, yet listening to the news, one might think that any recent market gyrations are something new. They are not. They are part and parcel of investing, as figure 8 clearly demonstrates.

*For further information or help please contact one of our advisers on **01252 626200**, email Office@CometWealth.co.uk or visit CometWealth.co.uk*

Figure 8: Markets go up and down – that is what they do. (Monthly after-inflation returns 1/1976 to 12/2024)



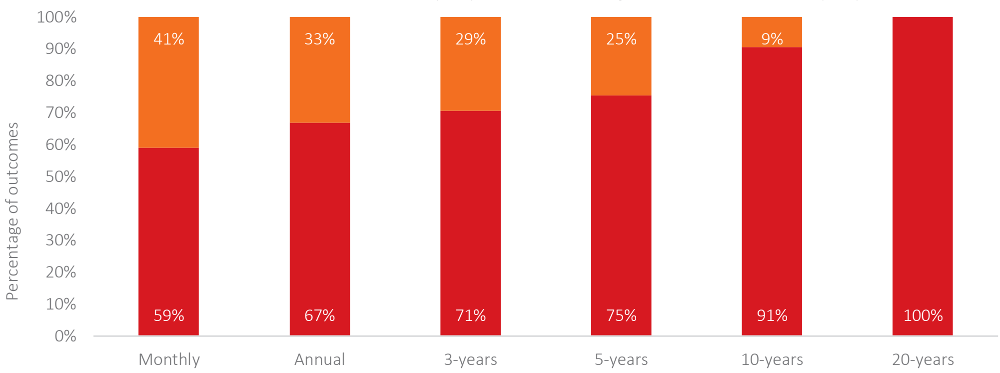
Cumulative returns after inflation – 1/1976 to 12/2024. Global equities from Hale, T. (2023) 'Smarter Investing'

Impatient investors (the hares) tend to lose faith in their investments too quickly. They try to speed up the game of investing but end up forgoing long-term, systematically-collected returns offered to the patient investor. The wise words of Warren Buffett – one of the world's best-known investors – are worth recalling.

> ***The stock market is a device for transferring money from the impatient to the patient.***
>
> *Warren Buffett, CEO of Berkshire Hathaway*

If you want to be a good investor, you have to be patient. On your investing journey, you will spend a lot of time going backwards, recovering from the set back and then surging forward, often in short, sharp bursts of upward market movement. You just have to stick with it. Remember that you have to be in the markets to capture their returns. In any one year, history suggests you have a one-in-three chance of seeing a negative return in the equity part of your portfolio. Be prepared.

Figure 9: The tortoise beats the hare – outcomes become more favourable over time



Source: Morningstar Direct © Period: 01/72 - 12/24. Inflation: UK RPI (31/01/88), UK CPI (thereafter). Equities: MSCI World (31/12/00), MSCI ACWI (thereafter). Returns in GBP. Figures based on rolling monthly returns.

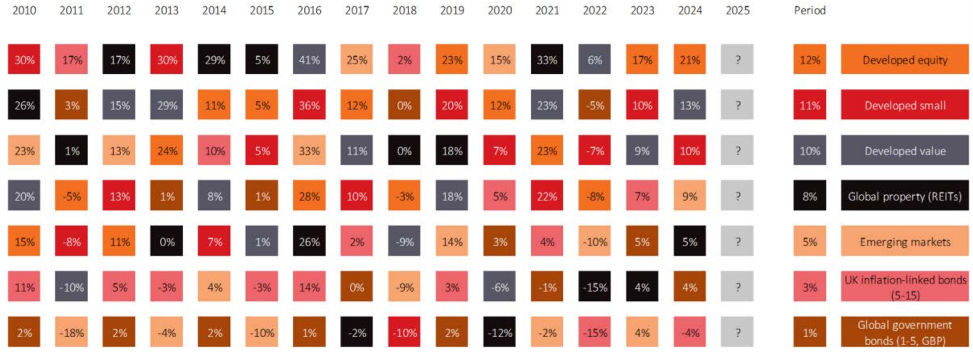
Investment principle 5: Be disciplined

Patience and discipline are close bed fellows. Once you realise that to generate good long-term returns takes time, patience, and belief in the markets, it is essential to put in place the discipline to stop yourself succumbing to impatience and ill-discipline. Discipline comes in many forms: sticking to the principles above; constructing well-researched and tested portfolios that should weather all investment seasons relatively well; and not chasing investments that have gone up dramatically but sticking with the logical reasons for not owning them in the first place.

Figure 10 demonstrates that asset class returns do not follow a predictable pattern in the shorter term. Trying to guess next year's winners and losers is impossible and anyone who says they can probably has a motive for pretending! Being influenced by recent returns, or seeing patterns in the data, are commonly identified biases that we hold. **Hold fast!**

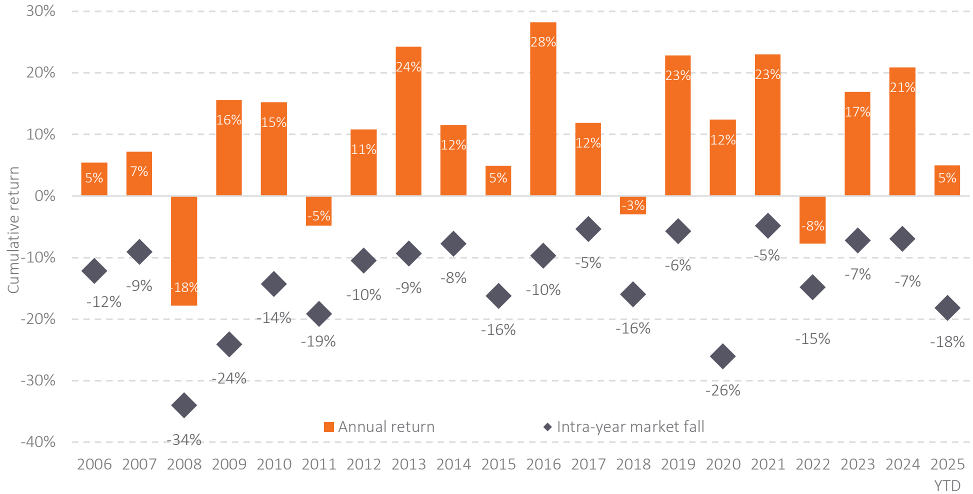
The discipline to not become despondent about short-term, unimportant market noise, and abandoning – or at least being tempted to abandon – your long-term strategy is critical. It is worth taking a closer look at this. Investors intuitively know that markets go up and down, yet many still worry about a sideways or downward movement in the value of their portfolio between one meeting with their adviser and the next. It is worth noting that every year markets fall from their intra-year highs. Yet, to respond to these falls is likely to be costly, as figure 10 illustrates. For example, in 2016 the market fell -10% during the year but ended up 28%. Getting out of the market – fully or partially – would have been a very costly strategy. **Remember that you need to be able to pick when to get out AND when to get back in again**. Market timing is an extremely difficult game to win at.

Figure 10: Do not get tempted by what has just done well (markets or managers)



Source: Morningstar Direct © Indices: MSCI World, Dimensional Global Value (adjusted), Dimensional Global Small (adjusted), MSCI EM, S&P Global REIT, FTSE WGBI 1-5 Yr Hdg GBP, Bloomberg UK Gov Inf Link 5-15Y. Returns in GBP.

Figure 11: In every year markets fall below their peaks at some point – ignore the noise



Source: Morningstar Direct © All rights reserved. Vanguard Glb Stk Idx $ Acc used as proxy for global stock market returns. Returns in GBP. YTD = 31/07/2024

We know from research in the field of behavioural finance that we tend to feel at least twice the pain from losses than we do gains of a similar magnitude. So every time a portfolio falls, we feel glum. The key to this discipline is to understand the very ordinariness of market falls and not to look at your portfolio too often. **Some investors look at their investments almost every day as a form of self-torture!** The discipline of not looking at your portfolio on a regular basis makes good sense, as short-term gyrations should eventually even out. Infrequent reviews of your portfolio paradoxically have more meaning than a review of short-term noise. As the wise old saying goes:

Look at your cash every day if you must, your bonds every five years and your equities every ten years.

4. Five effective investment practices

Having established a sensible set of investing principles, let us turn our attention to five key investment practices that the evidence and theory suggest we should focus on. In essence, our goal is to provide a systematic, disciplined, long-term investment approach through which to invest your money, allowing you the confidence to stick with the plan and sleep soundly at night. Our approach relies on identifying sensible risks to take and then capturing the rewards on offer as effectively as we can using products capable of doing just that.

Investment practice 1: Build a well-structured portfolio for all seasons

Once you accept that returns come from markets, it is evident that structuring a well-thought-out mix of different investments – often referred to as asset classes – should sit at the heart of your investment programme.

> ***For the individual investor, the asset allocation decision is by far the most important factor in determining returns.***
>
> *Sandler Review (2002) – commissioned by the UK govt.*

Your long-term portfolio structure will dominate the investment returns obtained during your investment lifetime[7]. **Building you a portfolio structure that you believe in, and which has every opportunity to protect and grow your wealth, across the varying market seasons, is the core of our investment process.** We do not try to jump in and out of asset classes, markets or funds that are expected to do well or badly. That would require a crystal ball and short-term forecasts. We leave that game to others in the industry. The evidence provided above of fund managers failing to deliver on their promises reveals that most investors' crystal balls are extremely cloudy.

Successful investing is all about taking on well-understood risks that deliver a positive return expectation. These are carefully selected market risks associated with company share ownership and lending to governments and companies by buying their bonds[8]. It avoids taking on risks that add little (or worse) to the portfolio, such as illiquidity, poor judgmental portfolio manager performance, and opaque and complex product structures.

> ***Since the future cannot be predicted, it is impossible to specify in advance what the best asset allocation will be. Rather, our job is to find an allocation that will do reasonably well over a wide range of circumstances.***
>
> *William Bernstein, author of 'The Intelligent Asset Allocator'.*

Our portfolio construction process can broadly be thought of as building two different components, 'growth' assets and 'defensive' assets. The growth assets are formed of a highly diversified mix of global stock markets – in both developed and emerging markets – which incorporate moderate allocations to slightly riskier parts of the market such as 'cheaper' value stocks (they are cheaper because they are riskier) and smaller companies. These allocations help to provide greater diversification and improved expected returns. Risk and expected return are related, as we explored above.

The defensive assets are just that. They focus on shorter-dated, higher quality bonds that can be combined with the growth assets to build a portfolio with an appropriate level of risk for you. We expect that these assets should, in general, hold their value at times of extreme stock market stress.

Investment practice 2: Use diversification to manage an uncertain future

Not putting all of your eggs in one basket is an intuitive and valuable concept. No-one knows what the future holds and owning a highly diversified portfolio spread widely across asset classes (bonds, equities, and property, for example) and across global markets, industry sectors and companies, helps make sure that we are prepared for whatever the markets throw at us over time. **Think of this as a portfolio for all seasons, if you like**. The simple example below provides some insight. It starts in 'Mix 1' being a portfolio that only holds UK equities and by the time it reaches 'Mix' 6 it is better diversified, across geographic markets, property and bonds. There is not a huge amount of difference in returns, but the 'risk %', in this case representing the volatility of returns, drops materially along with the downside losses at times of stock market trauma including the technology stock crash of the early 2000s and the Global Financial Crisis in 2007-9. Note that this is not a suggested strategy, but simply an example of the possible benefits of diversification.

Table 1: Diversification usually pays – basic example (Jul-1989 to Jun-2025)

	Portfolio structure					
Jul-89 to Aug-23	Mix 1	Mix 2	Mix 3	Mix 4	Mix 5	Mix 6
UK equities	100%	90%	80%	70%	60%	50%
World ex-UK equities		10%	10%	10%	10%	10%
Emerging market equities			10%	10%	10%	10%
Global property				10%	10%	10%
Short-term bonds					10%	10%
Inflation linked gilts						10%
Annualised return %	3.9%	4.0%	4.3%	4.4%	4.2%	4.1%
Risk %	14%	14%	14%	13%	12%	11%
1/2000-1/2003 fall	-45%	-45%	-45%	-39%	-34%	-29%
11/2007 to 2/2009 fall	-41%	-40%	-41%	-42%	-37%	-33%
Return per unit of risk	0.28	0.29	0.31	0.33	0.35	0.37

Data source: Dimensional Returns Web © All rights reserved. Indices used: MSCI United Kingdom Index (net div.), MSCI World ex UK Index (net div.), MSCI Emerging Markets Index (gross div.), S&P Global REIT Index (gross div.), FTSE World Government Bond Index 1-5 Years (hedged to GBP), Bloomberg Barclays UK Government Inflation Linked 5-15 Year Bond Index (GBP).

As we can see, combining different types of investments with return paths that are different to one another can help to make the investment journey smoother, without necessarily giving up returns[9]. **This is one of only two free-lunches available. The other is paying lower costs.** Your portfolio will be diversified broadly by investment asset class, geography, industrial sector, and company. It is the key tool that we have against the uncertainty of the future.

> ***Sensible investors prepare for a future that differs from the past, with diversification representing the most powerful protection against errors in forecasts of expected asset class attributes.***
>
> *David Swenson, CIO, Yale University Endowment*

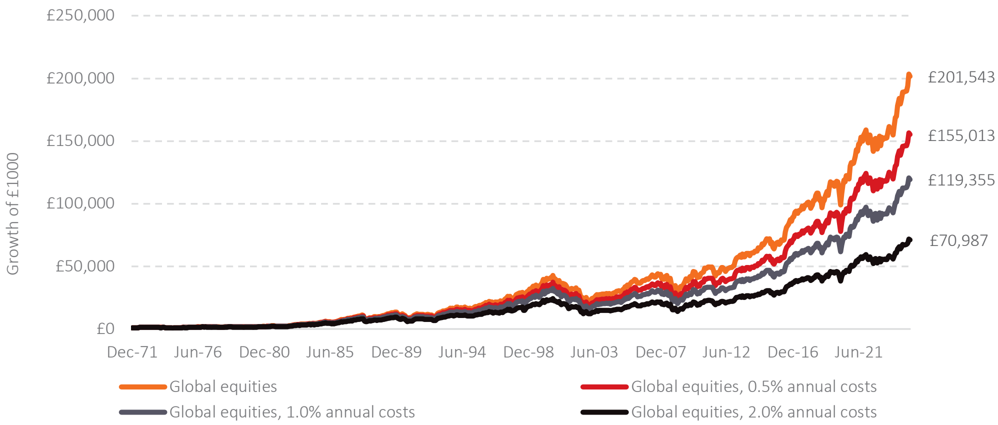
Owning a diversified portfolio brings its own challenge. Inevitably there will always be one or two parts of the portfolio that are doing well, but one or two that are not. The patient and disciplined investor knows that this is what diversification is and there is little point in knee-jerk responses. It is simply the way that markets are. The impatient and ill-disciplined will seek to change their strategy.

> ***Diversification is always having to say you are sorry!***
>
> *Anon.*

Investment practice 3: Avoid cost leakage from your portfolio

Costs are insidious and eat away at the market returns that you should be gathering for yourself. After all it is you who is taking the risk with your hard-earned money. The effect of small differences in costs will compound into large differences over extended periods of time, potentially materially affecting your future lifestyle choices. Figure 12 shows the long-term impact of seemingly moderate fees on final financial outcomes of a starting portfolio of £1,000 invested in global equities.

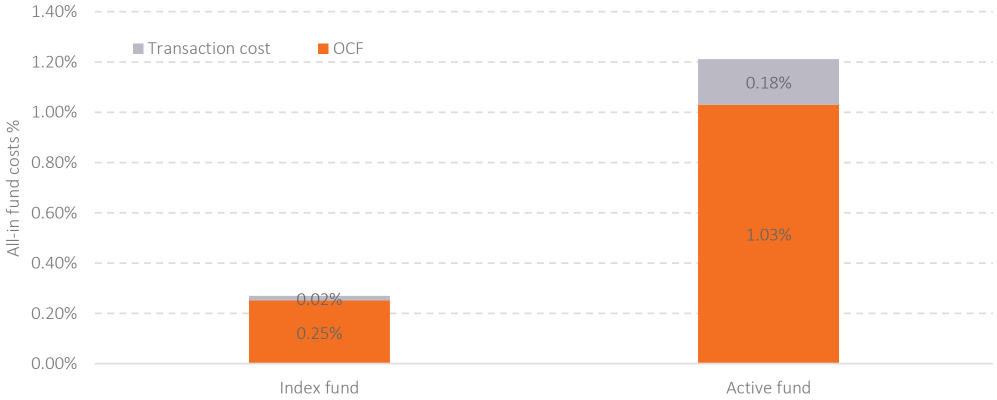
Figure 12: Costs matter



Source: Morningstar Direct © Period: 01/72 - 12/24. Equities: MSCI World (31/12/00), MSCI ACWI (thereafter). Returns in GBP.

The evidence indicates that investment industry costs are still high, particularly those related to judgmental, active managers i.e. those attempting to outsmart the market through market timing and traditional stock picking. The costs of investing are more than simply the annual management charges (AMC) charged by the fund manager. Other fund related costs can also be offset against the fund's performance which roll up into an ongoing charges figure (OCF). Yet that is not all. When a manager buys and sells equities or bonds, they incur transaction costs, which eat further into returns. Figure 13 provides a simple example comparing the average all-in cost of global equity index funds that seeks to capture the return of the broad market – what we would call a systematic approach – to the average all-in cost of judgmental, actively managed global equity funds seeking to beat the market.

Figure 13: A big difference in costs exist between the two approaches



Source: Albion Governance Update 24 (October, 2022)

The 0.94% cost differential may sound small, but it is not as we saw above. Let us assume, perhaps somewhat generously, that both portfolios deliver the same return before costs. Professor William Sharpe – a winner of the Nobel Prize for economics – came up with a simple means of gauging the impact of such a cost differential, by estimating how much more wealth would be held by the investor if they adopted the lower cost strategy of the two, assuming the gross return of each fund is the same. In this specific example, the lower cost, systematic approach would, on average, deliver 32% more wealth at the end of 30 years, and a staggering 45% more over 40 years[10]. That is a lot of good living that someone else will be doing at your expense!

> ***'In investing, you get what you don't pay for'***
>
> *John Bogle, Founder, Vanguard Group*

Investment practice 4: Control your emotions through process

Unfortunately, evolution has hard-wired the human brain to be particularly poor at making investment decisions. A deep-seated, sub-conscious battle is constantly being waged between greed and desire for reward, and the fear of uncertainty and loss, which creates on-going anxiety and irrational decision-making in many investors. Investing is certainly not emotionally easy.

In practice, we have two minds. One is our intuitive mind that is fast, automatic, and effortless, and requires little conscious input in making rapid judgements. We tend to have great confidence in our intuitive decisions, which can result in a number of mental biases and short-cuts that can lead to very poor investment decisions. Our other mind is more reflective. It is slower, more analytical, more conscious, and requires far more effort to come to decisions. It also tends to accept the decisions of the intuitive mind, unless they are obviously wrong. A simple example is provided by the cost difference above. The difference does not intuitively sound much, yet engaging your reflective mind allows you to see what damage high costs can really do.

The balance between intuitive and reflective decision-making varies between individuals and under different emotional circumstances. As mentioned above, investors feel approximately twice as much pain from losses as they feel pleasure from gains[11], which exacerbates emotions in the face of losses.

Evidence of wealth-destroying, emotionally-driven decision making is plentiful, as impatient, and ill-disciplined investors have a propensity to chase fund managers (and markets) that have previously performed well and sell poorly performing investments. Buy-high, sell-low is not a good investment strategy.

> ***If I have learned anything from my 52 years in this marvellous field, it is that, for a given individual or institution, the emotions of investing have destroyed far more potential investment returns than the economics of investing have ever dreamed of destroying.***
>
> *John Bogle, Founder, Vanguard Group[13]*

Differences exist between returns that a fund achieves, and the returns achieved by the investors in the fund, due to the timing of their cash flows into and out of the fund. It appears that fund investors are not good at market timing, resulting in achieving lower returns than the funds they invest in. **This wealth destroying phenomenon has been coined 'the behaviour gap' by the industry and is widely observed across a wide range of fund sectors. It is somewhere in the region of 1% to 2% a year[13]. Patience and discipline are surprisingly rare!**

Figure 14: The eternal cycle of emotionally-driven wealth destruction

Source: Albion Strategic Consulting

Recognising that both investors and advisers suffer from a range of behavioural biases that are more likely than not to result in the erosion of wealth, we believe that the design of a disciplined, systematic, and understandable investment process, and its on-going implementation, is central to your success as an investor. Closing the gap between what reflective, patient, and disciplined investors should earn from markets and what emotional, irrational, and intuitive investors tend to earn is of enormous value.

One of the really important roles that advisers play in the investment process is to ensure that clients remain as calm as possible, resisting the urge to change their portfolios in the face of fear and greed. Knowing why a portfolio is structured as it is, accepting that some parts of the portfolio may not perform at times as well as others, and being confident that it is a robust *'portfolio for all seasons'* can help to provide the discipline required.

Investment practice 5: Manage risks carefully across time

Our approach to investing positions us as risk managers, rather than performance managers as advisers have traditionally been. It may sound like a subtle distinction but focusing on managing risks is likely to avoid being blind to unseen risks by seemingly strong returns. We therefore place a lot of emphasis on understanding and managing the risks in your portfolio. Our risk management programme – overseen by our formal Investment Committee that meets on a regular basis – can be divided into three key areas:

1. Rebalancing your portfolio back to its original structure

Having spent considerable effort ensuring that a client's portfolio is both suitable for them and robustly structured, it is important to keep it that way. Over time, the riskier assets (equities) tend to rise in value and begin to overpower the more defensive assets (bonds) in the portfolio, and the risk level starts to creep up. We will periodically realign – or rebalance – your portfolio(s) back to its original structure.

> ***The fundamental purpose of rebalancing lies in controlling risk, not enhancing return. Rebalancing trades keep portfolios at long-term policy targets by reversing deviations resulting from asset class performance differentials. Disciplined rebalancing activity requires a strong stomach and serious staying power.***
>
> *David Swenson, CIO, Yale University Endowment*

Rebalancing usually involves selling out of better performing assets and buying less well performing assets i.e. selling, rather than buying 'hot' performing asset classes. This enforces a systematic – rather than a market valuation based – defence against possible market bubbles. Rebalancing is simple in concept, but in practice it is hard to do; it requires considerable discipline and fortitude, particularly at times of market turmoil, when our emotions, particularly fear or greed, are heightened. **Selling safe bonds and buying equities is hard to do on the back of large market falls.**

2. Reviewing the best-in-class fund choices

Choosing which funds to recommend to our clients is a big responsibility that we take very seriously. We employ a detailed and insightful fund screening and due diligence process to ensure that we fully understand the products we recommend. They tend to be large, lower cost systematic funds managed by some of the world's best known fund management houses, which are highly diversified. They are designed to capture market returns from specifically identified market risks. It is important to remember that while costs are important, they are not the be-all-and-end-all of the fund selection process. In a wider sense, the quality of a fund should be judged as its ability to capture the expected rewards for the risks being taken on. For example, a very cheap index tracker might not be that good at tracking the index and it would be better paying a little more for a fund that delivers outcomes that more tightly match the index.

Our focus is always on risk management that starts with eliminating fraud, exploring operational risks, then focusing on product structure risks, and finally looks at the ability of the fund firm to deliver market returns effectively.

3. Challenging and refining our approach

It is entirely possible, and likely, that your portfolio will look much the same between one time period and the next with little activity, except for rebalancing. That most definitely does not mean that nothing is happening. We hold regular Investment Committee meetings. If we were an active management firm, these meetings would be taken up with economic analysis, forecasts for markets, tactical short-term market timing decisions and fund picking choices. Our meetings are far less exciting, focusing on any new evidence supporting or challenging our approach, the latest research on asset classes, and additional due diligence on products ensuring that our best-in-class funds remain just that. This is all part of the patience and discipline required.

5. In conclusion

At the start of this note, we stated that investing was simple but never easy.

We hope that this detailed note has provided you with a good insight into the key principles and investment practices that guide our systematic approach to investing. We are confident that our approach will provide you with every chance of having a successful investment experience. We cannot guarantee what returns the markets will deliver in the future, but we can guarantee that you will capture most of what is available through our systematically managed, best-in-class funds. By owning a well-diversified portfolio for all seasons, having faith in capitalism, allowing the markets to do the heavy lifting, and being patient and remaining disciplined, you give yourself – with our continued help and guidance – every chance of success.

If you have any questions on anything in this document, or you would like to talk through our investment approach in more detail, please contact us and we can arrange a time to talk. ■

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