How to create an investment plan

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I Introduction

"An investment in knowledge pays the best interest." — Benjamin Franklin

Saving money is important, but only to a certain degree. History shows us that unless you are able to grow your savings in a safe and effective way, you may not have enough of a nest egg to support you through your retirement. History also shows us that investing in the stock market has yielded solid and generally reliable returns over the long term.

One of the biggest reasons people don't invest in stocks however, is because they don't understand the stock market and the myriad of investing strategies. There's a general assumption that stocks are for ultra-rich people, or only those with a financial background and experience.

The goal of this Guide is to equip you with the knowledge and confidence to create your own investment plan to grow your savings safely. By following this simple step-by-step methodology, we will assist you in assessing your current situation, setting your goals and risks, allocating your capital, and teaching you how to monitor your portfolio.

II Creating an investment plan

Why create a plan?

This is our second Benjamin Franklin quote, but it's certainly true that *"If you fail to plan, you are planning to fail!"* Fortunately, creating an investment plan is not a complex task. In the paragraphs below, we will present a list of steps you can follow to create a sound investment plan. But before we do, it is important to be aware of the following cautions as you go through the process:

1. Be patient. There are no shortcuts in making money by investing. If it was easy to make a fortune overnight by investing, then everyone would be billionaires! Therefore, your strategy and investments should be a result of realistic, informed, and sound decisions.

2. (Perhaps the most important!) <u>Never get emotional</u>. By having a clearly defined investing plan it will be far easier to avoid reacting rashly to the inevitable swings in the financial markets that all investors must endure. Our plan sets out what we need to do in both good times, and in times of uncertainty. You've made this initial investment by creating your plan, so consult it often, *and stick to it* when times get tough. Emotions and impulsive decision-making will only hamper you in achieving your ultimate goal.

3. Finally, don't trust others blindly. In today's world where everyone has access to social networks and the opinions of billions of people worldwide, it is important to research the expertise of anyone that is offering advice on how you should manage your capital.

5 steps to creating an investment plan

A sound investment plan should help you come up with answers to the following list of questions:

- How much can you invest?
- What are you trying to achieve?
- When will you need to withdraw your invested capital?
- How much should you risk?
- What is the return you are trying to achieve?
- Which stocks to buy?

We'll answer each of these questions as we go through the steps required to set up your investing plan.

1) Assess your situation

Whichever task, project or job you undertake, the needs-assessment phase is always the first on the list. This phase is closely associated with question number one: *"How much can you invest?"* As a start, you should look at your savings and income. Maybe you have just sold a property and you have a lump sum you'd like to invest, or you are simply looking to set aside a portion of your regular monthly income.

A lump sum is typically a larger amount of money that provides you with more options. Typically, you can invest in a wider array of stocks at the outset, and therefore achieve a higher level of diversification. This simply means spreading your capital across a number of different stocks, preferably in different sectors of the market, for example, in health care, technology, materials, financials etc. Regardless of your starting capital, diversification is an important goal for all investors, so keep it in mind as you are selecting your stocks.

If you are planning a smaller initial investment, say by regularly applying a portion of your income to building a portfolio, dollar-cost averaging is a strategy widely used by smaller investors. This is a simple investing strategy that involves purchasing extra shares of the companies in your portfolio (and gradually adding others) at regular time intervals. This strategy is ideal for small investment amounts and reduces the pressure on selecting 'the absolute best time' to purchase a stock - because let's face it - this is close to impossible to predict! For example, say you have earmarked $3,500 to invest in a particular stock. Instead of doing this in one lump sum, you instead decide to invest $500 on the first

day of each month. Figure 1 shows that over time the stock rises and falls, as does the number of shares you purchase each month. At the end of the period, you have invested your capital, not paying the best price, but certainly not paying the worst either.

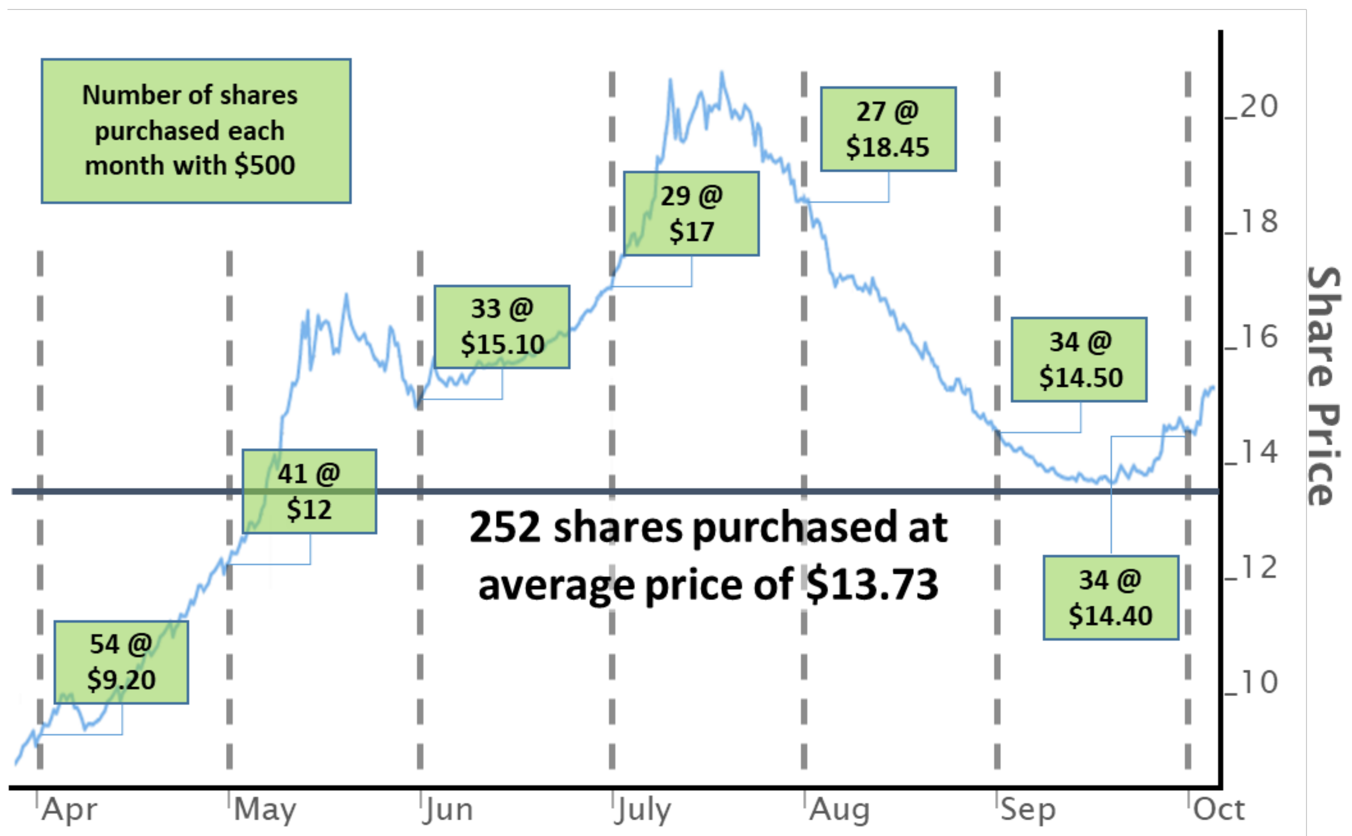

Figure 1: Dollar cost averaging example

Regardless of which option suits you best, the assessment of your current situation should be realistic. The main goal of this phase is to identify how your starting capital may impact upon your desired investment strategy, and if there are any gaps between this and your goals.

2) Establish your goals

After assessing your current situation, you need to establish your goals and timeframes. This step should help you answer the following questions: *"What are you trying to achieve?"*, and *"When will you*

need withdraw your invested capital?" Your investment plan should be designed with your investment objectives in mind, in other words, what do you want to get out of your investments?

The obvious answer is to grow your capital. But we need to go further in defining our goals. For example, are you looking to achieve long-term growth? Are you looking to generate a regular annual income from dividends? Or, perhaps, are you looking to generate a regular income from buying and selling shares for profit? This last activity is often referred to as 'trading' rather than investing, and we'll tackle this rather large topic in another Guide!

In the end, everything will come down to what kind of an investor you are, for example, a student, a working mum or dad, or a person looking for retirement income. This is where the three broad stock investing strategies come into play: value investing, income investing, and growth investing.

The first type of investing strategy, 'value investing', is typically best suited to those who consider themselves as 'active' investors. Usually, market analysts define a 'value stock' as a company whose business operations are undervalued by the broader investing community. They expect that eventually, other investors will realize the true value of the company, and buy its shares causing its price to rise. In most cases, value investors can't be sure when this price rise is going to occur, so value investing is typically a long-term strategy.

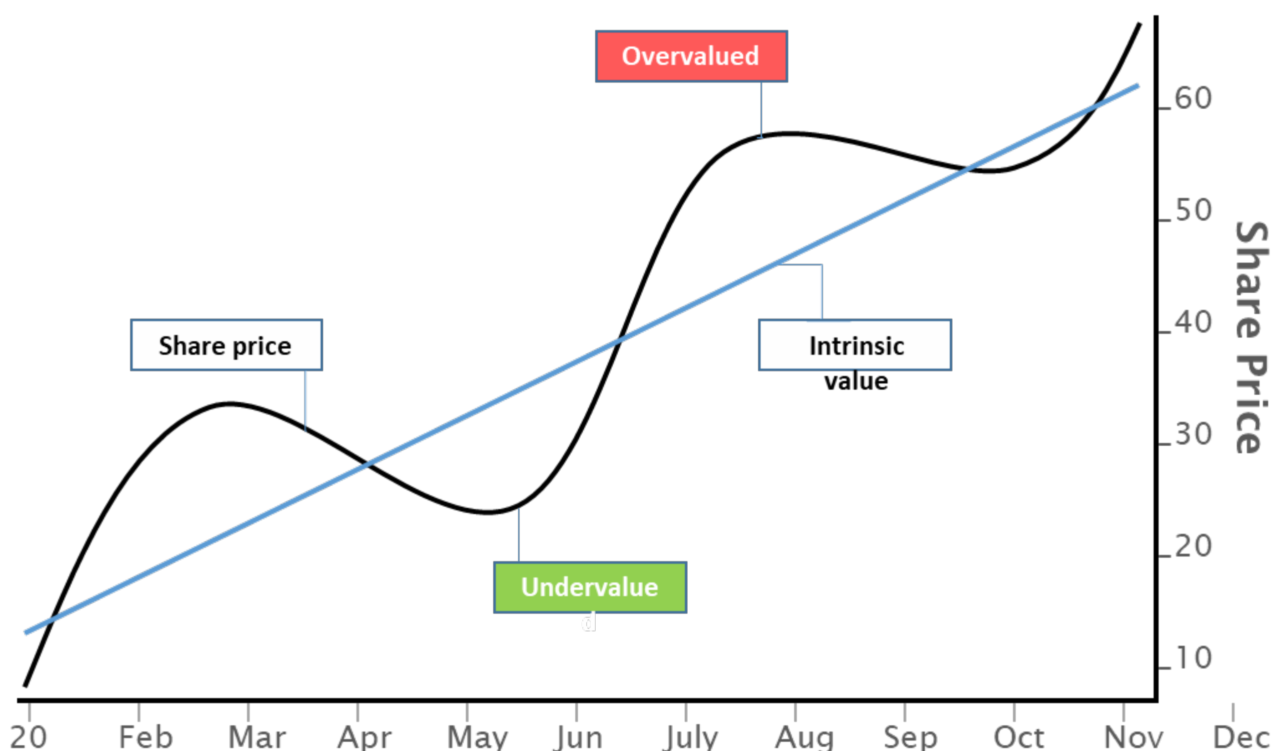

Figure 2: Value investing philosophy

To identify a value stock, you are required to calculate its 'intrinsic' value. Value investors consider this to be the true financial value of a stock, stripping back the noise of market sentiment and fad investing. To be able to calculate the intrinsic value of a stock, you must have a certain degree of knowledge and experience in analyzing company fundamentals such as earnings, cash flow, and management. Additionally, one should understand how broader economic fundamentals might affect a company's profitability - hence this approach is described as an active approach. As a result, value investing is either best suited to those with a financial background, or those prepared to engage the services of others who do.

The second type of investing strategy, 'income investing', is focused on stocks that will generate a regular and reliable income. This type of strategy is focused on identifying 'income stocks' that have a history of paying regular dividends. Dividends are typically paid on profits that a company doesn’t require for the continuing operation and future growth of its business. This means that companies that pay substantial and regular dividends are typically well-established businesses that may have limited opportunity to reinvest profits to grow the business further. As a result, these stocks tend to deliver the bulk of their investing returns as dividends rather than growth in their share prices.

Finally, we have 'growth' investing. This is another active strategy and is probably the most aggressive out of the three. The goal of a growth investor is to identify stocks whose business are either growing rapidly, or likely to do so soon. 'Growth stocks' typically have much lower dividend yields than income stocks because they prefer to reinvest their profits back into the business to grow it further. Instead of receiving a regular income from dividends, a growth investor is instead targeting receiving capital gains from their growth stocks. Keep in mind however, that whilst growth stocks might have higher rates of return in general, they may also be accompanied by high risks as well. Growth in profits may not always eventuate to the degree the market was expecting, and the price of the stock could fall. In this scenario, the growth investor has potentially missed out on a regular income stream from dividends and may have also experienced a capital loss. As such, growth investing is best suited to investors who can be more active, who have higher risk tolerances, and who have enough time to ride out the ups and downs associated with some growth stories.

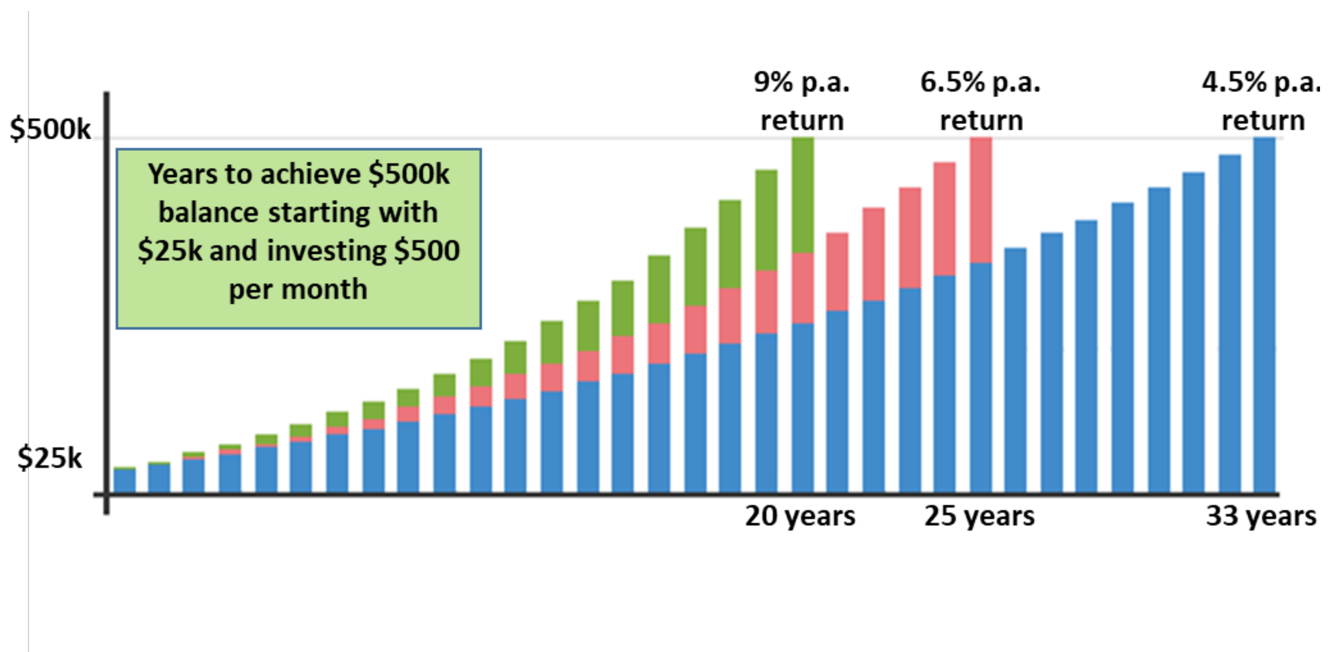

Figure 3: Returns required to achieve an investment goal, and the impact on time taken to achieve it

Your investing style will largely be defined by your investing goals and when and how you require to withdraw your invested capital. This is your 'investing timeframe'. Investors who have a longer timeframe to retirement, or who have more time to analyze companies' value/growth prospects, may be better suited to the value and or growth investment strategies, whilst those who are closer to retirement, who have less time to conduct research, or who require a steady income from their investments, may be better suited to an income investing strategy. This is a generalization of course, and one must be realistic about the returns they will require in order to achieve their investing goals (see Figure 3 above). So, it is possible, that whilst you may consider yourself to be more of a longer-term income investor, it may turn out that your goals require you to be shorter-term in your approach, or to consider stocks with more growth-style returns. As we will see in the next section, higher growth is typically accompanied by higher risks, so one should only consider their goals within the context of understanding their risk tolerance.

3) Understand your risk tolerance

“Risk comes from not knowing what you are doing.” — Warren Buffet

Risk generally measures the chance of failure in achieving objectives or goals. Risk management is arguably the most important aspect of your entire investment strategy, and therefore of your investment plan. This section is designed to answer the question: *"How much should you risk?"*

Once you have set your goals, the next step involves evaluating your risk tolerance. This is a personal preference, and there is no 'official' right or wrong answer as to how much risk you should take on. The most important guideline is that regardless of the style of investing you choose, over a long period of time you should remain comfortable with your returns and any fluctuations in those returns that will inevitably occur. Having said this, there is no reward without risk in the markets, and one must be realistic about taking enough risk to meet one's goals. The table below demonstrates that investing in the stock market over the 25 years between 1992 and 2017 involved both large swings to the positive and large swings to the negative. Typically, however, the good periods tended to outweigh the bad ones, and the average return for Australian stocks over the last 30 years is over 9% p.a.[+]

Q4 1992 to Q4 2017	Number of quarters with gains of 10% or greater	Number of quarters with declines of 10% or greater
S&P ASX 200 (Australia)	12	6
CAC 40 (France)	15	11
DAX (Germany)	24	10
FTSE 100 (UK)	8	9
Hang Seng (Hong Kong)	22	12
Nikkei 225 (Japan)	18	19
S&P 500 (USA)	15	8

Figure 4: Quarterly returns >10% and < 10% for various country benchmark stock indexes 1992-2017[*]

Let's now try and answer the question: *"What is the return you are trying to achieve?"* If you are targeting higher returns, you will typically require a portfolio that is skewed towards value or growth stocks. As suggested in the previous section however, these stocks are typically associated with greater risk of capital loss in the case of growth stocks, and potential periods of underperformance in the case of value stocks. For those with shorter-term goals, really only growth stocks are likely to deliver the near-term gains required. However, a short-term focus may expose the investor to selling a stock at a loss in order to recoup their capital.

[+] (*Source: https://www.canstar.com.au/online-trading/australian-shares-on-the-rise/*)

[*] *Source: https://www.fidelity.com.au/insights/investment-articles/volatility-an-investor-survival-guide/*

At the other end of the spectrum, those with longer-term goals, have the luxury of holding through short-term price fluctuations, and better still for income investors, of earning a reasonable rate of return from dividends in the meantime. Certainly, those planning for retirement, or who are in retirement are likely best suited by a portfolio dominated by income stocks. These investments are typically associated with lower risk of capital loss and are likely to offer risk-averse investors the best combination of stability and regular income.

Regardless of the style of investing, or perceived risk tolerance, any investment in the stock market has risk attached to it.

4) Allocate your capital

“Behind every stock is a company. Find out what it's doing.” — Peter Lynch, *Beating the Street* 1994

Consider the previous three steps as factors that you should consider when coming up with an answer to the key question: *"Which stocks to buy?"* With respect to allocating your capital, you should first decide on a management style. There are two basic management styles - passive and active. Passive management is far less onerous, and typically aims to hold a portfolio as close to the market performance as possible, thus reducing the probability of underperformance. Passive strategies are best executed by purchasing listed investment companies, that is, companies listed on the stock exchange that invest in a wide range of other listed companies, or exchange-traded funds (ETFs) that mirror the established indexes e.g. S&P500, S&P/ASX 200 etc.

Active management is focused on outperforming the wider stock market. For instance, the performance of the S&P/ASX 200 index may be used as a benchmark to compare your portfolio’s return. As the name itself suggest, this management style is suitable for investors who are prepared to make continuous tweaks to their portfolio. They will often be buying and selling based upon rotating into the stocks they feel are most likely to outperform the benchmark.

If you decide to adopt an active management style, this is when the virtue of patience comes in. It’s incredibly important to do your homework so you are well positioned to make informed decisions. In other words, don't buy the first stock you read about in the paper, or hear talked about on the six o'clock news. Target stocks that are consistent with what you’ve determined from the previous steps - situational analysis, goal setting, and consideration of risk-tolerance. These steps are likely to reduce the number of available options to you, leaving you with just those stocks that fit your investing style.

At this point you may wish to consult an investment adviser, a trusted analysis source such as a research provider or a newsletter or undertake your own analysis. The more confirming points of view you can obtain about a prospective investment, the better. Importantly, you should remember that you

are unlikely to only ever select one stock and stick with it forever. Rather, you should aim to construct a diversified portfolio as soon as practicably possible. The goal here is to spread your investments across different companies whose earnings are derived from various business sectors, markets, and regions. By adopting this approach, you are focusing as much on risk as you are focusing on return. Also, it reduces the likelihood of becoming obsessed with one underperforming stock you own, at the expense of continuing to tactically manage the rest of your portfolio.

Finally, regardless of your asset allocation style, resist the temptation to invest all or your capital. It is sensible to retain some cash for those opportunities that arise from time to time (for example, a dip in the markets). Many professional investors retain around 10% of their capital in cash for this reason.

5) Monitor your portfolio

You have now constructed your portfolio. It is important to review the performance of your investments at regular intervals, and to consider how closely your implemented investment plan is meeting its stated goals. At each review, consider whether each investment is consistent with your goals and risk tolerance. Perhaps these have changed since your last review? At an investment-specific level, companies regularly release reports on how their businesses are performing, and provide their outlook for the near future. Have they disclosed any concerns about maintaining or growing their profits? You may find that some of the companies in your portfolios have increased or decreased their dividends - if you are an income investor this is particularly important.

In all cases, *be decisive* about underperforming investments. Sometimes it is better to reduce or exit holdings in companies that are underperforming badly, even if it means taking a loss, and reallocating this capital to a prospect more aligned with the goals of the investing plan.

Monitoring your portfolio takes time and effort. But as they say, you don't get something for nothing! If you commence this process and decide to manage your portfolio yourself, *commit to the program* and you are more likely to be rewarded. Be honest about your own performance over the last period, and be honest about your commitment to the process. Where did you fail to act? Did you act irrationally or irresponsibly? What processes can you implement for the next period to prevent these actions from occurring again? Remember: *"Those who fail to learn from history are condemned to repeat it."* — Winston Churchill.

III Summary

Creating a solid investment plan is the foundation of a successful portfolio. To make a sound investment plan, you have to know why you are investing, how to set your goals, you must decide how much you are willing to invest and how much you are willing to risk, you must know how to allocate your capital in a diversified way, and finally, you must be committed to monitoring your portfolio.

Even after all of this, the portfolio planning process never stops. If recent events have shown us anything, it is that the world we live in can change very quickly indeed. Regardless, the portfolio planning process remains the same. By following each of the five steps discussed in this Guide, you'll ensure that the best investment strategy for your needs is always in place.

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