Chapter 1

The pitch

Many people say they don't like the sharemarket. In 2002 I was pitching our funds management services to one of Australia's wealthiest individuals, who I had mistakenly believed was interested in allocating part of his vast wealth towards us, when he blurted out that he didn't understand shares. His logic was that shares weren't tangible. He preferred property any day of the week because he could see it, touch it and, above all, he could use it as security to borrow more money from his banks.

He went on to explain how he thought shares were risky and volatile, played by people who punt the market during the day, the casino at night and horse races on the weekend: 'It's not an investment, it is a gamble!' He rounded out the discussion by declaring that all stockbrokers were confidence men—not bad coming from a guy who had earned his first fortune selling cars.

At the time I wanted to take on the challenge and twist this guy's arm until he conceded the sharemarket was a worthwhile investment, but I refrained. These days I think it is fantastic that there is still a squadron of people out there yet to discover the wonderland that is the sharemarket. This leaves more for the people who do want to participate, who can see the benefits of playing the game every day.

In reality it is virtually impossible to convince the doubting Thomases of the sharemarket's merits. However, I have learned from many other discussions over the years that there is also a large group of people out there who would like to be in the market but for some reason or another have not taken the leap: some people have never had the confidence to get started; others just don't have the excess money to start with; and then there are those who think it is a mystery they would enjoy solving, but just don't know where to begin. These are all reasonable excuses, but they are not insurmountable.

Let's get rid of the negatives and focus on the positives.

The easiest game on earth

The consensus view among professional investors is that they operate in a highly competitive and tough industry; that as an individual, you must be careful because there are landmines buried around every corner, waiting to rip an arm or leg off if you take a wrong step — a view trumpeted every day across all forms of media since the GFC stamped itself into the history books back in 2008. The reality, though, is completely different. There might be some hidden landmines, but the fact is, if approached the right way, the sharemarket is one of the easiest games on earth. You can afford to step on the odd landmine, feel mortally wounded and still have a genuine chance of finishing on top of the pile. This is particularly so for an individual investor, who is not shackled by the mandate restrictions that institutional investors regularly complain about. Peter Proksa believes he needs only two of his high-risk investments to work for him to live the life of a millionaire.

So why is the market so easy? The first reality is that markets go up. On average the US and Australian sharemarkets have risen in value in seven out of every ten years, dating back over more than the last 100 years (see figure 1.1). Sharemarket historian Ashley Owen has calculated that, over 1200 separate 10-year periods, the Australian sharemarket has yet to deliver a negative absolute return.

Figure 1.1: Australian sharemarket performance 1883–2010: up seven out of 10 years

					2007			
					2003			
					2001			
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				1956	1928			
				1949	1927			
				1948	1926			
			2010	1944	1925			
			2002	1943	1924			
			1994	1940	1923			
			1992	1939	1921	2006		
			1987	1937	1919	2005		
			1984	1920	1917	2004		
			1971	1918	1914	1995		
			1965	1913	1911	1978		
			1960	1912	1909	1963		
			1951	1910	1908	1934		
			1941	1907	1906	1933		1993
			1938	1904	1905	1932		1986
		1990	1929	1897	1902	1922	2009	1985
		1882	1916	1896	1900	1903	1991	1983
		1981	1915	1892	1899	1895	1979	1980
	1974	1970	1901	1890	1898	1888	1972	1975
	1973	1952	1893	1886	1894	1887	1968	1967
2008	1930	1891	1889	1884	1885	1883	1950	1959
<–30	**–30 to –20**	**–20 to –10**	**–10 to 0**	**0 to 10**	**10 to 20**	**20 to –30**	**30 to –40**	**>–40**
Total market returns (%)								

Source: IRESS

What does this mean exactly? If you measure from January 1911 to January 1921 and then February 1911 to February 1921 and so on, you would get more than 1200 ten-year periods to measure over the last century. A dollar invested at the beginning of any of these 1200 periods would have still been worth at least a dollar 10 years later, not including dividends. That is a major comfort for any Australian investor. There is no guarantee that this will be the case in the future, but it is strong evidence that things won't go too wrong over a 10-year period. Critically, though, a lot of pain can be avoided if you can enter the market when it looks cheap and not after a stellar multi-year upward move. It will be intriguing to observe if the historical 100 per cent strike rate continues for people who bought shares in the Australian market in November 2007. Since that month, the bears have been in charge of the market and they will be doing their utmost to create history and deliver the first decade-long negative return. At this point in time I am willing to bet against them. The US market has had several periods of negative 10-year returns, but at the same time it has enjoyed much longer periods of prosperity.

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Equally, I would not like to dispel the myth of the importance of market timing, but with the local sharemarket peaking in late 2007 we may well have avoided the worst time to start investing. If you can make that leap of faith and believe the bulls can recapture the high ground then you are on your way to realising the spoils that are potentially on offer in the sharemarket.

On average, over the last 127 years the sharemarket has delivered an annual return of approximately 10.5 per cent (when capital gains and dividends are taken into account). This is a real return of between 7 and 8 per cent, taking into account a long term inflation rate of about 3 per cent. To put it another way, if you had invested $100 000 and reinvested all your gains into the market, your money would have grown to $271 408.09 over 10 years and $736 623.49 over 20 years. If you got started in the investment game early, then after 40 years your total would be slightly more than $5.4 million—not a bad retirement fund. These figures assume that you only stay level

with the market, but if you managed to do 2 per cent better than the market each year and reinvested all your winnings back into the market then your $100 000 would turn into $324 732.10 over 10 years, and more than $12.10 million over 40 years.

Equity reflects many things, but primarily it measures human endeavour. The majority of people go to work all over the world striving to advance themselves, do their jobs more efficiently and generally improve their standard of living. This overall attitude to life and work feeds into equity prices of companies listed on stock exchanges around the globe, as productivity manages to gradually creep higher as time passes. Shares acutely reflect the effort of humans and their ability to continually become more productive. While there are ups and downs over time, as a whole, people have proven remarkably resilient and resourceful. When you think of the sharemarket in this way, as representing the value of human endeavour, it seems short-sighted to claim that it is a risky adventure that needs to be handled with care by seasoned professionals.

Don't leave your common sense at home

That said, the sharemarket, like every other part of life, has the ability to singe your fingers if you forget to bring your common sense and judgement to the game. For example, if a market has been going higher for five years straight, clocking up 20 per cent gains each year, you should tread warily. The sharemarket has a great ability to mean revert. In other words, following those five bullish years, market returns will slip back to the market's long-term average of 10.5 per cent returns per year—which is another way of saying one or more negative years could follow. We will examine the behaviour of overall markets in the final section of the book but, rest assured, taking out a large margin loan and throwing it at the sharemarket following a series of stellar years is a sure way to incur serious financial injury. I do not advocate investors take out margin loans to buy shares at any time, but I cannot state strongly enough my opposition to leveraging when the bull has been parading in the corral for some time.

Conversely, retail investors who have become gun shy since the mauling of the GFC should not turn their backs on what is

unfolding. Once the bear goes back into hibernation, there will be a multi-year rally that will deliver enormous returns. You can never predict the exact moment a market turns, because you will only be able to declare it in hindsight, but it is crucial that you start your research when events look hopeless and totally unattractive. Events will turn — they always have.

As easy as kissing

Once you accept that the sharemarket does go up over time and delivers real returns to investors, you can then start to delve into shares and discover why the market is set up for most people to win. Some investors want a peaceful life and so should not concern themselves with trying to pick winners and losers. The better option for these people is to choose the lowest cost managed fund that has a portfolio representing the market. They can then just sit back and collect the 10.5 per cent returns a year.

For those of us who think they have the ability and the risk appetite to pick stocks (shares) the game is completely different. The key is to do some homework on shares that you think are winners and then place a series of bets. Don't throw all your money into one or two stocks and hope they go up like Peter Proksa did in his first decade of investing. Rather, look at investing in 10 or maybe 12 firms across a variety of companies operating in various parts of the economy rather than choosing one concentrated bet. If you have a reasonable amount of spare capital you should think about spreading it further, buying 20 to 25 stocks. Sure, this will cap your potential upside, but it allows you to be wrong regularly, and still have a genuine chance of generating great returns. Buying shares in more companies also takes out a lot of risk that goes with putting all your money on red instead of having the luxury of some of your money on red and some on black at the same time. At Wilson Asset Management, our best estimate was that we got about 50 per cent of our investment decisions right, still managing to get an annual return of more than 20 per cent over 13 years. If you can regularly pick six winners out of ten, you are running with the best in the world,

including Buffett. You are a superstar! Is there another profession in the world where you are allowed to get so many things wrong? If you are an engineer and your design is wrong, a building or bridge might collapse. If you are a surgeon and you get half your decisions wrong, people may die. A lawyer who delivers the wrong advice to his clients half the time will be out of business in quick time.

Everyone gets it wrong

Perhaps it is the fact that everyone gets at least one or more investment decisions wrong that spooks people into abstinence. They watch their first investment plummet and, like rabbits frozen in the headlights, just sit and gaze wondering what went wrong. It put Peter Proksa on the sidelines for more than three years. Alternatively, virgin investors see the prices of shares they have not bought move higher and higher, and become agitated that they were not on board the rocket ship. As my former colleague Geoff Wilson liked to say, 'You can't kiss all the pretty girls'.

The key to getting it wrong is admitting you are wrong and making sure you don't hang onto stocks that are heading down over extended periods. Cut your losses and move on. There are more than 2000 companies listed on the Australian Securities Exchange (ASX) and there are thousands more on foreign exchanges, so it's not like you are struggling for choice. At Wilson Asset Management we operated with a trading stop loss rule, which meant that if a stock fell 10 per cent or more we would sell it. This did not close the door on the company, but it meant we needed to sell, walk away and then reassess when and if there was a reason to look at the stock at another time. On the other side of the coin, let your winners run, until they either hit your valuation or if the facts change to alter your view. For now, though, I will just try to sell you on the market.

It is so much better than horse racing

Recently I asked Geoff Wilson why he liked the sharemarket so much. Surprisingly, even though I had known and worked with

Geoff for 17 years, he gave me an answer that I had never heard before, and believe me I heard many of his stories multiple times. This was a thoughtful answer and revealed why someone like him, who loves to place a bet, would be so attracted to the market.

Geoff had always had a weakness for horseracing. Horseracing, like other forms of games of chance, is an industry where most of the punters lose their money to the industry body. For some reason this does not stop most of them from making further bets. In contrast, the sharemarket is set up entirely differently, and it works strongly in favour of the people placing the bets. Geoff said to me, 'What I like about the sharemarket is that you can put a bet on at the start of the race. If your share is going well then you can double your bet. If things are not working out, you remove your bet before the race has ended. It's like you get so many chances to revise your bet before the final outcome is known. You are not locked in from the outset like you are at the horseraces'. Or as sharemarket analysts and investors like to say these days, investing in the market should not be binary, like a horserace, where you are either right or wrong from the outset of the race.

In reality you can expand on Geoff's thoughts. An investor can actually back a series of horses in the one race and, as the race goes on, he can increase his bet on a horse running well and remove all the other bets. The flexibility is quite amazing.

The market can take you around the world

Unlike any other business I can think of, the sharemarket has the wonderful ability to take you to multiple destinations in the economy and to any place on the globe. For most people, investing in or buying a business is a commitment to one part of the economy. For example, if you buy a restaurant in downtown Melbourne, you are basically stuck in that business until you are able to sell it. You ride the ups and downs of the city economy and have to face any competition that might turn up three doors down. If you decide to invest your money in a rental property on the Gold Coast, you are permanently attached to the ups and downs of the beach strip

in south-east Queensland. This could be a profitable decision if the property market prospers, but it could be a lobster pot if the market turns down and liquidity dries up — a lobster pot is easy to get into but impossible to escape from.

The magic of the sharemarket is that you can go anywhere you want. In one week I can be in Kalgoorlie digging for gold, selling expensive handbags in Hong Kong, stocking milk on supermarket shelves in Townsville, providing insurance to a company in fast-growing China or building a residential property in Adelaide. The companies are cut into little bits called shares and even if you haven't got a large amount of ready cash, you can still jump on board a company that may be doing well somewhere in the economy. The opportunities are endless and you have maximum flexibility. The value of this advantage is almost immeasurable.

During recent years the place to be has been in the fast-growing mining industry. The returns, especially those of the smaller listed companies, have been astounding. But if you are worried that China's economic miracle might take a breather and demand for Australian resources will therefore stall, you can opt out and sell your mining shares. You might decide to go back to cash or, if you believe that technology services shares or stocks exposed to a recovering US economy have a better short- to medium-term outlook, you can move into those areas as well. No other investment class can give you the flexibility to travel the world trying to work out what looks promising and what looks depressing.

The sharemarket is clean

Compared with other asset classes the sharemarket is clean. You call a broker or place an order online and buy shares in a company. A small amount of commission is paid to the broker for buying the shares for you. Money is then deducted from your designated account and you are electronically allocated your shares. In a short space of time you will receive a statement from the company's share registry showing how many shares you have bought in the company. From that point onwards you wait and see what happens. If you have picked the right

company, you receive dividends every six months and the share price starts to rise. There are no maintenance costs, no tenants to look after and very little tax to pay until after you sell the stock. The return you receive from the company is not diluted by the multitude of add-on costs that are associated with owning property. And if the investment does not turn out well, then you can sell it, as long as you have taken care to calculate the liquidity of the stock.

Liquidity

The sharemarket is always open. From 10 am to 4 pm, Monday to Friday, the market is open to all its participants to trade. The prices are printed for everyone to see, with all the bids on one side of the screen and the offers on the other. Depending on the size of the company you should be able to sell your shares or buy more. This is what market participants call liquidity, and it is a tremendous advantage the sharemarket has over most other asset classes. You don't have to wait months to offload the asset, go through a marketing campaign or pay large amounts of stamp duty. If you need money for another part of your life, then you can sell your shares, or some of your shares, that day and the money will be in your account within three days. The only cost is a small brokerage fee on the way out.

When you are buying, you don't have to wait years for the only house you like in the street to come up for sale. If you want to buy a certain stock that you like, then you can buy it then and there. If it is too expensive, then you go to the next company you fancy and, if the price is right, you tell your broker to buy. As a mum and dad investor a lack of liquidity should never be too much of a problem — you should always be able to sell small parcels of shares compared with the millions a professional fund manager might own. However, if you like to buy shares in companies that are smaller and have fewer shares on issue you will need to gauge carefully how many shares have traded in the company in recent history. If the stock trades in the market only every fourth day, or as brokers like to say, by appointment, then you may not want to take too big

a position (buy a large number of shares) just in case you end up in your own lobster pot.

Compounding returns

The argument most sharemarket evangelists like to put forward as the clincher to playing the market is the joys of compounding returns. This means that if you buy shares in a company and you stick with that company for an extended period you can achieve enormous returns. For example, if you bought $1000 worth of shares in a bank and it delivered a total return, made up of capital appreciation and dividends, of 15 per cent per year for 10 years, your initial investment would turn into $4045.55. That is a total return of 304.55 per cent. The example assumes that you hold the shares for the whole period and you reinvest your dividends into the stock, rather than take the cash.

For certain investment vehicles, such as superannuation funds, the returns are even higher when you take into account the benefits of franking credits. Superannuation funds in Australia generally only pay 15 per cent tax, while the companies they have invested in pay 30 per cent tax. This means that each dividend, whether accepted in cash or reinvested, will have that 30 per cent tax credit attached to it. As a result, the superannuation fund will get a tax refund.

While there is little doubt about the miracle of compounding, I am not a major fan of the concept. It requires one of two things to take place. First, the riches of compounding normally rely heavily on the existence of a bull market, which is fine most of the time, but is foolhardy when the market is grinding its way through a protracted bear market, as we have experienced in recent times. Second, you must have a knack of foreseeing the long-term future of specific companies. As for perfect line of sight of a company's long-term future, that is a giant leap of faith. As discussed above, the market does go up over time, but this is no guarantee that an individual stock will be invited to the party.

If, however, you do enjoy a major long-term compounding return then watch the miracle unfold.

Shares are not the be all and end all

So far in this chapter I have given you the pitch for why shares are a superior asset class to invest in. The reality is that we can put forth an argument for any asset class. In his book *One Up On Wall Street* Peter Lynch recommends that individuals should always try to buy their own home before investing in the sharemarket. I couldn't agree more with this argument. Everyone needs somewhere to live, and if you have a family, the desire to have the stability of owning the property rather than renting it escalates. In addition, a bank will normally lend you the lion's share of the property's purchase price and won't send you a margin call letter saying they will sell the property by 11 am tomorrow if you do not pump some funds into your account immediately. Finally, in Australia any capital gains on your principal place of residence are tax-free. That makes your home a compelling place to start building your wealth. Once the home has been bought and there is a little spare cash, the sharemarket must be the first place you think about heading.