Chapter 3B: Basics of Investing – Portfolio Management

Portfolio management is not rocket science, but it is absolutely key for long-term investment success. It means following a few core principles on how to build and maintain a sound and balanced investment portfolio:

Rule 1: Adopt a sound asset mix

Select an appropriate mix of the 3 main financial asset types—cash, bonds, and equities. There are no strict rules and opinions differ, but here are some fundamental principles that most people agree on:

- Cash should cover at least 3-6 months of living expenses, and possibly more given the uncertainties of today's job market. You should have enough cash and liquid assets (those you can turn into cash at short notice) to cover unforeseen events or expenditures. Life is full of surprises – and even the pleasant ones can cost money…
- Equities should account for the major proportion of your financial assets, i.e., at least 50% and likely more, as they tend to produce the highest returns in the long run; the younger you are, and the more willing to take risks, the higher the share of equities should be
- Bonds or fixed-income investments should generally account for between 10% to 40% of your financial assets, mostly in form of government and high-quality corporate bonds; in times of ultra-low interest rates, you might supplement these with alternatives like high-yield bonds or low-risk equities
- Owning a home is generally a desirable objective, as long as it is affordable and makes sense in your current circumstances (see Advance Level Chapter 4: Housing).
- A portfolio could also include other assets, such as real estate (physical properties or financial investments), gold and commodities, hedge and private equity funds, etc. But cash, bonds and equities form the cornerstone; other assets could be considered by more sophisticated investors and under certain circumstances.

Rule 2: Stick to your asset mix

Once you've defined a target asset mix, you should rebalance your portfolio from time to time to stay on track. If you want to own a mix of 5% cash—25% bonds—70% equity, and equities have risen to 80% following a bull market (period of rising share prices), you should sell some equities to restore the balance. You'd be selling when prices are high which is generally a good idea!

As your circumstances changes, you could make some amendments to your target asset mix. For example, as people near retirement age, it may make sense to reduce the share of equities in their portfolio (since equities tend to rise in the long run but can go through long periods of decline).

Rule 3: Diversify

Diversification is important not only for the overall asset mix but also within each asset category. You should buy different types of stocks and stock mutual funds. Mutual funds offer diversification along with professional asset management and liquidity. There are different types of funds, specialized by country, sector, type of security, active or passive management, etc. You could buy a mix of funds with different features.

Diversification also applies to bonds: you should buy a mix of short and long-term bonds, and a majority of safe bonds (government and high-grade corporate) along with some higher-risk bonds. You could invest through fixed-income mutual funds, especially in areas like high-yield or foreign bonds where specialized expertise is particularly useful.

Diversification can reduce the risk of your portfolio without sacrificing return: it takes advantage of the fact that not all assets go up or down at the same time. An important factor is the correlation between different assets, i.e., the degree to which their performance tends to move in tandem: by mixing assets with low correlation, you can enhance the overall stability of your portfolio.

Rule 4: Balance risk and reward

High risk should be compensated by high returns. Examples of relatively high-risk investments that should offer high potential returns are venture capital funds, emerging markets, and junk bonds. You could consider investing in them if you understand the risks involved and they account for a relatively small proportion of your portfolio.

Rule 5: Don't try to time the market

Stocks should account for the bulk of your portfolio since they have outperformed other asset classes in many countries over long periods of time. The best strategy for stock investing is "buy and hold": it minimizes trading expenses and avoids buying at the top and selling at the bottom.

A smart way to accumulate stocks is dollar or pound-cost averaging: you invest a certain amount of money in a stock or mutual fund every month or quarter; when prices are high, you buy more units, and when prices are low you buy less.

Rule 6: Investing is not speculating

If you want to bet on individual stocks that you think are hot or that someone recommended to you, keep in mind that speculation is inherently risky and nobody knows the future. The best advice is to stick to sound, long-term investment strategies. But if you really want to take a punt, make sure it's for a small amount that will not materially affect your well-being if it goes sour (nor leave you exposed to your family's sneers…). Never bet the farm on any one idea!

Rule 7: Avoid leverage

Leverage or gearing means borrowing money to invest in risky assets. It can magnify returns when the asset goes up, but also losses if it goes down. Leverage is a double-edged sword and is strongly discouraged for all but the most wealthy and sophisticated investors.

You should also be aware of leverage in companies and funds you invest in. Using borrowed funds to boost returns is a common strategy. It can be useful under certain conditions, but the risks need to be carefully managed and fully disclosed.

Rule 8: Minimize complexity

Stay clear of investment products that are highly complex and that you don't fully understand. If you can't explain it to your granny, you should probably avoid it!

Rule 9: Consider taxes and fees

Always consider the tax implications and the fees associated with any investment you make. Neither can be avoided, but both can be reduced if you play it smartly!

Rule 10: Keep an eye on your net worth

Net worth is the difference between the market value of your assets and liabilities. It can vary for many reasons, but should gradually increase over time as you earn and save more, your investments increase in value, and you build your "home equity" by repaying the mortgage. But beware: rising incomes can lead to higher spending financed by debt, while investments can turn sour. Check your net worth from time to time to make sure you're on the right track!

Rule 11: My home is my castle

In recent years, house prices have risen sharply in many countries, as low interest rates made investing in property more attractive. There is no guarantee such trends will continue, but owning a home – if you can afford the mortgage – can provide financial security and personal comfort. A roof over the head will always be worth something (especially in countries where it rains a lot…😉)