PRINCIPLES FOR THE INDIVIDUAL INVESTOR

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Abstract

The article tackles the subject of principles, decisions and behavior that individual investors should adopt and implement in order to obtain good results from their activity over long periods of time. The paper describes and defines what an investment truly means and how is it different from speculation, it takes a look at what are the main characteristics of major investment classes and how they perform over time.

So, I invite anyone interested in the fascinating world of investments and financial markets to go through the pages that follow and, weather you already have a lot of knowledge in the field or you are in a stage of fast accumulation in the desire to cultivate financial and investment education, I hope you will find the reading both enjoyable and useful.

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JEL Classification: G00 (General Financial Economics), G02 (Behavioral Finance: Underlying Principles), G10 (General Financial Markets), G11 (Portfolio Choice, Investment Decisions), G15 (International Financial Markets)

Introduction

In today's society most of us whether we like it or not, whether we are interested or not, whether we do it or not, we must be and we are to some extent investors. Of course, the nuances that this feature of ours has differs greatly from case to case but we all share, in one way or another, the element underlying the whole concept of investment: giving up some of the present benefits in order to enjoy superior benefits in the future.

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Why are we doing this? Generally, for two reasons: either because we need and we must, even through legal obligations in some cases, or because we want to conserve and increase our wealth. The second reason is the one that really fascinates and the main element on which the success of this initiative depends is compound interest, also called "the eighth wonder of the world". Therefore, we will continue to discuss what principles, approaches and ways of action can maximize the long-term returns, or the compound interest, for our investments

Distinction between investment and speculation

A clear and concise distinction between investing and speculating is provided by Keynes (1936) saying that investing is an activity of forecasting the yields of an asset over its lifetime and to speculate is an activity of forecasting the market psychology. It can be deduced from this that if in the case of investments we are talking about an objective analysis of the economic characteristics that an asset possesses, in the case of speculation its characteristics do not prevail but what the market perceives and believes about it in any given period. Another way to differentiate between the two terms is offered by Graham (1972) namely: an investment operation is the one that, on a thorough analysis, offers the promise of recovering the initial capital and obtaining an adequate return; operations that do not meet this requirement are speculative. Again, by this definition the emphasis is on the fact that the investment requires an objective analysis of the asset, designed to estimate the returns that it can generate over time to the investor and to decide whether they are satisfactory or not, while trading assets without meeting this condition falls within the sphere of speculation. Similarly, in Buffett's view (2002), an investment involves laying some funds now for an asset that will return more funds over its lifetime from what it generates. The present discounted amount of those funds that the asset will generate in the future provides a maximum price level that should be paid to realize the investment. Speculation, on the other hand, also implies laying some money for a certain asset but in order to obtain a larger amount of money from its sale at a later date, leaving aside what the asset itself can generate from operation. Thus, in the case of an investment, the current market price of the asset after the acquisition should not be a concern for the owner but the cash flows that the asset produces. In the case of speculation however, the owner of the asset is permanently dependent on what the market or the next buyers of that asset are willing to offer for it.

In my opinion, it is safe and prudent to say that a distinction between investment and speculation can easily be made when it comes to a certain category of assets, namely non-productive assets. Purchasing them cannot be considered an investment in the sense of the above, since this type of asset does not generate any income in itself. Whether we are talking about, for example, precious metals, commodities, unexploited land, or, more recently, cryptocurrencies, their owners are always dependent on what the market is willing to offer as a purchase price for them at any given point. As such, buying and trading non-productive assets falls as speculation. But with regard of productive assets however, things become more nuanced. We cannot say that their acquisition is automatically qualified as an investment operation only because it generates income. In fact, we can recall the relatively recent events in which huge speculative bubbles were formed from the trading of some

productive assets of the most important ones: real estate, in the pre-crisis period of 2008, and the shares, especially those of the technological companies, during the "dot com era" from the late 1990s, early 2000s. In order to qualify as investment, the acquisition of a productive asset is vital to meet these essential conditions: the medium and long-term outlook of the revenue it generates to be good and the price at which the acquisition is made to be reasonable in relation with it. Of course, the lower the price or the higher the future revenue than expected, the more efficient the investment will be.

Main Investment Asset Classes

As distinguished in the previous chapter, when referring to investment assets, we will refer only to the productive ones, which generate income for their owners. These assets can be generaly classified in four main classes of assets available to individual investors, namely: cash equivalents, medium and long-term bonds, equities and real estate.

"Cash equivalents" are the most liquid and probably the most simplistic, including savings accounts and bank deposits, money-market funds, short-term government securities (generally with a maturity of up to one year) and so on. They are characterized by very low or no volatility, and for this reason and because most of them are guaranteed by the state in one form or another, they are considered risk free. The yields they offer however are among the lowest usually to barely keep pace with inflation, sometimes over, sometimes below this threshold. Thus, at the level of the individual investor it is a mistake, in my opinion, if one's investment horizon is long, for many years or decades, to keep capital invested in this asset class. This is not just risky, but is certainly a losing strategy in terms of cost of opportunity against the alternative of investing in asset classes with higher returns. This asset class, of cash equivalents, is useful for investors in the short term, just as a "parking place for capital" until finding attractive placement opportunities.

Table No. 1: 3M US T-Bill Yields

Period	Arithmetic mean of annual yields	Average annual rate of return (geometrical mean)	Nominal compounded value of 100 USD invested at the beginning of the period
1928-1937 (10 years)	1,61%	1,61%	117 USD
1938-1947 (10 years)	0,26%	0,26%	103 USD
1948-1957 (10 years)	1,67%	1,67%	118 USD
1958-1967 (10 years)	3,28%	3,28%	138 USD
1968-1977 (10 years)	5,76%	5,75%	175 USD
1978-1987 (10 years)	9,07%	9,04%	238 USD
1988-1997 (10 years)	5,37%	5,36%	169 USD
1998-2007 (10 years)	3,49%	3,49%	141 USD
2008-2017 (last 10 years)	0,42%	0,42%	104 USD
1968-2017 (last 50 years)	4,82%	4,77%	1028 USD
1928-2017 (last 90 years)	3,44%	3,39%	2016 USD

Source: Prof. Aswath Damodaran's data series from NYU's Damodaran Online and personal processing

The second major class of investment assets available to the individual investor is medium and long-term bonds. The main investor risks within this type of instruments are credit risk and currency, or inflationary risk. As with all market economies the targets are for moderately positive inflation, as it is normal to be in order to stimulate investments and productivity, I would say that the inflationary risk is not just a risk to bonds but a cost instead, considering the level of certainty to occur and thus, it should be deduced from the nominal income by investors in order to analyze in real terms the attractiveness of the investment.

Table No. 2: 10Y US T-Note Yields

Period	Arithmetic mean of annual yields	Average annual rate of return (geometrical mean)	Nominal compounded value of 100 USD invested at the beginning of the period
1928-1937 (10 years)	3,65%	3,57%	142 USD
1938-1947 (10 years)	2,72%	2,74%	131 USD
1948-1957 (10 years)	1,97%	1,92%	121 USD
1958-1967 (10 years)	2,21%	2,17%	124 USD
1968-1977 (10 years)	5,41%	5,20%	166 USD
1978-1987 (10 years)	9,99%	9,29%	243 USD
1988-1997 (10 years)	9,75%	9,42%	246 USD
1998-2007 (10 years)	6,39%	6,11%	181 USD
2008-2017 (last 10 years)	4,29%	3,86%	146 USD
1968-2017 (last 50 years)	7,17%	6,76%	2630 USD
1928-2017 (last 90 years)	5,15%	4,88%	7310 USD

Source: Prof. Aswath Damodaran's data series from NYU's Damodaran Online and personal processing

The third major class of investment assets, namely equities, are generally seen as one of the most risky classes of assets, because their prices are volatile, fluctuating in the short or medium term. But for the long term indvidual investor they are likely one of the best alternatives to choose from. If stocks are viewed and analyzed like what they really are and that is shares in various businesses, we realize that the investor in them has virtually the minority shareholder's share in a business, but with the benefit against the case where the business to be private, that the investor can sell at any time his participation at a price that the market is willing to offer, which should be done only if that offer is too good to refuse, according to the investor's beliefs, of course.

Table No. 3: S&P 500 returns with dividends reinvested

Period	Arithmetic mean of annual yields	Average annual rate of return (geometrical mean)	Nominal compounded value of 100 USD invested at the beginning of the period
1928-1937 (10 years)	5,01%	-0,62%	94 USD
1938-1947 (10 years)	10,06%	8,73%	231 USD
1948-1957 (10 years)	17,76%	16,49%	460 USD
1958-1967 (10 years)	13,92%	12,82%	334 USD
1968-1977 (10 years)	5,27%	3,64%	143 USD
1978-1987 (10 years)	15,65%	15,1%	408 USD
1988-1997 (10 years)	18,69%	17,9%	519 USD
1998-2007 (10 years)	7,14%	5,82%	176 USD
2008-2017 (last 10 years)	10,27%	8,40%	224 USD
1968-2017 (last 50 years)	11,41%	10,05%	11.995 USD
1928-2017 (last 90 years)	11,53%	9,65%	399.886 USD

Source: Prof. Aswath Damodaran's data series from NYU's Damodaran Online and personal processing

Regarding to real estate, which is the fourth class, there have been a growing number of financial vehicles in the recent period through which investors can take exposure to the real estate market through marketable securities such as REITs (Real Estate Investment Trust) or REOCs (Real Estate Operating Company). These are legal entities similar to companies, which are operating as open-end real estate investment funds. Thus, an investor can buy shares or fund units of theirs, thereby indirectly investing in various real estate market segments that are in their managed portfolios.

Table No. 4: FTSE NAREIT returns with dividends reinvested

Period	Arithmetic mean of annual yields	Average annual rate of return (geometrical mean)	Nominal compounded value of 100 USD invested at the beginning of the period
1972-1977 (6 years)	7,69%	2,06%	113 USD
1978-1987 (10 years)	15,18%	14,34%	382 USD
1988-1997 (10 years)	13,23%	12,12%	314 USD
1998-2007 (10 years)	11,50%	9,64%	251 USD
2008-2017 (last 10 years)	9,63%	7,75%	211 USD
1972-2017 (last 46 years)	11,41%	9,73%	7146 USD

Source: NAREIT's data series from www.reit.com website and personal processing

The main way of investing in real estate however is represented by private investments, of each investor on his own and without a system or a general framework such as stock exchanges. This is true especially considering those who own their living homes. I argue that this is an investment also for them even if they do not intend to generate further gains from it, considering saving the opportunity cost of renting a similar home, which is actually a form of hidden income.

Table No. 5: Real and total rates of housing returns

	Real annualized return 1950-2015	Real annualized return 1980-2015
Australia	8,6%	9%
Belgium	10,70%	9,35%
Demark	7,86%	5,17%
Finland	11,49%	9,47%
France	9,67%	5,76%
Germany	5,29%	4,12%

Italy	5,55%	4,57%
Japan	7,25%	3,58%
Netherlands	8,53%	6,41%
Norway	11,53%	11,34%
Portugal	8,18%	7,7%
Spain	5,83%	4,62%
Sweden	8,94%	9%
Switzerland	5,64%	6,19%
Great Britain	7,21%	6,81%
United States of America	7,58%	7,68%
Average return	8,21%	6,92%

Source: Oscar Joda, Katharina Knoll, Dmitry Kuvshinov, Moritz Schularick, Alan Taylor –
The Rate of Return on Everything, 2017

These results, obtained and presented in "The Rate of Return on Everything" (Joda, et al., 2017), show the real and total annualized returns, so which take into account inflation and the reinvestment of the revenue generated by the properties, for the housing (residential real estate) market in 16 major economies over the past decades.

Conclusion

Throughout the article we talked about how an investor should distinguish between investment and speculation and the importance that this has in his investment activity and about the main classes of investment assets that he has at his disposal, their characteristics and how they performed over time.

We can conclude from all of it that usually the long-term investor needs to concentrate a large part of his portfolio's resources on the stock and real estate markets, these being the asset classes that offer higher returns over long periods of time. Cash equivalents and bonds are instruments that should be held at a low degree in the long run. They are more useful to the investor as relatively short-term holdings when he or she considers the other classes of investment assets to be too expensive, in which case neither finding optimal particular investment opportunities in these markets (particular listed shares or real estate properties) is easy and common.

I also think it is always very important for any individual investor, regardless of the circumstances of the markets, to focus on the approaches, analyzes and investments that he personally understands and believes in. This gives the investor a certain degree of prudence and confidence in his own decisions and judgments, which may be of great importance, especially from his psychological perspective when inevitable and often unpredictable downsides of markets occur. These periods could be a real "stress test" for most investors, especially as they usually come after periods of euphoria generated by long-lasting up trends of the same markets. This is market's nature and the investor's duty is to adapt both in terms of knowledge and in terms of psychology.

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