MANAGING YOUR WEALTH IN UNCERTAIN TIMES

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Managing personal savings and investments is a quandary for many people. Finding your way through the hurly-burley of financial markets can be unnerving. But letting your money just sit there isn't an option either. Low savings rates increase pressure for higher returns elsewhere. But will interest rates remain low for much longer? Is the dizzying high of the stock market for real? Is it foolhardy to invest bank savings in the market? As people get richer the task of managing and retaining wealth becomes more complex. So how do you approach this?

Investors should take a long term perspective. Over time various types of investments of asset classes will earn different rates of returns and risk, or losses. A well-diversified portfolio of investments matched to a person's requirements and risk tolerance can lay the foundation for long term financial security. This is wealth management. Stock picking and market timing are not consistent source of returns. Avoid the temptation to chase markets and seek professional investment advice if you want to build wealth.

With recent changes announced in the Budget proposals, it is likely that Sri Lankans will be able to gain global investment exposure from early 2011. This will pave the way for truly diversified portfolios. This is an exciting period for Sri Lankan investors. However, investing globally also takes expertise, to understand the risks and rewards of various asset classes. Seek professional advice to make sure you and your investments match.

Wealth management, not investing, is the key
Wealth management is about matching an investor to a portfolio. It is not stock picking or investing cleverly in real estate. A concentrated portfolio faces greater risk of loss than a well-diversified one.

Wealth management begins by understanding yourself, understanding markets and finding a balance between capital preservation and future growth in your investment portfolio. It is important to do this in the context of your ability to bear losses and other constraints. The most important aspect of investing is to match the investor with a portfolio that is well diversified through asset allocation and suits individual needs and wants.

Know your weaknesses
Humans are emotional and operate on rules of thumb. When it comes to investing, this can be a risk. There is a large body of literature called behavioural finance which focuses on exactly this. Some of the key findings are that our behavioural biases are prominent in our investment decisions and can lead to poorly diversified portfolios, because we are over-confident of our ability to pick winning stocks, or we don't sell falling stocks, because we don't want to realise the loss. There are many other examples. The message is to be precise and rational when making investment decisions.

Investors are often motivated by fear or hope. Fearful investors aim for capital preservation. Hopeful investors aim for high returns even if it means more risk. In reality, there needs to be an optimal balance between the two.

Investors will often hold very concentrated holdings in one 'winning' stock. While this may be a great way to riches, there is also a risk the company may fail. One off events can have serious impacts on a company. For example, the global financial crisis has eroded returns on many financial service companies, which seemed bullet-proof only a few years earlier.

Wealth management means managing risks to your wealth and maximising returns.

Know who you are first
Know your goals and constraints before you start investing. In professional wealth management, the starting point is an Investment Policy Statement (IPS). The IPS is a detailed document that lays out an investor's financial goals, appetite for risk, ability to take risk and constraints.

Financial goals can be short or long term and are sometimes conflicting. They can range from retirement, sending children to a university abroad or an Alaska cruise. It is important to prioritise your goals and ensure that the

investments match them. For example, make less risky investments for goals you cannot do without, but take more risk with the Alaska cruise.

Risk is often difficult to identify and is prone to misunderstanding. Risk is the probability of loss. With fixed deposits, the risk of losing your capital is low, but erosion of your purchasing power is high due to inflation as the upside is also limited. With equities, there is a risk that you could lose money, but there is also a good chance of higher returns than fixed deposits. Different assets and investments exhibit varying degrees of risk. Cash and bonds are typically low risk, while equities and private equity are higher risk. Real assets come somewhere in between but does not offer quick liquidity.

Ability to take risk and appetite for risk can be different for different investors. An investor close to retirement may have a large enough nest-egg that he or she may wish to take more risk. However, there is little time before retirement to recover from a market fall, so their ability to take risk is low. Conversely, a young person should invest in higher risk assets, because they can easily recover from market falls. However, some young people may not want to take too much risk, because they are saving for a first home or a car.

It is important to also know your other constraints. For example, some may wish to bequeath to their children or donate to charities. This may mean a larger than otherwise retirement fund.

Match yourself to a portfolio

After a thorough self-examination in an IPS, the next step is to make investments. The investments should be such that they meet your return requirements and also your risk profile. The key driver for sustainable returns over the long term is asset allocation and diversification.

There is a large body of literature that shows the benefits of diversification and asset allocation. In fact asset allocation is the most important driver of long term returns. Fund manager selection or stock picking are much smaller contributors. There is some scope for tactical changes in the portfolio to match market conditions. For example, a professional wealth manager will reduce exposure to equities when markets are hot and increase exposure after markets have fallen sharply.

In constructing a portfolio, particularly for high net worth individuals, it is important to have a well-diversified portfolio. There is a dizzying array of investment products out there. The typical breakdown is between traditional and alternative assets. Traditional assets include equities and bonds, both local and global. But there is also a large range of investment options, including commodity Exchange traded Funds (ETFs) such as oil and gold, real estate investment trusts (REITs), currency ETFs and private equity.

Many assets move in opposite directions. Building a portfolio with a number of assets that respond to different economic and policy signals can reduce risk and smooth returns. This is why literature focuses so profoundly on diversification and asset allocation. A professional wealth manager will find a selection of assets that together maximise long term expected returns depending on the investor's risk tolerance level.

Understand your portfolio

Once your portfolio is all set up, it is important to review it regularly. Make sure you understand your portfolio, whether it is aggressive or conservative and whether the asset allocation is really providing the diversification you need. Compare your returns against benchmarks, like bank deposit rates but not returns on a single stock. Once a year, reassess yourself and your portfolio – make sure you still belong together. If not, reflect the changes in your personal circumstances in your portfolio.

Managing wealth

Managing wealth is about making an informed and long term investment decision that matches your needs and risk profile with an investment portfolio. The key to long term returns is diversification through appropriate asset allocation.

The universe of investments is large and risks vary. Investors have conflicting goals and risk profiles. Aligning everything can be a complex task. Seek advice from a qualified investment professional if you can't do it yourself.

Managing wealth is not about getting rich quick, or speculating on the stock market. Wealth management is a well-considered journey to prosperity.