Herald Sun

Choosing your objectives essential to an investing plan

TERMS OF TRADE
with CARL CAPOLINGUA

IN my last article I outlined the seven key components of a robust investing plan.

This week I will expand in greater detail on the first item, objectives.

Ideally your investing objectives are defined before you ever buy a share.

For many investors however, the sole objective of their first foray into the share market is probably to make a pile of money!

If the investment subsequently goes the right way, this objective might evolve into making an even bigger pile of money.

If the investment goes the wrong way however, it might become holding on until the original investment can be recouped (ie. break-even).

This is hardly a consistent and planned approach.

Before we can plot a course for success in any endeavour we need to know where we are going, or in this case, what investing outcomes we are trying to achieve.

It is also important to note that when we refer to "investing plan objectives" we mean long-term objectives of a portfolio as opposed to the objectives of any single investment.

So what are we trying to achieve with our investing?

Obviously the goal is to make profits. Note though, an investing plan which only has profit or "return" as an objective is only half-baked.

One must also set "risk objectives". Good investing considers both reward and risk.

Each will be governed by an investor's income requirements from their investing and their aversion to loss.

There are no strictly right or wrong answers when it comes to choosing objectives.

What I can do is provide some guidelines on robust and achievable objectives.

Firstly, let's define return and risk. I define return as capital growth and income received from investing activities over the course of 12 months expressed as a percentage of the starting amount.

I prefer to set a return objective on an after costs but pre-tax basis.

I define risk as maximum drawdown. This is the loss you will endure before removing yourself from the markets completely.

When setting a return objective the first important consideration is to make it realistic.

Start small with your expectations. It takes many years to become an expert investor who executes a well devised plan with total discipline and consistency.

The golden rule of investing is: more money, more expertise, and more effort, equals more return.

Also, returns are going to be largely governed by the performance of the market in which one operates.

The long-term return on the Australian sharemarket is approximately 8 per cent per annum.

A good guideline for a well-seasoned investor is a return objective of 2-3 times the return of the benchmark index.

If you're just starting out, your goal might be to achieve a return of just 1-1.5 times the benchmark.

A risk objective must also be realistic. In the markets reward and risk are inseparable.

If you desire a higher return you must endure a greater amount of risk.

If you adopt a system of maximum drawdown, that is, you completely exit the market when this objective is hit, you must be careful not to set your risk objective too low.

It could mean that you are out of the market frequently and therefore are unable to achieve your return objective.

Risk too much, however, and it might take you a very long time to recoup losses.

A good guide for setting your risk objective is approximately half-to-two-thirds your return objective.

So for example, an expert investor might have a return objective of 20 per cent and a risk objective of 12 per cent, while a beginner investor might have a return objective of 12 per cent with a risk objective of 7.5 per cent.

Carl Capolingua is senior trading Strategist at Elite Wealth

13 March 2015