Building wealth is about more than stock markets

As investors, we tend to spend our time selecting the right shares to buy. But if we step back, we may realise that our success in picking stocks may play a relatively small part overall in our lifelong financial security. We need to broaden our thinking and diversify our investments beyond stock markets. That may not be what financial advisors tell you of course. They will speak about 'diversification', but when most advisors use that word they usually mean diversification within the stock market, so they can continue to earn fees while managing your money. That is not real diversification. When markets panic, most types of market investment can suffer, especially when there is a liquidity problem, as we experienced in 2008. Investors are then forced to sell anything they can to raise cash. The good goes out with the bad (except perhaps government bonds). If we have a truly diversified portfolio, across many asset classes in addition to the stock market, we can breathe a bit more easily. The truth is, skill in picking shares plays a smaller part in building long lasting wealth than most investors realise. Total asset allocation across many asset classes plays a much larger role. The asset classes one might consider alongside shares are the subject of this article.

Asset Classes

1. Most of us own a home. Some of us might own additional properties as Buy-to-Let investment for income and capital gain. That is one asset class
2. Most of us pay into a pension scheme or expect a state pension. That is a second asset class
3. A third is the cash we hold
4. Fourth, one may own fine art
5. Fifth, some people stash away gold or silver for a 'rainy day' and never touch it, though others may trade it too
6. Sixth, the shares and bonds we use in the monthly investor portfolios can be considered another asset class, and though these may overlap with your pension scheme holdings they differ by being under your direct control
7. A seventh could be angel investments in other peoples' start-up companies
8. Investment in your own company is number eight
9. Land might be a ninth asset class
10. Ownership of shares in commercial property is a tenth.

Maybe you can add more. The list will be different for all of us. With a decent spread across several of these asset classes, wealth will be less disrupted by big movements in any one asset class. Some assets tend to do well when others are suffering, as they may be seen as 'safe havens' or be in different cycles. If we think we are really clever, we might try rotating our money between these asset classes to benefit from those doing well. There is a place for this within stock market portfolios (because different industries prosper at different stages of the business cycle) but in this bigger picture across all asset classes we may be wiser to hold long-term a spread of assets come what may and not try to predict economic, political and market conditions. That is what the wealthy do.

Each of us may have different views on the total asset portfolio we aspire to. The important point is that we have a plan, one that suits our aspirations and life-style.

Some of the assets listed above would seem applicable to most of us (home, cash, pension scheme, shares, gold and bonds.) Others require work (Buy-to-Let) for which we may not have time or require specialist skills that we lack but could develop with perseverance (angel investing, building a privately-owned business). The critical underlying factor, whichever asset classes we choose, is our personal skills, which we must continue to develop.

It will not be possible to achieve the finally-desired allocation immediately. Early on, we may need to hold more of our wealth in our own home and the stock market while also steadily contributing to pension schemes. As time passes, we may be able to take cash out of our stock market portfolio to re-invest in Buy-to-Let / property, gold, silver, land or fine art, which should reduce volatility in total wealth as market conditions and the business cycle change. As wealth increases, we may want to have a bit of fun and help society with angel investing, accepting that it is a lot of work to learn the skills and build and manage a portfolio. This option will not reduce volatility in total wealth but could increase it dramatically if we choose the right investments.

Wealth building through a diversified portfolio

With that background, let's look a bit more closely at building a diversified portfolio of assets. Ideally, over time we should try to construct a portfolio that can withstand all types of market conditions, but there are some basics that need attention first.

Cash: A first consideration is to have a cash reserve for emergencies. People vary in the amount they recommend – 6 months, 1 year, 2 years living expenses – but most agree that holding sufficient cash to cover at least 6 months living expenses is a minimum to guard against job loss, sickness etc. With increasing wealth, and particularly in retirement, we may prefer to be closer to 2 years' cash. In that position, one can sit out stock market crashes and house price falls and wait for the recovery without being forced into liquidating assets. For retirees, there may be little chance to recover if forced into such action, so a good cash reserve seems essential to me. Market crashes transfer wealth. Most investors lose by selling after markets crash, while the savviest gain, using their cash to buy at the better values.

Debts: The only borrowing I ever had was a mortgage on my main home. That was in the 1970s-1990s and my interest payments ranged between 10%-15%. Mortgage rates were never below 10% during those 25 years I had a mortgage!!! Often, over half of my income was going into paying the mortgage because of those high rates. Rates fluctuated terribly. I could never be sure that rates would not leap the next month and drive my monthly outgoings above income. I paid that mortgage off as soon as I could, when I first made a big gain in the stock market. The day I paid off my mortgage was one of the happiest of my life. I believe we should all pay off debts asap. *Interest payments on our debts only make other people wealthy.*

All Weather Asset Allocation: Let's be clear, it's a long road for most of us and the sooner we start, the sooner we will have financial freedom. The power of compound growth is amazing. Albert Einstein famously stated: "Compound interest is the eighth wonder of the world. He who understands it, earns it... he who doesn't... pays it." Play with your calculator and see how £10,000 grows over the years at 5%, 10%, 15%, and 20%. We tend to focus on the percentages but note how the years are just as important.

Percentage growth is never a steady 10 or 15 percent however. There are average years, boom years and years of bust in all investment markets. Ideally, we want to even out those ups and downs in our total wealth as much as possible both for our nerves and for income reasons. This is where asset allocation comes in. An 'all weather' portfolio should be designed to withstand inflation, deflation, both at the same time as we seem to have today, and also geopolitical panics and emergencies.

Banking crises should be given particular consideration, as they occur at least a couple of times in most lifetimes. Some of that emergency cash and holdings of precious metals and coins should be physically available immediately and not dependent on third party delivery or blocked by a government lock-down on banks. Remember Cyprus and Greece. It could happen anywhere. The G20, which includes the UK, has agreed to 'bail-in' depositors in future banking crises because governments can no longer afford to bail out banks. Greece and Cyprus can happen here and probably will one day.

Another factor is that our financial systems have gone almost totally electronic and web-based, which is great for convenience but open to hacking and unproven in a time of real emergency. It makes sense to be prepared for system failure even if that failure is only temporary.

So, what could a diversified portfolio look like? What percentage of assets could be held in each asset class? As we said above, it will vary for everyone. There are many publications on this topic. All we can do is give a 'typical' percentage that appears in the more thoughtful articles, and which accords also with the actions we have taken with our own assets. Planning for retirement, or in retirement, one could aim to gradually build something like this:

Cash 20% - 25%: Carefully consider the Bank Deposit Protection Limit set by the FSCS. From 30 January 2017, the UK deposit compensation limit is £85,000 though it can vary with the strength or weakness of the pound. If you have more than that, split it between two or more *unrelated* banks. (Check carefully). Even then, none of us can be absolutely sure that deposits within that limit might not be subject to 'bail-in' in a really dire situation. In the UK, National Savings might be the safest option of all as NS&I is guaranteed by a government that can 'print money' to pay back its citizens if necessary. Our neighbours in the Eurozone would not have that option. Also consider the speed of access to your cash. Keeping some physical cash seems wise (and gold or silver coins, see below).

Housing / Buy-to-Let / Commercial Property 20% - 25%: Our main home is part of our wealth. We spend decades paying for it and some people may use its capital value to generate cash in later life by 'downsizing'. Addition of a second property is a very different matter. In some ways, it resembles investing in shares because over time one will likely achieve capital growth as well as regular income. Buy-to-Let has been an area of interest to Chancellors wishing to take more from us in taxes, and that may continue. At the present time, Buy-to-Let remains attractive for those who have a just a few properties and who can purchase them with cash. If one has the means, owning at least one property in addition to the main home does give good diversification, protection against inflation, and a regular income stream, all for relatively little work if an agent is engaged to manage the property.

Pension schemes 25%: Most of us will have some pension from the state and we should be clear of the likely income we will receive. It will be small but all contributions add up in retirement. Personally, I think it wise to maximise that state pension.

Most of us will also have some type of pension from our career if we have been in employment, although entrepreneurs and owners of private businesses may fail to build a pension, relying instead on selling their business. Personally, having seen that in my own family, who mostly owned their own businesses and farms, I think it is a mistake to rely on the sale of a business when one wants to retire. Regular contribution to a pension scheme would help balance the risks and maybe give more flexibility in timing of the sale of a business, with better chance of obtaining a good price.

Gold and silver 5% - 10%: Consider using funds and ETFs for ease, but also physical holdings of gold in vault storage, and coins held at home or within easy access without dependency on banks. Silver coins would be easier to use for bargaining purchases in the case of a shut-down of the financial system.

Bonds 10% - 20%: One can hold bonds in funds as part of one's overall stock market investments. This is a very specialist area which was covered in David Brown's slide presentation to Markets Now in June 2017.

Many portfolios hold bonds, both for income and for hedging. We would intend to retain some as hedges through a bear market.

Shares 10% - 20%: Investing in shares can help grow capital and generate income if one has the skills, patience and emotional strength required. In keeping with the theme of this article, one should ensure that share holdings are diversified too. One needs 15 - 20 holdings across different sectors and investment styles to achieve this. Holding a good proportion of those in funds helps achieve that goal. Using several different investment styles also aids diversification, though one rarely sees that mentioned in articles.

Angel investments, fine art, land, classic cars etc 5% - 10%: Private investors I know personally, who participate in Angel or VC ventures generally restrict their investment to 5% or at most 10% of their total assets. One needs a portfolio of 30-40 investments to spread risk adequately, all of which require your due diligence and involve a lot of legal paperwork. It takes a lot of time and effort. Making a speculative investment in a company because one 'likes the idea' or for 'friends and family' is a good way to lose both money and friends! This is an area for High Net Worth investors who have the money, time, interest and skills. It is best to specialise in a sector that one really understands. Returns can be high, however - a figure of 22% annualised was published by NESTA, the UK innovation foundation. I suspect there is some 'survivor bias' in that figure as the loser investors will have disappeared from the scene. Investment in land or fine art may appeal to others.