



The benefit of hindsight – 23rd March 2009

What is the most useful tool a successful investor could have? Strong research? Access to company management? A prodigious memory? These are all useful – perhaps even vital – attributes. However, the most useful tool is the one thing nobody can have: the benefit of hindsight.

As long experience shows us, different asset classes and industry sectors will provide strong or weak performance at different times. For example, equities are widely acknowledged to have provided the best long-term performance of the four main asset classes - but most investors who lived through the meltdown of the "dot-com" sector know only too well that, in the short term, things can be quite different. Bonds on the other hand, are viewed as medium to lower-risk investments, particularly when economic growth is on the wane - but the recent credit crunch left many with burnt fingers. Meanwhile, in times of uncertainty, investors make tracks for the safe haven of cash – but leave your money there too long and the value can fall prey to the corrosive effects of inflation.

The theory runs like this: during periods of strong economic growth, equities are likely to perform well, whereas when economic growth is in decline, bonds and cash should prove more beneficial. "Specialist" asset classes – such as commodities and property – are also available and can perform differently from all of the above. However, do note - these need expert advice and should be approached with a degree of caution.

What can be tempting for investors is to chase the best returns by jumping from one asset class to the next when the returns look promising. However, in reality this rarely works. If judging the right time to switch and where to switch to were easy, we would all be rich. Even some of the full-time, so-called professionals consistently get these decisions wrong. Therefore, instead of trying to choose which asset class to be in and when, perhaps it would be better to have a bit in all the asset classes, all of the time.

This is called diversification – the act of spreading your investment across more than one asset class. In doing so, you not only make sure you are invested in the asset class that is performing best, you also ensure you are not 100% invested in the asset class that is doing worst. Instead you get a bit of everything – and as a result, your investment returns should be smoothed out as performance rotates through the asset classes and each compensates for another as time goes by.