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DROWNING IN INFORMATION, BUT STARVED FOR KNOWLEDGE

Many investors must face huge financial decisions, from how to fund a retirement that can last several decades to how to pay for a child's college education that could cost hundreds of thousands of dollars. Still, when it comes to knowing financial basics that could help them achieve those goals, many people get a failing grade.

The latest evidence of this is a test on investment terms and the basics of equity (stock and bond) markets and unit trusts given to 1,000 investors by the Vanguard Group and *Money* magazine. The average score was 40%, up only slightly from 37% on a similar test two years ago.

The majority of people taking the test didn't understand how much one they would need to save each year to reach retirement financing goals, didn't know the impact of expenses on unit trust performance, and had little idea which investment has offered the best protection against inflation over the long haul.

What you don't know can cost you. Vanguard commented, It's an opportunity cost. By not knowing those things, people are missing the opportunity to save, to perhaps do more with (a retirement account), invest in a less expensive fund or put more into equities because they have a long-time horizon and need inflation protection.

The problem may not be a lack of information but rather information overload, some say. Investors are drowning in information but thirsty for knowledge. Some financial experts say investment firms need to do a better job of teaching the basics to investors. But investors need to do their part, too. People need to apply the same amount of time to investing as you would to buying a car or house. It's that important. With that in mind, here are some of the issues that gave investors trouble on the multiple-choice financial test.

- Bonds and interest rates. This relationship is often misunderstood, and only 31 percent of investors taking the test knew that when interest rates fall, the price of an existing bond or bond fund generally will rise.

Say you bought a bond that pays annual interest of 6 percent and want to sell the bond before it matures (as most bond buyers do). If interest rates have fallen since the bond's purchase and new bonds offer 4 percent, your bond is much more attractive and you can sell it for more than you paid for it. If rates have risen and new bonds carry a 7 percent rate, your bond is less enticing and you will have to sell it at a discount.

This inverse relationship may be even more important to understand now because so many investors, disillusioned with stocks, are chasing the better-performing bonds and bond unit trusts. In the first nine months of this year, the net cash flows into global bond funds reached \$102.3 billion, up from \$59.5 billion in a similar period last year, according to the Investment Company Institute. Unfortunately, the fact of it is, interest rates are really, really low, and that has given bond funds an exceptionally good performance during the last couple of years. When rates start to go up again, a lot of those bond funds will get hurt-- as will the poorly educated investors who chase their past yields.

- Stocks over the long haul. Seventy percent (70%) of those surveyed didn't know that stocks generally have outpaced inflation in the long run. More conservative investments, such as bonds and money market investments, may not pay enough interest to keep up with inflation. In addition, two-thirds (67%) didn't know that the average annual total return of U.S. stocks from 1926 to 2001 was 11%.

Investors often overlook how factors such as timing can affect returns. For example, if you invested at the top of the market in 1929 (just before the great depression) and didn't reinvest dividends, by today you would have had an average annual return of 4%. If you invested in US major stocks at the bottom of the 1932 bear market and reinvested dividends, your average annual return would have been about 13.5%.

Global stock market investors should expect future long-term returns somewhere between those extremes.

- Fund expenses. Say two unit trusts hold the same securities, but one has higher operating expenses. Only 36% of test takers recognized that the fund with lower costs would have a higher return. Annual operating expenses, expressed as an expense ratio, are taken out before returns are reported. That can make them easy to overlook. But expenses can make a big difference, particularly during bear markets, which was a contributing factor to 84% of all CPF approved unit trusts losing money (-15% on average) during the third quarter of 2002 in Singapore.

When the stock market was going up by 20 or 25 percent every year in the late 1990s, paying 2% fees didn't seem like a big deal. But in a 6% environment, paying 2% to own a unit trust, your return gets lowered to just 4%, and fees come under close scrutiny again, as they should.

- CPF contributions. Many investors don't understand the tax and compounding advantages of maximizing CPF contributions and investing CPF funds into inflation-protected vehicles. Today, most of your CPF savings can be placed into low cost stock market index funds to achieve long-term market returns, and a portion can even be allocated into individual (approved) stocks. Of course, you can also apply CPF savings into a property investment, but this won't help your cash crunch at retirement. If you retire at 65, and live to 95, you need 30 years of income! That requires careful and effective advance planning.

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