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ASK DR MONEY

How to earn high returns with low risk

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Q: I would like to earn high returns in the stock market but take no risk of loss. Please tell me how to do this.

A: What you are asking for seems impossible, but incredibly, it can be done.

Conventional wisdom is, 'You can't get high returns without taking risk', 'There is no free lunch' and, 'You can't get something for nothing.'

Recent stock market research shows this is not correct. You can earn high returns with little risk of loss. Not only that, it is easy.

The only requirement is that you remain invested in shares for the long-run. If you do, you can expect to earn 15 per cent per year on a diversified portfolio of Singapore stocks, with little risk of losing your money.

A diversified portfolio of US stocks will earn about 12 per cent.

THE EVIDENCE

The evidence comes from the US, with its history of 200 years of stock market data.

It shows that risk declines as an investment's holding period increases.

A key statistic is that over the past 200 years, there has never been a 17-year period in which stocks have shown a negative return.

Another is that over holding periods of 10, 20 and 30 years, stocks have out-performed bonds 80, 90 and 100 per cent of the time respectively.

This shows that many of us are making the wrong investment decisions by keeping our long-run investments in fixed deposits, bonds and guaranteed funds.

We think of these investments as less risky, but precisely the opposite is true. The safest long-term investment for preserving your wealth is a diversified portfolio of stocks.

As the holding period increases from 1 to 3 to 8 to 17 and to 30 years, you can make more risky investments without incurring the risk of loss.

(By the way, this doesn't mean, you must buy one particular counter like SingTel and hold it for 17 years in order to enjoy high returns with no risk of loss. You can still buy and sell frequently, but it must be among other stocks and stock funds.)

TIME DIVERSIFICATION

If you haven't heard about this, you're not alone. Even financial advisors seem unaware that stocks are riskless for long-run investors. They continue to wrongly advise that you are better off by putting your CPF money into guaranteed funds.

This finding goes by the name 'time diversification', and there are dozens of academic articles on the subject. However, the good news hasn't filtered down to the man on the street.

There is a possible flaw.

Nobel Prize winning economist, Paul Samuelson points out that: 'We have only one sample of history'.

What if Germany and Japan had won WWII? What if there had been a nuclear war? Surely, that would change the statistics.

The risk of a catastrophic event producing huge stock losses increases with time. This seems to make long-run stock investing less of a sure thing.

A SURE THING?

No worries. Stocks are a sure thing. Here's why:

(i) First, we should ask, 'If there were a long-lasting disaster, would bonds and fixed deposits be less affected than stocks?' I doubt it.

Suppose a terrible event like a nuclear war wiped out half of humanity. Then, bonds and fixed deposits would probably become worthless, just like stocks.

(ii) Second, a statistical fact is at work. That's because stock gains can exceed 100 per cent but losses cannot.

For example, stocks earning 15 per cent per year will double in value - a gain of 100 per cent - every 5 years. In 30 years, your stock investment will grow an incredible 66 times, a gain of 6,600 per cent!

On the other hand, stocks will never fall more than 100 per cent. That's because the most you can lose is all of your investment.

Recommendation: Stay invested for the long-run. If you have CPF funds which you don't intend to touch for 17 years, I suggest you invest all of it in stocks or stock funds.

These are more likely to preserve your wealth than a strategy of investing in fixed deposits, bonds, guaranteed funds and other so-called safe investments.