The Expat Spouse as Household CFO: What You Need to Know About Investing

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This is the fifth installment in "The Expat Spouse as Household CFO" series. To read the previous installments in this series, see recent AWC newsletters or contact Creveling & Creveling, www.crevelingandcreveling.com, for copies.

Last month we focused on how you as the accompanying spouse can help your working partner and family members boost your household's savings. While saving is one of the most important tasks you can take on, unfortunately very few of us will be able to save enough to afford to keep all of our savings in cash or in a savings account. Therefore in addition to saving, it's also important that you learn how to invest your savings wisely.

Investing is a full-time profession for many, and myriads of books have been written on the hows and whys of making smart investment decisions. Expats also must consider the role that different currencies and tax jurisdictions should play in their portfolio. Given the complexity involved, our goal here is to simply introduce you to some of the concepts behind successful investing, as well as to provide you with some additional resources and book recommendations to further your understanding.

The Difference Between Speculating and Investing

In popular media, speculating is often confused with investing, but there is an important difference between the two. Speculating involves betting on the direction of short-term price movements, while investing is purchasing assets that generate an economic return over time. Betting on the short-run (also called market timing) is generally a losing proposition – you may occasionally get lucky, but you'll generally lose over the long-run. This is because short-term returns, driven by market greed and fear, are inherently unpredictable. On the other hand, long-term investment returns are ultimately driven by the cash flows generated by the underlying businesses. Having a calculated, well-thought out long-term investment strategy is much more likely to work for you than trying to time the market and hoping to get lucky.

Risk, Return, and the Relationship Between Them

Return is generally defined as how much you've made on an investment, and it is measured in percentage terms versus the original cost of the investment. At a basic level, we often think of risk as the possibility that a given investment will lose money. In the investment world, risk is often defined as deviation from the return that was expected. Risk is often measured in terms of annual volatility or standard deviation from the mean, but both risk and return can be measured in either the short or long-term.

The important points for you to remember when it comes to investing are: 1) It is really the long-term return and risk taken that should concern you; and 2) There is a link between the amount of risk taken and the expected return of an investment. Generally, you have to take on more risk (in this case, annual volatility in the price of your investments) in order to get a chance (not guarantee) of a higher long-term return.

Diversification - Not Putting All Your Eggs in One Basket

Diversifying means spreading investment risk between many investments. Holding a couple of concentrated positions in individual stocks, even market favorites like Google or Apple, rarely makes sense. The risk of something going wrong in owning just a couple of stocks is simply higher than can be justified by the potential return those stocks may generate.

A better strategy is to purchase the entire asset class (in this case US Large Cap Growth stocks). While some of the companies in an asset class may experience real difficulty, overall a broadly defined asset class will not. Instead, the value of the asset class can be expected to appreciate over the long run, corresponding with the aggregate growth of the underlying companies in that particular asset class.

In today's world, buying an asset class is easy to do – you can purchase an index mutual fund or Exchange Traded Fund (ETF) that tracks the entire asset class. That way you get the overall growth of the asset class combined with diversification benefits, but at a far lower cost than you could do on your own.

Asset Allocation - The Driver of Long-Run Returns

Allocating your savings between a defined mix of different asset classes is called "asset allocation", and numerous studies have shown that it is asset allocation (as opposed to market timing) that is the major driver behind the long-run return of a portfolio. The greater proportion of volatile asset classes (equities and alternatives) that you include in your portfolio, the greater your chance at a higher returns over the long-run. But to have a shot at the greater long-run returns, you'll have to put up with volatility. Remember that while diversification will reduce your risk of loss, it doesn't guarantee that your portfolio won't experience a down year.

Investment Portfolio Returns - What To Expect

The following table is intended to give you some realistic expectations of what kind of returns an investment portfolio might generate over the long-run, as well as what types of short-term (single year) losses you might have to put up with on the way to achieving those returns. As this table shows, if you were to look back after more than 30 years of investing, the pathway to the end result would have been volatile, but if you were to take an average of the return achieved, you would find that you'd done well:

Investment Portfolio Returns (1970-2010, in US Dollars)

Broad Asset Allocation		End value of $10,000	Worst One Year Loss (2008)	Avg. Annual Return		One Year Range of Returns
Equity: Fixed Inc	Risk			Total	Real	
20% : 80%	Low	$247,424	-4.0%	8.1%	3.8%	2.2% - 14.0%
40% : 60%	Moderate	$287,861	-11.6%	8.5%	4.2%	0.5% - 16.6%
60% : 40%	Moderate	$358,161	-21.0%	9.1%	4.7%	-2.0% - 20.3%
80% : 20%	High	$450,133	-30.0%	9.7%	5.4%	-4.8% - 24.3%

Source: Ibbotson & Associates, MGP

Notes: Both equity and fixed income are globally diversified among several sub-asset classes. Returns are pretax and exclude fund fees and assume annual rebalancing. Real return excludes average inflation of 4.38% per year during the period. One Year Range of Returns corresponds to one standard deviation, or the range that returns fell within two out of every three years

Passive vs. Active Funds - Why Minimizing Fund Fees Matters

To get exposure to a certain asset class, you can either choose a passively managed fund such as an index mutual fund or an Exchange Traded Fund (ETF), or you can choose a mutual fund with an active