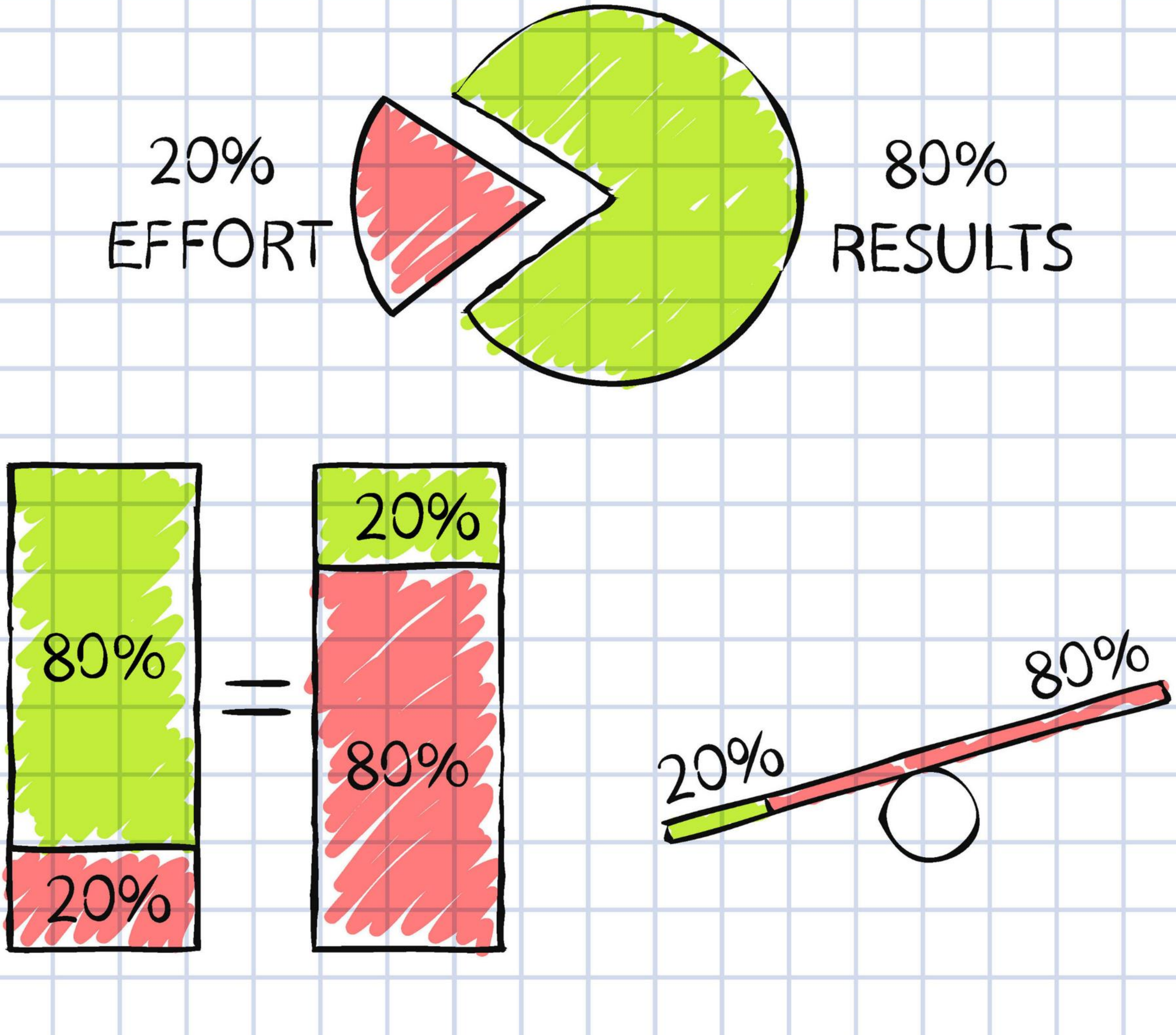
THE 80-20 RULE



The 80-20 Rule

One of the biggest issues for equity investors is their propensity to gamble. This is especially so if the investor is rich or young. There are a lot of people in Australia who, at the age of 40 or so, still have 20-30 years to retirement, have collected a bit of Super and know they have the ability to set up an SMSF and choose where to invest the money rather than simply keep topping up some managed fund suggested by their employer.

The danger here is threefold:

- **They don't know how to invest even though they can** (technology is not always progress). There is a base level of trading knowledge you can acquire and should acquire before you go trading and investing, but it does take time to acquire and many people don't have the time and interest and are impatient to set up their trading account and start hitting the buttons. As one of my tennis colleagues who trades full time and retired at 50 to trade, says, it is about learning a process and you need to start with a clean sheet.
- **They have a propensity to gamble**, everyone does to some degree, it's just which shade of grey you are. But when it comes to gambling the inevitable is inevitable and if the government really wanted everyone sucking on the State Pension then they have done the right thing, put large sums of superannuation money in the hands of many unqualified and impatient individuals who live on a diet of adverts some of which say gambling and is smart and clever and in the same Ad break say taking control of your Super is smart and clever. If you believe the Ads anyone would think that gambling also makes you happy and that the winners are social heroes, all of which is the utter opposite of the truth.
- **They are too young or rich to care whether they make money or not**. They don't see Super as 'real' money. It would actually be far better to open one of those very technologically dazzling online betting accounts and lose $10,000 in a year fulfilling your gambling urge in the open (honestly gambling) than you take the same approach to the money that has been painfully collected over decades to buy your groceries and pay your electricity bill when you are a retiree. Because your superannuation money is real cash. It will be paying the bills. You will be withdrawing it from an ATM. Money is time in the end. Making it is buying time and losing it is giving away years.

Trading and investing (the same thing but on a different time frame) can become a fantastic, absorbing and stimulating intellectual pursuit, but for the majority who get sucked into it by the advertising, or on the suggestion of some financial professional, it can be a rather painful experience in failure, which, if made public, would be humiliating, but isn't made public because rather conveniently, nobody else is allowed to see your trading account but you, which means you can sweep your incompetence under the table and no-one is the wiser. This confidentiality is perfect for the industry that lives off your activity. The winners shout it from the roof tops and the losers slink off into the dark corners. Everyone is a success in the investment game, didn't you know? The truth is that if you could all see the average return and the average lifespan of traders on some of the online platforms it would be indistinguishable from that of an online betting account, if not more shocking, because the sums of money involved are larger and it is portrayed as intellectual not dumb.

So how does a young and rich first-time investor limit the damage and rein in the propensity to gamble? It's called risk management.

RISK MANAGEMENT

Risk management is a bit of a clichéd expression and everyone nods when you mention it but, on the ground, for the new investor, what does it mean?

There are a number of ways to limit your risk. Marcus Today Members get a pretty quick education in the identification of risk (volatility, ATRs) and the risk management of individual trades through the use of stop loss mechanisms (see our TRADING PORTFOLIO section to see that in action). But there are more holistic approaches to risk management, and this is one – the 80-20 rule.

THE PARETO PRINCIPLE

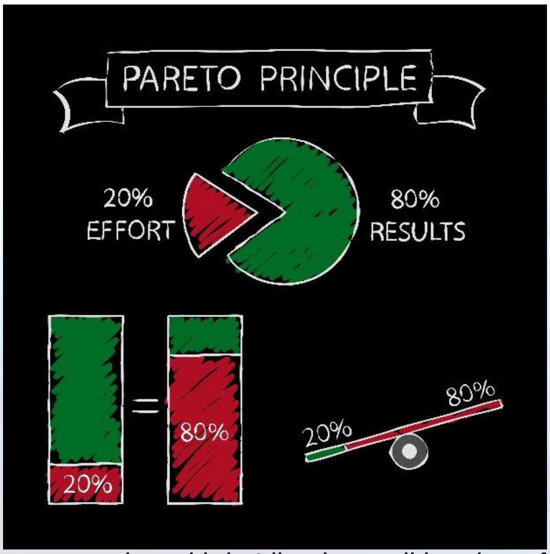
The '80-20 Rule', otherwise known as the Pareto Principle (you can Google that).

"….was first introduced by Italian economist Vilfredo Pareto, who, in 1906, observed that 80% of Italy's land was owned by 20% of its population. From there, it was developed by Joseph Juran, a 20th century figure in the study of management techniques and principles. Jurin took the rule and applied it to a number of different facets of business and the economy. It is now used to describe almost any type of output in the real world".
- Investopedia

Wlfredo Pareto
(1848-1923)

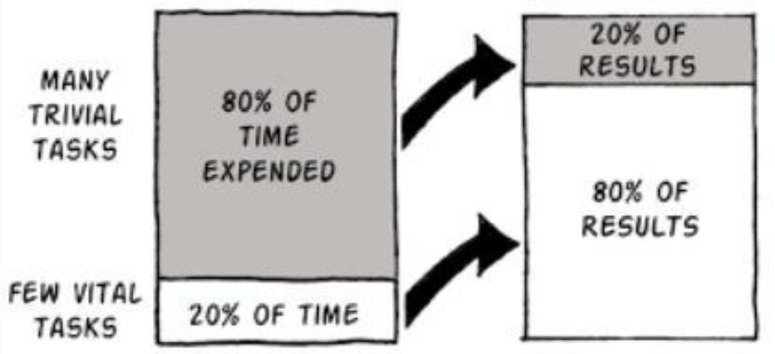
The most obvious example in business would be that 80% of the revenue comes from 20% of the clients, 80% of your revenue that comes in is generated by 20% of your employees, 80% of clients are closed by the best 20% of the sales people, and the original observation that 80% of a country's wealth is held by 20% of the population. But the purer version of the Pareto Principle is the statistical observation of the distribution of data that suggests that 80% of a specific event can be explained by 20% of the total observations.

The most common use of the Pareto principle is in time management whose creed is to rate tasks by importance and deal with the major tasks as a priority.
In business the idea is that you are better to provide an excellent service to the 20% of your clients that provide 80% of your income than to dilute that service by trying to provide it to the other 80% of your clients that only earn you 20% of your income. The business depends on the 20% not the 100%. Every client should be identified by their revenue and serviced accordingly, not all treated the same. At the very least, the best staff should be allocated to the 20% and with the 80% handled by less skilled and cheaper resources and in so doing you will see improvement in time management, productivity and overall client satisfaction. With an 80-20 understanding businesses will also find the focus turns to acquiring top 20% style clients rather than a lot of rats and mice. Value not volume.



In investment the suggestion is that 20% of your stocks are responsible for 80% of the returns. Which raises all sorts of issues, one of which is that you should focus on the stocks that are going to give you outperformance rather than all your stocks. The way you do that is to confine 80% of your money to 'average' or 'safe' stocks that don't take rocket science to pick and are relatively low risk and focus on getting a higher return out of 20% of your money.

This is a fairly standard approach that certainly works in some hands. My broking house for instance had an 80:20 Equity fund that my Super went into for a while. The idea is that you take 80% of your investable money and do something conservative with it. Like the traditional portfolio thing that most SMSF investors do, investing in 10-20 big stocks. Or something even more conservative like buying a managed fund, an ETF, an LIC or a term deposit or a property. Basically, something low or no-risk that that will deliver you a reasonably predictable or (in equities) average return. Something you don't have to worry about and tinker with.



In the 80:20 fund I was invested in for instance the 80% was confined to be invested in ASX 200 stocks and the 20% was to be invested in resources where this particular fund manager thought he had an edge. It was more marketing than reality (turned out he didn't have an edge and he burned the 20%) but that doesn't mean it won't work for you as a quasi-risk management method. 80% in boring investments, 20% to punt with. Sort of allows you to do the gambling whilst protecting the body of your Super.

If you are an 'engaged' investor the 80% will still provide you with a solid intellectual pursuit (picking 10 to 20 good stocks) and stills allows you to add some value above the average with good stock selection. That's the 80%. Plenty to be getting on with and most of you will be doing this already.

The other 20% you invest in higher risk/reward stocks. The 80-20 fund I was in said in its marketing that they would invest the 20% in "more entrepreneurial, speculative or trading stocks and other event-driven opportunities that may be outside the S&P/ASX 200, including capital raisings, entities raising additional capital or entities stating an intention to list on the ASX".

You get the idea. For you the 20% might be used to pick smaller stocks or used to trade with over a shorter time frame, put into IPOs or simply just stock pick growth companies. It matters not because the main game of the 80:20 approach in the hands of the amateur investor is not so much that you have a crack with an aggressive 20% but that you have a safe core in the 80% and in so doing limit your exposure to risk, volatility and in the case of some less capable investors, stupidity and the propensity to gamble instead of invest.

Without this framework a lot of private investors are liable to put the whole 100% in the face of danger without structure or discipline. 80:20 is a risk management system for people who are not responsible whilst in the hands of good (note: good) professional stock pickers it is a great structure that allows an in-depth knowledge of small stocks to be exploited within a structure that still appeals to the mainstream 80% investors. Done by clever stock pickers the 20% adds icing to the cake and in the hands of good stock pickers the cake can be pretty good too.

But the main point is that in the hands of the amateur the focus is on risk management, getting you to put 80% aside, to limit your exposure to your own gambling, for your own good.

Of course, 80:20 is only one suggestion. For the truly irresponsible who, were they honest with themselves, have failed in their pursuit of high gains in short time periods (everyone) the ratio might be better at 90:10, or even, try this, 100: zero with your spouse giving you $100 a week to spend on the pokies or the TAB or the bookies.

After all, if it's just the desire to gamble you are trying to satisfy there are better ways to do it that putting your whole financial future on the line, something that everyone is now, unfortunately, in a position to do without any investment skills, training or regulation.

At its best the 20% adds upside, excitement and hope and at its minimum protects the 80% of your money whilst you try to beat the averages with the rest. The main message is "Don't bet it all".

If you are already in control, you won't need this mechanism to rein you in. It's really for the inexperienced whilst they are finding their legs.