

The Frog Investor

September 2007

Apparently if you drop a live frog into a pan of boiling water it will jump straight out and will suffer no adverse consequences. If, however, you place it into a pan of cold water and very gradually turn up the heat, the frog will not jump out. Instead the frog will boil to death, oblivious to the changing temperature of the water until it's too late for it to muster enough energy to escape. Investors are sometimes a bit like frogs in water and from time to time will be either (or even both) a jumping frog or a sitting frog.

Jumping frogs

Jumping frog investors jump into the latest 'hot' investment, whether it be emerging markets, gold, technology stocks, hedge funds or Japanese smaller companies. Inevitably, after the boom comes the bust, which is usually within a few months of the investor piling into the 'hot' fund or sector. This is when the investor has his or her first frog experience. They jump straight out of the 'hot' investment, and wait for the market outlook to become more 'certain', whatever that means! Unfortunately this buy high and sell low strategy, together with periods of time sitting on the sidelines out of the market, causes the frog investor to miss out on the returns that are there for the taking for the logical, disciplined and patient investor.

Sitting frogs

Sitting frog investors take two forms: the 'investment' and the 'cash' sitting frog. The investment sitting frog invests their money into a portfolio comprising typically equities, fixed interest, property and possibly commodities. The amount allocated to each asset class being plucked out of the air and reflecting how the investment sitting frog investor felt at the time, which in turn was influenced by what the media was saying at the time. Over the years the investment sitting frog investor sees their portfolio rise in value so they are very pleased. Because the investment sitting frog never looks at their regular portfolio statements in detail, they don't notice that equities and property have surged in value and now make up 75% of the portfolio, compared with the 30% originally

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allocated to such risky assets.

Unfortunately, there is then a meltdown in the banking system caused by dodgy mortgage lending, which causes a once in a century crash in the value of equities and property. By the time that the sitting frog investor realises that the portfolio has been affected by the banking meltdown, the 75% held in equities and property has now fallen by 40%, causing a 30% fall in the value of the entire portfolio. Had the investment sitting frog investor rebalanced their portfolio back to the original allocation when the market had been high, they would not be looking at losses of a painful 30% but a bearable 12%.

And finally we move onto the cash sitting frog investor, who doesn't like investment markets so they decide to leave all their money in the bank to earn interest. Being a very careful frog investor, the money is spread across several banks with good credit ratings and competitive interest rates. Over the years the cash increases in value as interest is added and the cash sitting frog is happy. Unfortunately, the cash sitting frog investor isn't aware that the purchasing power of their capital is gradually but surely falling. Our sitting frog investor thinks that their capital is safe but actually, after tax and inflation, it is now worth less than they invested in terms of what it will buy.

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Even at a gross interest rate of 6%, after tax this equates to 3.6%, assuming higher rate tax (4.8% for a basic rate taxpayer). The Retail Prices Index (RPI) to 31st August was 4.10%, which is over twice the official inflation rate based on the Consumer Price Index (CPI) of 1.8%. However, the CPI is constructed in such a way as to be meaningless in financial planning terms. Many people are experiencing even higher rates of personal inflation, but we'll assume that the RPI is a fair indication of general inflation. After adjusting the net interest earned for the 4.1% RPI, our sitting frog investor is earning a negative real return of 0.48% per annum after higher rate tax or a marginally positive 0.67% after basic rate tax. Over a ten-year period this would mean a fall in the real value of the cash sitting frog investor's capital of 5%, even though they thought they were in a 'safe' investment.

Frog investors are destined for failure; either because they spend their days jumping about from one investment to another and destroying value in the process or because their inertia



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means that their investments or cash aren't periodically reviewed and adjusted to reflect the changing investment and economic environment.

Smart people aren't frog investors. They don't jump in and out of 'hot' or flavour of the month investments or react to the 'noise' of the market. This gives them the ability to capture the returns from capital markets which are there for the taking. They also don't allow their wealth to drift and be attacked by market movements, inflation and tax. Instead they make sure that their investment portfolio is regularly re-balanced whenever the various components deviate from their own specified allocation. They also only hold cash for the short to medium term and only then in a suitable tax shelter, spread across a number of different banks, notice periods and yields (both fixed and variable).

So next time that you talk to someone about investing ask yourself "Is this person a frog investor or a smart investor?", because there are an awful lot of frogs out there!

Contacts	Telephone	Email
Jason Butler	07973 951107	jasonbutler@bloomsburyfp.co.uk
Carolyn Gowen	07775 712969	carolyng@bloomsburyfp.co.uk
Robert Lockie	07951 725880	robertl@bloomsburyfp.co.uk

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