Rebound from share shocks

Anthony Keane reveals the share market pitfalls awaiting the unwary

INVESTORS beware. Share market traps are lurking, waiting to steal your hard-earned savings.

Now, some cynics might say the entire share market is one giant trap, given its performance in the past few years.

However, Australian shares have been a successful cornerstone of investment and super fund portfolios for decades. The rewards for those who have taken a long-term view have been significant.

Today we examine some of the common share market traps and how you should react to them.

SHORT-TERM THINKING

In recent years there has been a rapid rise of share experts and advisers telling us the long-used strategy of buying and holding quality shares for many years is dead. Instead, they say, it's now a traders' market and investors need to buy and sell more often to make good gains.

Getting caught up in this "portfolio churn" is a common trap, says Prescott Securities chief executive David White.

"Some brokers will try to convince their clients of the need to buy and sell frequently to take advantage of short-term movements. This will often end up costing the client more in the related transaction fees to the broker," he says.

White says impatience leads to short-term risk taking.

"The simple and proven strategy of accumulating quality assets and experiencing capital appreciation through earnings and dividend growth in the long term may not be exciting, but it works," he says.

AMP Capital Investors chief economist Shane Oliver says many people get sucked in by market noise, of which there's plenty floating around at the moment.

"Step back and take a longer-term view of what you want from your investments," he says.

GROWTH OR INCOME?

Last decade the share market was all about capital growth, with four consecutive financial years of annual gains above 17 per cent.

However, today the tide is turning towards income.

"People miss the fact that the income flows they're getting from shares are still coming through," Oliver says.

"Dividend yields are still quite high. Barring the global financial crisis, they're as high as they have been for a decade or so. I think investors should focus on the income they get for shares in dividends, but they need to make sure those dividends are sustainable and aren't being paid out of debt."

During the GFC, sectors such as infrastructure and property trusts were savaged because they were paying dividends from debt, which was unsustainable.

EXPOSING YOURSELF

Oliver says it can be easy for investors to be over-exposed to one company or sector, based on its previous performance.

"Psychologically we think that what's gone on in the recent past will continue," he says.

Marinis Financial Group financial strategist Theo Marinis says an example is buying only financial or resources stocks.

"This is wrong. Diversification minimises your risks – you know the saying, don't put all your eggs in one basket," he says.

Related to this is buying exotic or speculative shares in the hope of generating big returns.

"A gold mine in Somalia might offer returns of 27 per cent per annum, but what about the risk of losing it all due to sovereign risk, let alone getting paid a dividend," Marinis says.

POPULARITY CONTEST

Lanyon Asset Management portfolio manager David Prescott says investors who only buy popular stocks are unlikely to find bargains.

"Sometimes the most popular blue-chip company turns out to be a pretty ordinary investment," he says.

Even great companies such as Woolworths and Westfield can be average investments if you buy at too high a price, Prescott says. "The companies can perform very well, but the price you pay determines the level of future returns."

Marinis says chasing last year's share market winner is a trap, as prior performance is no guarantee of future success.

"You need to know what has changed and buy the appropriate sectors. Nobody drives their car looking entirely in the rear-view mirror," he says.

DERIVATIVE DILEMMA

Derivatives such as options and contracts for difference might sound exotic and be promoted as giving you the chance to make money whether the market is rising or falling, but the fact is you still need to pick the right direction of the market to be a winner.

White says investors can be lured by derivatives in times such as now when financial markets are volatile.

"Exchange traded options, warrants, contracts for difference, futures and short selling are recipes for disaster for the average retail investor," he says.

White says investors might assume they can pick how the market will behave, but in practice can never consistently pick short-term movements.

"You don't want to become a forced seller of quality assets as you can be giving up potentially larger profits down the track. And you don't want to be an accumulator of junk either."

A key reason for buying derivatives is to give yourself leverage.

For example, a CFD investment worth $100 might give you $1000 exposure to shares in a particular company, which magnifies both potential gains and potential losses.

"You are using leverage to juice up your returns and that's dangerous," Prescott says.

"Sensible investors don't need any leverage."

Prescott also warns about trying to follow the trendsetters.

"Listening to rumours and buying fads is a massive trap for retail investors," he says.

DODGY DISCOUNTS

Plenty of investors own shares that are trading at prices well below what they paid for them, and this can tempt people to buy more shares at the cheaper level to lower their total entry price.

This can be a trap, says Marinis. "Don't send good money after bad – this is essentially a form of gambling, hoping that your lucky number will come up," he says.

"Sometimes this is described as trying to catch a falling sword."

Other traps include failing to have a strategy, lacking proper advice, poor record keeping, holding shares in the wrong partner's name, ignoring good long-term buys, and losing sight of the end goal.

A HISTORY OF CRASHES

Over the past 111 years there have been plenty of stock shocks for investors, often related to historical events. This graph shows that shares have always recovered from a sticky situation.

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