Addition of Substantial Funds to a Portfolio

During the bear market from late 2007 to early 2009 many investors did not attempt to time the market and suffered the loss of substantial funds from their portfolio. Many of them had invested all their capital, leaving no cash reserve, so had to realise these losses in order to release funds for their living expenses. For them the losses were very real. In other cases, some of the stocks they held crashed and burned in the shakeout and they now hold only worthless CHESS certificates. Then there are those who are still holding on to the survivors and are hoping (some may even be praying), in denial that the losses are not real just because they have not yet sold those stocks. This is an area of great sorrow for me, because I devote a great deal of my life to teaching how to time the market and show my own results (see www.bwts.com.au About Colin/Investment Returns on the free website and Building Wealth Resources/Portfolio Details on the members website) as proof that anyone can do it with the knowledge and desire. My methods for market timing are set out in my book *Building Wealth in the Stock Market*. Those who do not learn from what we have experienced in the past are unfortunately bound to repeat the experience first-hand next time around in the bull-bear market cycle.

Then, in the midst of this general climate, I received an email from a reader who reminded me that I had in the past mentioned the opposite problem, which we would all like to have: how to handle the addition of substantial funds to our portfolio. Now, some of you can stop laughing when I call this a problem. Every time I talk about sudden big profits being a problem for investors, many inexperienced people laugh. Likewise, when I, or in this case my reader, asks about handling a sudden substantial increase in our portfolio there is more laughter from those who have not yet been fortunate to have been there and are amazed that anyone would think it was a problem.

Managing a substantial increase in our portfolio is a problem in several respects, as I will explain below. I have been there myself in the past, both because of the huge gains reaped in bull markets and also because of the addition of funds to my stock portfolio. I have been investing in the stock market since 1964. Over this time I have read hundreds of books about analysis, investing, trading and psychology. I have read *The Australian Financial Review* almost every day of that long period. I have studied Economics and Applied Finance and Investment formally and have been teaching investing since the 1990s. This has given me a deep knowledge and my investing activity has given me extensive practical experience. My area of expertise, then is investing in the Australian stock market. It follows that my own investment capital is all in Australian stocks, my cash reserve and the apartment in which we live and I work.

I began investing by saving. That is, I spent less each year than I earned. Once I was married, it became ***we*** spent less than ***we*** earned. Saving became far easier now because we had two incomes. Even though we had a mortgage and two wonderful children to bring up and educate, we have always lived off one income and saved the other one, except when our children were under school age and now my wife is retired. So, I had to invest these savings to make them grow. From my studies at university, I had developed a passion for the corporate world and the stock market was my natural and comfortable focus. Later, I was to discover that I had chosen to learn to invest in one of the top three asset classes (the other two are owning your own business and investing in property). So, I became a specialist and focussed on the area where I could develop my skills to be as good as or better than the professionals. My aim is to be where we are now: self-funded retirees, with great freedom to live the life that we choose and with no prospect of ever needing a government pension (in whatever form it survives).

The key aim here was to learn to invest as well as the professionals. This is not as easy as many beginners seem to suggest when, with no knowledge or experience, they take their money from professional managers and launch their own SMSF. I understood that I had to learn another profession (my employed career was in sales and marketing). This involves a lot of knowledge and many years of experience. I think it took me around 20-25 years to reach the point where I had the knowledge and experience to manage all of our own savings. Then I was able to retire at 44 from sales and marketing and undertake some full-time formal education as a base to becoming a full-time investor. During all of this learning period, I had split our savings between the superannuation system, managed by professionals and the balance I managed directly. It was not until I was matching or beating the professionals consistently that I took control of investing all of our savings. At that point, our investment capital was split 50% in our fully owned home, 25% in professionally-managed superannuation and 25% managed directly. So, my first experience of a large increase in my portfolio was when I brought the superannuation savings into my own control (they had all been in stock market superannuation plans). This doubled the amount I was directly managing overnight. I found this difficult to deal with for a while. After a great deal of agonising, I realised that the way to manage this situation was easy in principle, but required a huge shift in the way I thought about risk management. It was one of those moments when I personally realised that my own thinking processes (our psychology) is the last frontier in my learning journey and I was standing right there wondering how to move forward.

Later, we downsized from a house to an apartment, something we have never regretted after nine years (in 2015). This again increased our investment portfolio, although it was not as big a leap as had happened as described above. This time it was very smooth, because I had worked out how to deal with it.

There are other ways in which we might find ourselves with the problem of an increase in our investment portfolio. Some I can think of are:

- Marriage
- An inheritance or gift from a parent or relative
- A lump-sum compensation payment or insurance payout
- A big gambling win (races, lottery, lotto etc.) or other windfall
- Selling a business, being taken over or bought out and retiring
- Lump-sum on retirement or retrenchment including release from in-house superannuation
- A strategic change in allocation of investment capital between asset classes which brings significant additional capital into the stock portfolio

There are probably more, but these came to mind quickly as additional to those previously mentioned in my own experience:

- Taking capital out of professionally managed funds to manage ourselves
- A burst of profits in a strong bull market
- Downsizing our own real estate (really just a specific case of the last dot point above)

So, why is a sudden increase in investment capital a problem? We have all read the stories of people winning the lottery and blowing it all in two years because they did not know how to manage money. OK, but they had never managed such large sums before. However, we are here talking about someone who has had some experience in investing their savings. For them it may be a huge increase or just a substantial increase. The bigger the increase, I submit, the bigger the problem, in the sense that many people with a really big increase in funds to handle can be totally overwhelmed by it to the point that they are not only out of their depth, but physically and mentally terrified by the responsibility. Strangely, these are the easiest ones to advise. They should seek a licensed and competent investment adviser, or even better, seek advice from more than one adviser to be sure the advice is sound. The key is to seek and be prepared to pay for the best advisers. It is not an area where it pays to go to the cheapest. You get what you pay for as rich people know (they always use the best advisers). This is not the people for whom this article is intended and I will leave it there.

The investors who I will focus on here are those who have an existing portfolio that they manage themselves where they have built up some skills and experience in managing their own savings. I want to focus on how they manage an increase in their portfolio that is substantial – say 30 to 100%, but not of the proportions mentioned in the previous paragraph, which would introduce many additional issues. I will explain everything in terms of a stock portfolio, because that is my area of expertise and keeps things simple. However, the ideas can be applied to any other asset class portfolios that the investor manages.

For even experienced investors, a sudden increase of capital in their stock portfolio can introduce some increased risks. The risks I refer to are not at the simple level that the more we have to invest, the more we can lose, just because the portfolio is bigger. What I want to talk about are the more subtle ways in which risk can grow on us without us fully recognising it and adapting our investment plan accordingly.

Liquidity risk

I will start with a risk that I have wrestled with as my stock portfolio size has grown from $200,000 back in the early 1980s to around $5,000,000 now. Twice over the last decade, I have found myself with the problem of a sudden 100% increase in funds under my own management as I rearranged my investments. All of this money is invested in stocks (or cash reserve) and managed using the investment plan in my book *Building Wealth in the Stock Market*.

As those who have read my book will know, I focus on smaller stocks. This is because I have found from long experience that smaller companies can grow very rapidly, doubling, or more, for several years in the best cases. Big companies cannot often exhibit such high growth as quickly, nor for several years in succession. Of course, there is higher risk in small companies. They can fail completely very quickly. I do not invest in the speculative market (stocks that do not earn profits or pay dividends). I stick to investment grade stocks, but still the risks are high. I do not advocate that inexperienced investors try to do what I do in this area. If you do not know what you are doing in the stock market, don't do it. If you want to gamble, go to the casino, where James Packer *et al* will accommodate you.

So, I have had to make a wrenching adjustment in the last ten years. I used to make good returns from investing up to 6% of my capital in companies as small as $40 million market capitalisation. Now, I simply have to look longingly at the past, because in these companies I am now a whale.

I took an example from a company I read about recently: GR Engineering Services. Its market capitalisation was $125 million. The average daily turnover in GR Engineering Services in the preceding 22 days was $13,813. So, to invest $300,000 (6% of $5 million) would have taken me 21.7 days ***if I was the only buyer at that time*** (improbable to say the least). Even if I had only invested 2% of capital, my smallest position, it would have taken me 7.2 days ***if I was the only buyer;*** in practice it would take much longer. Of course, if something goes wrong and I have to get out, the picture is dire. Volume dries up when companies get into trouble and it could take several months to get out ***if I was the only seller***. The only way to get out faster would be take a huge hit on the price to find buyers. I am sure you can see that this is madness and a recipe for total loss of any control and therefore for disastrous losses.

This example is for my size as an investor, but the principle applies to anyone, just that the numbers are different. Liquidity of a stock must be defined in terms of the size of the investor's portfolio capital.

So, I have had to adjust my investment plan in terms of liquidity risk. Now, I will only invest 2% of capital (very occasionally 1% of capital) in one or two small companies at any one time. My investment plan guideline now defines "small" as $100 million market capitalisation and provided I can get in and out in one or two days. Even this is very aggressive and risky. I think I can do it because I know what I am doing and have the discipline to act ruthlessly on stocks that hit their stops. I can also deal with the significant slippage that will happen at times.

This example illustrates the first of the challenges we encounter as our portfolio grows in size. For most investors it will be a gradual thing and the increased liquidity risk can sneak up unnoticed until some unexpected event brings it home. However, when we have a sudden increase in our investment capital, it is likely that the problem will become obvious quite suddenly, when we try to buy into a smaller stock and the depth screen is in a different dimension to our order size. This can be very unsettling, to say the least, and we can be lost for a while. So, knowing about it in advance will prepare us for a change in tactics.

My method for how to deal with this is to have a guideline in my investment plan that defines the smallest company I feel that it is safe for me to invest in. Suppose that for you it is $500 million. The first step in dealing with an increase in capital is to increase that guideline number by the same percentage as your capital has increased. So, if you have a 50% increase in capital in your portfolio and your guideline for a small company was $500 million previously, your guideline should be increased to at least ($500 x 1.5) = $750 million. To be on the safe side, I would increase it further than that and then maybe bring it down gradually as you become comfortable with the new size of company. The numbers in this paragraph are to illustrate the method only. They are not a recommendation as such.

Risk of loss of focus

This next risk can be very difficult to pick up when it is happening to us gradually as we build up our portfolio in a bull market. Suppose that we have $300,000 in our stock portfolio. We decide that we want to allay specific risk by diversifying our holdings, so we will invest no more than $10,000 in any stock. So we buy 30 stocks, putting $10,000 into each one. Over time we get very used to this heuristic or *Rule of thumb*. When we sell a stock for any reason (at a profit or a loss), we invest $10,000 in another stock. This is possible, even when we have sold one at a small loss, because dividends will have built up and also maybe some capital gains from other sales. I will ignore tax and imputed credits in this discussion.

Now, suppose that over a few years, we are a successful investor. We make some capital gains which we reinvest. We also reap a strong dividend stream, which we also invest. Our stock portfolio might, over a good bull market, grow from $300,000 to $400,000. However, still we stick with our heuristic of investing $10,000 in each stock you buy. Some of our capital gains will not have been realised, so those holdings will now be worth more than $10,000. There are well-established rebalancing policies that we might employ, but let's leave that aside for the moment. However, it is quite conceivable that we now have around 35 stocks in our portfolio.

Now, let's assume that as well as this gradual growth in capital in the portfolio over time, we suddenly also have another $400,000 to invest. Our Portfolio is now worth $800,000. So, we follow our heuristic and invest the additional funds in new companies each $10,000 invested in them. Our portfolio now has 75 stocks in it!

Now we have two problems:

1. In my experience it is difficult to manage more than about 25-30 stocks in a portfolio. It takes a lot of time to do properly. There is a risk that we let a few laggards underperform based on the strong overall performance of our portfolio. In this case our performance slips a bit as an investor because we have become lazy and have lost sharp focus.
2. The bigger problem is that our role as investors should be to beat the professionals (otherwise why make all the effort, and it is a big effort to be a good investor). Research shows that most professionals struggle to beat the market index. The more stocks that we have in our portfolio, the more likely our returns are likely to approximate the index at best. We will have given away our potential advantage and at great effort.

From all my study, reading and experience, the only way to beat the market index is in general terms to focus strongly on the best stocks. There are many ways to identify what are the best stocks, but the principle holds. Yes, there are exceptions – fund managers with widely-diversified portfolios, but as I say these are the exceptional ones. There are, I think, far more exceptional investors who have very focussed portfolios – expert stock-pickers following either the value or the momentum styles.

To succeed as investors, we need, I believe, to be able to time the market and, when we are invested, we need to buy a focussed portfolio of stocks that outperform the market. The more stocks we hold, the harder it is to pick ones that will outperform the market.

So, if our capital increases slowly, our focus will tend to slip if we do not increase the amount we invest in each stock. If our capital increases suddenly, this can be quite a shock to our portfolio return unless we do something to increase the size of our typical investment in each stock.

In the previous section I alluded to the solution. It is in the form of a shift in mindset. Now remember that we aimed, with a portfolio of $300,000 to invest $10,000 in each stock, so that we held 30 stocks? The problem with this heuristic is that it is in fixed money terms. The mindset shift we need to make is to convert our heuristic to percentages.

So, $10,000 in each stock when we have a portfolio of $300,000 means that we invest (10,000 ÷ $300,000 x 100) = 3.33% of our capital in each stock. This is quite cautious in my view. However, let's assume that it sits comfortably with our level of risk tolerance.

Now it is simple, if we have $400,000 in our portfolio, we invest 3.33% of it in each new stock that we buy = $13,320.

If we get a sudden increase in capital to $800,000, we invest 3.33% of it in each new stock we buy = $26,640.

Thus, however much and at whatever pace our portfolio increases, we will always have around 30 stocks in it and maintain the focus that we need to have to achieve good returns.

The corollary, of course is that if we have a bad run, our investment per stock also falls, maintaining our desired level of diversification.

The rebalancing problem

The last of the problems with a substantial increase in the size of our portfolio was alluded to in the previous section. When we have a change in the size of our stock portfolio, either a gradual increase or decrease on the one hand, or a sudden increase or decrease on the other, our portfolio will get out of balance. This is especially so if one stock rises dramatically and becomes a large part of our enlarged portfolio.

The other important case is the subject of this discussion: a sudden substantial increase in the capital in our portfolio. To make this clear, let's put diversification aside now and keep our example manageable to bring out the point.

Suppose that we have $100,000 in our portfolio and we split it into five investments of $20,000 each, ie. We invest 20% of the portfolio in each stock.

Suppose that nothing much changes before another $100,000 comes our way to add to the portfolio. Since our policy was to invest 20% of our portfolio in each stock, we should now invest $40,000 in each stock (20% of $200,000). Now if we were starting from scratch, we would buy five stocks, each $40,000. However, we already have five stocks each $20,000. What we should do then, because none of them has moved much since we started, is to invest another $20,000 in each stock, rather than to buy new stocks. This maintains the balance of our portfolio and does not disturb the diversification policy implied in our investment in each stock.

However, in practice it is not quite so easy. What is more likely is that over time, some of our original stocks will have risen in price and others will have fallen. Our portfolio may look like this:

Stock 1	$55,000
Stock 2	$8,000
Stock 3	$17,000
Stock 4	$24,000
Stock 5	$26,000
Total	**$130,000**

One approach that seems to be tidy would be to bring them all up to $40,000. The two obvious problems with that are:

> Stock 1: It is already larger than $40,000. We could sell it down to $40,000. However, do we want to sell down our best investment?
>
> Stock 2: It has fallen a long way to only $8,000. We could buy more to bring it to $40,000. However, do we want to throw more good money after bad?

This illustrates the re-balancing dilemma. Investing is not a simple game of numbers. We have to think about what we are doing and what it means.

Now, there are situations when some rebalancing is necessary – especially after a long upward trend in the market. There are strong arguments for maintaining balance. However, there is a contrary mantra in investing that is observed by many of the best investors, which is to let our profits run and cut our losses quickly.

There is no simple solution here. One approach might be to reshape the portfolio for a sudden additional $130,000 coming into the portfolio like this:

Stock 1	$55,000
Stock 2	Nil
Stock 3	$49,000
Stock 4	$52,000
Stock 5	$52,000
Stock 6	$52,000
Total	**$260,000**

What I have done is to allow the successful Stock 1 to run – it already has more than 20% of the new portfolio total (20% of $260,000 = $52,000). Then I have sold Stock 2, which has performed very badly. For Stock 3, which was still slightly under water, I reduced the $52,000 perfect rebalance to $49,000 to compensate for the over-allocation to Stock 1. I have bought Stocks 4 and 5 up to 20% ($52,000) of the new portfolio total and also put $52,000 into a new one called Stock 6.

This is not the only way it could be done, but is provided as an example to illustrate a rebalancing.

In fact, it will never be as easy as this because there are so many possible scenarios. Tax could be a consideration. So might transaction costs, though generally they will be minor. They do worry some people more than they should.

The key thing to be conscious of is that a substantial increase in capital will unbalance further a possibly already unbalanced portfolio. The solution is ***not*** to just buy some new stocks. That will change diversification and weaken focus. Instead we need to be conscious that there is a problem to be dealt with and to think through a way to effect the necessary rebalancing without degrading our potential performance as investors.

Conclusion

That brings the discussion to a close. I have dealt with these problems at some length and in some detail because they are subtle and some investors find them difficult to appreciate fully. I have gone through the main risks in a substantial increase in capital, especially a sudden one. Perhaps there are more that I have not thought about just now. I welcome input on this from readers. Contributions to the discussion are valuable for the contributor and the listener. I also thank my reader (website member) for prompting this discussion.

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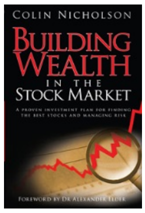

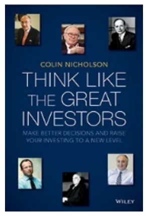

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