February 2015

Investing for Children

by GYC Investment Team

This article was featured in the Feb 2015 issue of Simply Her. Below is the original article for your reading pleasure.

Why is it important for parents to help their children to save money early?

The most important reason for starting early is getting time to work in your favour via the power of compounding returns, where returns are reinvested and in turn increase potential returns.

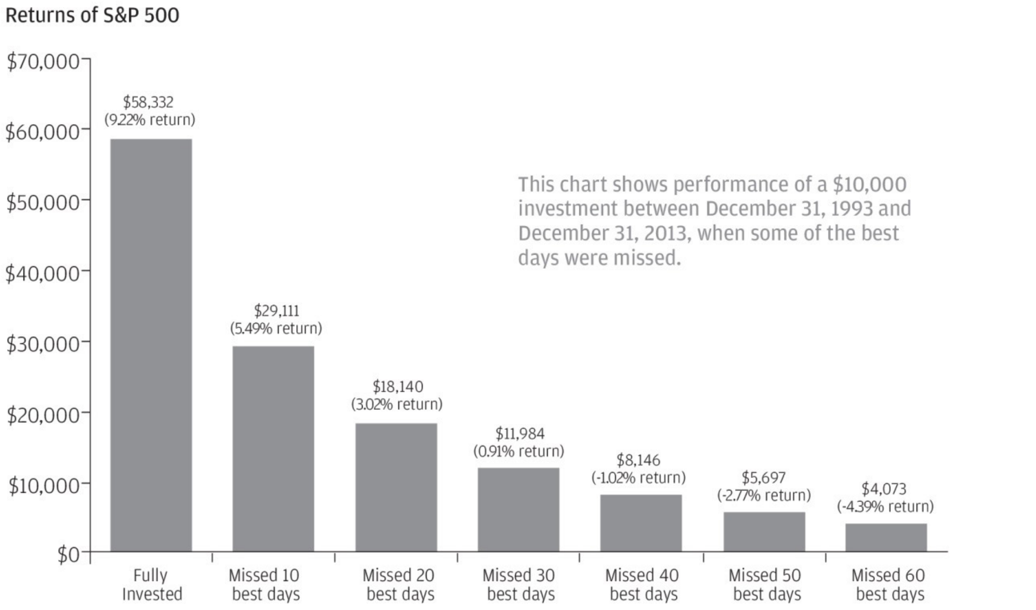
If you employ dollar cost averaging, where you invest the same amount of money on a regular basis (thus automatically buying more shares when the price is low, and fewer when the price is high), your money will likely also work harder for you in the long term.

These are fundamental, well-researched investment concepts. Some people advocate timing the market (getting in and out repeatedly) for better returns, but it is almost impossible to do so consistently over the long term because of investor psychology.

Investor psychology is greatly influenced by the deluge of information from the media, such that typical investors tend to exhibit herd behaviour – for example, if many people are selling, you would tend to do so as well, and vice versa.

Compared to someone with a steady and systematic approach to investing, the market timer tends to fare poorly.

The chart below shows how missing the best days in the stock market over the past 20 years (periods which included bull/bear cycles) will have vastly affected returns on investment:

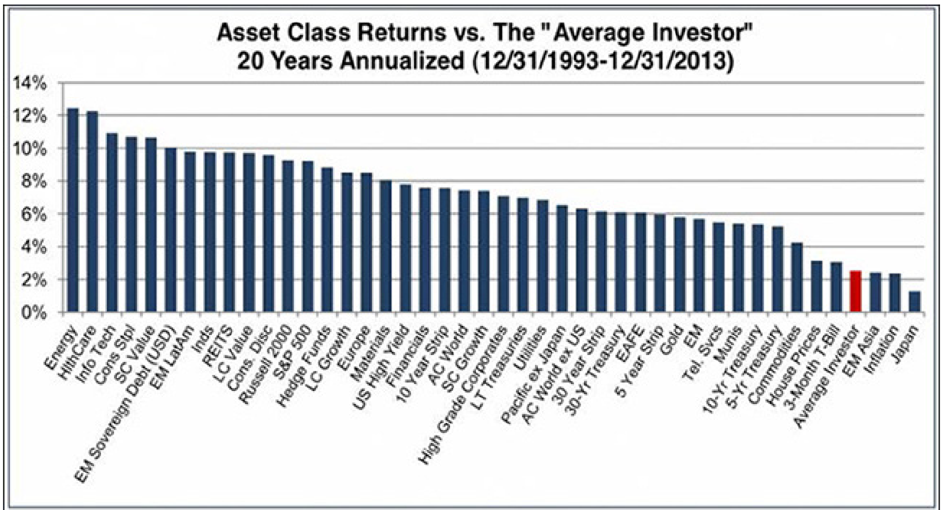


This chart is for illustrative purposes only and does not represent the performance of any investment or group of investments.

Source: Prepared by J.P. Morgan Asset Management using data from Lipper. 20-year annualized returns are based on the S&P 500 Total Return Index, an unmanaged, capitalization-weighted index that measures the performance of 500 large capitalization domestic stocks representing all major industries. Past performance is not indicative of future returns. An individual cannot invest directly in an index. Data as of December 31, 2013.

Is it important to get the child involved in the saving/investing process as well?

Yes. It helps children to develop a lifelong habit and discipline of saving. If your child understands the simple financial concepts described in the previous question, then he or she would be better equipped to ride out things like market volatility and be in it for the long term. The chart below shows that typical retail investor returns in the long run are mediocre, as they always tend to buy high and sell low.



Source: Richard Bernstein Advisors LLC., Bloomberg, MSCI, Standard & Poor's, Russell, HFRI, BofA Merrill Lynch, Dalbar, FHFA, FRB, FTSE. Total Returns in USD.
Average Investor is represented by Dalbar's average asset allocation investor return, which utilizes the net of aggregate mutual fund sales, redemptions and exchanges each month as a measure of investor behavior.
For Index descriptors, see "Index Descriptions" at end of document.

Are there any instruments (for low-capital investments) in the market today that can help grow a child's savings? What are the financial commitments involved, and what are the returns like?

The simplest and most convenient way is to set up a Regular Savings Plan with monthly or quarterly contributions into a fund/unit trust. While the retail public generally does not like unit trusts, because a lot of people experienced losses in the past due to behavioural finance and the psychology described in the previous question, unit trusts (especially one managed by good fund managers with an established track record) are the most cost effective way for retail investors to get exposed to a globally diversified basket of securities. Depending on the fund manager or the setup of the financial institution, you can typically buy a fund with just $1,000 upfront, or start with $100 a month. No other instrument allows you to gain exposure to a variety of US, Europe, and Asian stocks and bonds with such a small capital outlay.

A decent, globally-diversified equity fund over the long term should give you returns of between 5-6% after fees, whilst globally-diversified balanced funds (which have a combination of both stocks and bonds) should give you returns of between 4-5% after fees. Note that these are long term returns that include the recent financial crises.

Insurance agents will try to pitch buying an Investment-Linked Policy ("ILP") through one of the insurers, as these plans are also able to invest into a variety of different unit trusts. But one has to determine whether his or her objective is investment or protection (insurance). ILPs seem to be able to meet both objectives, but the trade-off is the higher hidden fees for the insurance element (which would erode long term returns) as well as the limited number of ILP funds offered by the insurer. In the long term, it is always better to buy a proper insurance policy for protection purposes, and plain vanilla funds for investment purposes.

Is it really possible for a child to save $10,000 by the time he or she is 10?

If you start by contributing $100 each month to a unit trust when your child is born, assuming the lower end of an average return of 4% per annum, by the time he or she is 10 years old, you would have accumulated over $14,500 simply from dollar cost averaging and the effects of compounding.

A description of each financial instrument

A unit trust or mutual fund is an open-ended collective investment (where funds from multiple individuals are invested as a group, so as to benefit from economies of scale) constituted under a trust deed. This means that if something should happen to the fund's investment manager, the investors' money will remain safe, as it is separated and not commingled with the manager's assets. There are a large variety of unit trusts that invest in a range of stocks, bonds, commodities and property around the world. The difference in the risk-return characteristics for different unit trusts also differs significantly from fund manager to fund manager. That is why one should look for a reputable financial adviser to help in selecting unit trusts for you to invest in.

An ILP is an insurance policy with an investment element. ILP's underlying investments are also unit trusts, but typically cost more than investing purely in unit trusts. Compared to term and whole life policies, an ILP policyholder has more flexibility to choose the unit trusts which the policy invests in from his or her premium payments. Part of the investments will be sold periodically to pay for insurance charges.

Much more detailed descriptions can be found on the MAS' MoneySENSE website:
http://www.moneysense.gov.sg/understanding-financial-products/investments/types-of-investments/unit-trusts.aspx
http://www.moneysense.gov.sg/understanding-financial-products/investments/types-of-investments/investment-linked-insurance-policies.aspx

The risks involved (high/medium/low)

As both instruments invest in financial securities, the risks range from medium to high. While there are also unit trusts that invest in money markets or short term duration bonds (which are generally lower risk), these are less suitable for growing wealth over the longer term due to their lower rate of return.

Specific products on the market

There is a plethora of unit trusts and funds available for investors in Singapore. It is best to speak to a reputable financial adviser on the risk/return metrics of such funds, as well as to map out a proper investment process and plan.

For ILPs, all the major life insurers offer such products. As the premiums, charges, exclusions, and conditions differ between each policy, it will also be best to speak to a reputable financial adviser and go through a proper financial planning process before a specific recommendation can be made.

We have purposely not discussed buying individual stocks or index funds like ETFs. These require more monitoring and selection, and are generally unsuitable for the general public who cannot afford the time nor possess the inclination or discipline to manage such investment instruments.

Why would you recommend this financial instrument?

As investing and saving for your child is a long term commitment, it also affords you a long investment horizon as there is no need for the money in the short term. You can thus theoretically take on a higher risk, as you'll have the ability to ride out negative short term market movements. That said, everyone's risk tolerance differs, and doing a proper plan will ensure that you take on the right amount of risk and do not end up panic selling at a loss during volatile times.

Tips for parents who want to teach their kids how to invest

a) Start when your children are young. The moment they start to understand the value of money and how much and what a dollar can buy, children instinctively hoard every cent they get in order to save up to spend on something they want. But by the time your child is a teenager, it would be too late to start teaching them, because they will most likely be too busy spending money to learn about it. University of Cambridge did a study which showed that children's money habits are typically formed by age 7. http://www.moneyadviceservice.org.uk/en/static/habit-formation-and-learning-in-young-children

b) Teaching kids how to run a simple business is an effective tool. For example, buying a bag of sweets, packaging them individually and then hawking them at a funfair will let them learn the fundamentals of the cost of goods and services, productivity and profit. Warren Buffett launched an animated series aimed at teaching children simple lessons for business and life. http://www.smckids.com/

c) Teaching children to apportion their money into various buckets will also help them prioritise their needs and wants. Simply by creating 3 different jars labelled Save, Spend and Donate, and dividing ang pow or chores money equally into the 3 jars, they can learn that we need to slowly build up resources and use money effectively to buy things, save up for the future, and help the less fortunate.

When teaching kids how to invest, you should also encourage their generosity and helping spirit. Let them know that in the process of making and saving money, they should always treat others fairly and not lose sight of good moral values.

www.gyc.com.sg enquiries@gyc.com.sg +65 6349 1441