Successful investors are informed investors

Ignorance may be bliss – but as far as investing is concerned, what you don't know can definitely hurt you.

Investing is sometimes defined as an optimal trade-off between risk and reward. That means, getting the best returns for accepting a given amount of risk. But how can you work out whether a particular trade-off is a good one if you don't have all the facts?

The golden rule is not to sign anything until you fully understand the terms and conditions of an investment. That means taking away the Investment Statement and reading it at your own pace. You may also wish to take independent advice from an investment adviser, lawyer or accountant of your choosing.

If there is something you don't understand, chances are it will be something to do with the risks or possible downside of the investment. It almost certainly won't be about the positive aspects, as the promoter will generally make sure they're easy to understand.

An example many New Zealanders will be familiar with is the Metropolis bond issue. Back in the late 1990s, around 1,750 people collectively invested $21 million, attracted by promises of 14%-a-year returns. However, the promoter defaulted on repaying their capital more than a year ago and now it appears they may get back only 50c to 80c in the dollar.

Unfortunately, many investors didn't fully understand what could go wrong, nor the fact that they wouldn't get their money back until a major bank had first had a multi-million dollar mortgage over the scheme repaid. Had they realised this fact, many say they would never have invested in the first place.

Another example is the legendary US investor, Warren Buffett. Buffett is one of the most successful investors of all time, but in the late 90s he seemed to have lost his Midas touch. For a couple of years, while some investors were making money hand over fist, Buffet's returns looked decidedly pedestrian. The reason? Buffet was not investing in the thriving dot.coms – because he said he couldn't understand them.

He says he looked at their skyrocketing share prices, but couldn't work out what justified them, given that many had negligible cashflows and few were yet profitable. So he preferred to stay with companies he could understand – companies with real businesses, real cashflows and real profits.

Of course, Buffett had the last laugh when the technology sector declined and the share prices of many dot.coms plunged to a fraction of what they once were. While Buffett wasn't the only investor who didn't understand dot.coms and what was driving them, he was one of the few with the courage to acknowledge it.

Let's give Buffett the last word. He is renowned as a long-term investor who likes to hold on to stocks rather than trade them in for a quick profit. When once asked for his definition of 'long term', he answered: "Hopefully forever".

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