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Three ways to avoid howling mistakes

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Shareholders must be prepared for prices to respond to the inevitable tightening in monetary policy. The likely direction is downwards.

Three rules for avoiding mistakes

• Avoid irrational exuberance

Rising markets can be exciting and lead to risky behaviour. Prime Value says. Avoid overspeculating and overleveraging.

• Stick with your thematics

A solid portfolio always needs focus, Prime Value says. Stay with what you know.

• Quality is better than hype

As assets around the globe grow, it's important to look through the hype. A well-run company is central to wise investment, Prime Value says.

Retail investors want upside, but they also want to protect their capital. As central banks around the world ponder the inevitability of tightening monetary policy, shareholders must be prepared for prices to respond. The likely direction is downwards.

Prime Value Asset Management joint-CIO Leanne Pan says it is not a good time to be complacent.

"Virtually all asset classes have gone up in value because there's lots of money supply around," she says. "When that is reviewed, it might have implications on the market."

An investor who thinks income from a portfolio of yield stocks will beat cash in the long term is taking a risk share prices won't retreat when interest rates inevitably are increased.

“At that time, they might think a term deposit of 2 or 3 per cent is not such a bad thing,” Pan says.

“Don’t be caught up thinking the sharemarket is going to return 15 or 20 per cent perpetually. Don’t forget what is driving that return.”

It is always obvious when stocks are overvalued in hindsight but how can you tell when valuations are stretched in real-time?

“At the end of the day you have to look at the cash flow and the ability of a business to generate cash flow in the future,” Pan says.

Nothing is certain about the future, of course, but share price valuation methods which use historical data are equally as open to interpretation when forecasts on earnings and the economy are bolted on to them.

“There are just so many factors involved,” Pan says.

If companies do look fully valued or overvalued, some investors might consider increasing allocations to cash. But not all investors.

“That is hard to call,” Pan says. “It depends on the individual and their stage in the life cycle.

“When you talk to someone in their 80s about ‘long-term’, they might tell you they don’t buy green bananas any more.”

Shares can be overvalued for long periods, she says. When the central banks raise rates, investors who are caught in a stupor of complacency will get hurt.

“You have to assess your assumptions,” Pan says. “Those big mistakes can cause you a lot of pain.”

Avoiding lemons is more important than picking big winners, she says.

“It is possible to make big mistakes in a rising market. Sometimes these mistakes are only apparent when the market turns, which is why investors should avoid becoming too comfortable.”