MODERATE RISK

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I asked several people with limited financial knowledge how they would turn $5000 into $50,000. Their answers almost universally involved gambling or other get-rich-quick schemes as the core strategy. While these responses don't necessarily surprise me, it is concerning that the consensus view was to try something that's almost guaranteed to lose money.

A more robust option is to focus on the key variables that impact the ability to turn $5000 into $50,000. Fortunately, there are only three:

- Time
- Taxation
- Investment returns.

1 Time

While you cannot control time, it is predictable. If you set the time horizon for 20 years, it will take exactly 20 years to get there – there are no surprises. As obvious as this sounds, it is a crucial point as time has such a significant effect on returns.

To illustrate this, consider the following hypothetical:

Twin brothers at 20 each receive a $50,000 inheritance. One spends it, the other invests it (assume a 10%pa return). At retirement (70) this investment will be worth $5,869,543. The brother who spent his inheritance decides at 45 it's time to catch up with his sibling. He is shocked to learn that he would need to invest $541,735 to be in the same position at retirement. While the elapsed time between receiving the inheritance and retirement has only halved, the required capital is almost 11 times as much.

Time is a powerful contributor to turning $5000 into $50,000. With this in mind, let's focus on the other variables.

2 Taxation

You have some ability to control tax paid by the type of investment you choose, as well as the tax structure you invest within.

Let's consider the range of outcomes, again assuming a 10%pa return. Under the most favourable taxation position (no tax), it will take 24.2 years to turn $5000 into $50,000. At worst (top marginal tax rate) it will take 44.6 years – almost double the time.

Therefore, being tax aware when investing matters ... a lot. Unfortunately, there is no one answer for everyone, as it will depend on personal circumstances. However, as a general tip, investors on higher marginal rates should consider structures such as super, insurance or investment bonds and trusts. Those on lower marginal rates may be best off investing in their own name.

Spending some time understanding the taxation implications for your investment before you act will be worthwhile.

3 Investment returns

In this case, I have chosen an approach with moderate risk. In traditional asset allocation terms, this would mean a mixture of growth assets such as shares, property and infrastructure as well as defensive assets such as cash and fixed interest, which would smooth out volatility. However, there is a price to be paid for reducing volatility and that's lower returns.

Business schools teach that volatility is a direct proxy for risk – reduce volatility and you reduce risk. I, like Warren Buffett, believe this link is convenient but flawed. It's not that there is no link, it's that the link is not predictive.

History shows that buying the market in periods of extreme volatility and selling when volatility is low has been an excellent strategy and, vice versa, a woeful one. The reason isn't cryptic – it's because when no one perceives risk prices are high and when they do perceive risk prices are low.

I would define risk as the likelihood of permanent loss of capital. The greatest determinant apart from the asset and the price you pay for it is your investment time frame.

To illustrate this:

If you have a short time frame (say two years) and you invest in growth assets, there is a very real risk you could suffer permanent loss of capital. This is not necessarily because your investment decision was poor but because market corrections are largely unpredictable, meaning that if one happens while you are invested the requirement to sell inside two years will mean you may suffer permanent loss of capital.

However, if you have a long time frame (10 years or more), the likelihood of a permanent loss is greatly reduced. To illustrate this, even if you invested at the top of the market before the GFC (November 2007) you would still be considerably ahead today. This is despite it being one of the largest financial crashes on record.

> The more you invested in cash, the more likely it is you would not reach your goal

While cash is attractive for liquidity and short-term investing, over the long term it has done little better than inflation. In fact, in more recent times and in inflation-adjusted terms, you would have gone backwards – more so if you are paying a higher marginal tax rate.

The time frame that it would realistically take to turn $5000 into $50,000 would be about 20-plus years. Therefore, the more you invested in the perceived safety of cash (or bonds for that matter), the more likely it is you would not reach your goal in that time. Accordingly, I would not include either of these in my recommendation.

Recommendation

Given the size of the initial investment, your choices and ability to diversify are limited. As such I would limit my recommendation to one investment. However, I would not recommend one "business" such as a bank, miner or tech company, as this would unnecessarily expose you to a single sector, industry and stock-specific risk.

I would recommend the entire $5000 be invested in the listed version of the Magellan Global Equities Fund (ASX: MGE). It is a long-only, unhedged global equities manager of exceptional quality and track record. However, it is only as good as its current team and processes, so if things changed you may need to change as well. For those wanting to set and forget, I would recommend the unhedged Vanguard MSCI Index International Shares ETF (VGS).

Why global and not exclusively Australian? In short, there are very few companies in Australia that are class-leading. If you have only one choice, to me it makes more sense to exclude Australia than to exclude the rest of the world.

While possible, I think it is unrealistic to expect future returns to be greater than 10%pa for almost any asset class given where prices sit today. Assuming 10%pa, it would take 24.2 years to grow $5000 to $50,000. However, if you are patient it will only take a little over seven more years to reach $100,000!

WHAT IF I STARTED WITH $20,000?

At this starting point the transaction costs are still relevant and the investment options are limited. However, I think this is enough to diversify the original recommendation to include $10,000 of Australian share exposure. I would not expect this to increase the overall return, despite the significant boost from franking credits. But I would expect it to reduce risks.

Along similar lines to my $5000 recommendation, I would suggest an active and passive option depending on your circumstances. For my active exposure, I would recommend the listed investment company Century Australia (ASX: CYA). Wilson Asset Management has recently taken control of investment management – we have a very high regard for chief investment officer Chris Stott and director Geoff Wilson. For my passive recommendation, I would go with the Vanguard Australian Shares Index ETF (VAS), which tracks the S&P/ASX 300 index.

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