We have met the enemy and he is us

I keep thinking about the studies done by Dalbar on the United States investment markets. Over 30 years the average return of investors in equity funds was 3.66%. The return over the same period in the S&P 500 was 10.35%. The index would have been the major market in which the general equity funds Invest. The underperformance was 6.69% per annum.

For fixed interest funds the average return was 0.59% per annum. The Return on the Barclays Aggregate Bond Index was 6.73%. The underperformance was 6.14%. We are told that if we spread our investment over different asset classes we reduce risk. And that is true because if you diversify you normally eliminate the risk of losing all your money at once. Also investors in the multi asset funds tend to stay invested longer than investors in single asset funds. But if you look at the performance of the mixed asset investors in the United States they underperformed by 7.25% against a simple 60% equity 40% fixed interest breakdown .

While these statistics relate to the United States we know that the same thing happens in South Africa.

In 2016 the Allan Gray equity fund the biggest of the general equity funds, had a net outflow of 3.84 billion. Yet in 2016 the fund returned 9.91%. The JSE All Share Index returned 2.6%, including dividends.
We stress, quite correctly, the need to diversify. But despite their asset managers performing many of the individuals investing with those managers are not.

We need to dig deeper to find out why this is happening.

Modern economic theory, and investment theory is predicated on people behaving rationally. The economists call this rational expectations.

The problem is that they don't always do so.

Firstly, it is difficult to assess risks and probabilities. Not even the experts predicted the 1987 decline of 20% in one day. Investment theory said it could not happen.
Long-term Capital management assembled in their hedge fund some of the most brilliant economic and investment thinkers of our time. The US Federal Reserve eventually had to bail them out to save their financial system.

Secondly, emotions do affect our thinking and behaviour. This leads us into the

field of behavioural finance, which looks at how we view investments and why we make mistakes. I want to discuss some of their findings.

1) Loss aversion

Daniel Kahneman's research showed that we feel a loss 2.25 more than a gain.
If your investments are up by R100 000 that is nice. If it is down by R100 000 that is a mini disaster.
The problem is that if you invest in shares you will, at times, suffer losses and these could be large.
What's more, they are going to occur fairly frequently, once every 3 years, and they can last longer than you like.

The key here is to see if you are still on the path to achieve your long term goals with your existing investments.

2) Anchoring

This is a tendency to focus on one piece of information, normally your last portfolio statement. This is summed up by the expression "I'm losing money, put me in cash".
The correct question is what has my investment done in the long term and is this trend likely to continue in the long term.
I hear this often. The client invested R1 million, it grew to R1.5 million and then declined to R1.4 million. The client feels that they lost R100 000. Not gained R400 000. The key here is whether your current asset allocation is going to meet your long-term needs.

3) Familiarity bias

We prefer to invest in what we know. If you look at the share listing for the JSE 30 years ago and you look at it now, it looks completely different now. A lot of the familiar names have disappeared.
In 1900 railroad stocks made up 63% of the US market by capitalisation. In the UK it was 50%.
Today it is less than 1% in the US and close to 0% in the UK.

4) Mental accounting

Richard Thaler pointed out that we tend to think of money in a compartmentalized way. We invest in a savings account paying us 5% while we have a bank overdraft at 9.5% or outstanding credit card debt at 16%.
In tax we like to get a refund but we hate to pay in. The result, if you think about it rationally, is we are giving SARS and interest free loan.

5) Gamblers Fallacy

We tend to forget that a lot of modern portfolio theory is originally based on research done for gambling.
The modern application of this is the belief that the current trend will continue.
We assume that there is a pattern which will continue.
As Louis Bachelier pointed out, as early 1900, the expectation of a gambler tossing coins for each bet is 50 / 50.

6) Herd Behaviour

We are influenced by other people's opinions. This is why bubbles arise. This is also why, I believe, the rand is one of the most volatile currencies in the world.
The key is to remember the Dalbar figures and what happened to the Allan Gray equity fund in 2016.
Often, public opinion is just that, public, but not necessarily correct, especially when it comes to predicting long-term investment returns.

Conclusion.

I think that as an independent advisor I was aware that investors do not always behave rationally.
I also believe that working out an asset allocation that meets your risk profile and financial requirements is important.
Selecting good managers is also important but I also realise that it's not enough. I need to watch how clients make decisions and help them make better decisions to achieve long-term investment success.
I also realise that ultimately Pogo was right, we have met the enemy and he is us.

Kind regards
Brian Goodall