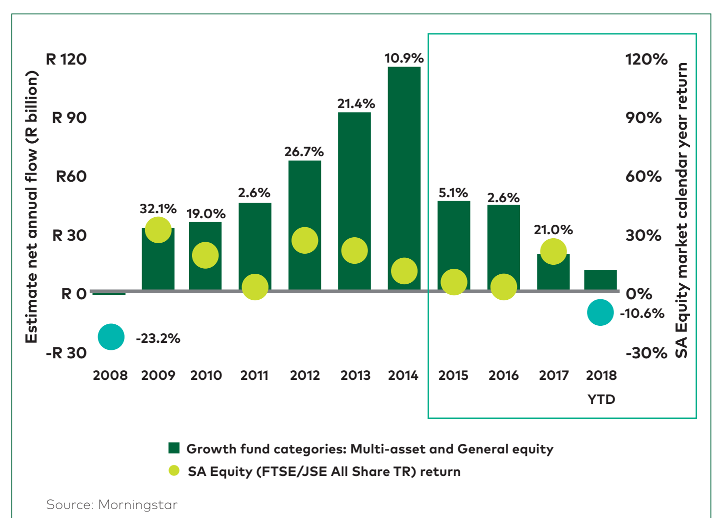
THE INVESTMENT DECISIONS YOU AREN'T AWARE YOU ARE MAKING

As human beings, we are constantly making judgement calls. We judge the things we see, the people we meet and the opportunities we are offered - each with our own distinctive filters and biases. It is almost impossible for us to be unbiased in decision-making.

SEUGNET DE VILLIERS
INVESTMENT ANALYST

These biases are part of human nature and essentially define our personalities. However, when it comes to investment decisions, cognitive and emotional biases can be dangerous as they often lead to illogical or irrational decisions. To make matters worse, when markets have fallen or are volatile, and the stakes are high, normal behavioural biases become amplified through fear and panic.

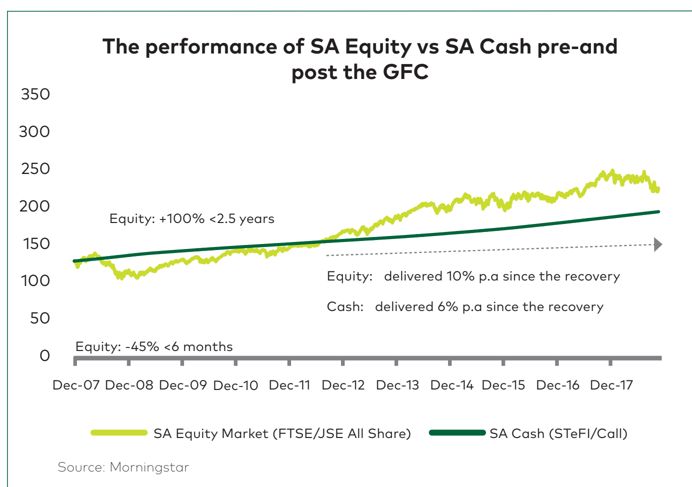
A look at investor behaviour over the last decade illustrates just how emotional investors can be.



Source: Morningstar

Post the 2008 Global financial Crisis (GFC), it took investors several years to build up an appetite for riskier growth assets – and 7 years later, in 2015, they stopped investing at the first signs of weakness. Investors are repeating their past behaviour of parking in cash or income funds while they wait for the markets to turn.

This is despite the lessons learnt from the GFC (illustrated in the below diagram) which are still so fresh in our minds:



Source: Morningstar

1. The end of 2008 felt like the worst time to invest in our equity market and the right time to switch to cash - but in hindsight it was a great time to invest or maintain equity exposure.

2. Even though a recovery felt impossible at the time, markets bounced back quickly.

3. Investors who switched to cash after the GFC, intending to wait for equity markets to recover, performed significantly worse than investors who stuck to their original investment plan and objectives throughout.

SO WHY DO INVESTORS REPEAT PAST (BAD) BEHAVIOUR?

Availability bias

One of the most common causes is what is termed "availability bias". This is a shortcut our minds take to judge the likelihood of something happening based only on recent or memorable events. Think of the lottery – a perfect case for exploiting this bias. Jackpot winners are promoted heavily to ensure we continually hear of people who won, leading us to believe in the UK lottery's slogan "it could be you", while the likelihood of any UK ticket holder winning the lotto is in fact only 1 in 13,983,816. Similarly, media reports on events like shark attacks and plane crashes lead us to believe that these are much more likely to occur than they truly are.

What is currently fresh in South African investors' minds is the fact that since the start of 2017, cash has outperformed the equity market 75% of the time on a rolling 3-year basis. Investors place great emphasis on this recent experience to conclude that cash offers a better investment opportunity than equity. The true likelihood of cash outperforming equities measured over several complete investment cycles is in fact 32% over a rolling 3-year period and only 10% over a rolling 5-year period.

Recent events do not change the long-term fundamentals of asset classes. Growth assets can be very volatile in the short-term but offer much greater long-term real return potential than income assets. Or stated differently, income assets offer greater stability in the short-term, but lower real return potential over the long-term.

Anchoring bias

Another cognitive bias we are guilty of is anchoring. This is when we focus too heavily on a single (and often irrelevant) piece of information when making decisions. A famous experiment conducted by economists Amos Tversky and Daniel Kahneman illustrates this perfectly. Participants were asked to estimate the number of African countries belonging to the United Nations, while witnessing the spin of a roulette wheel. Participants who saw the wheel stop on the number 10 guessed on average 25%, while those who saw the wheel stop on the number 65 guessed on average 45%. In this experiment, a *clearly* random number had a dramatic impact on people's judgments.

Similarly, investors tend to use the most recent calendar year performance of asset managers to decide which manager to invest with. Year after year the worst performing fund of the previous calendar year is the biggest loser of assets the following calendar year, whilst the best performing fund receives the largest net inflow. Ironically, the reality is that often the best performing fund one year is the worst the following year. Consequently, investors who chase past short-term performance are generally significantly *worse off* than investors who stick to a well-diversified solution with minimal short-term change made on impulse due to market volatility.

Source: The Behaviour Gap

HOW DO WE OVERCOME THESE BIASES?

Given these behavioural biases (which are just a few of the common behaviours affecting investors), it is no surprise that various studies have identified behavioural coaching as the biggest value-add financial advisors can offer their clients. Vanguard, one of the largest asset managers in the world, estimates the annualised value-add of behavioural coaching in the region of 1.5% p.a. compared to six other value-add areas they identified collectively amounting to less than 1.5% p.a.

A financial advisor can independently assess and identify the biases in clients' investment plans and remind clients:

- that what happened today will not necessarily happen tomorrow, nor in the long term;
- that emotions and short-term, knee-jerk reactions can erode future returns and thus value;
- what their investment objectives are and why their agreed upon portfolio is still the most suitable solution.

Overcoming behavioural biases in investment decision-making is crucial to avoiding the common investment pitfalls that erode value over time or keep investors out of the equity markets unnecessarily in favour of overweight conservative cash position. ■

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