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Making better long-term investment decisions

Investors are prone to different 'behavioural' mistakes when they invest. A particularly pertinent example is that most investors become more risk averse after a recent loss. This is often to their financial detriment.

An appropriate level of risk avoidance is wise after many types of losses because it is how we learn from our mistakes. For example, if you suffered a big loss after investing in a company without doing a thorough due diligence, being more thorough in future would be a positive learning. Caution is a good thing. It does not mean that you should never invest in a company again. After a radical change in market prices, such as those we witnessed last year, the danger is that investors take away incorrect lessons.

1. The logical argument

Investing in shares is risky, and share prices don't rise in a straight line. The market has previously experienced the kind of fundamental change that we saw this last year. After other historic falls in prices, the share market has recovered. Shares have continued to outperform all other types of investment (including bonds and property) over the long-term. So, the question really is: Are you better off increasing your exposure to shares when the FTSE/JSE All Share Index (ALSI) is near 33 000 (as it was at its peak last year) or nearer to 21 000 where it is now? Investing in equities now makes more sense than it did a year ago, but is easier said than done. Not only does it feel counter-intuitive, but acting on logic and sound investment principles remains a challenge for the average investor.

2. The human response: do your emotional reactions sabotage your investment decisions?

When markets fall, investors listen to their 'gut'. For example: many investors' gut reaction to a major loss last year could be to avoid share investment in future, as evidenced by the significant flows into more 'conservative' funds. This response is a combination of emotions, cognitive thoughts and actions or physical responses. Reward seeking and loss avoiding behaviour often lie below our awareness, directing behaviour automatically through subtle emotional influences on judgement, thinking and behaviour.

Overwhelming flows into fixed interest funds

Loss avoidance behaviour and fear of risk can undermine your real wealth. According to the Association for Savings & Investment SA (ASISA) at the end of 2008, 51% of unit trust assets were held in fixed interest funds. Only 22% of assets were invested in the equity market. Money market funds were by far the most popular unit trusts in 2008, attracting close to 82% of all net inflows.

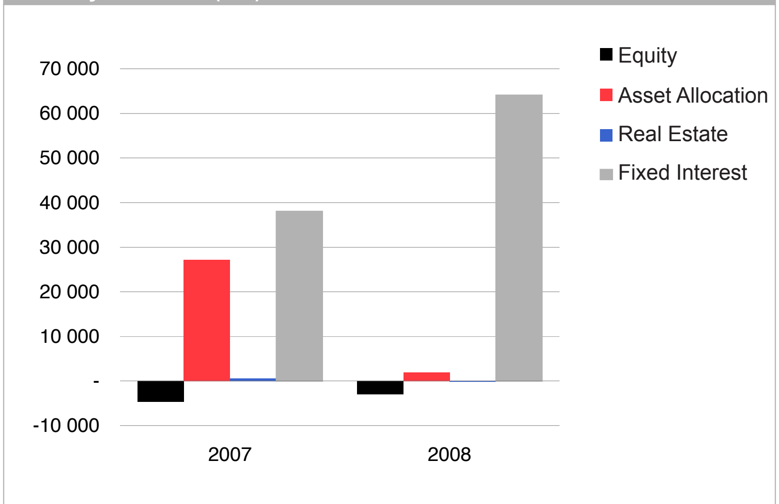
Your money is not 'safer' in fixed interest funds or money market funds

Investments in more conservative types of funds such as fixed interest or money market unit trusts are over the medium term, subject to a much bigger, but less visible risk: the risk of inflation eating away at the value of your money. Inflation reduces the 'purchasing power' of your money. Unfortunately, fixed interest unit trusts have barely managed to beat inflation after tax over the medium to long term, with only equities having consistently outperformed inflation over the long term in SA. Local money market funds delivered 11.9% for the year ended December 2008, 8.6% a year for the past five years and 10.1% for the past 10 years (and that is before the effect of tax which could be as high as 40% for personal income tax payers). At the same time, however, inflation (CPIX) came in at 10.3% for the year ended December 2008, at 6.4% for the five years to the end of last year and 6.8% over 10 years.

After experiencing losses investors wait for price confirmations

Investors tend to wait for 'price confirmations' (or enough of a positive movement to reassure them that they will be able to dip a toe in the water without getting burnt by an unexpected downturn) before getting back in the market. Investors may even sit out of the market until it reaches new highs. Of course waiting for price confirmations could mean missing out on much of the positive price move, but many people are prepared to pay this cost for enhanced confidence.

Industry Net Flows (Rm)



Source for the figures used in chart and text: Allan Gray, I-Net Bridge and Morningstar

Awareness of one's flaws is the first step to managing your investment behaviour

Much of optimal investment decision-making is about managing ones emotions and all too human behavioural responses. The first step is to be aware of these flaws and then to put strategies in place to counter these. This may be as simple as having an independent financial adviser who is able to help provide an objective framework for making decisions and then managing this relative to an overall plan over time. This is not to say that one should absolve oneself of accountability for your decisions. Contrary to popular thinking, the first step in seeking professional advice is taking responsibility for your finances and investment affairs.

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