Being an effective and trusted behavioural coach

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The power of human emotions, fear and greed in particular, is arguably one of the most formidable forces of value destruction in investing. These emotions triumph over logic and reason and can cause us to make irrational financial decisions. This could have a detrimental impact on our savings and investment plans, and ultimately our wealth.

The chart below demonstrates the human behavioural component of the market cycle: investors typically become interested in investing in the market or a particular fund after it has done well and are prepared to pay significant premiums to own an asset/fund at this stage ("buy high"). The flip side of the "fear-and-greed" roller-coaster ride is when the sell/disinvest decision follows a period of underperformance ("sell low"). In this case, the fear of losses (which may be absolute or relative) is the primary driver of investor behaviour, rather than sound investment principles.

One of the most critical roles that a good financial advisor can play is to help their clients navigate the stormy seas of investing and steer them safely to their destination. In addition to helping clients formulate a well-thought out investment plan that suits their objectives and risk appetites, this can be achieved by helping them to identify and manage the emotions (and inherent biases these introduce) that could impair the investment decision-making process. As Benjamin Graham famously said, "Individuals who cannot master their emotions are ill-suited to profit from the investment process."

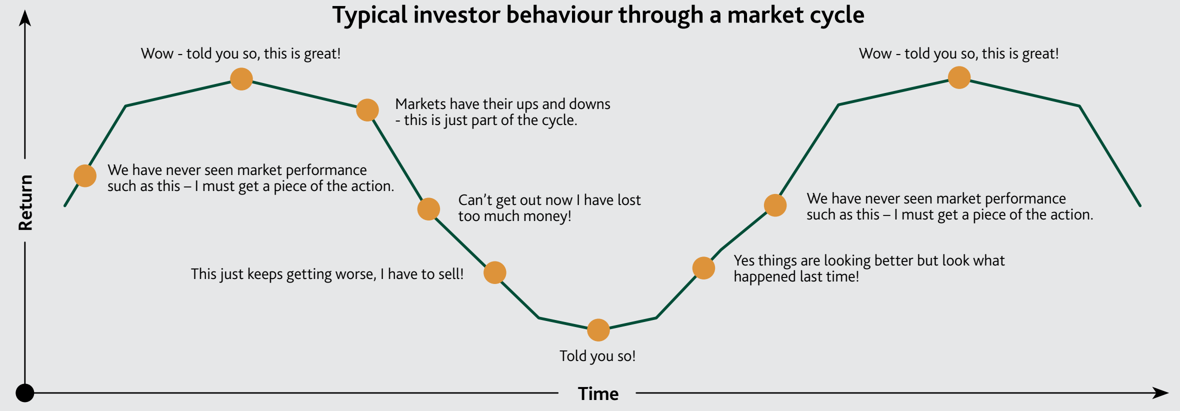
Boston-based research firm Dalbar has been studying the phenomenon of the "investor behaviour penalty" for over 20 years. Their annual Quantitative Analysis of Investor Behaviour report has measured the effects of investor decisions to buy, sell and switch into and out of mutual funds (unit trusts) over various periods[1].

The results are sobering and show that the average investor in a (US) mutual fund typically earns a substantially lower return than the average fund for a particular strategy has reported[2].

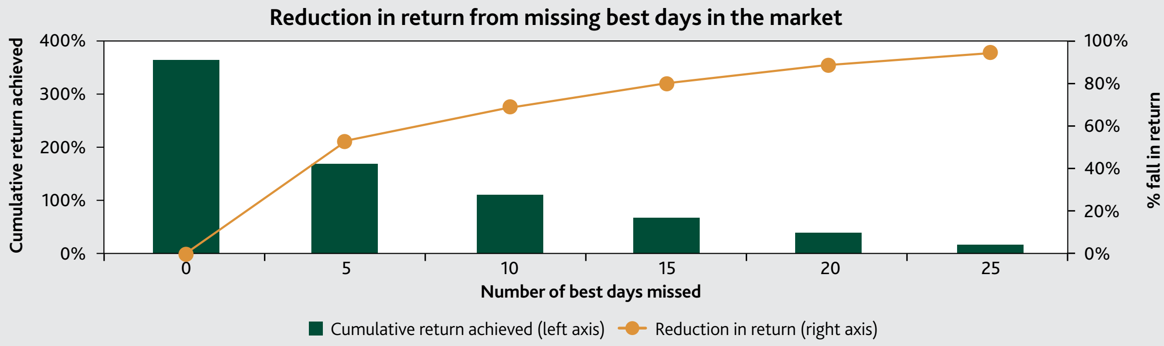
Our own research confirms the existence of this trend in the South African context, with large inflows and outflows in/out of funds generally following periods of short-term out- or under-performance respectively.

We tried to quantify the impact of this by looking at the 10 largest funds in the ASISA General Equity Category[3], using the longest common period (measured in calendar years) for which data was available for all funds[4]. We used the funds' money weighted rate of return – i.e. the internal rate of return using total cash flows into and out of a fund[5] – as a proxy for the average investor return in the fund over

Typical investor behaviour through a market cycle



[1] www.Dalbar.com
[2] From 1992-2011, the average stock fund returned 8.2% p.a. while the average stock fund investor earned only 3.5%. Source: Avoid self-destructive investor behaviour (Dalbar, Lipper) www.davisfunds.com
[3] As per Morningstar, 30 April 2016. Single manager funds only, multi-manager funds excluded.
[4] 31 December 2002 to 31 December 2015. Start period selected as the first calendar year-end for which data was available for all 10 funds.
[5] Approximated using monthly market cap and price series data per fund. Source: INET



Source: Nedgroup Investments, INET. Based on daily total returns of the FTSE/JSE ALSI over the 10 years ending 31 December 2015.

the period, and compared this to a fund's annualised return assuming a buy and hold strategy. Our findings revealed that the average fund return exceeded the average investor return by about 2% p.a. for the period 31 December 2002 to 31 December 2015.

The above analysis is not intended to suggest that a buy-and-hold strategy is the best or most suitable strategy for all investors. It does however highlight the potential value that an advisor can add to the advice process by putting structures in place to control and minimise the damaging impact of emotional decision making.

Some common pitfalls that investors fall prey to, which a good financial advisor can help their clients identify and manage, include:

- *Trying to time the market*
  As the old adage goes, it is time in the market that counts, and attempting to time entry and exit points to coincide with market lows and highs is a near impossible and often value destroying strategy. In the graph above we show how missing just five of the best days in the market over a 10 year period, resulted in about a 50% reduction in return (read orange dots on the right axis) compared to an investor who remained fully invested over the period. When we extend this to 10 days, the impact becomes even more severe, with the reduction in return now increasing to 70% relative to a buy and hold strategy over the same period.

  Timing the market requires being able to predict when to exit (to avoid a downturn) and when to re-enter (to enjoy the upswing). Even if you have been lucky enough to get the first part right and have managed to avoid a significant sell-off in markets, market recoveries may be swift and significant and impossible to time.

- *Recklessly conservative behaviour*
  Insufficient exposure to risk assets to avoid the accompanying volatility that these asset classes exhibit - even when the time horizon may be sufficiently long to mitigate this risk – could completely jeopardise an investors ability to achieve their investment objectives.

  The risk that long-term investors should be more concerned with is that of not generating sufficient returns above inflation. If the return on your investments is below inflation, this means that spending power and real wealth is reducing over time.

  Although cash acts as a safe haven during volatile times and offers investors the option of buying risky assets at lower prices should markets drop, the reality is that most investors get the timing decision spectacularly wrong. This has a detrimental impact on longer-term returns and could result in pensioners (who may already have a low level of savings to start with) being increasingly unable to meet their costs of living.

Where advisors can add value

- Help investors focus on the things they can control:
  - Develop a sound financial plan with clearly defined objectives
  - Understand the level of risk they will need to accept to achieve those objectives
  - Apply a strategy that is suitable to their investment time horizon
- Manage expectations: Disappointment is usually a result of expectations not being met. Advisors should use their expertise and knowledge of financial markets to help clients formulate reasonable expectations.
- Do your homework: Pick a manager with a sound process and philosophy and accept that even the best managers periodically underperform in pursuit of long-term outperformance.
- Ensure that clients' investment strategies are suitably diversified and contain an appropriate allocation to risk assets.

Understanding that these behavioural biases exist (even for financially savvy investors!), and putting strategies in place to safeguard against them, is critically important to ensuring a successful investment outcome. Many of the best investment managers are well aware that they too are at risk of behaving emotionally and apply disciplined processes to ensure that they stick to their well thought out plans and philosophies. It is here where an advisor can guide the behaviour of their clients and add significant long-term value. ☐