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Understanding investor behaviours

"The big money is not in the buying and the selling, but in the waiting"
- Charlie Munger

The JSE has been trending sideways since September 2014 delivering less than 10% over the period. While the low returns were expected given the high returns between March 2009 and September 2014, the volatility has spooked a lot of investors.

Since September 2014 the market has experienced numerous occasions where it has either gone up or down by double digit numbers in a very short period of time. Factors driving this included the slowdown in China leading to falling commodity prices, the sudden firing of Minister Nene, uncertainty around US interest rates, and the unexpected Brexit vote.

The reality however is that volatility and uncertainty is a constant feature of investment markets, the reasons for that volatility and uncertainty come and go. A few years ago everyone was concerned about the so-called PIGS economies (Portugal, Italy, Greece and Spain), the fragile five (SA, Brazil, Turkey, et al), the Scottish referendum, the recall of President Mbeki, and many others. In all instances, these risks dominated the conversation for a while, and then petered out before other risks increased and became the focal point.

Investors that respond to these risks often compromise sound investment strategies that can deliver long term excess returns.

It is important that investors understand two things; risk and investor behaviours. We will look at the issue of risk in more detail in the next newsletter. What are deep risks that investors need to respond to versus normal risks that are an inherent part of investing? This newsletter aims to deal with the issue of investor behaviours as this is what we are seeing a lot from clients and in the market in general.

Money is an emotive thing which can cause otherwise rational people to behave in ways that are completely out of character. An international research survey found that a driver's attention to the road reduced by as much as 90% if the driver was on a cell phone discussing issues related to money. Other issues such as relationships, religion and politics did not come anywhere close to the effect that money conversations had. Because of the strong responses people have to money related issues, the role of the financial adviser has to necessarily extend beyond just portfolio construction.

Investor behaviours that cause investors to make sub-optimal investment decisions

Most investors are familiar with the usual suspects; fear and greed.

However, if you dig a bit deeper you will find other equally destructive behaviours that investors exhibit when markets misbehave.

We have summarised these in the table below:

Behaviour	Definition
Regret Theory	Deals with the emotional reaction people experience when they've made an error in judgement. Similar to anchoring, investors tend to avoid selling a share or fund at a lower price than they paid for it in order to avoid the regret of having made a bad investment
Mental Accounting	The tendency of investors to create mental compartments for money based on the source of the money or the intention for that money. This often leads to investors making sub-optimal allocation of resources, and not having a coherent overall strategy
Anchoring	A cognitive bias that describes the human tendency to rely too heavily on the first piece of information offered (the anchor) when making decisions. This can play out in numerous ways; investors can anchor return expectations, or share prices, etc. It is this behaviour that also causes investors to place too much credence in recent market views, opinions or events, and extrapolate recent trends long into the future
Prospect / Loss Aversion Theory	People express a different degree of emotion towards gains than towards losses. Individuals are more stressed by a prospective loss than they are happy about an equal gain. So a 10% loss stresses investors out more than a 10% gain makes them happy. Investors either act decisively to get rid of their losing position, or they remain anchored to the higher level and wait for the recovery
Overconfidence	People generally rate themselves as being above average in their abilities and can overestimate the precision of their knowledge and their knowledge relative to others. This often results in investors trying to time the market, either going in or coming out.

There are a host of other behaviours that can influence decision making on the part of investors. It is important that investors become mindful of their decision making process to improve the likelihood that they will achieve their investment objectives. Trying to out-guess the market does not pay off in the long term, and often has unintended consequences such as increased tax liability, costs, etc.

The best approach remains to implement a sound investment strategy, at a reasonable cost, and stick to it as far as possible.

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