April 2024

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Investing for a world of change

The more things change, the more they stay the same

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Post the COVID epidemic, it seems that we are in a period of accelerating change – the fastest interest rate hiking cycle in decades, regional conflicts with the real fear of escalation, increasingly concentrated financial markets driven by the 'Magnificent 7', deglobalisation, ChatGPT, and Bitcoin.

Closer to home, we must contend with continued loadshedding, deteriorating infrastructure, the very real possibility that the ANC loses its absolute majority at the 29 May elections, and so on, and so on.

But in a sea of change, the one constant is investors continuing to act contrary to their own best interests. Further evidence of this self-destructive investor behaviour has been provided by DALBAR, a financial services market research firm. DALBAR recently released the results of their 30th annual Quantitative Analysis of Investor Behaviour (QAIB) study to the end of 2023. This study measures the effects of investor decisions to buy, sell and switch into and out of mutual funds (unit trusts) over short- and long-term time frames.

Unfortunately, the results of the QAIB study do not change. Due to their behaviour, investors earn less – in many cases, much less – than mutual fund performance reports would suggest.

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For the calendar year 2023, the US equity market was up 26.3%, whereas the average equity investor realised only 20.8%. This means that their behaviour cost them a significant 5.5%! This was also the third largest average investor gap in the last 10 years. Interestingly, the two largest average investor gaps both occurred in strongly positive equity markets – on average investors are therefore not benefiting from the full equity market upside. Over longer time periods the average investor gap, while still significant, is lower; approximately 3.6% per annum over both 5 and 10 years.

This investor behaviour cost is not unique to equity investors. It is also evident across fixed income/bond investors, where the average bond investor gap was 2.6% in an environment where the bond market only returned 5.5% in 2023. The average multi-asset investor realised a return of 9.6%.

No doubt, South African investors behave the same way. Therefore, the behavioural finance role played by financial advisors is critical, especially during periods of increased market volatility and uncertainty, and during market corrections. We believe that financial advisors need to consistently reinforce the following key messages in ongoing counselling of investors:

1 To stay the course i.e., stay invested, and reinforce the prudence of a long-term buy-and-hold approach

The key message for investors is not to panic and interrupt their compounding period. Yes, a market correction is a scary thing to live through, but often the recovery is swift. Anyone who sells out in panic may miss all or most of the gains when markets recover.

Furthermore, investors often underestimate for how long they will be invested. Even someone mid-way through their working career realistically has a 40-to-50-year remaining investment time horizon. Unfortunately, underestimating your investment time horizon often results in you reacting too negatively when equity markets underperform in the short term. However, with time comes a greater degree of certainty; while over shorter time frames equity investors do run the risk of a negative return, as the investment time horizon lengthens, so the risk of a negative return is ameliorated. What is noteworthy is that the South African equity market has never had a negative 5-year return, a clear demonstration that time helps to lessen risk and improve investment outcomes.

These two articles explore this theme in more detail:

1. Why good clients achieve great investment outcomes
2. You may have longer than you think and why it matters

2 To be aware of the negative impact of common behavioural influences – loss aversion, mental accounting, anchoring, herd behaviour, regret, etc.

Often, we are our own worst enemy. This can be particularly true when it comes to investment decision-making. Traditional investment theory is founded on the belief that investors consider all relevant information before making rational investment decisions. However, in practice, this is often not the case, given that investors are negatively influenced by any number of behavioural biases.

It is at times of increased market volatility and disappointing investment returns that the impact of these biases is more pronounced, and investors feel compelled to act by selling their long-term growth investment seeking the perceived safety of cash. However, as difficult as it is to do nothing in market downturns, an analysis of previous market corrections shows that it may just be the best investment strategy.

For more on this, see this article: Know and overcome your biases

3 To reflect on lessons from the past – that markets go up over time, and that hiding in cash will not generate the necessary real returns to retire comfortably

With seemingly attractive interest rates on offer, South Africans are increasingly hoarding cash in retail bank accounts and money market unit trust funds. However, the average retail investor's holding period exceeds 12 months, with the result that they are not maximising the return potential of these conservative cash holdings by investing in more suitable growth-oriented investments.

Read more here: Do not be lazy when dealing with your cash investments

4 To maximise the benefits of compounding by investing at the earliest possible opportunity

The timing of when, or even if, to invest in equities often seems fraught with danger — the markets are expensive, there is risk of recession, interest rates are high, countries are at war, etc. Unfortunately, there is always something to be concerned about, and yet equity markets go up over time.

And then, how best should you enter equity markets? Immediately? Gradually over time? Wait for the best possible entry point, but can you identify it, or for that matter avoid the worst entry point? One approach may be psychologically more comforting, however another may be statistically more sound.

Studies of the US and South African equity markets have confirmed that 75% of the time it is better to invest a lump sum immediately rather than average in over 12 months. And interestingly, even investing at the worst time results in a better outcome than staying in cash.

View the full article here: Be decisive and act

Conclusion

During times of market instability, investors must not panic. They should revisit and recommit to their long-term investment goals and bear in mind that they are more likely to achieve these by ensuring time in the market rather than trying to time the market. Consistency and sound investment behaviours compound meaningfully over the long term, resulting in great investment outcomes for good investors.

A good financial advisor can help investors understand their future cashflow requirements and ensure that investment portfolios are set up correctly to cater for these needs. A correctly structured investment portfolio requires surprisingly little attention during periods of excessive market volatility. We therefore recommend that investors seek professional investment advice, tailored to their individual circumstances.

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CS_600 04/2024 MACS I 17177