

Who is our enemy?

Newsletter 50: March 2011

What we should be aware of...

Though a complex subject, we thought to share a few thoughts on behavioral finance in this newsletter. Recently several articles in various publications discussed this very relevant topic. The roots of behavioral finance are in decision-making theory and psychology and explore the reasoning and motives behind some human errors when investing. In making investment decisions we are more than often our own worst enemy. We have summarised some common pitfalls below (source WikiPedia):

- **Optimism and overconfidence** is the tendency to be over confident about the outcome of planned actions. It is the leading cause of human error. Humans tend to believe they are better at activities than they actually are, especially if they do it regularly. Most investors believe they can beat the market. Inevitably most are proven wrong. For example this also explains why fitness centres can convince their members to sign up for a long-term contract – they are betting that you would visit them a lot less than you initially intended. Inflated expectations almost guarantee eventual disappointment.
- **Anchoring and recency** is our tendency to rely too heavily, or “anchor” ourselves on one trait or familiar piece of information when making decisions. It also causes us to extrapolate the most recent future into the future and that historical performance will be repeated indefinitely. For example, we come to the conclusion that offshore investments have not performed over the previous decade, hence they will continue to under-perform. Conversely listed property has recently been the best performing asset class and investors believe it will continue to do so in the years ahead. As humans we tend to relate to stories and less to logic or facts – we love to be entertained.
- **Loss-aversion** explains why we dislike losing the things we have, more than we appreciate gaining the things we don't have. This is why money-back guarantees work well for some businesses – you are not likely to take up the offer. Loss-aversion becomes more severe when individuals are committed due to the size of their investment, or effort they have put into it. In the wake of distress e.g. a project or investment failing, these individuals will more than often take extreme risks in order to get even.
- The **herd instinct** often explains our tendency to adopt the opinions and follow the behaviour of the majority – either to feel safer, or to avoid conflict. We are social beings and share traits of “our herd”. Even though we are free to make our own choices, we tend to imitate others especially if we are uncertain, or perceive them to be similar to us – we feel more comfortable this way. This is why we have fashions and fads. Groups do not encourage differences in opinion and we often tend gravitate to the popular trends. When capital starts to go after the same opportunity, there is a greater likelihood of over-pricing and eventually losses.

Other biases include irrational escalation, advisor bias, hindsight bias etc. and we could easily be susceptible to behavioral misjudgment. At Afrafin our clear investment framework creates a natural barrier which protects us from being emotionally involved with our investment decision-making. This ultimately ensures that we stay on track with the long-term plan we initially created.

The interest “syndrome” and economic cycles

Interest rates tend to move up and down with economic cycles. Typically, when an economy contracts, interest rates are reduced to spur economic growth – in order to provide the necessary stimulus for investment and employment. Currently, in South Africa, rates are at a 10 year low. With this come pain and relief... pensioners are punished while those who have sizable mortgages find some respite. On average income from interest dropped almost 40% from 30 months ago. For the person paying off a mortgage relief was considerable. Mortgage holders would (by the way) be wise to continue with their regular monthly payments.

Proper planning starts with determining the lifestyle which your assets allow you to enjoy. Part of any proper plan would be to provide for the effects of inflation in order to maintain the future purchasing power of your cash flow requirements. This process should not be affected by fluctuations in interest rates. When pensioners feel the pinch of lower interest rates to the point where they need to make lifestyle alterations, it is invariably the result of poor planning and diversification. It is our responsibility to ensure that we isolate our clients from this movement in interest rates without taking on additional risk; e.g. many other investment vehicles such as government bonds and listed property pay handsome interest with minimal or no fluctuation in the underlying capital.

General

Due to the pace of transformation, it is a challenge to stay abreast of the changes and industry reform. As an example the recent budget speech of Mr. Pravin Gordon brought sweeping amendments to the retirement industry and its taxation. Many companies in the following 12 months will need to reconsider their employee benefit structure.

Willem Smit recently received his CFP® (Certified Financial Planner) qualification which is a post graduate diploma in Financial Planning at the University of the Orange Free State. This course covers the South African regulatory environment; employee benefits and medical aid schemes; investments; retirement planning and estate planning. The qualification has almost become a pre-requisite for our industry.

We are about to finish the first version of our new administrative system. This database will enable us to keep in touch more regularly and report timeously on clients' investment portfolios. As usual we urge our clients to ensure that we have their updated contact information i.e. email address. We hope to receive feedback from you.