momentum
investments

IN THE
moment

When it comes to money, know when your brain lies to you

The COVID-19 crisis has shown us that humans hate uncertainty, and our brains rely on past experiences to try and create a more predictable world.

"These two interconnected neuroscientific realisations are very important from an investment perspective," according to Paul Nixon, the head of technical marketing and behavioural finance at Momentum Investments.

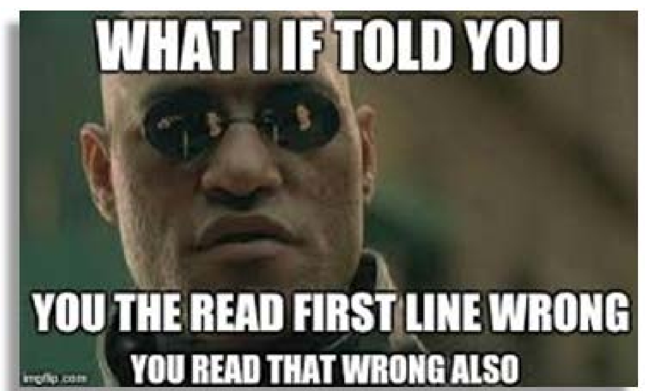
Nixon presented a session on the behavioural science of investing at the first virtual Outcome Matters event for 2020.

"During times of high uncertainty, like we are experiencing now with COVID-19 and the extended nationwide lockdown, people are more predisposed to use their gut instincts and put critical thinking on the backburner. This puts us at risk of making decisions that could sabotage the success of our financial future."

Nixon went on to explain that the human brain has a rule book to make the world more predictable. "This rule book is essentially a belief system about how the world works.

"However, sometimes our brain will convince us of something that isn't true, which is the essence of a cognitive distortion. This is because the brain is not necessarily looking for truth; it is looking for meaning," said Nixon, who pointed to some examples of optical illusions as proof of this, for example figure 1:

Figure 1: The world is more of an illusion than you think.



"Arising from past interactions with assumptions about the world, 'unconscious inferences' can lead to a visual percept that appears to differ from reality. Similarly, cognitive distortions stem from heuristics or thinking shortcuts."

Applying this concept to an investment or advice scenario, Nixon explained that, depending on what experiences and information clients have been exposed to in the past, they would have formulated belief systems around investing. "Some of these belief systems may very well be false, such as the common misconception that past investment returns are a great way to select future investments.

"These belief systems are going to inform their investment choices going forward, but ultimately, when they don't get the results that they desire, their willpower to stay invested for the long term will be tested. This only perpetuates the cycle, because clients will then start looking again for other

investments options that have performed well in the past, switching course from their original plan.
"Unfortunately, even if proven unsuccessful, a belief system that has been developed based on past experiences is very difficult to change," noted Nixon. "As financial services providers, we are going to have to arm financial advisers with tools and diagnostic techniques that enable them to have the right conversations with clients around the psychological dimensions of financial planning."

Importantly, he also highlighted that "behaviour tax" is at its highest during times of extreme market uncertainty. "
A behaviour tax is the difference between the return an investor would have received if they'd stuck to their original plan, and the return they actually received as a result of their switching activity."

Despite the heightened uncertainty COVID-19 has caused, Nixon emphasised that, as long as clients' investment goals haven't changed, their plans to reaching these goals should not be changing either. "The biggest cognitive distortion out there for investors right now is the market turbulence trap. When we look at our long-term investment goals through a short-term lens, we get the illusion of a lot more volatility and uncertainty.

"People have very short memories and, in a year or two, most will have completely forgotten how they were feeling during this time of uncertainty. In this sense, what remains most important now is protecting clients against cognitive distortions and keeping them invested in terms of their long-term goals," Nixon concluded.

Reasonable steps have been taken to ensure the validity and accuracy of the information in this document. However, Momentum Investments does not accept any responsibility for any claim, damages, loss or expense, howsoever arising out of or in connection with the information in this document, whether by a client, investor or intermediary. The content used in this document is sourced from various media publications, the Internet and Momentum Investments. For further information, please visit us at www.momentuminv.co.za. Momentum Investments is part of Momentum Metropolitan Life Limited, an authorised financial services and registered credit provider, and rated B-BBEE level 1.