momentum
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UNDERSTANDING THE SCIENCE BEHIND FINANCIAL SUCCESS

NEW BEHAVIOURAL FINANCE RESEARCH SHOWS HOW GREED AND FEAR IMPACT RETURNS OVER TIME

Fear and greed both represent strong emotions that people link to perceptions of danger and opportunity. These emotions – backed by the powerful reward and stress chemicals of dopamine and cortisol – are ever-present in today's modern society and challenge the normal representation of rationality in decision making, even when it comes to investing.

To gain a deeper understanding of how fear and greed impact South African investment behaviour over time, Paul Nixon – Momentum's Head of Technical Marketing and Behavioural Finance – along with Professor Evan Gilbert from the University of Stellenbosch's School of Business and Dirk Louw, an actuarial analyst at Transaction Capital Recoveries, recently performed a pioneering risk-based analysis of the switching decisions of 23 390 investors on the Momentum Wealth Linked Investor Services Platform (LISP).

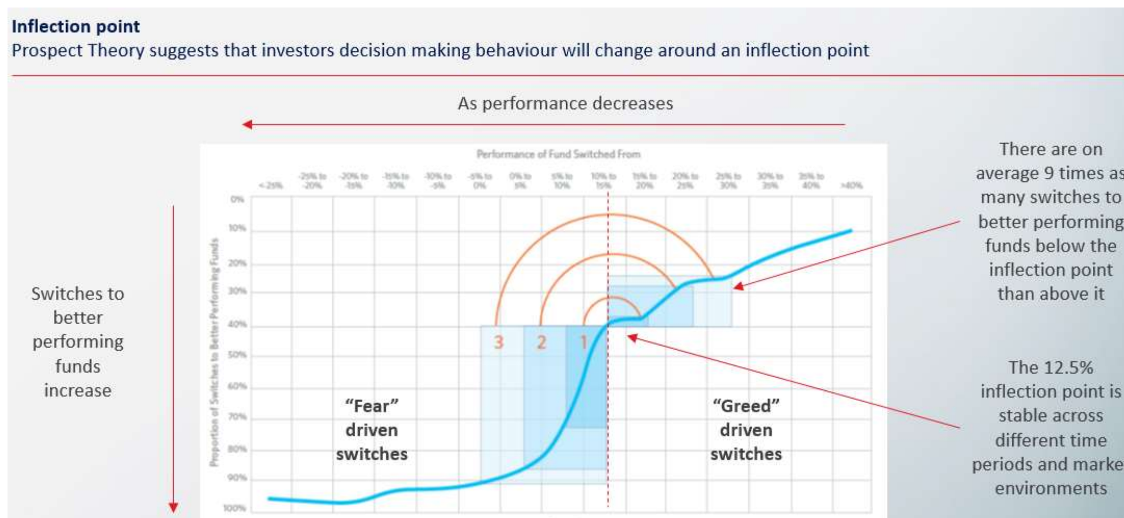
The results, which have been presented in a White Paper and were recently unpacked in the Investment Edition of the Momentum Science of Success for Media series webinar have presented fascinating insights for investors at a time when the environment for making investment decisions is at its most volatile.

"We wanted to develop a South African first by segmenting local investors based on the switching of their holdings in discretionary unit trusts. This allowed us to capture different elements of investors' risk attitudes and resulting decision-making behaviour. Ultimately, our aim was to better understand the compromising nature of myopic risk behaviour, in order to help investors, avoid the negative implications that cost them in the form of a behaviour tax. And as we have learned at Momentum Investments, behaviour drives success," says Nixon.

This "behaviour tax" Nixon refers to is a lower investment return as a result of an investor's behaviour, like hastily switching funds because markets are falling, compared to portfolios which are bought and held. "This essentially explains why following our gut instincts when investing often does not serve us well."

To begin with, Prof. Gilbert explains how each investor in the sample received a score based on how many switches fell either above or below a certain inflection point, which is a practical application of the work of Nobel Laureate Daniel Kahneman called "prospect theory" and reflects the level at which there is a sea-change in investor behaviour.

“This ‘inflection point’ means that as investment returns dip below around 12.5%, investors become nine-times more likely to change to another fund - their sensitivity to returns increases sharply and then later decreases. The inflection point therefore marks two distinctly different patterns of behaviour: to the left of it, investors fear painful losses and so sometimes increase risk to avoid or make up these losses.



“The term ‘Greed’ has been used to describe investors making switches to better-performing funds above the inflection point; and ‘Fear’ to those switches made below this point,” he adds.

Then, by categorising switches based on the level of past relative performance; changes in the risk profile of the switched funds; and switching frequency and average asset allocation, Gilbert says they were able to identify groups of investors with similar switching behaviour. “With further investigation into the general behaviour exhibited by each of these clusters, it was possible to identify five investor archetypes, namely: Avoiders; Contrarians; Market Timers; Anxious Investors; and Assertive Investors.”

He goes on to explain the final step of the study, which was analysing the change in the various clusters’ switching behaviour over time. “This was the most challenging yet valuable part of the analysis, as it provided a general view of the archetypes’ varying switching activities during different economic events.

“During the 2008 Global Financial Crisis (GFC), for example, switching behaviour was mostly linked to the Avoiders and Anxious Investor clusters. Then, during market recovery post-GFC, there seemed to be a lot of active Market Timers; while during bullish market periods we observed an increase in Contrarian type investors. The Assertive Investor cluster remained relatively constant during all economic cycles, reflecting their likely predisposition to overconfidence,” Gilbert reports.

One behaviour trait, however, that he says permeates across the board, is that investors are prone to making short-term decisions that are not aligned with their long-term investment goals.

Based on these findings, Nixon says that the team was able to pinpoint three general hurdles to overcome in order to reduce the possibility of South African investors' decisions leading to a behaviour tax. "Firstly, a sound and objective basis for the accurate assessment of investor risk preferences or risk tolerance is needed. Theory suggests that these are both stable and long term in nature but measuring them accurately is something the industry has been battling with for some time and may be critical to helping South African investors on their journey to financial success."

Secondly, Nixon notes that each investment fund's history experienced places the investor at risk of making decisions being driven by their (changing) risk propensity. "Simply put, their current tendency to take risk may have shifted out of sync with their long-term preferences due to recent experiences. Propensity to take risk is an emotional decision link to recent, salient events and if used as the basis for choices can lead to inconsistent investment outcomes."

The final, yet arguably most noteworthy hurdle that Nixon unpacks, is the effects of time. "This is a difficult one, because belief formation is a significant predictor of future behaviour, and while an investor's risk propensity is variable, it becomes increasingly difficult to influence over time as investment outcome experience builds.

"This means that if we as an industry are not successful at intervening from the early onset of investment outcomes, the challenge in getting investors to stick to long-term investment goals becomes increasingly challenging," he notes.

"At the end of the day, the goal therefore remains to better align investors' short-term decisions with their long-term investment goals, something that we at Momentum Investments remain committed to achieving through our outcome-based approach. This will give you control of your financial success journey by getting a financial adviser who understands your unique long-term investment goal. By connecting to the outcome, you want to achieve, you focus on your end goal, instead of being disheartened by short-term underperformance that triggers switching," Nixon concludes.

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