momentum
investments

Mindfields

July 2019

Dear reader

Welcome to our latest edition of Mindfields, and we're excited that it coincides with our conference.

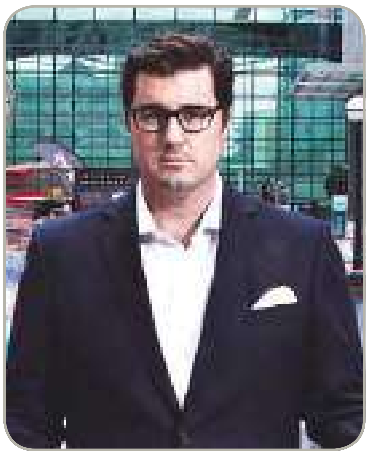
We all know how challenging the investment environment is at the moment and, apart from being resilient in a low-growth environment, we need to understand investors better, that we can help them achieve their goals with more confidence. That is exactly what the three articles of this edition will highlight.

- Greg Davies of Oxford Risk warns in his article "Travelling or arriving" that we often confuse risk and volatility, and how that can be detrimental to the interests of investors.
- Paul Nixon, head of Momentum Investments Technical Marketing, takes us along on a rollercoaster ride in his article explaining how South African investors, too, let their emotions run away with them, while we should help them manage their anxiety.
- In their article "How outcome-based investing can trump global economic challenges," Eugene Botha, deputy chief investments officer, and Herman van Papendorp, head of investment research and asset allocation, explain why the days of wild goose chases after arbitrary benchmarks should be numbered.

We hope you find the articles insightful and the thinking empowering.

Sonja Saunderson

Chief Investment Officer



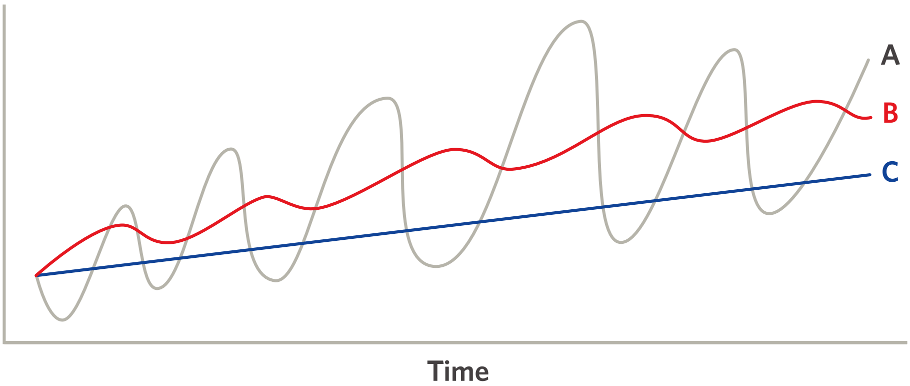
Travelling or arriving?

Written by
Greg Davies,

Oxford Risk, a specialist in applied decision science, behavioural finance, and financial wellbeing; dedicated to improving decisions through behavioural science.

What matters more in investing, the journey or the destination? Ultimately, we're all investing for a means to meet our ends, so the outcome surely matters more than the ride that gets you there. And yet, if the journey is too rough, we risk turning back, taking a longer route, or arriving somewhere less enticing. To succeed, we need to pay attention to both, and the right balance will be unique for each investor.

To supplement a decent psychometric assessment of risk tolerance, a financial adviser or consultant may sketch a chart like the one below and invite investors to say which path they prefer to be on.



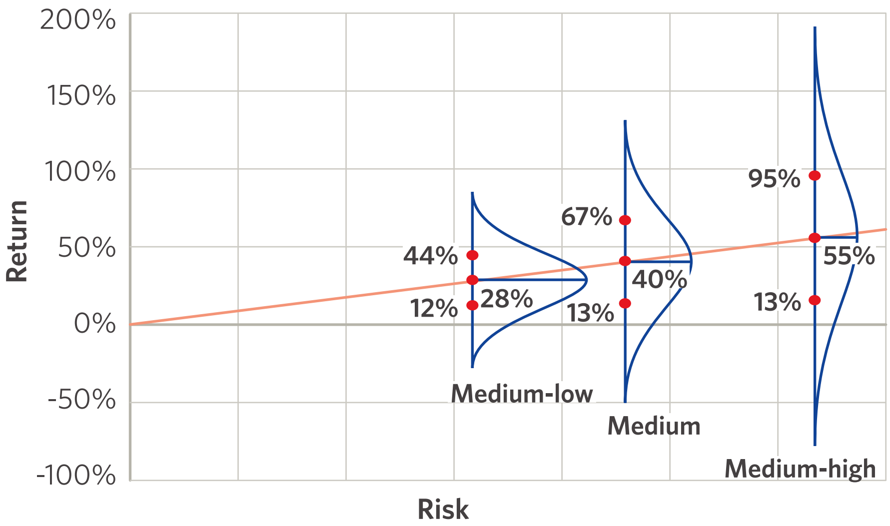
Source: Oxford Risk

The way a chart like the above is usually presented ensures everyone picks B and, hey presto, everyone is 'medium risk' (give or take a leaning towards A or C that define the upper and lower bounds of medium).

This has the advantage of matching what we know about risk tolerance – that there are more people in the middle than those that have extremely high or low tolerance. However, it has the disadvantage of being misleading. For A, B and C don't show risk.

The focus of a chart like this is on the journeys. But risk is not about the journey; it's about where you could end up. What the chart shows is volatility. The difference is important and goes well beyond the world of semantics and theory Misunderstanding the difference leads directly to mismanagement of risk in the real world of investors and their investments.

A better way of looking at it is something like the graph that shows ranges of possible outcomes for some typical portfolios (on some simple and reasonably conservative assumptions) over 10 years. Risk is the chance of ending up with an outcome on the low side of those distributions regardless of how turbulent the journey was that got you there.



For each level of risk, there is (in blue) the distribution of possible outcomes after 10 years of investing and (the red dots) the expected returns of the bottom fifth, average and top fifth of the expected outcomes. For example, 20% of the medium-risk portfolios have a return higher than 67%, while the most likely return is 40%.

Investment risk is the risk of money not being there when it's needed, reflecting the chance and the severity of poor returns. Investors' risk tolerance is their willingness to accept the chance of bad final outcomes in the hope of good ones. Risk management is, therefore, investor-specific, because for an outcome to be bad, it needs to be bad for someone.

Volatility, on the other hand, is the risk of a bad journey (towards a bad or a good outcome). Willingness to accept volatility is, therefore, a different matter to risk tolerance, despite the proliferation of profiling tools that confound the two, mistaking comfort for success, measuring turbulence and calling it risk.

If you look at a graph showing the history of an investment's value over a given period, it will tell you how volatile that investment was over those years. It won't tell you how risky the decision was to purchase it at the start of the period, because the path it took was one of innumerable paths it could have taken. And yet many risk-tolerance assessments continue to ask about perception-based tendencies like optimism and pessimism in financial decision-making.

When adequately understood, it's clear that while volatility is visible, risk is not. Because while you can see ups and downs along the way, and indeed where you ended up, you cannot see either the chance of ending up where you did, or all the other places you could have ended up, but didn't.

This is important, because misunderstanding the difference leads to mismanagement, which in turn leads to more uncomfortable and, quite possibly, poorer clients. A meaningful understanding of risk is crucial for good financial decision-making.

Unbundling relationship management

A deeper understanding of what risk really is tells us how much long-term risk is right for each investor to take right now (in the context of their long-term plans). It also tells us which elements of the experience of this risk over the journey should be accepted rather than avoided. In other words, it helps you to know if an investment is suitable or not, and how to construct portfolios that find the right focus on controlling the journey compared to the destination.

A suitable approach to investor management is to construct a solution for the right level of risk to take, based on the investors' risk tolerances and risk capacities. It also – separately – puts in place a plan to control their emotional reactions to volatility, based on their financial personality or how they prefer to be emotionally comfortable. Taking the most volatile portfolios off the table does work, in one sense. But risk avoidance isn't risk management and forgoing the chance of higher returns is often an excessive price to pay for being more comfortable with short-term turbulence.

Ideally, we would all avoid risk if it costs nothing to do so. But avoiding risk never costs nothing. It means giving up the chance of gains. We're better off acknowledging the trade-off and managing not the volatility, but how it affects us. Why give up on a good destination when we could simply change how we're likely to behave along the journey?

It's not the size of the risk, but what you do with it that counts

Risk management is not about avoiding risk, it's about getting the best deal for the risks you choose to accept. It's not smart to pay with foregone returns for protection from volatility when it's only the visibility of the volatility that affects your emotional comfort. Sometimes, shutting your eyes can open you up to see opportunities you would have overlooked.

The most successful outcomes – the anxiety-adjusted returns that account for investment returns and the investor's emotional comfort – are determined not by avoiding complexity, but by knowing how to navigate it.

For investors with very low composure, who are prone to panic-sell in response to any market dip (especially those who track their porfolios more frequently), limiting exposure to volatility can be a good means of managing their risks of poor ultimate returns. However, for many there are also other ways. Taking risk without being emotionally derailed by volatility can be accomplished more cheaply for most by preparing for and reducing the visibility of short-term ups and downs. Tailored education, changes to how financial information is presented and well-timed reminders of the longer-term plan at the exact moments that it is threatened can all help build emotional comfort with investment volatility.

The key to coping with volatility is self-knowledge. Specifically, knowledge of the right level of risk to take in the long term, and how to cope with being uncomfortable in the short term – and how best to mitigate these feelings – based on a unique financial personality. It's time to bring a bit more real-life behavioural psychology to the public's real-life relationship with risk. ■

South African investors ride the emotional rollercoaster

Written by
Paul Nixon,

Head of Momentum Investments Technical Marketing

It was the French poet and novelist Anatole France who once said, “It is human nature to think wisely and act foolishly.” It is this behaviour that translates into a quantifiable cost to investors who end up paying for what feels comfortable.

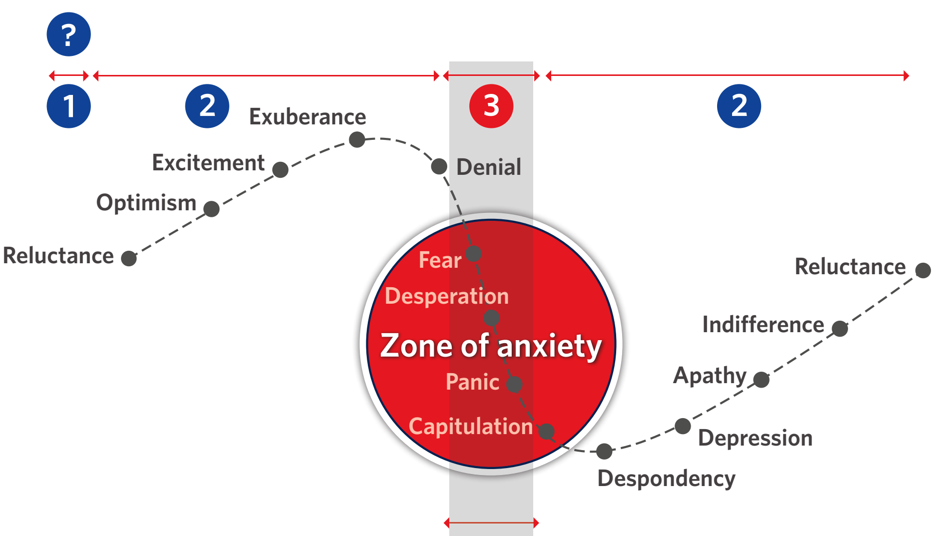
A so-called behaviour gap for investors opens up when there is a difference between what they should have earned if they stuck to their proverbial guns (the so-called buy-and-hold approach) and what they actually earned because the strategy was changed by switching investments along the way. The result is a cost or what we will call behaviour tax.

The developed world has had plenty to say on the subject with Dalbar, Morningstar, Barclays and Merrill Lynch publishing a number of pieces on the nature and extent of these behaviour gaps and associated costs, but what about South African investors? Are we different? Are we more astute or even immune perhaps?

Our approach to analysing the South African climate was to formulate a solid research framework and set up a South African first behavioural finance research unit with the North-West University, University of Pretoria and University of Cape Town, with input and guidance from global thought leaders like Oxford Risk in the United Kingdom.

The traditional market cycle may be overlaid with an emotional investor journey that begins with the reluctance to invest (the starting point of the diagram below).

Value add through tailored customer engagement



Source: Adapted from: Davies, Greg B: 2013. Overcoming the Cost of Being Human. Barclays Wealth White Paper

This is the first cause of a behaviour gap (point 1) as potential investors remain locked in cash and often exchange inflation-outperforming investment returns for the emotional comfort that cash-based investments provide. This has not been quantified in the South African context as yet but will be a future focal point.

The second root cause of a behaviour gap takes shape once invested and stems from a typical investment journey illustrated on the left. The results of our pioneering study will be discussed shortly, but the investor ‘zone of anxiety’ illustrated as point 3 is the most costly.

Index – buy and hold compared to actual (all investors)

Figure 1: Value erosion index

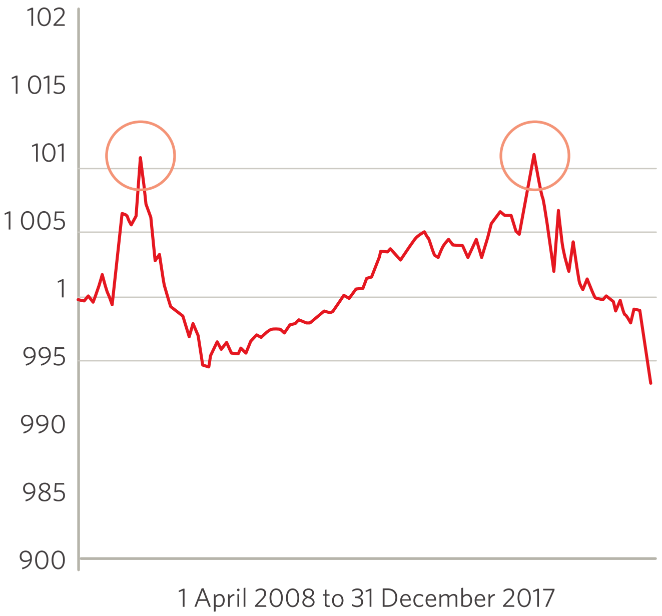
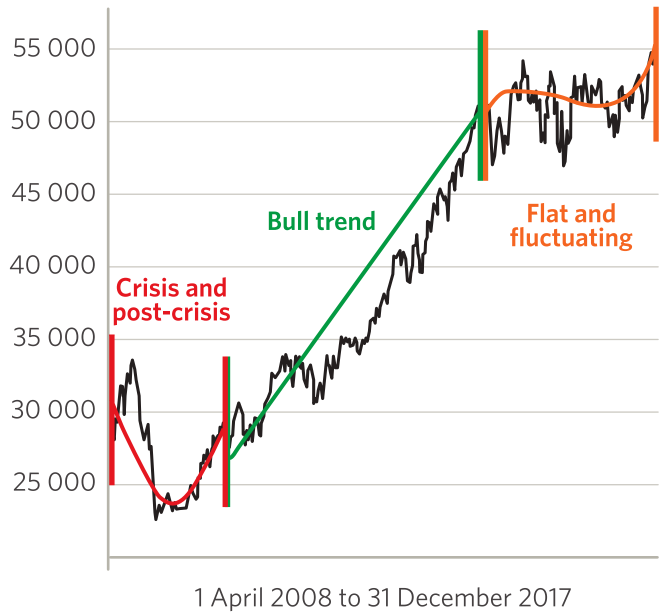


Figure 2: Market cycle



Source: Louw, Dirk JD: 2018. Investigating and quantifying the retail investor behaviour gap.

It also presents an opportunity for us to build an artificial intelligence and neural network capability to tailor customer engagement for a time when investors need it most.

A behaviour tax that varies with market cycles

In 2018, based on this research framework, we analysed the behaviour of more than 17 000 investors using data from January 2008 to December 2017. Over this decade, we see the following notable results by constructing a value erosion index to examine the relationship between aggregate investor behaviour and market cycles. An erosion index value of 101 (for example) implies investor switching behaviour eroded 1% in returns per year on average. The analysis revealed the following:

1. Switching is most dangerous during bear markets. Here the value erosion index spiked to 1,1% per year. To place this in perspective, a behaviour tax of 1,1% per year means a 22% difference in investment value over a 10-year period assuming a market return of 10%.
2. Switching is almost as destructive during flat and fluctuating markets (low-yield environments), where the behaviour tax reaches its second highest level of 1%.
3. Over all market conditions, one quarter of the population analysed attracted an average behaviour gap of just over 1% per year.

The current South African investment landscape could attract a higher behaviour tax from switching activity as asset prices fluctuate and so emphasise the importance of staying invested. The graph below shows a common timeline over the decade of analysis. The top graph represents the value erosion index (how the behaviour gap fluctuates) and we can see a clear negative correlation over the corresponding market cycle. In other words, the largest behaviour gaps present themselves when asset prices are falling (the two peaks circled).

The 'switch itch' is driven by fear

Our findings clearly showed that 64% of the time when investors switched, they were chasing past returns. This was however more of a 'fear' than a 'greed' factor, which was highlighted clearly by prospect theory. We know that Daniel Kahneman and Amos Tversky's ground-breaking contribution to behavioural economics was that traditional utility theory has two sides – we will happily take on risk to avoid losses because they hurt more than the equivalent gain. This is the essence of prospect theory, loss aversion drives investors away from being risk-averse to being risk-seeking.

When looking at investor utility through the lens of investment returns, we clearly see a similar relationship to the prospect theory S-curve in textbooks (look at the graph on the next page). Investors had eight times the 'switch itch' when their portfolio performed at between about 1% and 5% (poorly by any standard) than when it performed well, at between about 16% and 19%. This is shown below as point B, which is about eight times the size of point A. The vertical axis shows the percentage of investors chasing better returns, while the horizontal axis shows the corresponding investment returns. In other words, investors aren't switching when their portfolios are returning more than 27% and they are switching when their portfolios are returning negative 25% or below. We now understand when clients are likely to derail their investment goals and so we can tailor engagements to keep them on track and make sure financial advisers and consultants stand between investors and this behaviour tax.

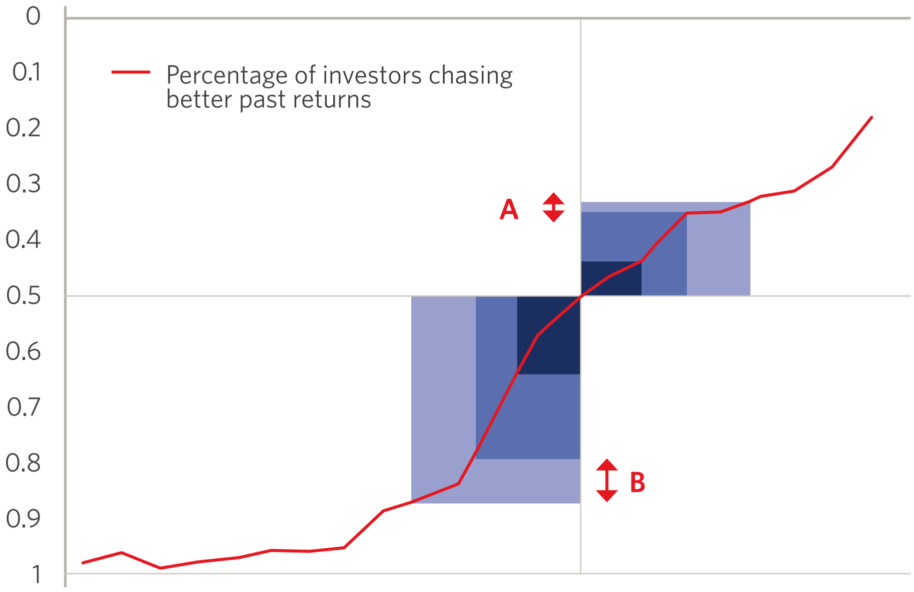
Mind the gap with outcome-based investing

The good news for South African investors is that outcome-based investing has proven to be a natural plug to the behaviour gap. We investigated all investors' initial portfolio selections and matched this with the closest equivalent outcome-based solution. We then compared this outcome-based solution to the following:

- The investor's actual return received over the life of the investment (inclusive of any switching activity)
- The return of the investors' initial portfolio selection (an assumed buy-and-hold) approach

Past returns of portfolios switched from

<-25% to >27.5%



Source: Adapted from: Davies, Greg B: 2013. Overcoming the Cost of Being Human. Barclays Wealth White Paper

On average, investors would have received an additional 0,70% for remaining invested in the equivalent outcome-based solution. One in three investors missed an opportunity to squeeze out an additional 1% in returns and one in 10 investors missed out on a substantial 3% in returns that the equivalent outcome-based solution would have yielded. In all cases, these additional returns were delivered at virtually identical levels of volatility (measured by standard deviation of returns). This is clear evidence that multi-asset-class investing is providing a more palatable investment journey and showcases the benefits of diversification through participating in market upswings.

We have found the results above to be statistically significant and will be submitting the results of this research to the Journal of Economic Psychology for publishing late this year. The second phase of the above research will start shortly. We want to investigate how to build a predictive model of investor behaviour and how we can build impactful marketing and communications strategies to help manage and close these gaps. ■

How outcome-based investing can trump global economic challenges

Written by
Eugene Botha,
Deputy Chief Investments Officer, and

Herman van Papendorp,
Head of Investment Research and Asset Allocation

The mindset of investing changes dramatically when an investor decides to invest to deliver on a specific goal or objective, rather than hunting for the next best opportunity to make money. This leads to a considered approach of outcome-based investing. It has a systematic focus on investors' needs and requirements to grow their wealth and follow a well-thought-out approach to achieve these at some point in the future. It's not about trying to make a quick gain and definitely not an outright gamble or speculative trade.

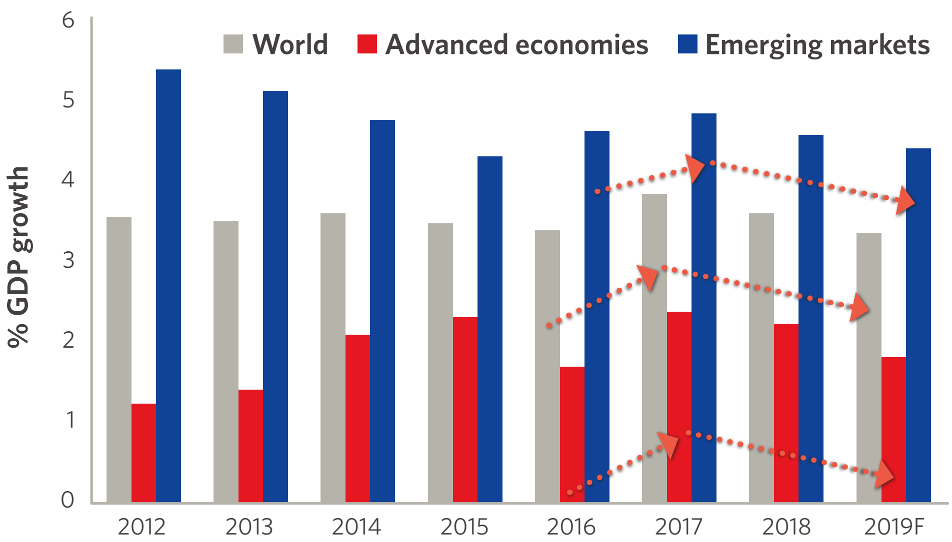
Prudent wealth creation or financial goals are typically longer-term orientated and therefore the investor should have a long-term mindset when making investment decisions. However, a short-term approach to investing is not always wrong. More often than not, certain financial goals in life are of a shorter-term nature. Investors need to make investment decisions accordingly to deliver on the goal with the highest certainty over the given investment horizon. The secret is in how to construct the portfolio to deliver on the required objective. Time is usually an investor's friend. The longer the investment horizon, the more certainty investors have of achieving the required outcome.

It is, however, important to understand the market environment and dynamics at play, as this often drives not only the behavioural aspects of investors over the short term, but also influences the outcomes over the longer term.

This also shows the importance of understanding why the global growth backdrop has seen a remarkable about-turn for the worse in recent years. Having experienced a synchronised recovery as recently as 2017, with most major regions experiencing accelerating growth momentum at the time, the world growth trajectory is now one of synchronised slowdown. Momentum is being lost over a large number of regions (see graph 1).

The two main drivers for this deterioration in the world's economic growth fortunes have been less favourable monetary policies and trade frictions. Firstly, until 2016, developed world central banks kept policy rates around historical lows, while pushing additional liquidity into their economies through the

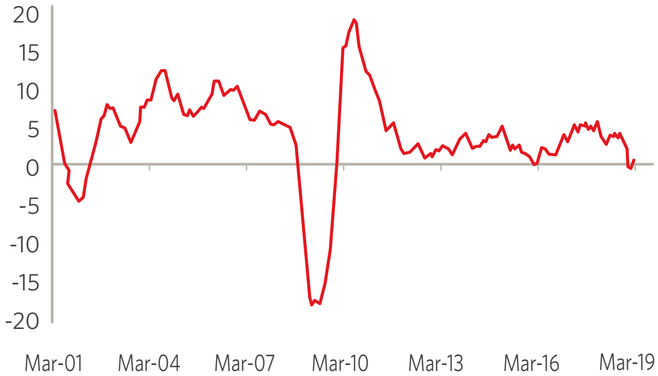
Graph 1: From global synchronised recovery to synchronised slowdown



Source: IMF

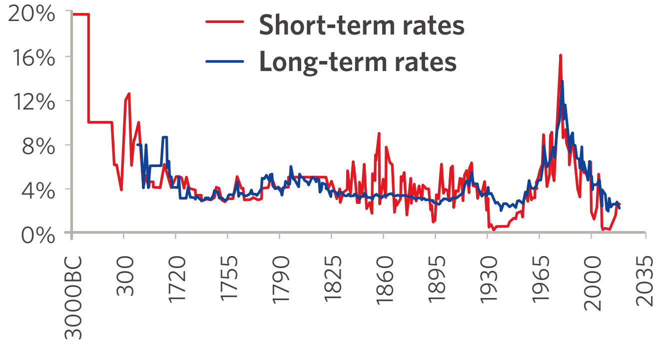
policy of quantitative easing. Since then, policy tightening has become more evident, led by the US central bank (the Fed) pushing up interest rates at a more aggressive pace, while culling their liquidity injections into the global financial system. The negative lagged effect on growth of this less conducive monetary policy has become increasingly evident since 2018. Secondly, the rising threat of trade wars between the US and its traditional trade partners has become an additional constraint to global growth since 2018 (see graph 2). As long as the US continues to feel aggrieved that its historical role as global geopolitical stabiliser has benefited the rest of the world disproportionally more than itself, trade tensions will likely remain. In this regard, economic growth in Europe and emerging markets that have a high export dependency are most at risk from the 'new normal' in trade relations with the US.

Graph 2: Growth in global trade volumes



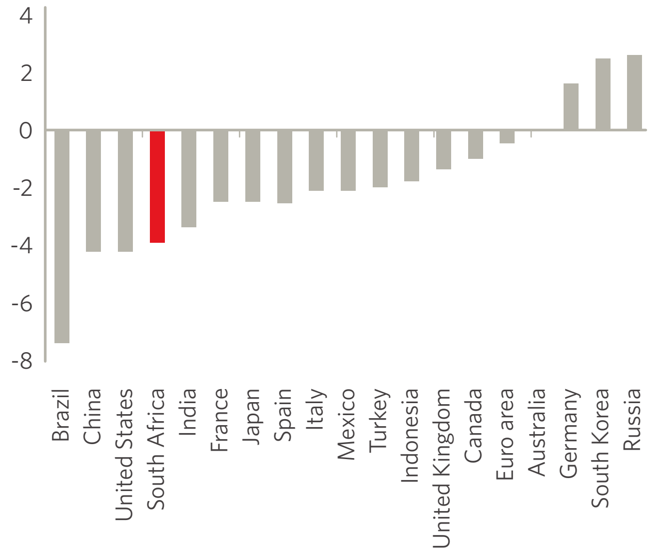
Unfortunately, the reality is that global policymakers have a limited tool set to counter the synchronised slowdown. With global interest rates still not far off their 5 000-year lows (see graph 3), room for rate cuts outside the US is very limited, leaving more quantitative easing as the only viable option. However, with sovereign bond buying in Europe already at regulatory limits, the European Central Bank will have to start contemplating buying other asset classes like corporate loans or equities as part of its quantitative easing mix. There is also little room for additional fiscal stimulus from constrained budget positions outside of Europe (notably Germany) and selected emerging markets (mainly Russia and South Korea) (see graph 4).

Graph 3: Global interest rates close to historical lows



Source: Bank of America Merrill Lynch

Graph 4: Government budget balance (percentage of GDP for 2018)



Source: Bloomberg

So what are the broad investment implications from this global reality of synchronised growth slowdown amid limited policy options?

- Many asset classes face low returns in coming years in an envisaged environment of low growth and low interest rates.
- Greater volatility and dispersion across asset classes should be expected in a more unstable and unpredictable world.
- The low margin of safety asset classes could be particularly exposed (for example US equities and global bonds).

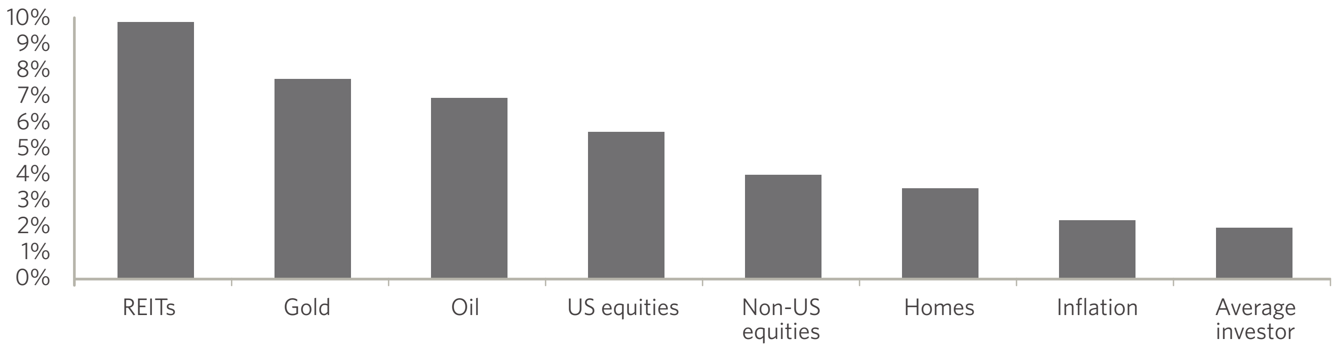
Our outcome-based investing philosophy and portfolio construction approach should prove to be a superior strategy during the anticipated challenging market environment. It will provide investors with an enhanced probability of attaining their ultimate investment goals and manage the client experience en route to the destination. By making the journey less stressful for the investor, particularly during periods when asset prices fall or volatility spikes, irrational investor behaviour (selling at the bottom when market sentiment is despondent or buying at the top when market sentiment is exuberant) can be limited by keeping investor sentiment on a more even keel over the investment horizon.

Here are some of the key considerations to offset behavioural biases:

Avoiding bad investment behaviour that could torpedo good investment outcomes.

Typical consumer behaviour is to buy when goods are on sale rather than when they are expensive. It is therefore surprising that typical investor behaviour turns out to be the exact opposite – to invest when prices are rising rather than when they are falling. A recent global study shows that the average US investor underperformed asset classes and portfolios in the last two decades due to looking in the rear-view mirror too often – buying previous winners and selling previous losers (see graph 5).

Graph 5: Twenty-year annualised returns by asset class (1999 to 2018) in the US



Source: JP Morgan

**Real estate investment trusts*

Table 1: Behavioural biases that caused this poor investment behaviour

Behavioural bias	Associated bad investment behaviour
Loss aversion	Selling recent losers
Herding	Buying recent winners
Overconfidence/Knowledge illusion	Excessive switches

"Buying on the cannons and selling on the trumpets."

We continually evaluate recent underperforming asset classes to potentially enhance future returns. Although investing in unpopular asset classes is a lonely strategy, it can be very lucrative. This is very applicable to South African equities and South African listed property, which have both experienced very lean times in recent years. These opportunities are often evaluated from a strategic perspective and a shorter-term tactical perspective to align to the overall outcome of the solution.

Managing risk.

This is done by increasing portfolio quality. One example is by investing in equities with high-quality characteristics. Quality can also be defined as asset classes or strategies that will offer risk diversification and increased downside protection when turbulent times are expected or when valuations of specific asset classes have become stretched.

Exploring alternative and real assets to enhance returns.

Alternative risk premia are important in client solutions, given the investment attributes of risk management and yield enhancement they can bring to traditional asset classes and strategies within a broader portfolio. We believe there is a requirement for alternative premia in a client solution over the longer term, given the benefits they add, especially in the low-yield environment evident in the market. These asset classes typically include infrastructure, physical property, and natural resources such as agriculture, energy resources and physical commodities. In the case of private equity specifically, the global trend is that private markets now provide wider exposure to new growth areas (shares) than public markets and should hence be explored for additional alpha-generating opportunities.

Often clients get tripped up by the costs of alternative asset classes and, therefore, adding value should always be measured on the value added after costs. We also believe certain alternative premia can be replicated in a passive or systematic way to deliver on alternative profiles in a more cost-effective way.

Conclusion

During such a challenging and unpredictable market and investment environment and to help manage the behavioural biases humans so often struggle with, the advantages of our outcome-based investing philosophy should clearly come to the fore. A major benefit of the outcome-based investing approach is our ability to use the full universe of portfolio management alternatives to take advantage of the benefits of diversifying across multi-asset-class capabilities (taking advantage of traditional and alternative premias), multi-strategies (exploring the return drivers within each asset class) and multi-mandates (choosing the most suitable investment manager for each strategy).

It also combines the best of breed characteristics of a single investment manager approach (using existing superior in-house skills), a multi-manager strategy, passive investing (little cost leakage when returns are low) and active management (enhanced alpha-generating ability when asset class correlations are low and dispersions high) – all very important and a requirement to navigate the low global yield environment we are facing. ■

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How we can help you

To find out more about our investing philosophy and our offerings, scan the QR code™ to visit our website, momentum.co.za/investments.