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The four most dangerous words of investing

"In the 20th century, the United States endured two world wars and other traumatic and expensive military conflicts; the Depression; a dozen or so recessions and financial panics; oil shocks; a flu epidemic; and the resignation of a disgraced president. Yet the Dow rose from 66 to 11,497." Warren Buffett

Local markets saw a sea of red on Monday, 24 February 2020, as fears of Covid-19 (the Coronavirus) hit commodity markets hard and sent the gold price increasing even more because investors prefer more certainty. Global production forecasts have tumbled, evidenced by the sharp decline in the oil price, after a sustained run. A warning of persisting downside risks is a consensus among market commentators. From a South African context, the looming Moody's decision later next month certainly does not help.

So, what does this uncertainty mean for clients, who are looking to advisers for more predictable financial outcomes? To investors who are saving for retirement, their child's education or even a rainy day, the short answer is to do absolutely nothing. When investors lose sight of the big picture and develop an unhealthy fixation on what is directly in front of them, the result may be flawed decision-making. Behavioural scientists refer to this phenomenon as 'myopic loss aversion'. The term 'myopic' refers to being short-sighted and an illusion of volatility is created when we constantly evaluate investment returns. Simply put, 10-year volatility and 10-day volatility are vastly different.

Our white paper published in 2019, clearly demonstrates that the largest 'behaviour tax' incurred by investors happens during volatile markets. A 'behaviour tax' is a lower investment return, resulting from behaviour like switching funds and/or investment strategies. The research shows that some investors are costing themselves as much as 2.6% per year, simply by making investment decisions to ease their emotional tension caused by markets. A market shock causes investors to move to safer investments and more predictable returns.

The problem is that the same investors sit on the side lines for way too long before getting back into markets and miss market growth before they're comfortable enough to dip their feet back into investments linked to market returns. As markets grow again, as they inevitably do, these investors will incur a growing 'behaviour tax' by being invested in the wrong place at the right time.
This perpetuates the cycle of selling low and buying high.

In times of uncertainty, it is worth taking a deep breath to reflect and collect one's thoughts – take a healthy dose of reality and seek solace in constant things that have been observed repeatedly. From a financial physics perspective, 'Siegel's constant' (from Jeremy Siegel's book on investing named 'Stocks for the Long Run') is one of these constants, revealing that long-term (1900 to 2009) real share returns average out to about 6.5% plus costs across 19 developed market economies (including South Africa).

Another constant is mean reversion or asset prices reverting to their long-term average returns.
Asset allocation depends on diversification (investing in various geographies, markets and economies), which creates value through the exercise of rebalancing and doesn't work without mean reversion (selling strong-performing investments in anticipation that underperforming investments will return to favour).
Having a well-diversified investment fund geared and managed to reach your clients' investment goals and allows financial physics to do the rest, remains a sound investment strategy in all markets.

The only action you should take is to ensure your clients are invested in a fund matched to their investment goals.

Our philosophy involves targeting a specific return over a chosen period and we define risk as the likelihood that the investment fund won't deliver the return it's targeting.

It may sound like semantics. However, it means risk doesn't have to be reduced to three simple definitions of 'low', 'medium' and 'high' anymore, but can be described in sync with clients' goals: Will they or won't they achieve their goal and, if they miss it, by how much will it be?

This goal-based investing approach has gained ground in countries like the UK and the US. We have followed this approach with our institutional clients, such as retirement funds, since 2011 and now individuals are also benefitting greatly from the skills and expertise we gained with this approach.

So, what are the four most dangerous words in investing? This time it's different. But, why not do things differently instead this time and stay invested.

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