Why are you investing?

After three years of relatively poor investment returns in South Africa, it is no surprise that many investors are asking why they don't just invest their money in a fixed deposit or some form of cash investment for the next three years where they can earn a virtually guaranteed return of 9% per annum.

This is a sound question, particularly in a rising interest rate environment where the returns on cash are likely to increase. The problem with this question is that it is not the right question to ask. Before investors ask "where should I invest?" it is important that they have answered the question, "why am I investing?"

This is an important question because for some people, investing in a fixed deposit for the next three years may be the perfect investment. But it can only be for those people who have a three year time horizon, know that the promised return on cash is enough to meet whatever their investment needs are, and be comfortable that whatever liquidity constraints come with such an investment are not counter to their own cash needs. Of course there is the further question of the tax implications of investing in cash, but again because each investor's circumstances are unique this may be a relevant factor for some, but certainly not for all.

For some investors though, a three-year investment in cash, no matter how appealing the virtually guaranteed return is, could lead to an exceptionally poor financial outcome over the longer term. For their need may be to accumulate a certain level of capital for the next ten years, and the problem with being in cash, is that you are very likely to miss out on any unexpected (which is usually the case) upturn in another investable asset class, be it the local or international market for equities, bonds or property.

So why are you investing? Ideally you will answer this question without looking at your recent past returns on your investments, and without knowledge of what is happening in investment markets currently. Because as human beings we suffer from behavioural biases, which repeatedly cause us to make mistakes when we make investment decisions. One such bias is recent events or recent experiences which influence our decision-making far more than events or experiences in the distant past. For example, an article you read yesterday will have a greater influence on you than one you read last month.

So if you are invested in a balanced unit trust fund, you are likely to be painfully aware that the average balanced unit trust fund returned 6% per annum over the past 3 years, whereas cash gave a slightly higher return over the same period, at lower level of risk. No surprise then if you are one of those people asking, "should I invest in cash?"

But thanks to the sabotage of your recency bias, you may have forgotten, or not even have been aware, that over the past 20 years, balanced funds have delivered in excess of 13% per annum. Investing in cash seems appealing to secure a decent return, but in fact all it does is guarantee is that you won't achieve the higher long-term return that a balanced fund is very likely to deliver.

The problem with long-term returns in a diversified portfolio is that they do not come in a straight line. The returns are lumpy by nature. Which means in the short-term there may be some pain, possibly far worse than a return of 6% per annum for three years.

In the global financial crisis of 2008 we saw real short-term pain. In a matter of months investors in share markets around the world lost over 40% of the value of their investment in the space of months. But investors who endured this short-term pain saw their investments bounce back reasonably quickly. Since the end of the global financial crisis, the global share market as measured by the MSCI World Index has delivered in excess of 150% return in USD. But many investors, under the influence of the recency bias, cashed in their investments when they were 40% down, and will struggle to make up their resultant shortfall.

The recency bias also helps people sabotage their investments on the upside. In March 2000, at the peak of the technology bubble, US mutual funds, (the equivalent of SA unit trust funds) had their biggest monthly inflow of investments ever, as investors tried to get a piece of the action because returns were so “high”. Yet months later, the technology bubble burst and investors realized dramatic losses. They had sabotaged their investments by acting under the influence of the recency of high returns.

We often ascribe such actions to greed and fear, and that investors pay high prices for their investments as in 2000 due to greed (and the fear of missing out) and then sell investments at low prices, as in 2008, due to the fear of making further losses. This emotional roller coaster is simply a function of being human. Warren Buffett, the world’s most successful investor, talks about the need for an intellectual framework for making investment decisions to help resist the temptation of being influenced by our emotions. The problem with a bias like recency, is that it is both an intellectual and emotional frailty. Recency influences our emotions – we are aghast at the most recent terror attack, but have all but forgotten about the one last year. The challenge is to act rationally to limit the distortion that a recent event or experience causes.

To do this, we need to understand how the recency bias really damages our investments. It distracts us from “why” we are investing and gets us to focus on “what” to invest in. To answer the question “what to invest in?”, it is important for us to understand the characteristics of the investments into which we invest. Most investors’ focus tends to be on the return and risk profile of an investment, but often investors neglect to look at the long-term profile, and get caught up in the “recent” results.

As a result, investors forget that investing is a means to an end. All investors have a unique starting point, a unique need, and a unique end-point. Understanding these three elements will help an investor understand their “why” of investing. And once they have invested in an appropriate investment to address these three elements, then irrespective of what happens in investment markets, only a change in their personal circumstances that impacts on their starting point, need or end-point should influence a change in “what” they are invested in.

Investing is not a competition. It is not about comparing our investment to someone else’s investment. Or comparing one asset class to another to see which one is “best”. It’s about finding the right strategy that addresses “why “ you are investing and resisting the temptation to change course every time new information comes to hand, or another “big” event happens. Events that impact investment markets happen every day. Some have a greater influence than others. And the one truth of investment markets is that we cannot predict these events. Which is why we diversify our investments, and invest in investments like balanced unit trust funds.

And we can be reassured that over time investment markets have delivered returns in line with their long-term return and risk characteristics. Dalbar, a US investment research organization, has for over 30 years conducted annual research into investor behaviour. They have found that investors consistently do not do as well as the investments in which they are invested. The explanation for this is that investors fall foul of their behavioural biases and invest or disinvest at the wrong time, for the wrong reasons.

So to find the right reason for your investment decision, ask yourself why you are investing. Once you have this answer, consider what investments are appropriate to your starting point, your unique need (s) and end-point (s). If an investment in a fixed deposit is the appropriate investment, then go for it. But if you are doing this for any other reason, make sure you are not suffering from the bias of recency, and setting yourself on course to become another statistic that validates the Dalbar research.

30 April 2017

data provided by Profile Data Analytics, Reuters and Datastream

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol[1]	10yr Vol[1]
LOCAL MARKET INDICES (in Rands)									
FTSE/JSE All Share Index (ALSI)	ZAR	3.1%	7.6%	4.5%	6.3%	12.7%	9.8%	10.5%	15.1%
FTSE/JSE SA Listed Property	ZAR	0.2%	1.9%	0.0%	13.8%	15.3%	13.4%	14.3%	15.3%
SA All Bond Index (ALBI)	ZAR	2.5%	3.9%	10.5%	7.8%	7.3%	8.0%	7.9%	7.5%
SA Cash Index (SteFI)	ZAR	1.8%	2.4%	7.6%	6.8%	6.2%	7.3%	0.3%	0.6%
Balanced Benchmark [2]	ZAR	2.8%	5.6%	5.1%	8.4%	13.0%	10.3%	6.3%	6.3%
SA Inflation (1 month lag)	ZAR	2.3%	2.3%	6.1%	5.5%	5.7%	6.2%	1.4%	1.4%
GLOBAL MARKET INDICES									
Global Equity (MSCI World)	USD	5.4%	8.0%	14.7%	5.7%	9.9%	3.9%	10.9%	16.5%
Emerging Markets Equity (MSCI EM)	USD	8.0%	13.9%	19.1%	1.8%	1.5%	2.5%	15.3%	23.5%
Global Bonds (Barclays Global Bond Index)	USD	1.8%	2.9%	-2.1%	-0.4%	0.4%	3.3%	4.6%	5.9%
Global Cash	USD	0.2%	0.3%	0.7%	0.4%	0.3%	1.0%	0.1%	0.4%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	3.1%	7.6%	4.5%	6.3%	12.7%	9.8%	10.5%	15.1%
Global Equity (MSCI World)	ZAR	4.7%	5.7%	8.2%	14.5%	22.6%	10.8%	13.3%	13.8%
Emerging Markets Equity (MSCI EM)	ZAR	7.2%	11.5%	12.4%	10.3%	13.2%	9.3%	12.1%	15.8%
SA All Bond Index (ALBI)	ZAR	2.5%	3.9%	10.5%	7.8%	7.3%	8.0%	7.9%	7.5%
Global Bonds (Barclays Global Bond Index)	ZAR	1.0%	0.7%	-7.6%	7.9%	12.0%	10.2%	12.5%	14.6%
COMMODITIES									
Gold (US Dollars)	USD	2.9%	7.2%	-2.4%	-1.3%	-5.5%	6.3%	17.0%	19.3%
Gold (Rands)	ZAR	-1.5%	1.2%	-11.2%	5.7%	4.6%	12.9%	18.6%	21.8%
CURRENCIES (positive return = Rand weakening)									
Rand / Dollar	ZAR	-1.0%	-2.6%	-6.3%	8.3%	11.5%	6.6%	14.2%	16.5%
Rand / GBP Pound	ZAR	2.0%	2.2%	-17.0%	-0.8%	6.6%	2.1%	14.2%	15.3%
Rand / Euro	ZAR	0.1%	0.7%	-10.7%	0.0%	7.3%	4.2%	12.9%	13.8%

Spot Rates

30-Apr-17		5-May-17	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
CURRENCIES							
Rand/US$	Rand	13.5	13.4	14.7	7.7	7.3	4.4
Rand/GBP	Rand	17.5	16.8	21.2	12.3	14.3	7.2
Rand/EUR	Rand	14.8	14.3	16.8	10.2	9.7	NA
Rand/Aus $	Rand	10.0	10.2	11.3	7.9	5.9	3.5
RATED							
Libor 6m $	US$	1.4	1.4	0.9	0.7	5.3	5.9
Repo Rate	Rand	7.0	7.0	7.0	5.5	9.0	NA
Prime	Rand	10.5	10.5	10.5	9.0	12.5	20.3
All Bond Index Yield	Rand	9.3	9.4	9.5	8.1	NA	NA
COMMODITIES							
Gold ($/oz)	US$	1,227.7	1,247.3	1,234.3	1,663.8	660.2	348.0
Palladium	US$	809.0	798.0	569.0	651.0	352.0	146.5
Platinum	US$	909.0	940.0	976.0	1,640.0	1,241.0	373.5
Oil (Brent Crude) $	US$	49.3	52.6	40.0	123.4	67.1	18.6
INFLATION							
SA Inflation	%	NA	6.1	6.3	6.0	5.8	9.4