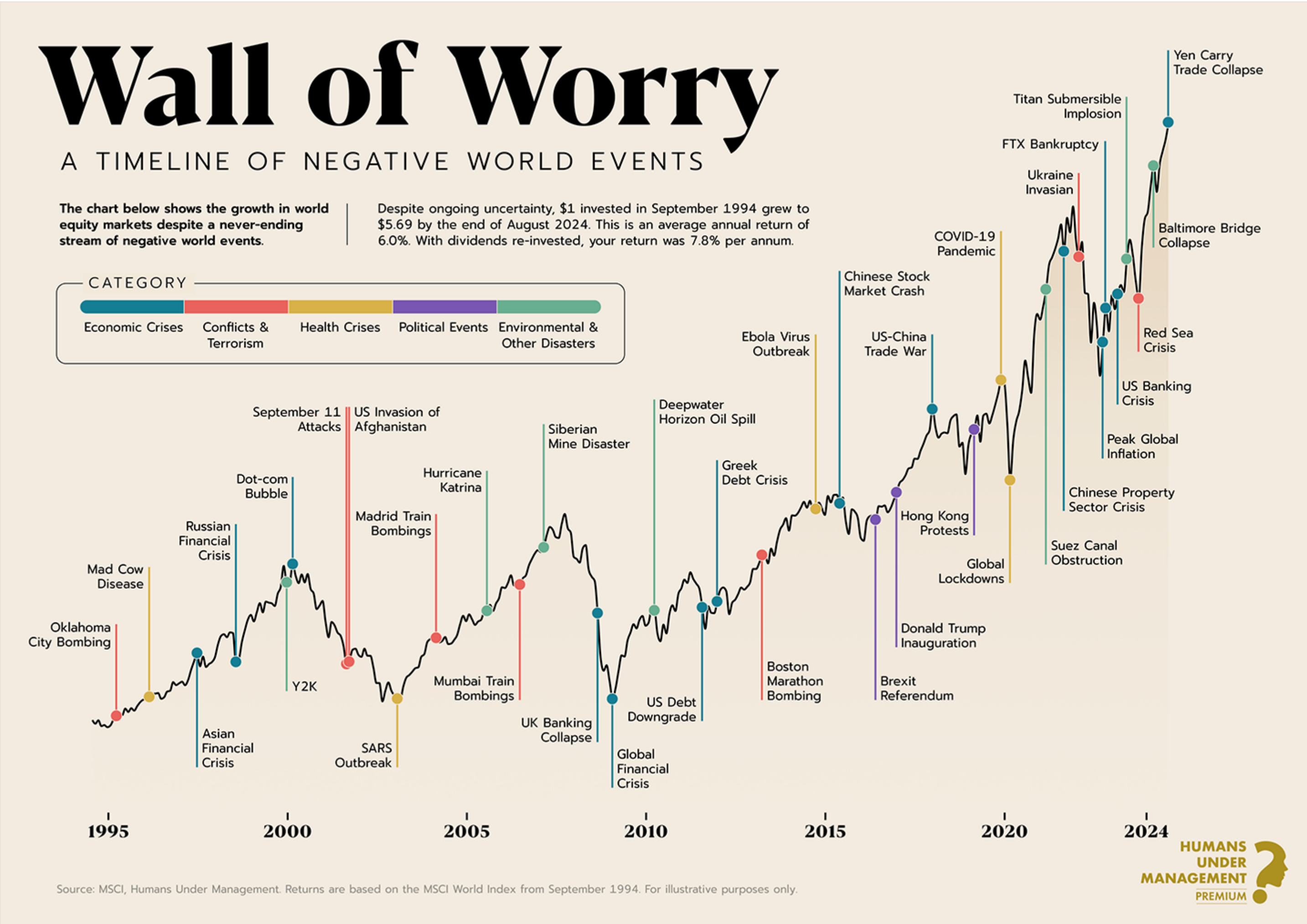
THE ALIWAL ROAD GROUP

October 2024

Wall of Worry

Global events and investment market movements mean less than you think when it comes to successful investing

The phrase "this time it's different" is one of the most famous - and dangerous - mindsets in investing, often used to rationalise extreme reactions to market movements, whether up or down. Investors chase rising markets, like during the dot-com bubble, believing new trends justify abandoning traditional valuation metrics. Conversely, in downturns, such as the 2008 financial crisis or the COVID-19 pandemic, fear-driven selling is justified by assuming the current situation is unprecedented. In both cases, the belief that "this time it's different" often leads to costly mistakes, as fundamentals eventually reassert themselves.



Source: Humans Under Management

Benjamin Graham, author of The Intelligent Investor, and mentor to Warren Buffett, offers a simple explanation why investors behave this way. He said, "In the short run, the market is a voting machine but in the long run, it is a weighing machine", and people very often vote unintelligently but over the long-term it's the weight of companies and economies that ultimately determine the returns to investors. The problem is, when investors vote unintelligently, by buying overpriced assets or selling underpriced assets, they are guaranteeing that they won't benefit from the weight of the companies they have invested in.

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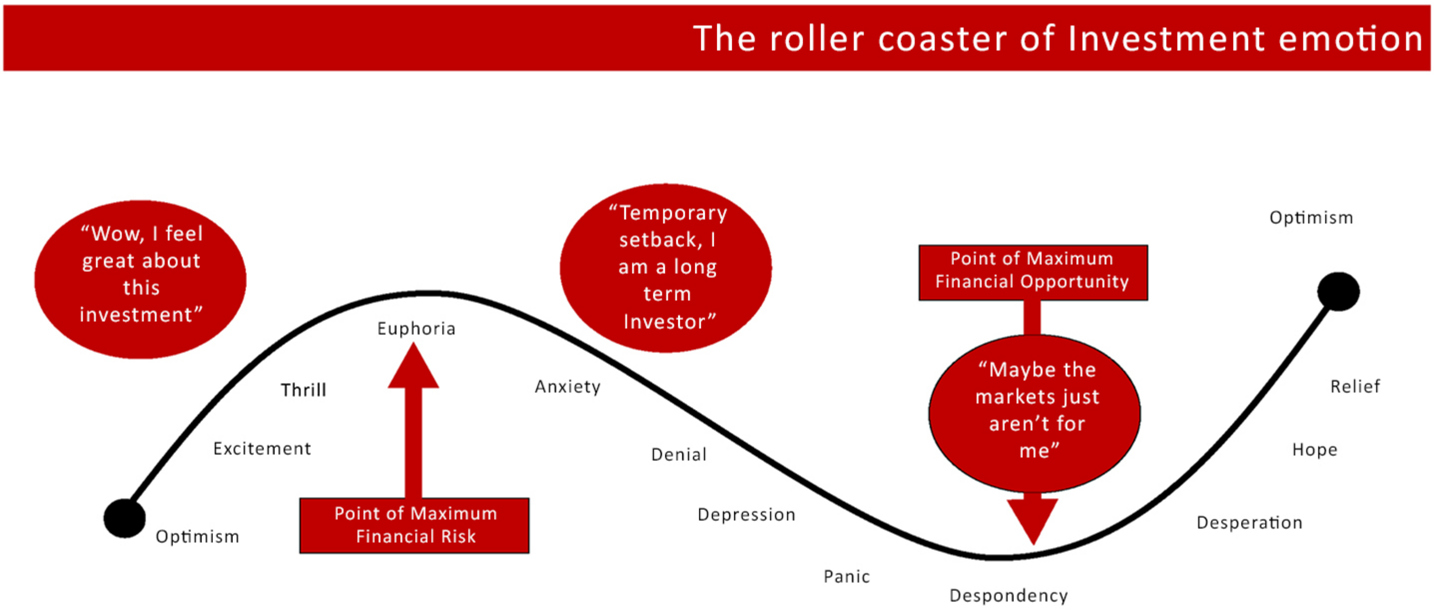
What drives unintelligent voting (investing)?

There are probably three key factors that drive "unintelligent voting".

Firstly, as social creatures human beings are influenced by what other people do. When markets are going up, we want to be part of the action. We don't want to be left out. Our social desire is to "flock" together. And when markets go down, we "flee" together.

Secondly, emotions are often a key driver of investor behaviour. When markets go up, we get greedy and when they fall, we get fearful. But our emotions are more complex than that, as the accompanying graphic, The Rollercoaster of Investment Emotion shows. When markets rise, we can move from optimism, through excitement to euphoria. When they fall, we can go from anxiety, through denial and depression, to panic and despondency.

Figure 1: Roller Coaster of Investment Emotion



Source: AMP Capital

Thirdly, while humans think they are rational creatures, we are *cognitively* flawed and psychologist Hebert Simon argues we have "bounded rationality". We can see this in the Rollercoaster of Investor Emotions graphic, at the point of Maximum Financial Risk, investors want to buy, and at the point of Maximum Financial Opportunity they want to sell. Another word that can describe this behaviour is "irrational".

Our brains are designed to keep us safe. They are also the operating machine that processes all the information that comes our way daily. But our brains are lazy. In processing information, the brain takes short cuts, which is the source of the many cognitive biases we fall foul of. So, when the AMP graph is going upwards, it's not only our emotions that are influencing our actions, but also our brain. It is extrapolating that the upward trend will continue, simply because of recency bias, and the fact that the brain is a pattern-seeking device.

When it comes to our money, we often have an action bias, believing that doing something is better than not. Disinvesting and putting our money into cash feeds this action bias, as well as our present bias which arises from the difficulty for our brains to look far into the future. Our brain wants to keep us safe now. So, we compromise our long-term financial health by acting on our cognitive biases.

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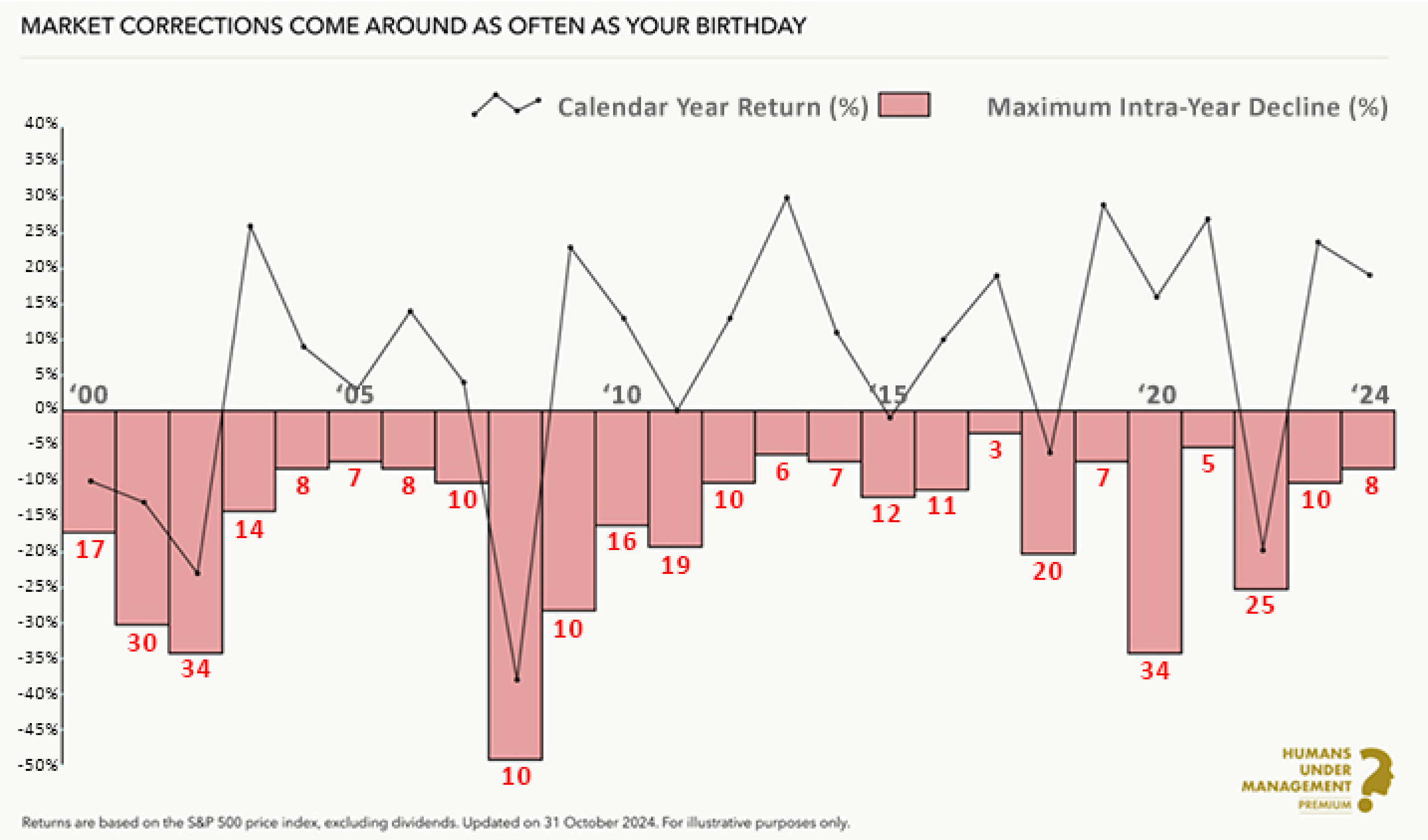
The risk of seeking safety when our brain perceives a threat from a negative return is shown in the graphic showing Annual Declines on the S&P 500 over the past 25 years. As can be seen, every year the S&P 500 has been in negative territory during the year, with negative annual returns of over -20% in two years (2003, 2022) and almost -40% in 2008. Yet the index had positive returns in 18 out of 25 years, with an average annual return including dividends in $US of 7% pa for the period.

Figure 2: Annual Declines



Source: Fund Analytics, Humans Under Management

What can we do to improve our approach to investing?

The Wall of Worry graphic serves as a reminder that there will always be reasons to invest or disinvest. While each dramatic event may feel significant at the time, it often ends up as just a blip on the Wall of Worry over the long run. Unfortunately, this perspective doesn't always prevent self-sabotaging behaviour from investors. However, it can help offer a sense of perspective, reminding us that perhaps "this time, it's not different."

But human behaviour has shown itself to be unresponsive simply to information. For the past 30 years Dalbar Inc. has conducted research annually on investor behaviour and shows that investors continually sabotage themselves. For the calendar year 2023, the S&P 500 Index returned 26.3% but according to Dalbar the average equity investor achieved 20.8%, an underperformance of 5.5%. Over the longer-term, this investor gap has been lower at around 3.6% pa which means that since 2000 the average $US equity investor has achieved long-term equity returns less than 4% pa, rather than the 7% pa return achieved by the S&P 500 since 2000. Why? Because they have responded to many of the events listed in the Wall of Worry graphic. Disinvesting at the wrong time. Re-investing at the wrong time and incurring significant costs in the process. This poor investor behaviour is despite the investment industry spending millions on ongoing investor communication and education. Simply providing investment education and information to influence investor behaviour is not enough. We have seen that there are multiple factors, social influences, emotional

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responses, and cognitive mistakes, that lead us astray. So, it appears we need more than information or education to adjust our behaviour.

Nudging investors seems more effective than educating them

According to Richard Thaler (Economics Nobel Prize winner) and Cass Sunstein, authors of the book Nudge, we need to find ways to nudge people's behaviour because offering information is not enough. In their book they relate the story of the men's public toilet at Schipol Airport, which had a problem with spillage at the men's urinals. Despite ongoing efforts to address this problem with posters in the doorways and on the walls imploring the users of the toilets to be considerate to others, and warning of the hygiene dangers of spillage, there was no shift in the behaviour of the users of the men's urinals. Finally, instead of pleading for a change in behaviour, a decision was taken to nudge the men into a change. A fly was painted into the basin of each urinal. Suddenly rather than appealing to men's cognitive reasoning, a target was provided for them to aim at in the urinal. The spillage problem was solved literally overnight. What can we learn from this story and apply to investing?

It is about the power of a nudge. The key characteristic of a nudge is that it doesn't require you to think about your action, which is very appealing to our lazy brains. If you've ever driven your car home and wondered how you got there, it's thanks to your brain loving to work on autopilot so that it doesn't have to use up the energy to think. How can investors nudge themselves into improved behaviour that is not self-sabotaging?

The most obvious way for us to avoid acting when the Wall of Worry hits us, is to have an automated investing process, which means that our decisions are not dependent on our thoughts, emotions, or social pressure. A good example of an automated process is when we invest via debit order. The decision to invest does not depend on anything other than the date of the debit order run. Similarly, an automated redemption instruction operates on the same principle. Investors who have a Living Annuity are effectively disinvesting once a month, and this is not dependent on what is happening in the markets. So, a nudge is a way to help us invest or disinvest irrespective of what is going on in markets and depends more on our own circumstances.

Pre-commitment: a way to keep the Wall of Worry at bay

The real power of a nudge is that it provides a pre-commitment to an action, no matter what is going on around you, whatever the Wall of Worry is throwing at you, or wherever you find yourself on the roller-coaster of emotion.

By anticipating when we are likely to experience emotions in response to a Wall of Worry event, with the help of your financial planner you can prepare for what you are likely to feel when the going gets tough and then create a plan to prevent you from acting on your emotions in the heat of the moment or responding to social pressure or making a cognitive mistake.

The formal act of pre-commitment is key. In the context of financial planning and investing, any form of verbal pre-commitment carries no weight unless it is documented and signed. The form of the document may vary according to your financial planner's advice process, but you could sign a financial plan, a record of advice or an investment policy statement that your financial planner has documented. Whatever the document is, it should ideally include the behaviour you commit to in the future, given a set of possible circumstances.

As the Wall of Worry suggests, there will always be events that trigger emotional, cognitive, or social pressure to invest or disinvest.

However, the Dalbar study shows that successful investing requires resisting these triggers. So, the next time someone insists "this time it's different," take it with a grain of salt. Trust that your pre-commitment to a disciplined investment strategy is the wisest course of action to safeguard and grow your investments.

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31 October 2024

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol1	10yr Vol1
LOCAL MARKET INDICES									
SA Equity	ZAR	4.3%	14.1%	26.2%	11.7%	11.9%	8.3%	16.8%	14.3%
SA Listed Property	ZAR	10.3%	25.8%	50.6%	14.8%	3.9%	2.8%	27.3%	21.4%
SA Bonds	ZAR	3.8%	13.6%	20.6%	9.9%	8.8%	7.8%	9.0%	8.3%
SA Cash	ZAR	2.1%	7.1%	8.5%	7.0%	6.1%	6.6%	0.5%	0.4%
Balanced Benchmark	ZAR	3.3%	12.5%	23.4%	10.8%	10.8%	8.8%	11.7%	9.8%
SA Inflation (1 month lag)	ZAR	0.6%	3.0%	3.8%	5.6%	4.9%	4.9%	1.4%	1.4%
GLOBAL MARKET INDICES BASED TO USD									
Global Equity	USD	2.4%	16.3%	33.8%	6.5%	12.1%	9.9%	17.8%	15.1%
Emerging Markets Equity	USD	4.0%	11.3%	24.7%	-1.8%	3.5%	3.1%	18.7%	17.4%
Global Property	USD	3.9%	5.0%	28.4%	-3.3%	-0.2%	2.8%	21.2%	16.9%
Global Bonds	USD	0.6%	0.1%	9.5%	-4.1%	-1.7%	0.2%	7.8%	6.4%
US Cash	USD	1.3%	4.5%	5.5%	3.7%	2.4%	1.8%	0.7%	0.5%
MAJOR INDICES BASED TO RANDS									
SA Equity	ZAR	4.3%	14.1%	26.2%	11.7%	11.9%	8.3%	16.8%	14.3%
Global Equity	ZAR	-0.4%	11.3%	26.2%	12.0%	15.8%	15.2%	15.9%	15.8%
Emerging Markets Equity	ZAR	1.1%	7.6%	17.6%	3.3%	6.9%	8.1%	13.9%	13.8%
Global Property	ZAR	1.0%	0.6%	21.1%	1.7%	3.1%	7.8%	18.6%	17.3%
SA Bonds	ZAR	3.8%	13.6%	20.6%	9.9%	8.8%	7.8%	9.0%	8.3%
Global Bonds	ZAR	-2.2%	-3.3%	3.3%	0.8%	1.5%	5.0%	12.9%	13.8%
COMMODITIES									
Gold (US Dollars)	USD	12.7%	32.4%	36.8%	15.5%	12.4%	8.7%	14.2%	13.5%
Gold (Rands)	ZAR	9.5%	28.0%	29.0%	21.4%	16.1%	13.9%	17.1%	16.8%
CURRENCIES									
Rand / Dollar	ZAR	3.0%	3.5%	5.5%	-5.0%	-3.2%	-4.8%	14.1%	14.7%
Rand / GBP Pound	ZAR	2.8%	2.5%	0.0%	-2.9%	-3.1%	-2.5%	11.8%	14.1%
Rand / Euro	ZAR	2.5%	5.0%	3.0%	-2.9%	-2.7%	-3.3%	11.6%	13.0%

KEY

Asset Class	Represented By:
SA Bonds	Satrix Bond Index Tracker
SA Cash	STeFi
SA Equity	Satrix ALSI Index Tracker
SA Listed Property	Satrix Property Index Tracker
Emerging Markets Equity	iShares Emerging Markets Equity Index Tracker
US Cash	Fidelity Institutional Liquidity The United States Dollar
Global Bonds	iShares Core Global Aggregate Bond ETF
Global Equity	iShares Developed World Index Tracker
Global Property	iShares Developed Real Estate Index Tracker

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Spot Rates		31-Oct-24	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
CURRENCIES							
Rand/US$	Rand	17.7	17.2	18.7	15.1	11.0	6.2
Rand/GBP	Rand	22.7	23.1	22.8	19.5	17.7	11.3
Rand/EUR	Rand	19.2	19.2	19.8	16.8	13.8	7.8
RATES							
SOFR 6m $	US$	4.7	4.7	5.9	1.9	0.3	2.3
Repo Rate	Rand	8.00	8.00	8.25	6.50	5.75	7.50
Prime	Rand	11.50	11.50	11.75	10.00	9.25	11.00
All Bond Index Yield	Rand	9.8	9.5	11.6	9.6	8.1	9.7
COMMODITIES							
Gold ($/oz)	US$	2,740.8	2,634.0	1,995.9	1,510.2	1,165.7	426.3
Platinum	US$	995.0	985.0	940.0	936.0	1,227.0	835.0
Oil (Brent Crude) $	US$	73.2	72.0	87.5	60.2	84.8	48.4
INFLATION							
SA Inflation	%	3.8	4.4	5.9	3.6	5.9	9.4

data provided by FE Analytics

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