Seven
Investment Management

Warning!
Your Investing Style Can Seriously Damage Your Wealth

You are probably a bad investor; as bad as you are a driver. Most people are bad investors when it comes to the emotional decision of investing their hard earned cash but do not realise it. Nearly everyone tends to overestimate their ability whether it is investing ability or driving ability.

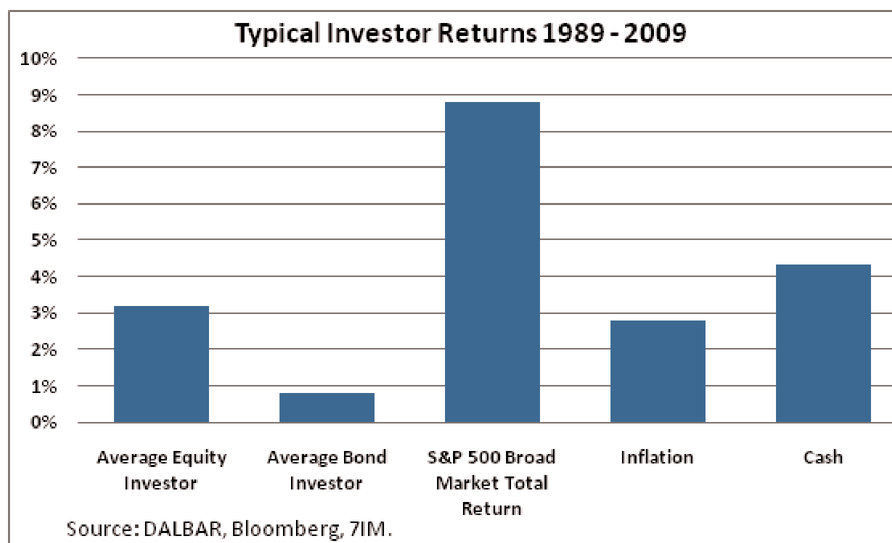
Interestingly most people, when asked how they rank their driving ability, reply that they are "above average". How can nearly every driver be above average? However you cut it, some drivers are plain bad, some average and some excellent and yet invariably we all rate our skills as "above average".

Similarly, many people are over-confident when it comes to assessing their investing ability. It is very hard to judge this dispassionately as we tend to remember our investing victories and ignore the disasters. Unfortunately those disasters, perhaps in that dot.com stock or tech fund ten years ago, tend to outweigh the victories.

It is a cliché (but sadly true) that as retail investors we tend to buy at the top of the market, when the newspapers are full of the great returns that have been earned in the stock market, and that we tend to sell at the bottom of the market, just as the pain of loss gets too great. After our sale though, the market rallies, leaving the big gains to the professional investors who had the experience to stick with the downturn.

Unfortunately for the optimists, there is proof that we are bad investors. Research by DALBAR, the US market research company, is not pretty reading. DALBAR looks at what we invest in as a retail investor group taking into account our market timing. DALBAR shows that the average equity investor achieved a 20 year equity return to the end of 2009 of only 3.2% a year, barely beating inflation which rose by 2.8% in that period and way behind the return from the equity market that averaged 8.8%[1].

If you are a bond investor I am afraid the news is even worse. The 20 year return for average bond investors is just over 1%, not even compensating you for inflation risk, which you may remember was 2.8% over the 20 years to 2009.



[1] S&P 500 Broad Market Total Return index

If you are not convinced by this horrible news from DALBAR, there is a diploma thesis written by Lukas Schneider looking at fund investor returns between 1992 and 2003. Mr Schneider concluded that the average fund investor's returns are 4% below the average fund's returns of about 7% a year, which in return is slightly below the market's return. The message from the UK is that our poor market timing is that our investment returns barely beat the rate of inflation and certainly do not compensate us for the risk we take.

Why are we such bad investors? This is a question that a new field of science called "behavioural finance" is looking at. The reason for us being bad investors may be buried deep in our primeval past. We are at heart social animals and we like to find reassuring confirmation in herding, investing when others invest. Perhaps we may be guided too much by the media, buying when the euphoria is high and selling when stockmarket pessimism is deep – when in fact we should be doing the opposite.

More importantly, what can we do to improve our investment performance? Perhaps most significantly the key thing we can do is to recognise our shortcomings and not try to "time the market" or buy the "flavour of the month" investments that we read about in the newspapers. The old investment cliché of it being important to have "time in the market" instead of "timing the market" is a very wise one.

The other valuable step we can take is to see a professional independent financial adviser (IFA) who can help with advice on investing into an appropriately diversified portfolio of stocks, bonds and alternative investments. It is up to you to go to an IFA though, as you would go to a driving instructor to help you learn to drive. If you are a bad driver a judge might take away your licence or even send you back to driving school. If you are a bad investor you will simply lose your money and possibly as a result have to work longer and harder for your retirement.

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