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Investment Strategy

Learning from our mistakes, but not quickly enough

Financial commentators love to suggest investors are all incapable, or at least unwilling to learn from past mistakes. We have repeatedly seen investors chasing performance, and the old adage, that greed and fear drives investor behaviour, frequently appears in the headlines.

Pleasingly, recent US research shows evidence that the average investor has learnt from some past mistakes, but there remains considerable scope for further improvement.

Dalbar is a US research organisation that has undertaken research into US investor behaviour for more than 20 years. It recently released its 2014 research edition measuring the returns of the average investor. This research reviews applications and redemptions into mutual funds over time. The aim is to calculate the return a typical investor has actually received, taking into account how long they were invested. The long term experience has shown that the average investor generated less than half of the return possible from a passive investment in the market as detailed below.

US Equity Returns	Investor Returns – Equity Funds	S&P 500 Index
Since Inception (1984)	3.69%	11.11%
20 Year pa	5.02%	9.22%
10 Year pa	5.88%	7.40%
5 Year pa	15.21%	17.94%
3 Year pa	10.87%	16.18%
1 Year	25.54%	32.41%

The results are even more shocking for the average fixed interest investor.

US Fixed Interest Returns	Investor Returns – Fixed Interest Funds	Barclays Aggregate Bond Index
Since Inception (1984)	0.70%	7.67%
20 Year pa	0.71%	5.47%
10 Year pa	0.63%	4.55%
5 Year pa	2.29%	4.44%
3 Year pa	0.70%	3.27%
1 Year	-3.66%	-2.02%

How is this possible?

This analysis shows investors are invest in managed funds after the funds have generated strong performance, which is often followed by periods of moderate or even negative performance. The fear of missing out is leading to investors actually missing out.

Investors are also likely to be crystallising their losses during weak market conditions due to fears of losing even more and only reinvesting once investment markets have rebounded. Unfortunately, this locks in the loss and removes the possibility of capturing any rebound in equity markets. The combination of these two actions has resulted in significant underperformance for the average investor versus the market.

Are there any positives from this analysis?

Yes. Importantly we have seen an improvement in the relative performance over recent times. Over the last five years, the gap between the average investor and the market return has narrowed. This is both within equities and fixed interest, although more so within equities. Whether it is a focus from the industry on better education; or the significant impact that both the recent tech boom and GFC have had on investors, we have seen an improvement. But there is still a long way to go. It is unacceptable that the average investor still performs well below market (benchmark) returns.

Another positive outcome of this research is that the average investor in asset allocation funds has also seen a significant improvement in returns over the last five years in particular.

US Investor Returns	Investor Returns – Asset Allocation Funds	US Inflation
Since Inception (1984)	1.85%	2.80%
20 Year pa	2.53%	2.37%
10 Year pa	2.63%	2.38%
5 Year pa	7.70%	2.08%
3 Year pa	6.26%	2.07%
1 Year	13.57%	1.52%

Whilst over the last 30 years the average investor in asset allocation funds failed to even keep pace with inflation, the results over the last five years are substantially different with returns far in excess of inflation. We have also seen the average investment period within asset allocation funds rise from three years in 1994 to five years today as investors continue to embrace a longer term outlook.

How can we ensure this trend of improving investment outcomes for the average investment continues?

Unfortunately, volatility in investment markets is unlikely to go away. We need to accept that it exists. We need to set appropriate and realistic investment goals and constantly assess our performance in light of those long term goals, rather than focusing on short term outcomes.

By Sally Campbell, Executive Director, JBWere