momentum
investments

21 April 2021

Understanding the true cost of noise when investing

Why judges, investors and advisors shouldn't make decisions on an empty stomach

The four most dangerous words in the world of investing just might be "this time it's different". When it comes to making investment decisions, consistency is key, and making emotional decisions in reaction to extraordinary events, often destroys market value for investors.

These are the cautionary words of Paul Nixon, head of behavioural finance at Momentum Investments, speaking at a media webinar, which unpacked the findings of the Momentum Investments and Oxford Risk Noise and Investment Advice Study.

"Momentum's white paper on the COVID-19 Investor Behaviour case study certainly provided a very clear snapshot of the detrimental effect that market turmoil and panic can have on investor behaviour. Of course, the market conditions in 2020 looked somewhat different from what investors had experienced before. The news headlines led with stories that seemed almost post-apocalyptic and there is no doubt that these fueled investor fears. Yet, as far as market crashes go, last year was not that special."

Still, some investment trends last year certainly demonstrated the effect that emotion can have on the market. About R100 million was lost and 6.5% of investment value was destroyed on average, as a result of investors switching to lower-risk investments in reaction to COVID-19-related market volatility between April and December 2020. As a result, many South African investors' savings and investment strategies have unnecessarily suffered significant setbacks.

"Additionally, 11 608 switches were made on the Momentum Wealth platform of at least R1 000 or more. The average value of these switches was slightly more than R150 000. By March 2020, the number of switches spiked to nearly 300% compared to January 2020. Overall, there was a distinct 'risk-off' strategy during March and April. Of course, this was followed by a very quick switch to a 'risk-on' strategy – but the problem here is that people missed the recovery completely."

As Nixon explains, investors generally conform to one of five switching behaviour patterns that often dictate how they would make investment decisions, especially under stress. “These archetypes include assertive, anxious, contrarian, avoider and market timer. While we have gone into more detail around these types of individuals and their decision-making processes on various occasions, what is important to note is how last year’s market trends really brought out these archetypes. For example, one can see that the majority of the investment switches in last year were made by the avoider-type investors but anxious investors lost the most because they need a lot of confidence before re-entering markets and, in this case, missed the market recovery completely. ”

Of course, the focus of the launch was the Momentum Investments | Oxford Risk Noise and Investment Advice Study, which also brought some interesting facts to light on the effect subjectivity has on the adviser as well.

Greg Davies, head of behavioural science at Oxford Risk, says that this study is the first piece of research that has been done with a commercial organisation of its sort. “A subject that is becoming extremely topical for advisers in particular, is the notion of ‘noise’. Even if you aim to remove as much bias as possible from the advice that a firm might give its clients, there may be variations in advice that the individual adviser gives to individual clients (possibly influenced by factors such as emotion). However, it is vital that the advice received by every individual client, remains as close to their specific objective needs, and not the characteristics of the adviser. Consistency of advice is also crucially important for any advisory firm. This is why being much more aware of noise and how to combat it, is so vital.”

One of the interesting findings of the study was that the conventional methods of giving risk to individual investors, is subject to a fair amount of noise. “Advisers in the study were asked to assign a level of risk to each client, on a scale of one to five. We found that even though the clients remained the same, the levels of assigned risk had a tendency to vary quite significantly from adviser to adviser. Equity allocations for these clients also varied, with clients at risk level three, for example, being given equities of anywhere 75% and 10% of their portfolio. This does seem to be a high level of variation.”

Davies says that the outcome of the study provides several remedies for inconsistent behaviour and reduces the risk of such wide variations in the advice process. “The answer to a lot of this is to acknowledge that processing a lot of data and coming to a consistent answer, is not something that we humans are very good at. At the same time, any client situation has to involve huge amounts of information. If there isn’t a system

to capture that information, and arrive at a reliable answer, we will always see noise creeping in. If we want to do this better, behavioural technology will have to play an increasingly important role in how investment firms test their strategies and decisions."

With that said, Davies says that the research into noise in the investment world is only just getting off the ground. "We believe that the financial industry still doesn't have any idea how big or small this problem really is – which is why more of these types of studies will need to take place," he concludes.

In closing, he says that there are many lessons to be taken from the nationwide lockdown period that would be useful to create a better investment atmosphere. "Ultimately, we are likely to face similar periods of uncertainty in the near future. It is therefore important to start recognising noise when we see it, and adjust our approach to advice accordingly," he concludes.

-ENDS-