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## Linking Performance and Investor Behaviour

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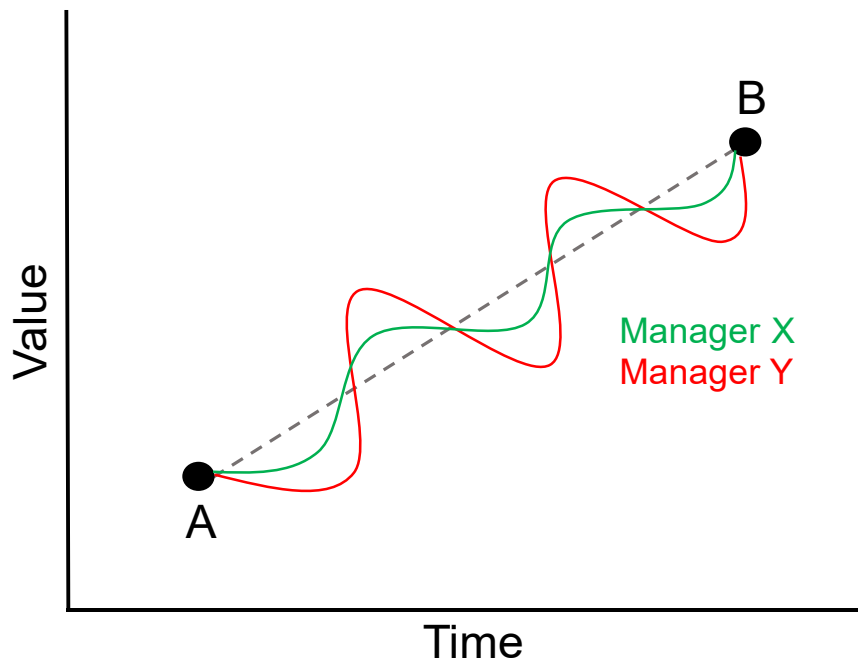
### HOW RELATIVE RETURNS CAN DRIVE INVESTOR HAPPINESS AND SUCCESS

There is no denying that investing for the long term makes good financial sense. Reaping the magical wonders of compounding only comes to those who are patient and invested. However, investors should only take the necessary risk to achieve an investment objective and no more. Although the asset management industry can agree that investors should invest for the long term, many of them make it unnecessarily difficult to do so. Because of this, investors make bad decisions at the worst of times, resulting in realised returns that are far below what is stated on fund fact sheets. As part of a broader value proposition to investors, asset managers must assume greater accountability for the investor journey, extending beyond mere focus on the ultimate destination.

## The Journey Matters

An investment journey entails a starting point and an endpoint, with a given amount of time linking the two destinations. However, any period can be broken down into a series of shorter time periods that compound, and it is through these shorter time periods that investors *experience* the full investment journey.

Two managers with the same investment objective, investment period, and market environment can both succeed in meeting the long-term required return, i.e. reaching the desired end destination. However, the path they take can be materially different.



Source: PortfolioMetrix

The example above shows **Manager X** and **Manager Y** successfully transferring the investor's starting value (point A) to the required end destination (point B). The only difference is that **Manager Y** did this with higher relative volatility. Is this just a simple case of all is well that ends well?

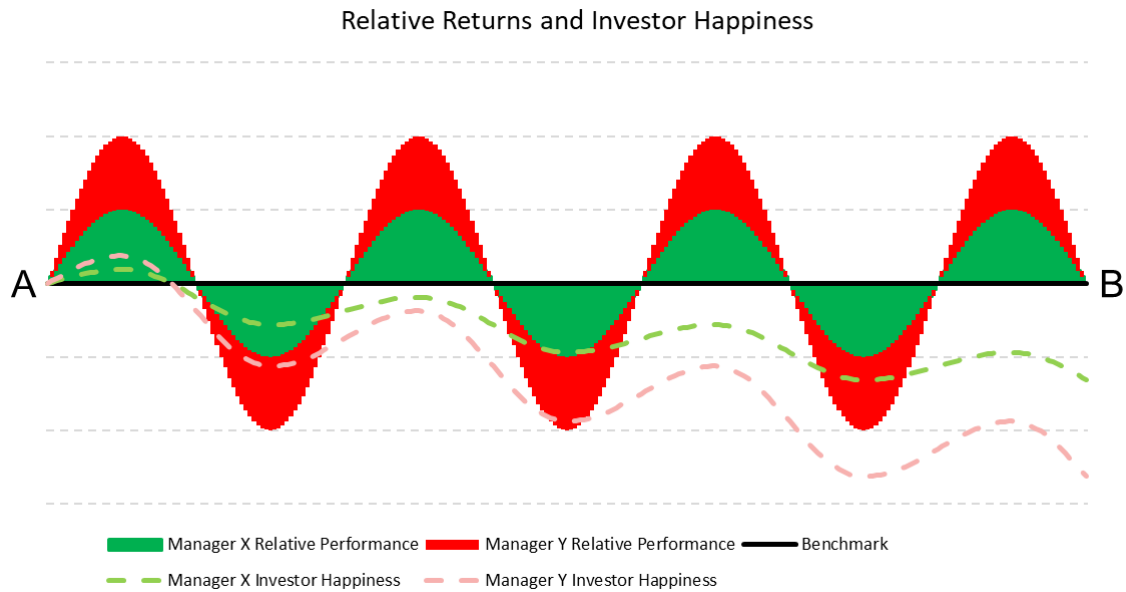
Research into investors' behaviour towards their investments and financial decision-making in general suggests that this is not the case. Prospect theory, developed by Amos Tversky and Daniel Kahneman, stems from the concept of loss aversion, where it was observed that people feel losses greater than that of an equivalent gain. In a 1992 paper, the duo estimated that losses can be twice as powerful psychologically as gains. This asymmetrical experience of volatility can result in the investor feeling compelled to act, possibly at the worst time. This can be devastating to a financial plan.

All else being equal, the investment portfolio that can reach the end destination with the least amount of volatility will be superior behaviorally. This is because there's a greater chance the investor can tolerate the journey, reducing intervention and improving success probabilities.

## Relative Volatility

Volatility, framed absolutely or relatively, impacts investor satisfaction. While absolute risk is crucial for achieving returns above cash and combating inflation, relative returns and risk differentiate managers in the short term.

Applying a 2:1 ratio for relative losses/gains, higher relative volatility leads to greater unhappiness for investors despite benchmark returns.

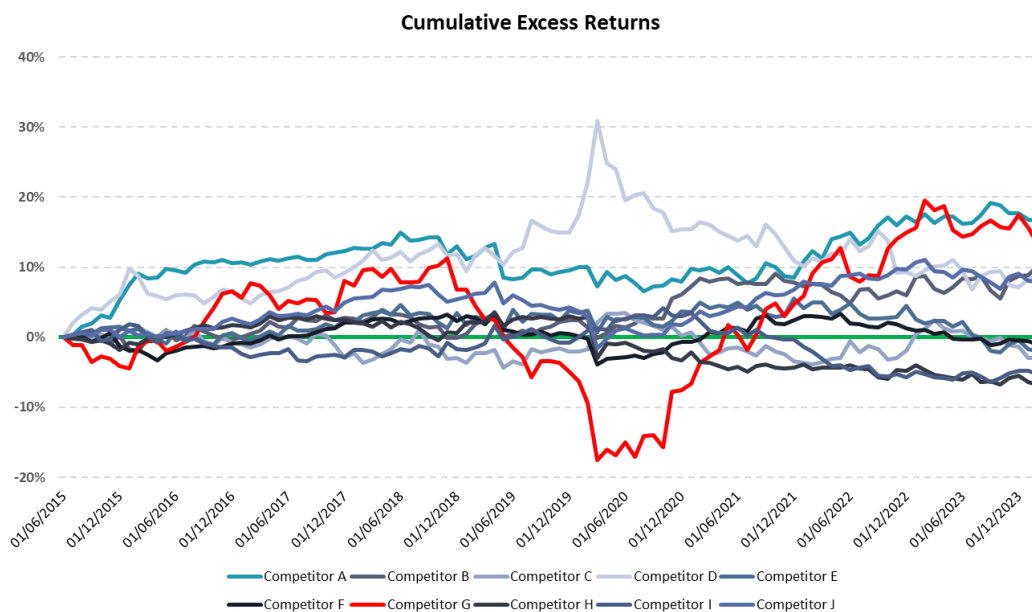


Source: PortfolioMetrix

Compounding this over four cycles of outperformance/underperformance results in investors with **Manager Y** being roughly twice as unhappy as investors with **Manager X**.

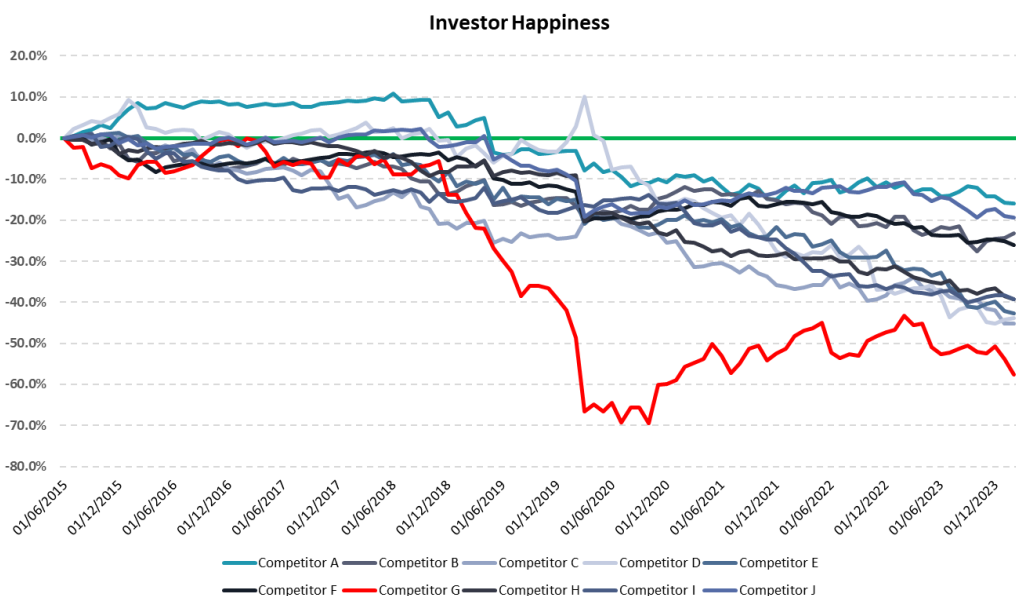
## Introducing a Happiness Index to well-known Balanced Funds

We can apply this same methodology to the real world by using several well-known and well-supported balanced fund managers within the ASISA Multi-Asset High Equity Category. In this case, we use the sector average as the benchmark to assess relative returns. The chart below calculates the cumulative excess returns for each of the balanced fund managers relative to the industry average.



Source: Financial Express, PortfolioMetrix, 30/06/2015 – 29/02/2024

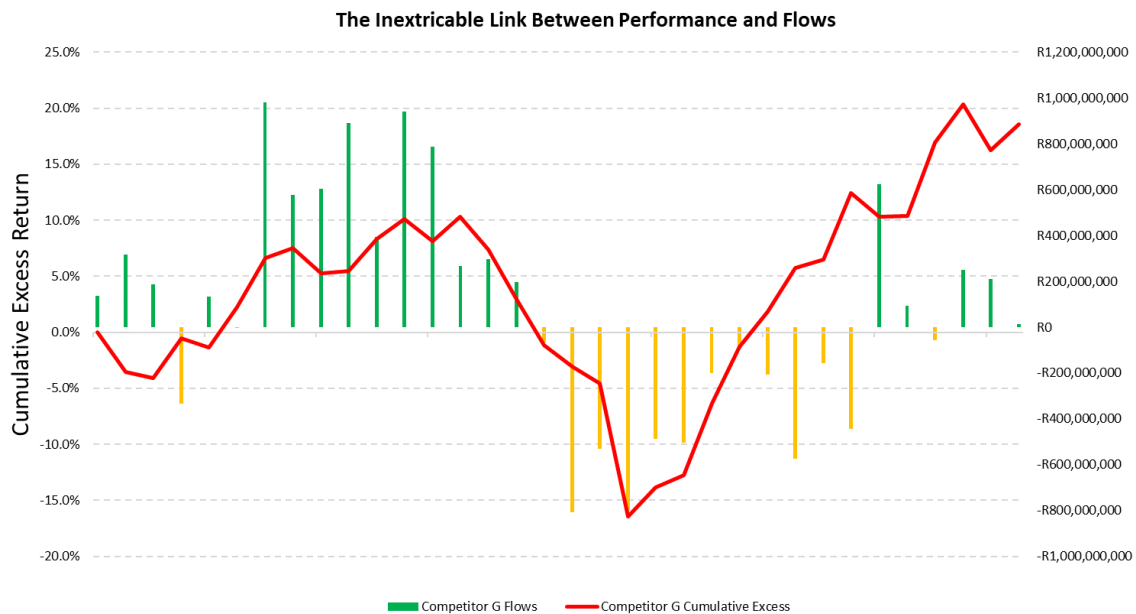
Highlighting **Competitor G** in red, we see that the manager was the second-best performing manager over the entire period. However, when applying their cumulative excess return profile to assess their underlying investor happiness, we see that their investors are the least happy. Even top-performing managers may leave investors dissatisfied due to excessive volatility.



Source: PortfolioMetrix

## The Inextricable Link Between Relative Returns and Flows

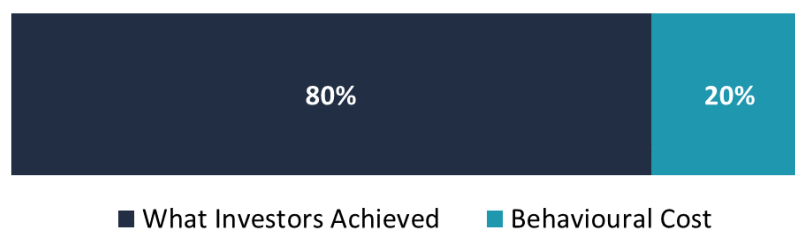
The concepts introduced so far have been entirely theoretical. We now assess whether the cumulative excess return profile plays any role in influencing investor behaviour by investigating net fund flows.



Source: *Financial Express, PortfolioMetrix*

Generally, the net flows for **Competitor G** follows that of their cumulative excess return profile. However, there is a lag between performance and flows resulting in investors typically buying after periods of strong outperformance (buy high) and then selling after periods of underperformance (sell low). This contradicts rational investing principles and can be destructive to long-term returns.

This tendency incurs a "behavioural cost," representing lost returns due to poor investment timing. For **Competitor G**, we calculated the behavioural cost to be roughly 20% of the available annualised return.



Source: *PortfolioMetrix*

For an investor investing R1 million over the period, the behavioural cost would be just over R200,000. This is material. However, one can model out what a behavioural cost of 20% implies for various available annualized returns and time periods. It increases significantly as returns and time increase.

Behavioural Cost of 20% of Annualised Return Assuming a R1mil Initial Investment						
Available Return		6%	8%	10%	12%	14%
Investment Period	5 year	R74,053	R105,662	R141,182	R180,901	R225,121
	10 year	R192,715	R299,339	R434,817	R604,895	R816,223
	15 year	R376,242	R636,314	R1,005,079	R1,518,458	R2,222,391
	20 year	R653,107	R1,202,897	R2,066,543	R3,391,527	R5,385,617
	25 year	R1,063,138	R2,132,835	R3,986,231	R7,108,526	R12,251,078
	30 year	R1,661,816	R3,632,096	R7,386,745	R14,317,045	R26,787,561

Source: PortfolioMetrix

Focusing on the Available Return column of 10% and a period of 20 years, we have a rand value of R2,066,543. This represents the difference in end value for an initial investment of R1 million if we were to penalize the Available Return by 20% for the behavioural cost.

### Conclusion

Asset managers must acknowledge their role in shaping investor behaviour throughout the investment journey. While advisers play a part in keeping investors composed, asset managers must ensure journey quality. Understanding and addressing the impact of volatility on investor satisfaction is crucial for mutual success.

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**Glacier Research would like to thank Brendan de Jongh for contributing to this week's *Funds on Friday*.**

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Brendan began his career in 2008 as a trainee financial adviser after completing his undergraduate degree from the University of Pretoria. While gaining valuable experience in the financial planning industry, Brendan studied part-time for his Honours qualification as well as the CFP® designation. He worked as a financial consultant to individuals as well as the technical trainer at Alexander Forbes prior to joining PortfolioMetrix in 2013.

