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Investors' Myopia won't lead to Ayoba investment performances!

By Daniel R Wessels

"We've long felt that the only value of stock forecasters is to make fortune tellers look good. Even now, Charlie [Munger] and I continue to believe that short-term market forecasts are poison and should be kept locked up in a safe place, away from children and also from grown-ups who behave in the market like children." – Warren Buffett

"You make more money selling advice than following it. It's one of the things we count on in the magazine business — along with the short memory of our readers." – Steve Forbes

"Myopia" or nearsightedness – A visual defect in which distant objects appear blurred because images are focused in front of the retina rather than on it. As a metaphor investors' myopia refers to the tendency of investors to make judgments and decisions based primarily on recent performances or expectations in the near-term, while ignoring the long-term consequences of such decisions.

"Ayoba" is an expression of delight, excitement, joy and approval. Like the "vuvuzela" and "makaraba" it is uniquely South African and became synonymous with the 2010 Soccer World Cup event held in South Africa.

At the beginning of each year a casual survey of financial articles will reveal hordes of investment predictions by prominent financial institutions and experts for the forthcoming year. A wide range of predictions are typically made: from the usual suspects such as the gold price, oil price and inflation rate and some other economic variables to predictions how the different investment asset classes will perform or how specific sectors of the market will fare and then to top it all, the exchange rate of the rand.

While such predictions undoubtedly make for interesting reading, it is after all only just that. Most likely one will find a broad common theme among the various forecasts and it may be even mildly comforting for the nervous investor. Yet, is it *insightful?* Well, depends how one uses it. For me, in some ironical way, it is simply a true reflection of how wrong experts can be in predicting future outcomes, especially if one keeps a scorecard matching their predictions with the actual outcome. Is it *informative* perhaps*?* I doubt it, in fact, like Warren Buffett said it might even be detrimental to the long-term performances of investors' portfolios, especially for those investors that are prone to the folly of speculative stories. Often, strong arguments are being put forward why certain outcomes will materialise during the course of the year and subsequently investors are convinced to change their investment strategies accordingly.

The question remains why every year the same experts and institutions will keep coming back for more? Well, for starters, they are the experts and perhaps they feel obliged to say something to honour their expert status. In fact, they might even believe that a large community of investors actually rely and act on their predictions, which sad to say, might even be true. Then, of course, like Steve Forbes said, the experts can safely rely on the short memory of people because very few will remember what the experts

predicted last year and how wrong they were. Basically, it is like starting every year with a clean slate or unblemished record.

By now some readers might question my harshness of criticism levelled at the experts. Granted, some institutions profess that they do not want to make any short-term predictions; they are only concerned about their long-term performances and investors should, therefore, align themselves with this philosophy. Kudos for them, but not necessarily for the others. An argument that the forecasts of professional investment institutions should be much better than that of the ordinary investor is questionable, simply because the facts do not support such an argument.

Consider the investment fund performances of financial institutions against their stated performance benchmarks over various holding periods [**Chart 1]**. In theory one should expect about a 50% "success rate", that is the number of funds out of the total that outperformed their performance benchmarks, like the All Share Index (ALSI) or the Shareholder Weighted Index (SWIX), because after all an index represents the weighted average return from all active trading. In reality, the "success rate" is much lower. For example, when the SWIX is used as a benchmark (arguably the most suitable performance benchmark for South African investors) we found that less than 20% of professionally managed equity funds outperformed the index over different time intervals.

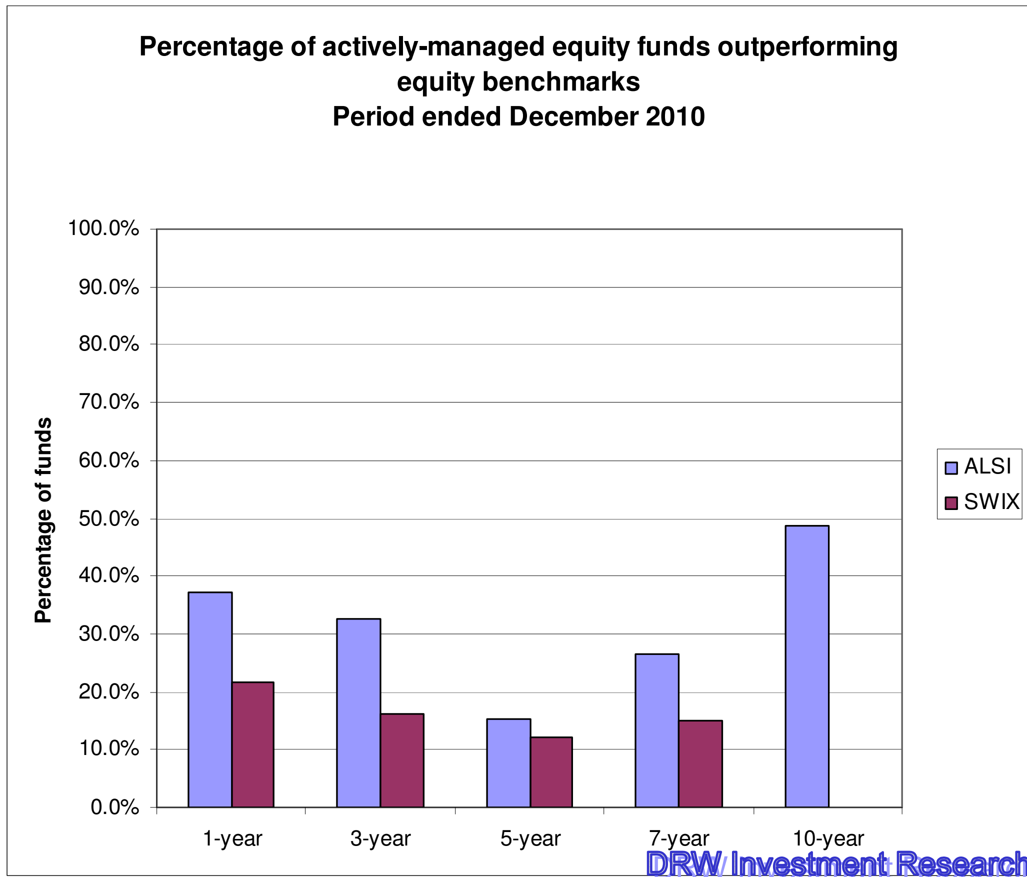

Chart 1: The percentage of actively-managed equity outperforming benchmarks

Source: DRW Investment Research

The bottom line is that it tells us something about the poor ability of financial institutions in general to predict the future performances of securities, and more specifically how their bets fared relative to the market benchmarks, which any ordinary investor would have been able to capture with index or enhanced index funds.

Likewise, consider the performances of the four different asset classes – equities, properties, bonds and cash – over the past twenty years [**Table 1**]. One can safely assume each year experts would have predicted that equities would have been the best performer year in and year out, which is actually easy to motivate if the underlying assumptions of market ratings and expected earnings growth held.

Table 1: Asset class performances over the past twenty years

Year	Equities	Listed properties	Bonds	Cash	Inflation (CPI)
1991	31%	21%	14%	14%	16%
1992	-2%	1%	28%	12%	10%
1993	55%	16%	32%	11%	10%
1994	23%	17%	-9%	10%	10%
1995	9%	10%	30%	11%	7%
1996	9%	-9%	7%	12%	9%
1997	-5%	13%	29%	17%	6%
1998	-10%	-4%	5%	17%	9%
1999	61%	44%	30%	16%	2%
2000	0%	26%	20%	11%	7%
2001	29%	6%	18%	11%	4%
2002	-8%	18%	16%	12%	12%
2003	16%	37%	18%	12%	0%
2004	25%	41%	14%	8%	3%
2005	47%	50%	11%	8%	4%
2006	41%	28%	5%	8%	6%
2007	19%	27%	4%	9%	9%
2008	-23%	-5%	17%	12%	10%
2009	32%	14%	-1%	9%	6%
2010	19%	30%	15%	7%	4%
Annualised return per year	**16%**	**18%**	**15%**	**11%**	
Real return per year	**9%**	**11%**	**8%**	**4%**	
Average return	**18%**	**19%**	**15%**	**11%**	
Standard Deviation	**23%**	**17%**	**11%**	**3%**	

Sources: *Investec Asset Management, DRW Investment Research*

Obviously, these assumptions did not hold whilst the actual performances widely diverged from the expected performances. In fact, only in seven out of the twenty years equities were indeed the best performer, but also have been seven times the worst performer! Cash – the ever-boring option and most likely the candidate that each year would have yielded the lowest predicted return, was only seven times really the worst option! [**Table 2**]

Table 2: Ranking the asset classes

YEAR	BEST	2ND Best	3RD Best	WORST
1991	EQUITIES	PROPERTIES	BONDS	CASH
1992	BONDS	CASH	PROPERTIES	EQUITIES
1993	EQUITIES	BONDS	PROPERTIES	CASH
1994	EQUITIES	PROPERTIES	CASH	BONDS
1995	BONDS	CASH	PROPERTIES	EQUITIES
1996	CASH	EQUITIES	BONDS	PROPERTIES
1997	BONDS	CASH	PROPERTIES	EQUITIES
1998	CASH	BONDS	PROPERTIES	EQUITIES
1999	EQUITIES	PROPERTIES	BONDS	CASH
2000	PROPERTIES	BONDS	CASH	EQUITIES
2001	EQUITIES	BONDS	CASH	PROPERTIES
2002	PROPERTIES	BONDS	CASH	EQUITIES
2003	PROPERTIES	BONDS	EQUITIES	CASH
2004	PROPERTIES	EQUITIES	BONDS	CASH
2005	PROPERTIES	EQUITIES	BONDS	CASH
2006	EQUITIES	PROPERTIES	CASH	BONDS
2007	PROPERTIES	EQUITIES	CASH	BONDS
2008	BONDS	CASH	PROPERTIES	EQUITIES
2009	EQUITIES	PROPERTIES	CASH	BONDS
2010	PROPERTIES	EQUITIES	BONDS	CASH

Source: DRW Investment Research

But really, to look at investment performances on a year-to-year basis (or any short-term basis) is meaningless and may in fact be highly misleading for investors; something I endeavour to illustrate in the following paragraphs:

When one considers the compounded returns from the different asset classes over the past twenty years it is clear that equity and certain property stocks yielded the highest real (after-inflation) returns, thereafter bonds and then cash, just as investment theory would indicate. In fact, one can review basically any long-term period (say, ten years and more) and the same return profiles will emerge.

But most importantly, this is only true for long-term investing and one cannot extrapolate these findings into short-term expectations. Undoubtedly, the returns from equities and property stocks may be quite volatile from year to year, but when the long-term return figures from these asset classes are quoted in a relatively short-term context, it actually masks the wide range of return possibilities.

To illustrate the dangers and folly of basing investment decisions purely on short-term performances let me compare two very different strategies and how they would have performed over the past twenty years: *First*, if each year monies were allocated to the asset class that in the previous year yielded the highest return, and, *secondly*, each year monies were allocated to the asset class that in the previous year fared the worst, what would the outcome have been?

A staggering difference to say the least. The second strategy (investing in the previous year's worst performing asset class) whipped the outcome of the first strategy by four percentage points per year! Or, in practical terms: If I invested R100 in each strategy, I would have ended with R1,450 by following the first strategy, while the second strategy would have paid me back R2,658!

Also, the first strategy would have fared significantly worse than two other strategies, namely a "clueless" allocation strategy where equal allocations each year to the asset classes were made, and a managed solution (typical allocation of 60% equities, 10% properties, 20% bonds and 10% cash). [**Table 3**]

Table 3: Comparing different strategies

YEAR	Previous year's best asset class	Previous year's worst asset class	"Clueless" or equally-weighted	"Managed"
Annualised return	14%	18%	16%	16%
Average return	15%	19%	16%	17%
Volatility	16%	17%	9%	15%

Source: DRW Investment Research

For me it is sufficient proof that following a strategy based on short-term winners is suboptimal. Also, mean-reversion among asset class performances is alive and well and should not be ignored in any prudent investment strategy.

But for equity and property investments "short term" does not only apply to one-year returns, since it might also be three years, five years and even seven years. For example, consider the performances of equities and listed properties since 2003 – 15% and 20% real returns respectively. Now, consider the period 1995-2002; then equities and properties performed only slightly better than the inflation rate, while bonds and cash delivered stellar returns over the same period. [**Table 4**]

Table 4: Annualised returns for different asset classes

Period	Equities	Properties	Bonds	Cash	Inflation
1995-2002	9%	12%	19%	14%	7%
2003-2010	20%	27%	10%	9%	5%

Source: DRW Investment Research

The question is whether investors that invested in the equity market during the period 1995-2002 fully shared in the fantastic bull market since 2003? I guess not, and herein lies the real danger of applying a myopic mindset. If you are not constantly aware of realistic returns over the long term, you will tend to believe that recent experiences will continue forever, and hence you will steer your investment allocations according those erroneous beliefs.

Today, the situation is reversed. Many investors are used to and expect high real returns from equity and property investments. To my mind they are bound to be disappointed in the next cycle. I am not necessarily implying poor returns relative to other asset classes, but rather much lower absolute returns than we have seen over the past number of years. I would definitely not avoid equity and property investing, but set my goals at maybe 3-5% real returns and not at the double digits of the recent past.

Investing is really about managing your expectations and emotions, or if you like, about the probabilities of achieving certain returns over time. Then, focus on those things that you can manage, namely your portfolio, your manager and your costs. Once you have set your investment plan and realistic objectives, be calm. Do not get side-tracked by predictions about what is going to happen next and thereby constantly changing your plan. In fact, I am sure you will spend your time much more fruitfully with family and friends or by reading some life-enriching books.