QUARTERLY INSIGHT

Sound investment decision–making requires a long–term focus

Ronald King

Head of Strategic Research and Support
PSG Wealth

It is easy to get caught up in the short-term noise of the latest press articles. But when it comes to making decisions about their investments, investors would do better by reminding themselves of their long-term objectives and ensuring they view share market behaviour from the correct time-perspective.

It can be difficult to keep a clear head when making decisions, especially at times like these when the world seems to be a mess. In such an environment, it is easy to become despondent and make the wrong decisions. However, sound long-term investment decision-making depends on our ability to ignore the short-term noise.

The current sense of disruption rests on:

Political uncertainty

We have already seen 280 terrorist attacks in the world this year. Political uncertainty is high. Xenophobia is not only a problem in South Africa, but also at the heart of many of the populist movements across the world. Many national and international politicians are in the news for using their positions for personal gain.

Disappointment with markets

The behaviour of the markets over the last two years have certainly not helped. The JSE has generated low returns, despite the ups and downs in between. Over two years, the index returned a meagre 0.88% per annum, which creeps up to 3.87% when dividends are included. This has left many investors wondering if it is worth the risk, and considering withdrawing from the share market.

Why your decision-making horizon matters

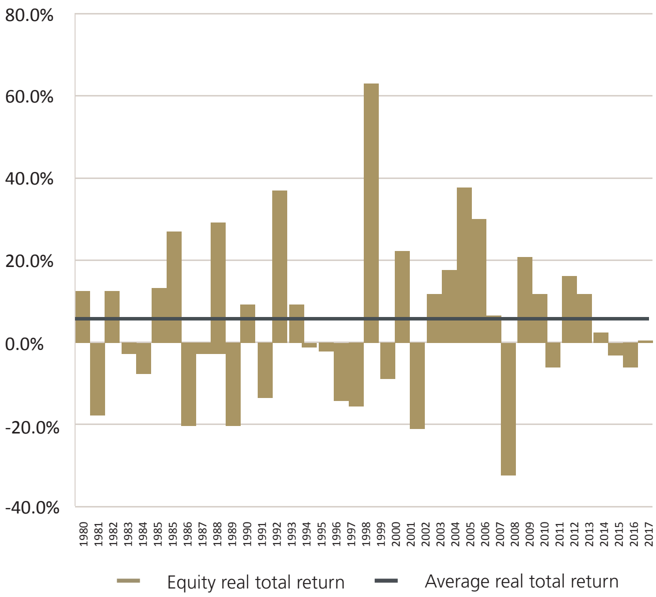
As Jac indicated in his article, people are living longer. Therefore, even retired investors could face an investment horizon of 30 years or longer. Focusing on short-term volatility when deciding where to invest is therefore a mistake. This view is not informed by our outlook for the market for the remainder of the year. Rather, it is based on a wealth of evidence about how the markets behave in the long run.

Markets are unpredictable – you could miss out

Counter-intuitively, the short-term volatility of markets means it is important to remain invested. We do not know when the markets will recover, but we understand that markets can move rapidly, and that those who sit on the sidelines are likely to miss out. Missing out on a few key days of growth can make a significant difference to your long-term returns.

The graph below clearly shows the volatility of the stock exchange and how easy it is to miss that growth.

Volatility of annual equity real returns



Source: Inet and PSG

Over the long term, market behaviour is more predictable

Snyman and Smith (2015) conducted research on the variability in the returns of the stock exchange. They found that if investors invested for a month at a time, they would earn an average return of 16.8% per annum over an 18-year period. However, for 2.5% of the months the return would be as low as -23.18%. Typically, it is negative returns like these that cause investors to flee the markets.

Volatility of monthly returns

Average return	16.80% annualised
Standard deviation	20.40% annualised
Number of data points	225
Returns < 11.07% p.a.	103

Source: adapted from Snyman & Smith

While most investors understand the importance of the average return, the standard deviation provides an indication that 68% of the returns could deviate from this average return by ±20.40%. Viewed on this basis, receiving the 'average' return is highly unlikely.

The table below considers the return if investors remain invested for a 20-year period. While the average return drops slightly, the volatility of the returns reduces significantly. The table indicates that 68% of the returns now vary between 12.73% and 16.61% (±1.94%), making it much more likely that you would receive the 'average' return. Importantly, their analysis showed that no investor would receive a return of less than 11% over any 20-year period. Viewed on this basis, equities fared better than any other asset class.

Volatility of returns (20 years)

Average return	14.67% annualised
Standard deviation	1.94% annualised
Returns < 11.07% p.a.	0

Source: adapted from Snyman & Smith

When making decisions, ignore short-term noise

While we do not know what 2017 will bring, we can say that its importance in the life-span of your investment will diminish over time. Trying to time the market is difficult and fails more often than it succeeds. When we realise that we are invested for the long term, the perceived riskiness of a share portfolio is not as high as many investors think. The best advice for 2017 is therefore to stop worrying about the return you are likely to see in the stock market over the next week or month.

Your time would be much better invested ensuring you portfolio is suitably diversified and aligned to your needs. By doing so, you are far more likely to reach your destination successfully.

Reference: The information in this article is in part based on a presentation entitled 'Equity risk in a retirement portfolio' delivered at the FPI convention in 2015 by Paul Snyman and Prof Nico Smith.