EFFICIENT GROUP

ECONOMIC COMMENTARY

- Dr. Francois Stofberg, with specialist input from Christiaan van Wyk

YOUR WEEKLY ECONOMIC UPDATE

9 May 2023

HOW TO AVOID PERMANENT CAPITAL DESTRUCTION

We all know the age-old adage that has held true throughout history: "It is not about timing the market; it is about time in the market". As investment managers, we have the pleasure of celebrating the wisdom of this adage with our clients when they achieve their long-term investment objectives. Unfortunately, we also witness the flipside of the coin, when clients sell out of underperforming investments and buy into the flavour of the month based on short-term return differentials. This is when the risk of permanent capital destruction is at its highest, and many investors make mistakes that are detrimental to their long-term financial planning.

Looking at historic returns data, performance between active investment managers diverge over time and, more importantly perhaps, tend to out-/underperform following a period of out-/underperformance, as each investment strategy has unique performance characteristics during different market conditions. This is common knowledge for most investors but clients tend to become short-term focussed when uncertainty is elevated. And who can blame them! The past three years have been somewhat of a rollercoaster ride, not only in the financial markets but in daily life as well. In the scope of less than three years, we have witnessed a pandemic that virtually shut down the planet, an ongoing war in Europe, a cost-of-living crisis caused by multi-decade high inflation, and two bear markets. Unsurprisingly, investors are cautious and feel as though they must do something, which is often erroneously changing investment managers.

We, as investment managers and financial advisors, are required to not only provide prudent financial advice but also to educate clients on behavioural biases that are more psychological in nature and that may lead to suboptimal decision-making. Behavioural biases are unconscious beliefs that influence our decisions and decision-making processes. We have found that investors often struggle with loss aversion, a bias that causes the investor to experience greater discomfort from losses than they find value in an equivalent gain. Compounding the problem is regret avoidance, in which investors fear the regret of not changing investment managers that are underperforming in the short term (experienced as a loss) without looking at the facts and remaining emotionally neutral during decision-making.

Historical analysis, therefore, unsurprisingly suggests that the probability of achieving long-term investment success increases as we manage biases and limit short-term decision-making – reducing the risk of permanent capital destruction by staying invested and by maintaining a long-term focus. The notorious investor, Peter Lynch, once said: "Stocks are a safe bet but only if you stay invested long enough to ride out the corrections". We believe that this holds true for the stock market as well as for investment managers. It all comes down to trust. Trust your financial advisor to guide you through the process of planning your financial future. Trust your investment manager to invest your assets prudently. Trust is at the core of what we do here at Efficient, and we maintain it by investing time with clients, helping them stay true to their financial plans, and celebrating with them as they achieve their long-term financial objectives.

Efficient Group