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Investment Fears

We all know that it's natural for financial markets to go up and down for varying lengths and at different times however, it never ceases to amaze me that whenever markets take a downturn, investor's concerns increase. The answer to this lies at the door of human psychology.

When looking at investor's views of risk, a company called FinaMetrica has surveyed customers with a scientifically-designed risk profile questionnaire that has been used for the past 12 years, assisting financial advisers evaluate whether their clients naturally feel comfortable taking risks, or whether they are the opposite and feel more relaxed when their money is kept safe under their mattress.

FinaMetrica test data covers 2,586 individuals who were tested twice – first between June 2003 and December 2007, and second between August 2008 and June 2009. After the results were plotted and compared, in simple terms, the scores demonstrated that surprisingly, those individuals actual tolerance to risk remained stable, whether the markets were falling (bear market) at the time or whether they were rising (bull market). What did change however, was that the Global Financial Crisis (GFC) gave people a different 'perception' of risk, which is different to their actual 'tolerance'.

It seems quite obvious if I say that most people are less excited about taking market risk these days, than they were in say the early months of 2007, just before the last GFC, however, there are some plausible explanations for the results of their survey and why risk 'tolerance' is different to risk 'perception'.

We need to consider what some have coined 'bravery', or what I believe is our courage and willingness to take chances. The FinaMetrica risk profiling system measures this with some of the questions it asks and we know from our experience, that results show that if we were willing to jump out of an airplane skydiving, go scuba diving or do something extreme before the last GFC crash of Autumn 2008, we are still just as excited now by doing this and putting our life in danger with an adrenaline rush, as we were before the GFC. Whatever happens within the financial markets doesn't change who we are fundamentally.

Another component to take into consideration is our risk capacity, i.e. how much financial risk we can afford to take. The 2008/2009 bear market possibly caused many of us to reconsider how early we might be able to retire or become financially independent, and for some, the probability of whether they're able to retire at all. Based upon this experience, we often feel as though we've become a little more conservative in our investment approach.

A further additional element is our risk perception. When we see the markets going up consistently, we don't really see much risk and focus on the upside. The proof of this is during the late 1990's when we experienced the tech boom and saw even the shyest investors throwing money into the market. When the financial markets deliver the opposite, we look at shares as very risky.

It's interesting to compare investor perception and experience here in New Zealand when discussing investing in shares versus property, the latter of which we all know that New Zealanders have a love affair with. Property is a less liquid asset, is only worth what someone else is prepared to pay for it, and creates problems if it's untenanted yet has a mortgage that needs to continue to be serviced. Interestingly, if we buy property and see its value decline, do we go back to the real estate agent who helped us purchase it and demand their commission back now it's gone down in value? We're generally prepared to hang on to it as we believe that in the long run the value will return and we know that the real estate agent isn't able to control the property market.

We're all familiar with the terms 'bulk buying' and 'buying when cheap', particularly when we see deals at the supermarket, wish to buy property when the market is 'low' or buying goods when there's a sale on. So why is it that we don't follow this philosophy when it comes to investing in shares?

Buying property means we need a large sum of money and in many cases, taking out a loan is the only option for many. Investing in the financial markets allows investors in take advantage of having a share portfolio with a much lower level of investment and allows us to save surplus income on a regular monthly basis; KiwiSaver being a prime example of this.

Investing in shares allows us to reduce our risk of loss through having a diversified portfolio owning many shares across many countries, something many of us aren't able to do when holding property as an investment asset. Shares are able to be sold at any time pretty much, and we know the value on a day to day basis.

I'm not advocating that we shouldn't invest in property, I'm just highlighting the need to consider diversifying our investment assets so that we spread our risk and obtain different returns from different assets when those assets are performing differently at different times.

When looking at the facts about investing and what we should do, most people seem to understand the importance of staying disciplined with their investment approach as they have a long time horizon ahead of them. In practice however, the emotional part of our mind looks around at the share markets and conjures up negative statistics and starts taking on board all that 'noise' that the media print and what our friends and family tell us we should do, thereby focusing more on the risk than the reward.

It's important that we don't let greed or fear dictate how we should construct an investment portfolio. We know that to achieve our long-term goals and objectives, it's important to have a disciplined and robust investment strategy. Focusing on managing risk and ensuring our investments increase over time in line with our tolerance to volatility within the markets, and having a suitable mix of both growth and defensive assets that is suited to our circumstances and long term needs, is more important that just looking at the day to day ups and downs of the market. In the long run, having a diversified investment portfolio made up of varying types of assets will give us the edge on others who are responding to the 'noise' in the markets that drives them to try to 'time the market', pick the next 'winner' and get caught up in the emotion of risk and return, rather than 'staying the course' with a proven, scientific investment solution that is able to look after our wealth for the long term.

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