

Don't let emotions guide your investment decisions



"Be fearful when others are greedy. Be greedy when others are fearful."

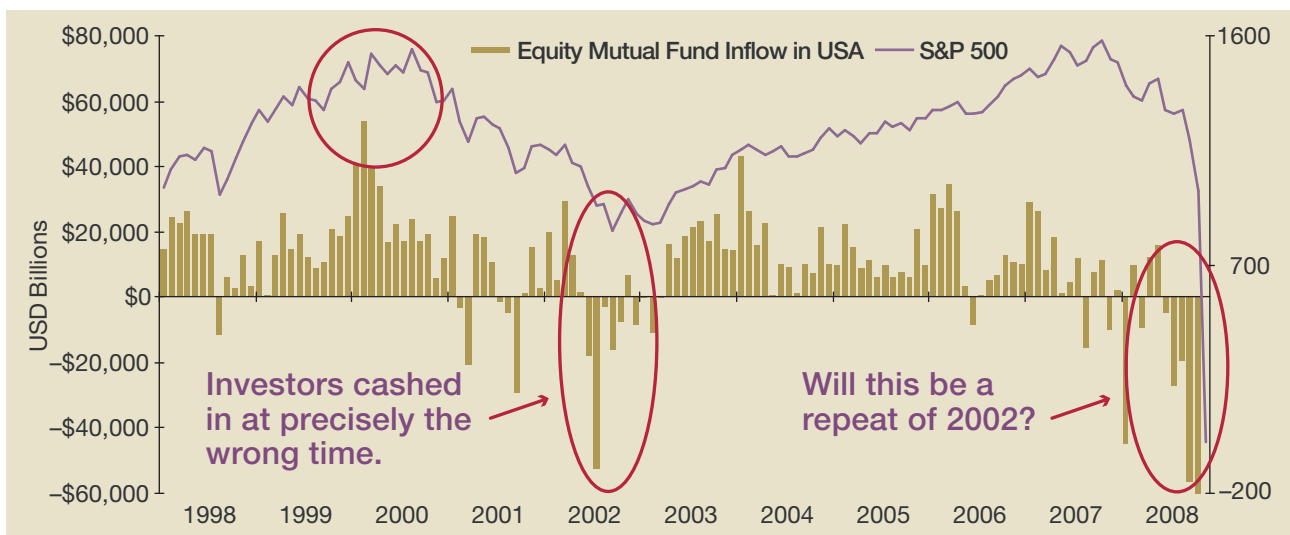
Warren Buffett,⁴ Chairman, Berkshire Hathaway

BUILDING long-term wealth often requires counter-emotional investment decisions, such as buying at times of maximum pessimism or resisting the euphoria around investments that have recently outperformed. Unfortunately, as **Chart 5** shows, investors too often let emotions guide their investment decisions. This translates to buying when prices are high and panic selling when prices fall.

Following three years of stellar returns from 1997–1999, in 2000 US investors invested record amounts into managed funds, just in time to experience three years of negative performance. On the heels of these three terrible years, sentiment turned pessimistic and net inflows into managed funds dropped right off, just before managed funds delivered one of their best ever returns of 29.7%. 2008 saw a similar reaction from investors gripped by fear, with managed fund inflows drying up completely and huge outflows as shown in **Chart 5**.

Judging from **Chart 5** it would appear that great investors recognise that an objective, disciplined, emotionally detached investment approach, which may include buying at times of maximum pessimism, can be key to building long-term wealth.

Chart 5

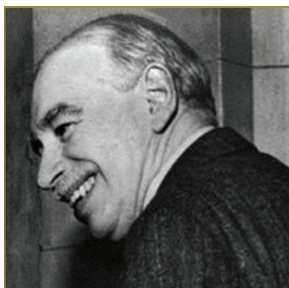


Source: Bloomberg and ICI

⁴ Warren Buffett (born 1930) is one of the worlds most successful investors and businessmen, and is one of the world's richest men, with an estimated net worth of \$62.0 billion.



Recognise that short-term underperformance is inevitable



“The social object of skilled investment should be to defeat the dark forces of time and ignorance which envelope our future.”

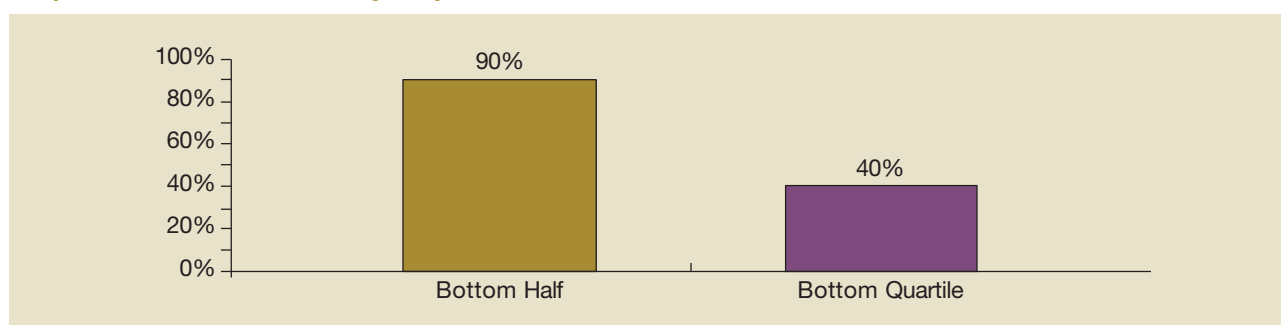
John Maynard Keynes,⁵ economist

IT CAN BE hard to take a long-term view when there is so much up to the second data available with regard to your investments. Paying too much attention to daily or weekly performance charts can not only be bad for your health, but also bad for your wealth. When faced with short-term underperformance from a fund manager, some investors lose conviction and switch to another manager.

When evaluating fund managers, short-term performance is generally not a strong indicator of long-term success. Comparing a fund manager against its peers over different periods, encompassing different stages of the investment cycle, should stand investors in good stead when evaluating performance.

An Australian study surveyed⁶ the 112 best performing large-cap equity funds with a 10 year track record. The study looked at which funds were most consistently in the first or second quartile in the period 1998–2007. The study then went on to look at how many of these top fund managers had suffered a period of sustained underperformance over the same period. The results were staggering. Of the top 10 managers: **90% of these top managers’ rankings fell to the bottom half over this period for at least one year, whilst 40% of these top rated managers rankings fell into the bottom quartile over this period for at least one year.**

Chart 6: Percentage of large cap equity managers whose performance fell into the bottom half or quartile for at least a one-year period.



Why is this the case? Investment managers who achieve good long-term results typically follow a rigorous and consistent process. There will invariably be times when their particular approach (or investment style) will not produce the best results in the short-term. Due to this, many investors try to combine managers with different approaches (e.g. value and growth styles), in order to maximise the consistency of their returns during different stages of the investment cycle.

In summary, even though the managers in the study delivered the best overall long-term returns, almost all suffered at least one difficult period. Investors who recognise this possibility and prepare for the fact that short-term underperformance is inevitable, even from the best managers, may be less likely to make unnecessary and often harmful changes to their investment plans.

⁵ John Maynard Keynes (1883–1946) was an economist whose ideas called, Keynesian Economics, still influence Keynes advocated interventionist government policies and is considered one of the most influential economists of all time.

⁶ Morningstar “The Most Consistent Large-Cap Share Funds” by Phillip Gray 21/05/2008.