

# Investor behaviour: the unexpected influence on financial strategies



By Peter Wilson

**Peter Wilson, Principal Consultant and Authorised Representative of Godfrey Pembroke Limited Australia, provides insight into how understanding our emotional responses to market conditions can impact our investment returns. A member of the Momentum Private Wealth panel of financial advisers, Peter has a personal interest in behavioural finance principles.**

As individuals strive to manage their financial wellbeing and provide financial security for their future, most have come to accept the simple fact that the creation of wealth does not occur by accident. Many understand that to create wealth a comprehensive financial plan is required, taking into consideration the strategic options and assets available now and in the future. Many have also come to understand the core principles of investing required to construct a solid portfolio – diversification, asset allocation, risk and return considerations, and the selection of a quality management team with a robust investment process.

What would come as a surprise to most investors though is that the dominant influence on wealth creation is actually individual investor behaviour. Understanding behavioural patterns and individual attitudes towards money and wealth can significantly influence a member's wealth creation in a positive way. Part of this involves understanding that, regardless of an individual's personal financial education, it is natural to base decisions on a range of emotional and psychological impulses that may lead to decisions which prevent or limit the creation of wealth.

This premise is demonstrated by the results of an annual survey conducted by Boston-based research group, Dalbar. The survey examines the performance of the US-equities market and the performance of individual investors over a 20-year period. To the end of 2007, the study showed that by buying and holding the average managed US-equity fund an investor should have earned an annualised return of 11.5 per cent. However the average investor actually only achieved an individual return of 4.5 per cent! Emotional reactions to changing market conditions led these investors to rob themselves of seven per cent of the potential return.

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# The financial advice services available to members

While many investors are inclined to think they wouldn't do this, research has shown that perhaps the strongest influencing behaviour is overconfidence, particularly with regard to the investor's own decision-making capability. Most concerning is that confidence is shown to increase along with the difficulty of the decision being faced! Other common patterns of emotional behaviour are herd mentality – jumping on an investment opportunity because it seems that everyone else is; timing the markets – mapping trends and trying to buy low and sell high; loss aversion – getting out of an investment on a downward trend rather than riding out volatility; and hesitation – not investing for fear of making mistakes and hence shortening the timeframe available to invest.

By recognising that many investors have a natural inclination towards at least one or two of these behaviours, or other behaviours not mentioned in this article, investors can take a significant step forward in their approach to investment. Importantly, investors can choose to work with a financial adviser who understands the importance of behavioural finance principles and who can work with them to ensure that their actions that are aligned with their financial goals rather than driven by emotional responses. In this way, investors can ensure that they are on the right path to generate the wealth that the market can potentially provide.

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1. Note: See Important Information on page 12.