



Developing your financial & investment plan

Myths, Perceptions, Biases, Facts and Fallacies...

Presented by

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The logo features the letters 'DRW' in a large, bold, green serif font. The 'D' and 'R' are connected, and the 'W' is a single, continuous stroke.

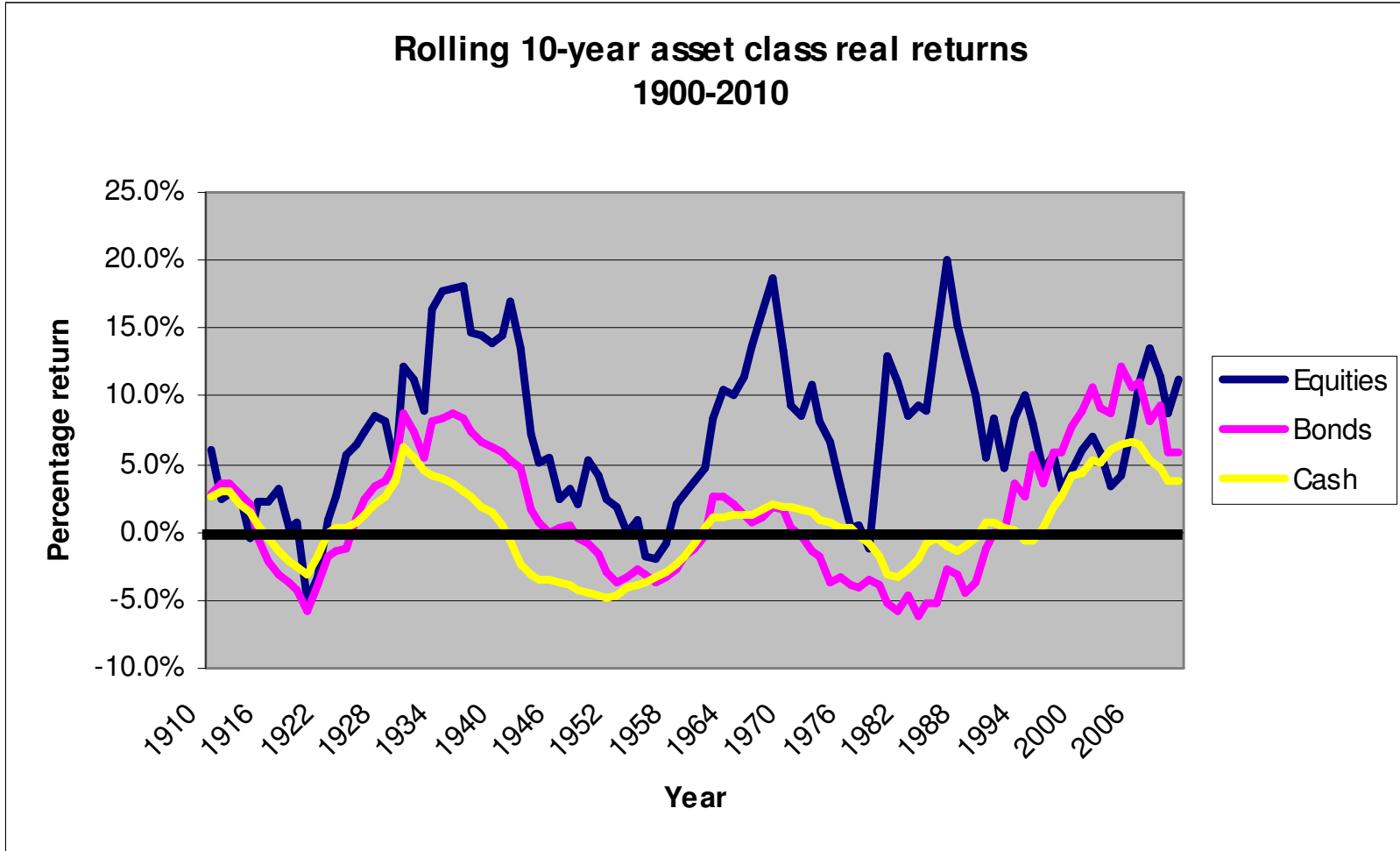
Investment Research

Investment success and financial independence

Simple, but not easy...

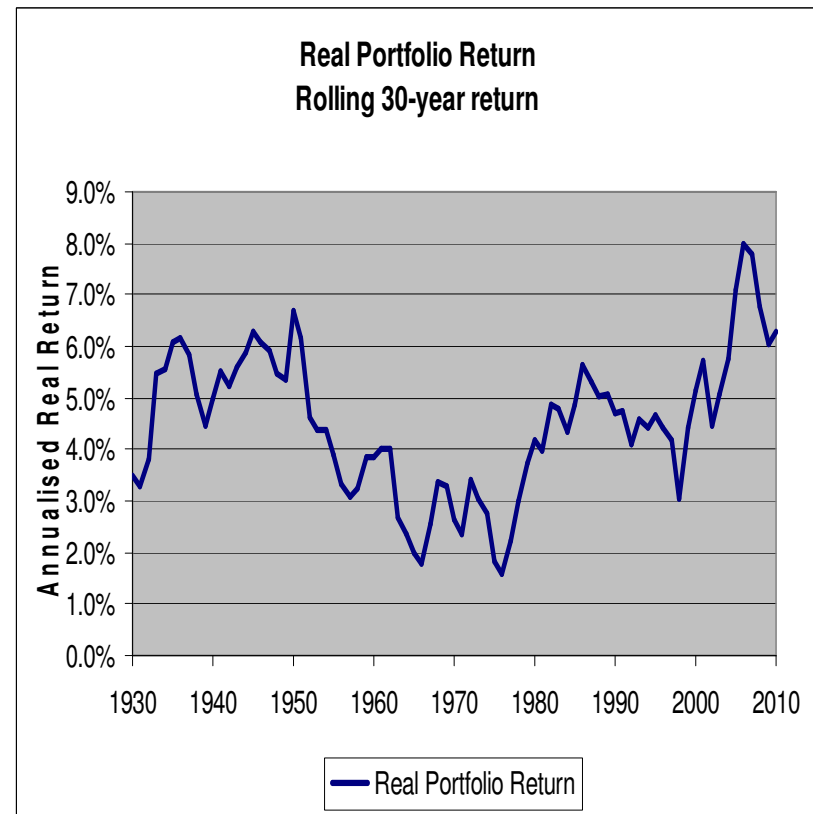
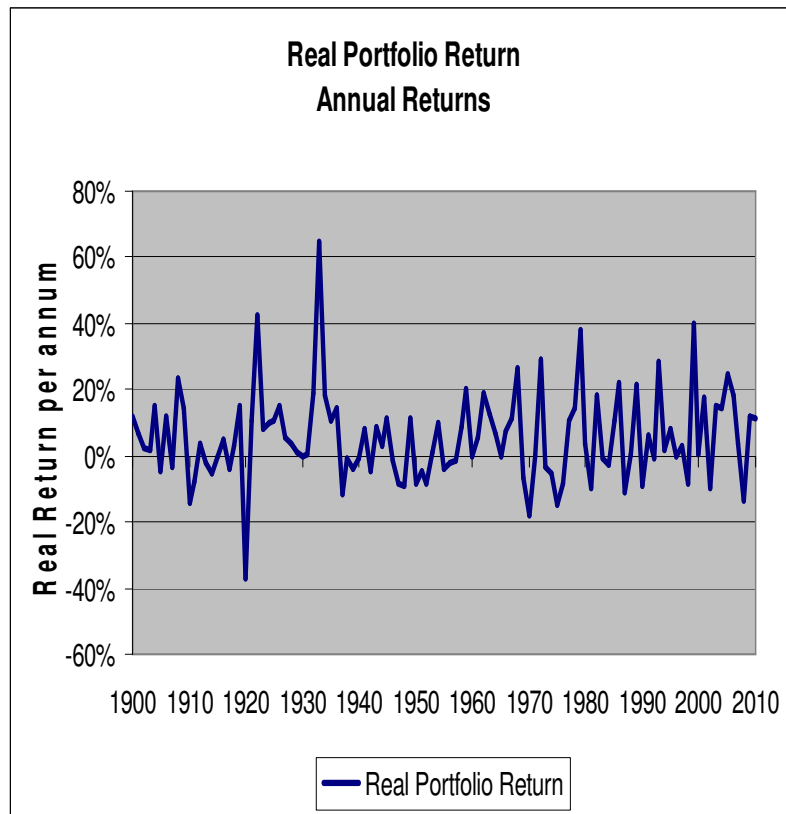


Real asset class returns



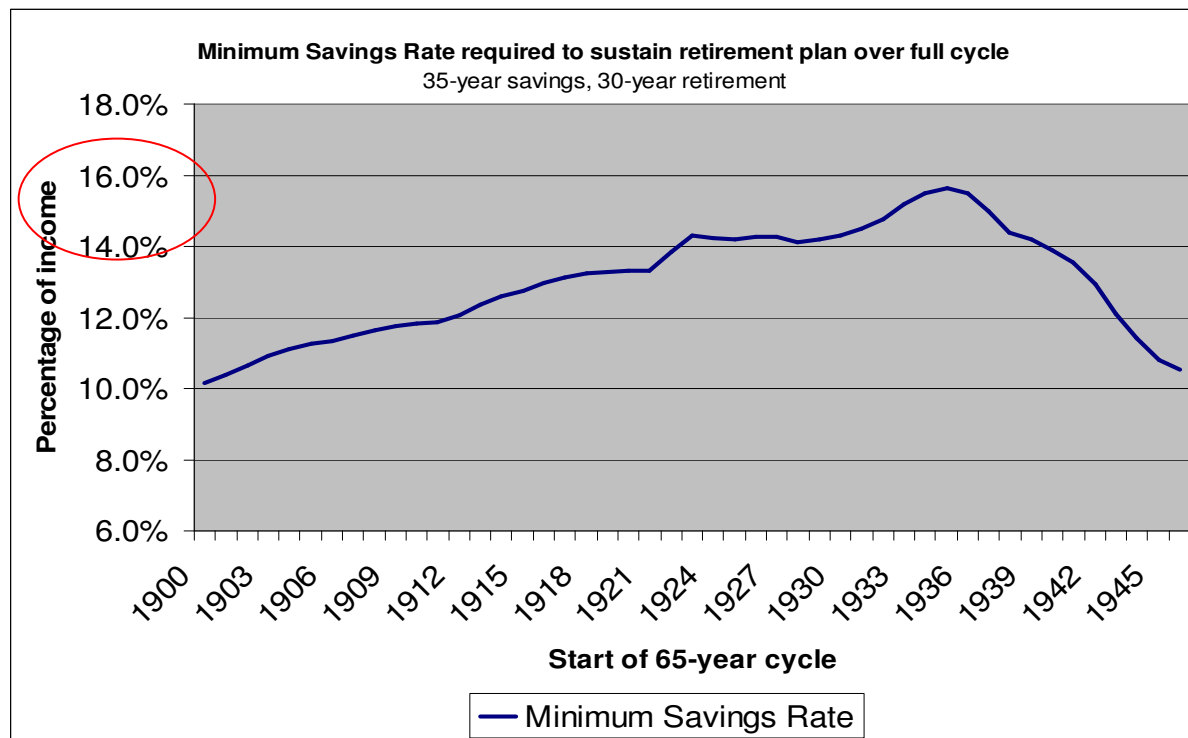
Medium-equity portfolio

(Balanced portfolio: 50% growth, 50% fixed interest)



Minimum Savings Rate required over time...

35-year contribution period, 30-year withdrawal period,
70% replacement rate, constant real income (annuity)





The real challenge...

But will you really stick to this simple recipe?

Along the way you will experience many temptations to deviate from your plan...because, after all, you are a human being filled with emotions!



Investment and Speculation

“Speculation is an effort, probably unsuccessful, to turn a little money into a lot.



Investment is an effort, which should be successful, to prevent a lot of money from becoming a little.”

» Fred Schwed

The purpose of investing:

to protect and increase the purchasing power of your monies... real, after-tax growth in wealth.



Bernoulli's gift



- How to do the right thing at all times....

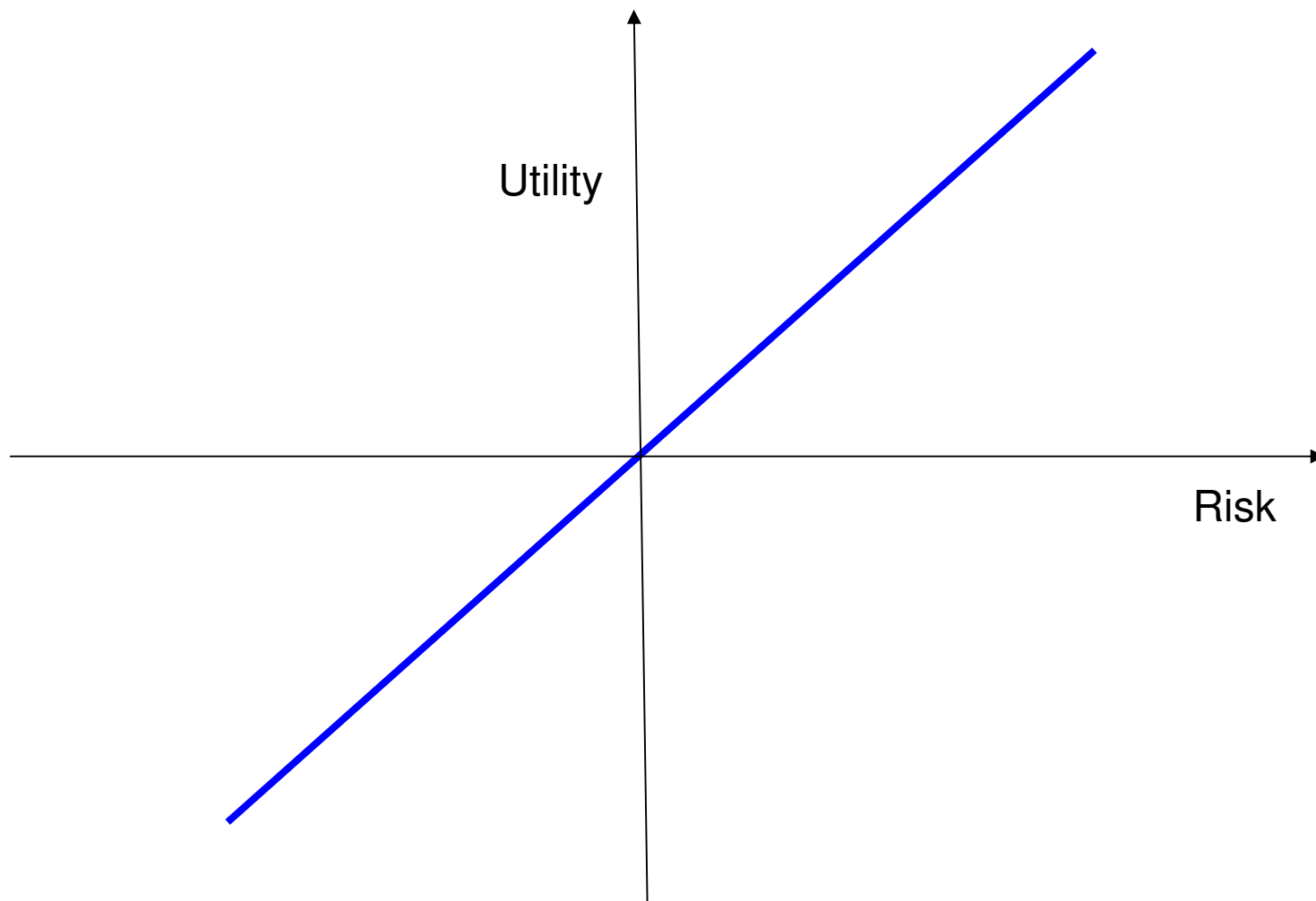
Expected value = **Odds** of gain x **Value** of gain

But we
get it
wrong
here

And
here
too!

- Underestimating the odds of future pains
- Overestimating the value of present pleasures

Risk & return trade-off



Emotional value of money

- Risk-averse and Loss-averse

A: 100% (sure) chance to gain R75,000

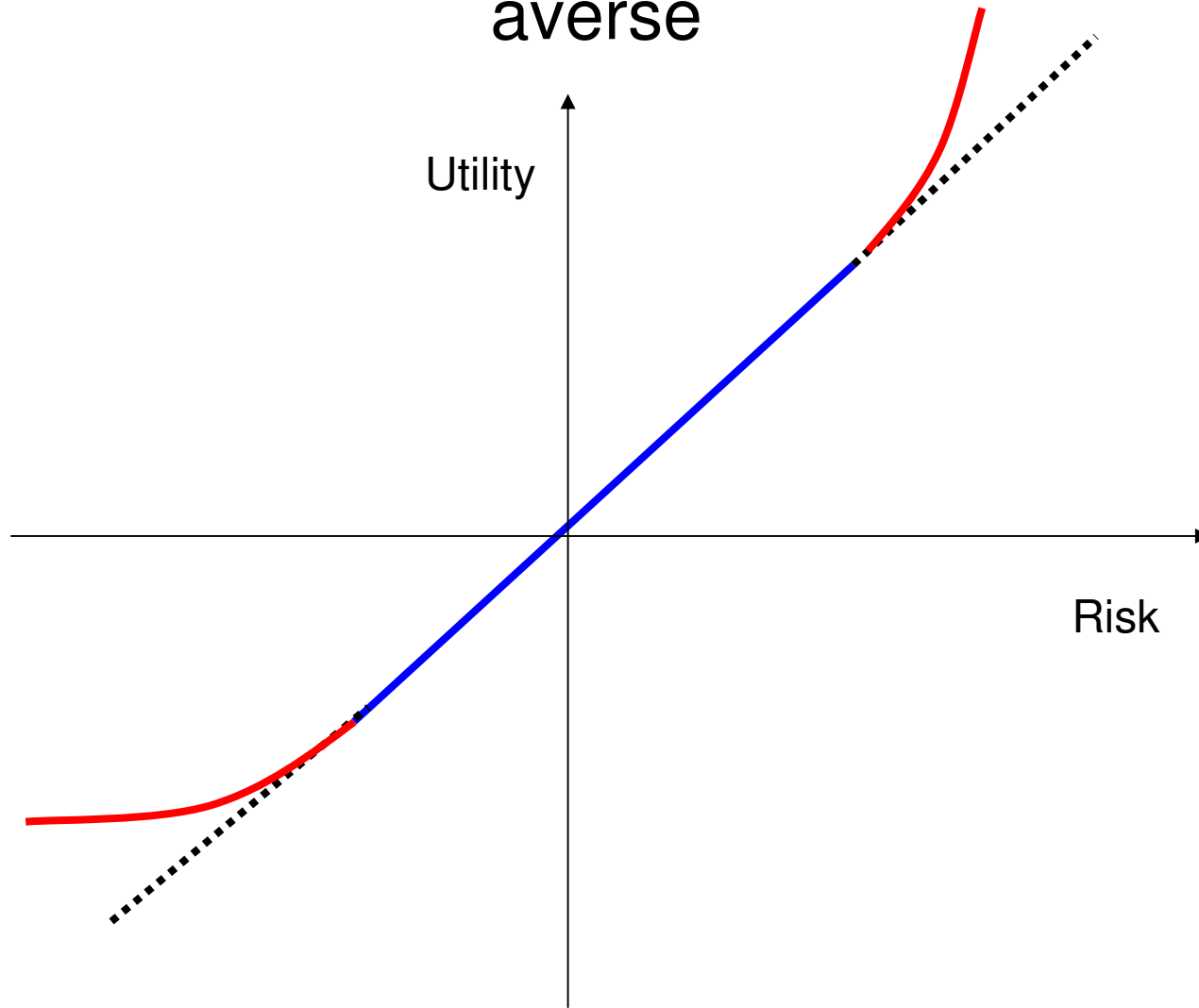
B: 75% chance to gain R100,000 and 25% chance to gain nothing.

C: 100% (sure) chance to lose R75,000

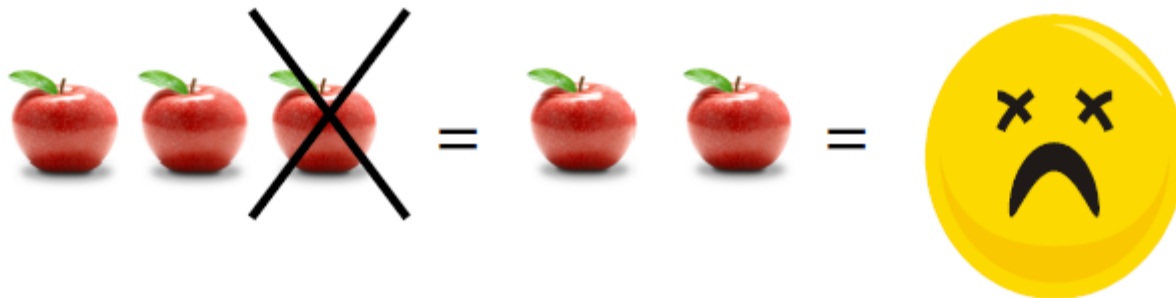
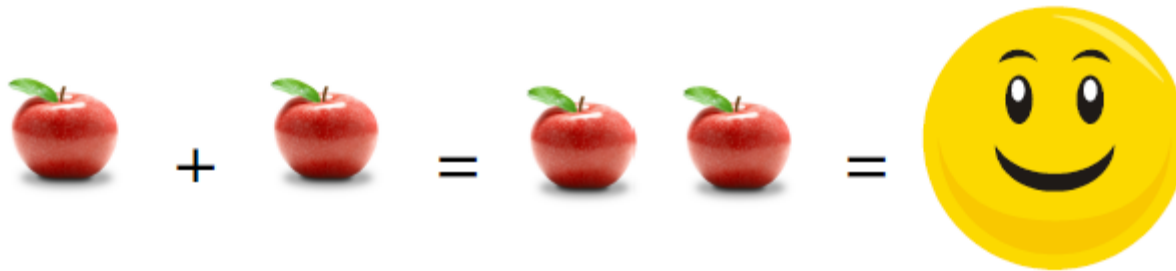
D: 75% chance to lose R100,000 and 25% chance to lose nothing.

Risk-return trade-off

Real life: We are more loss-averse than risk averse



Loss-aversion bias



The pattern-seeking mind



- Playing the lotto

We expect randomness, therefore we play

9, 17, 29, 32, 37, 44

And not

2, 4, 6, 8, 10, 12

- Investment choices

We don't want (expect) randomness, therefore we pick the past winners

The randomness of winners

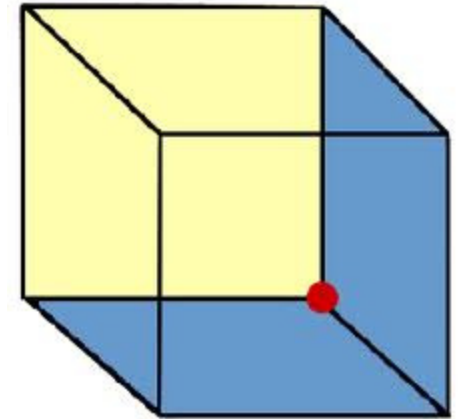
Fund	Jun-10 Jun-11	Jun-09 Jun-10	Jun-08 Jun-09	Jun-07 Jun-08	Jun-06 Jun-07	Jun-05 Jun-06	Jun-04 Jun-05	Jun-03 Jun-04	Jun-02 Jun-03	Jun-01 Jun-02
Allan Gray Equity A	Bottom	Middle	Middle	Middle	Middle	Top	Middle	Bottom	Top	Top
Community Growth Equity	Middle	Bottom	Middle	Top	Middle	Middle	Middle	Middle	Middle	Middle
Coronation Equity R	Top	Top	Top	Middle	Middle	Bottom	Top	Middle	Middle	Middle
Investec Equity R	Middle	Bottom	Middle	Top	Middle	Middle	Top	Top	Middle	Top
Nedgroup Inv Rainmaker A	Top	Middle	Middle	Middle	Middle	Middle	Top	Top	Top	Top
Oasis Crescent Equity	Bottom	Middle	Bottom	Top	Middle	Middle	Bottom	Middle	Middle	Top
Old Mutual Growth R	Middle	Middle	Middle	Middle	Middle	Bottom	Middle	Middle	Middle	Middle
Old Mutual High Yield Opp A	Middle	Top	Top	Bottom	Middle	Bottom	Middle	Top	Top	Middle
Old Mutual Investors R	Top	Middle	Middle	Middle	Middle	Middle	Middle	Middle	Middle	Middle
Prudential Equity A	Top	Middle	Top	Middle	Top	Top	Middle	Top	Middle	Middle
RMB Equity R	Middle	Middle	Middle	Middle	Middle	Middle	Top	Middle	Middle	Middle
Sanlam General Equity R	Top	Middle	Middle	Middle	Top	Middle	Bottom	Middle	Middle	Middle
STANLIB Equity R	Top	Middle	Bottom	Top	Bottom	Middle	Middle	Bottom	Bottom	Middle
STANLIB MM Equity FF A1	Middle	Middle	Middle	Middle	Bottom	Middle	Middle	Middle	Bottom	Middle
STANLIB Prosperity R	Top	Middle	Bottom	Top	Middle	Middle	Middle	Middle	Middle	Middle
Investec Value R	Middle	Top	Top	Bottom	Middle	Middle	Top	Top	Top	Top
Nedgroup Inv Value R	Middle	Top	Top	Bottom	Middle	Top	Bottom	Middle	Top	Top
Prudential Dividend Maximiser A	Top	Middle	Top	Middle	Middle	Top	Top	Middle	Middle	Middle
Sanlam Value R	Middle	Top	Top	Bottom	Top	Middle	Top	Middle	Middle	Middle
STANLIB Value A	Bottom	Top	Middle	Middle	Top	Bottom	Middle	Middle	Top	Middle
SWIX	Top	Middle	Middle	Middle	Middle	Middle	Middle	Middle	Bottom	

Persistency of relative fund performance...

- Year-on-year: Equal chance of

Position	Average	2008/2009	2007/2008	2006/2007	2005/2006	2004/2005	2003/2004
Same position	32%	22%	34%	32%	22%	46%	37%
Worsen position	34%	41%	33%	33%	31%	29%	35%
Better position	34%	37%	33%	35%	47%	25%	29%

The Illusion of Money



- Most people would prefer a 7% salary increase in a 6% inflation environment versus a 3% salary increase and 1% inflation.
- We prefer payments of 40, 45, 50 to 50, 45, 40.
- Profound implications for the way we invest, consider investment options, etc.

Time value of money

Compounding – working for **and** against you over time...

- Investment returns
- Investment costs
- Wrong decisions, not properly calculating the future impact of today's decision

The real cost of procrastination...

Investor	Paul	Peter
Contribution	R5,000 from age 25	R10,000 from age 40
Contribution Period	10 years	25 years
Return	10% p.a.	12% p.a.
Retirement age 65	R1,616,789	R1,503,339
Total contributions	R55,000	R260,000
Multiplier (Magic)	29.4	5.8

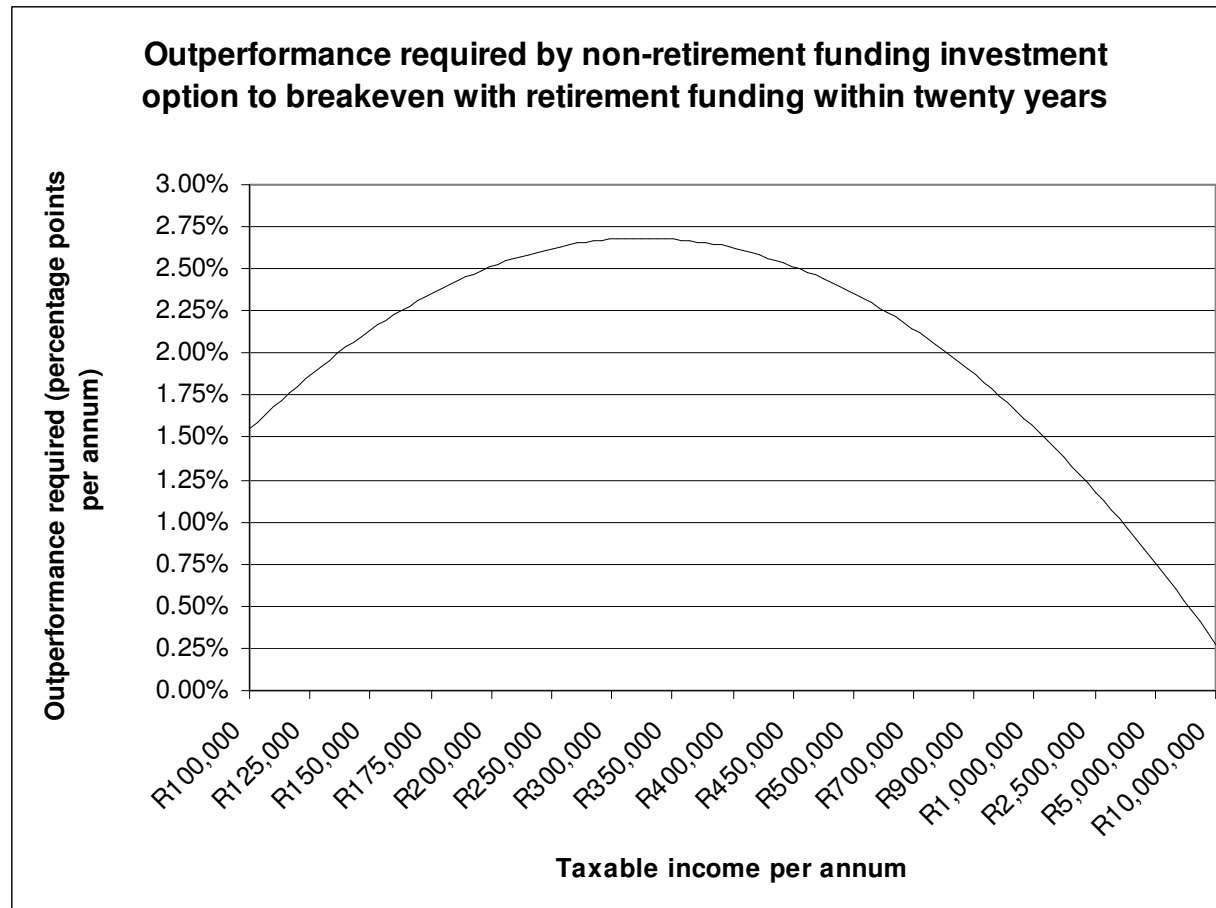
Investment costs

Warren Buffett's Berkshire Hathaway

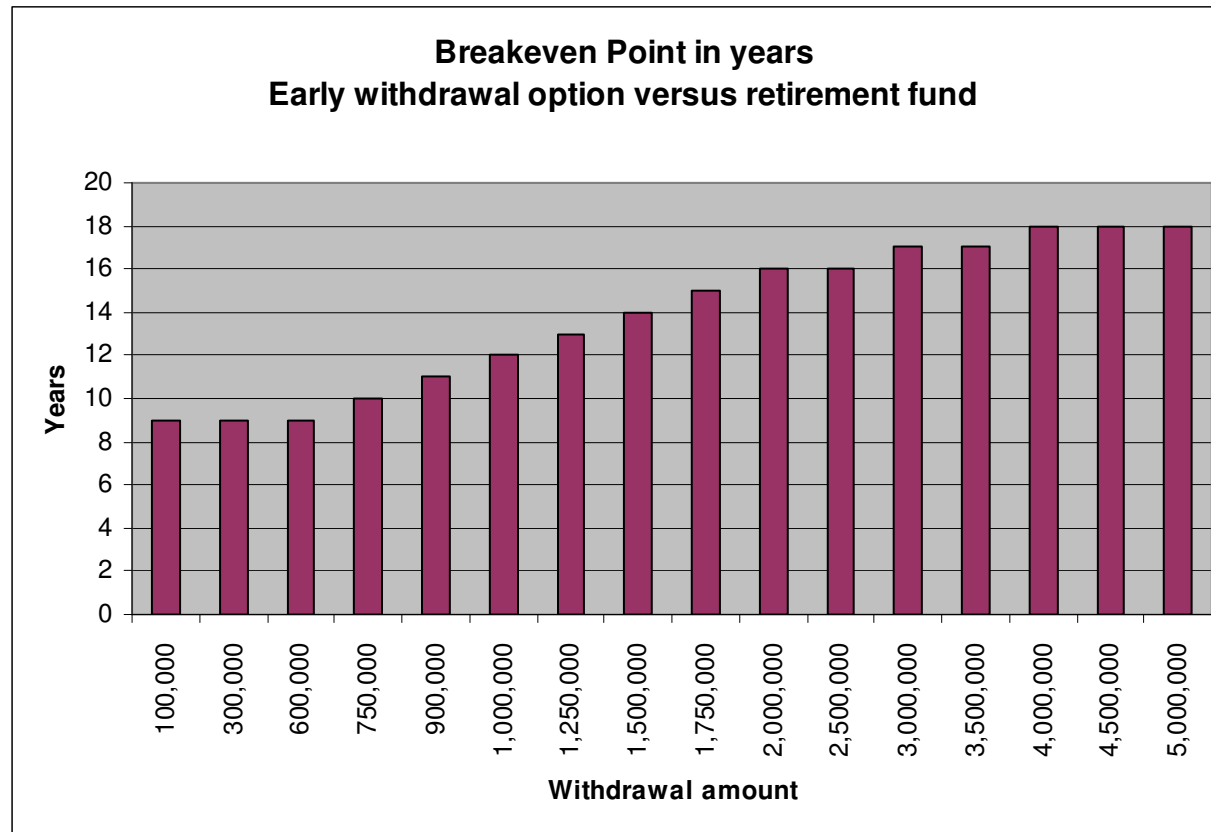
- 20% return over 40 years
- Compounded wealth = \$50bn
- What if BH was a hedge fund, then the 2% + 20% rule applies
- Reduction in yield = 6% p.a.
- Value of fund @ 14% after 40 years = \$8.5 bn
- 80% of potential value “lost”



Saving for retirement



Withdrawal from retirement funds





Visualising your future self

- The **present self** may be disconnected from the distant **future self**; we view our future selves as strangers!
- It is difficult to focus on the benefits of financial rewards that will be only available at retirement.

Seeing our future selves boosts savings



Seeing a happy future self further boosts savings



Potential calculation errors...

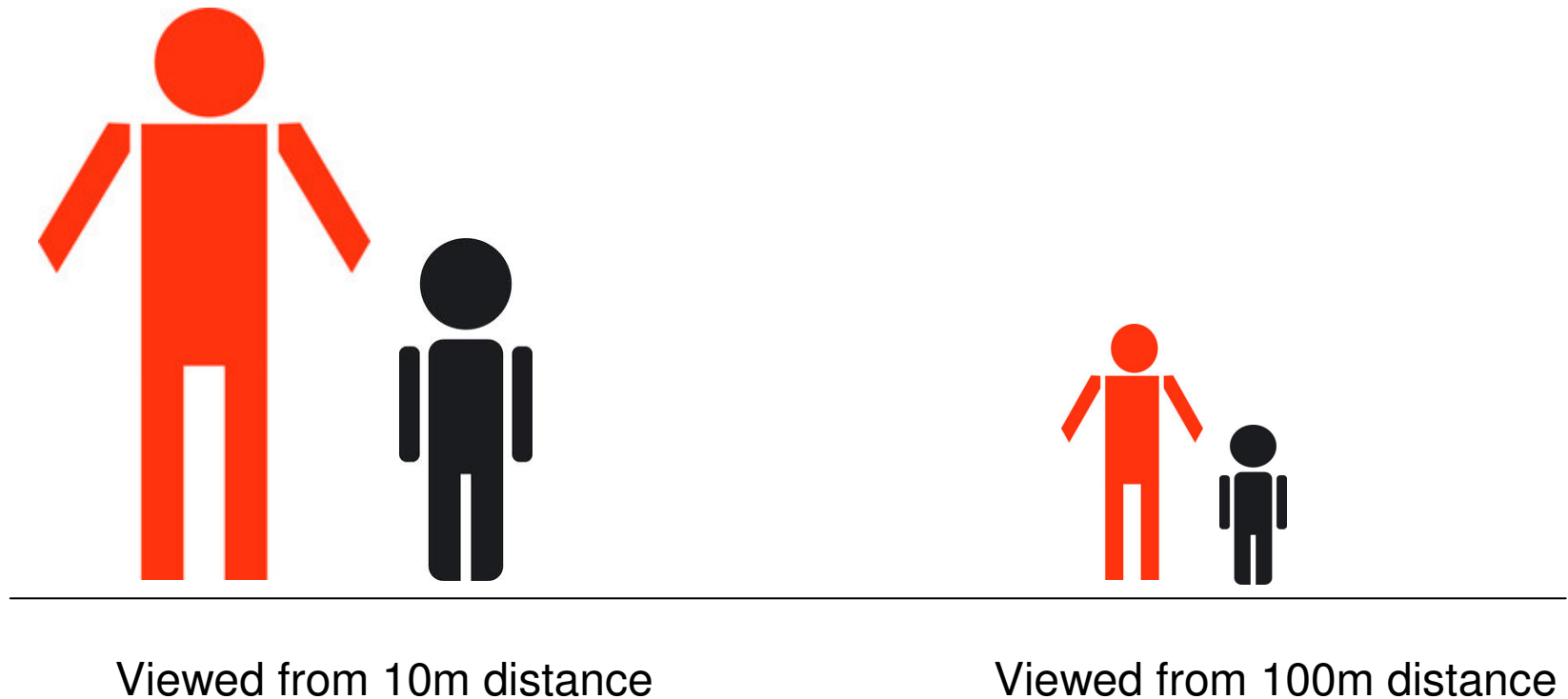
- The **quick** and **slow** answers...
- Folding a piece of paper 50 times and the distance from start to finish will be?
- A bat and ball cost R110. If the bat cost R100 more than the ball, how much does the ball cost?
- In a lake, there is a patch of lily pads. Every day the patch doubles in size. If it takes 48 days for the patch to cover the entire lake, how long would it take for the patch to cover half the lake?



The quest for instant gratification

“What space is to size, time is to value”

» Plato



Instant gratification explained Now or later?

R1,000 today or R1,200 in six month's time?



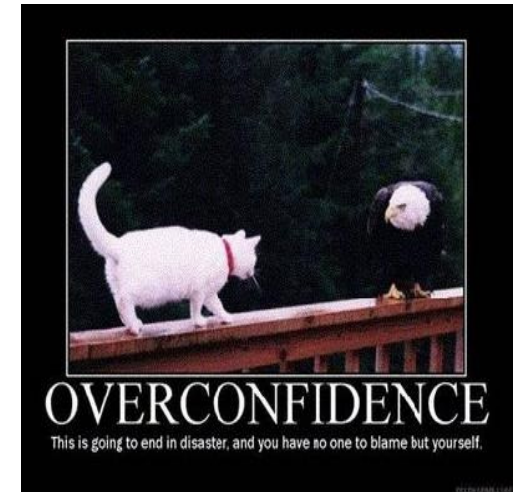
But we do get it right when the only choice is later!

- R10,000 twelve months from now or R10,200 in thirteen month's time?



Overconfidence bias

- Neglecting “the wisdom of crowds”
- Overestimating your (real) chances of “beating the market”



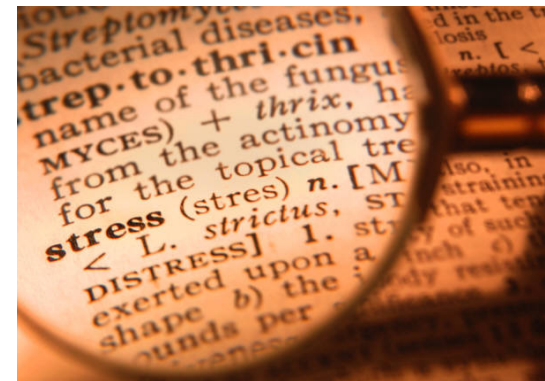
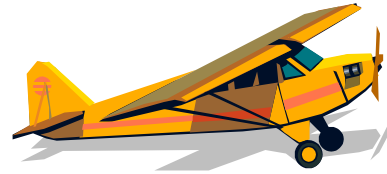
“Scepticism is the chastity of the intellect”

» George Santayana

“I can do it all by myself”

“No one in his right mind would walk into the cockpit of an airplane and try to fly it, or into an operating theatre and open a belly. And yet they think nothing of managing their retirement assets. I’ve done all three, and I’m here to tell you that managing money is, in its most critical elements (the quota of emotional discipline and quantitative ability required) even more demanding than the first two.”

» William Bernstein



Meet the above-average guy,
...most likely to be you!

“Closest to the pin” golf game



Rank	Average distance from pin
Pro's	1.5m (standard deviation 0.5m)
Low-handicap	4m (standard deviation 1.6m)
Mid-handicap	6m (standard deviation 3.0m)
High-handicap	8m (standard deviation 5.0 m)

The game's composition

Average distance from pin = 6.05m

Handicap	% of players	% Players above-average
Pro	10%	100%
Low	20%	78%
Mid	30%	43%
High	40%	28%

Based on simulated results (5,000 iterations) given the game's parameters

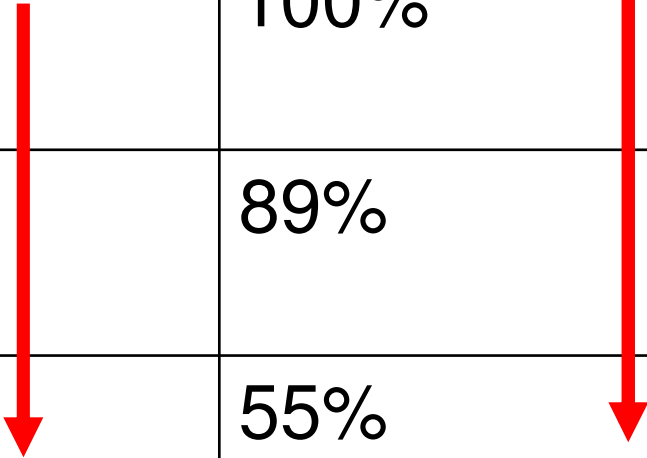
Introducing the “average” option to the game

- Are you likely to play yourself or accepting the average?
- It depends on the % of pro's playing the game
- The more competitive the game, the higher the portion of pro's are playing the game
- Your chances of winning...
- But in highly competitive game even a relatively high percentage of pro's will underperform...
- With the “average option” it means you will have a fair chance of beating the pro's!

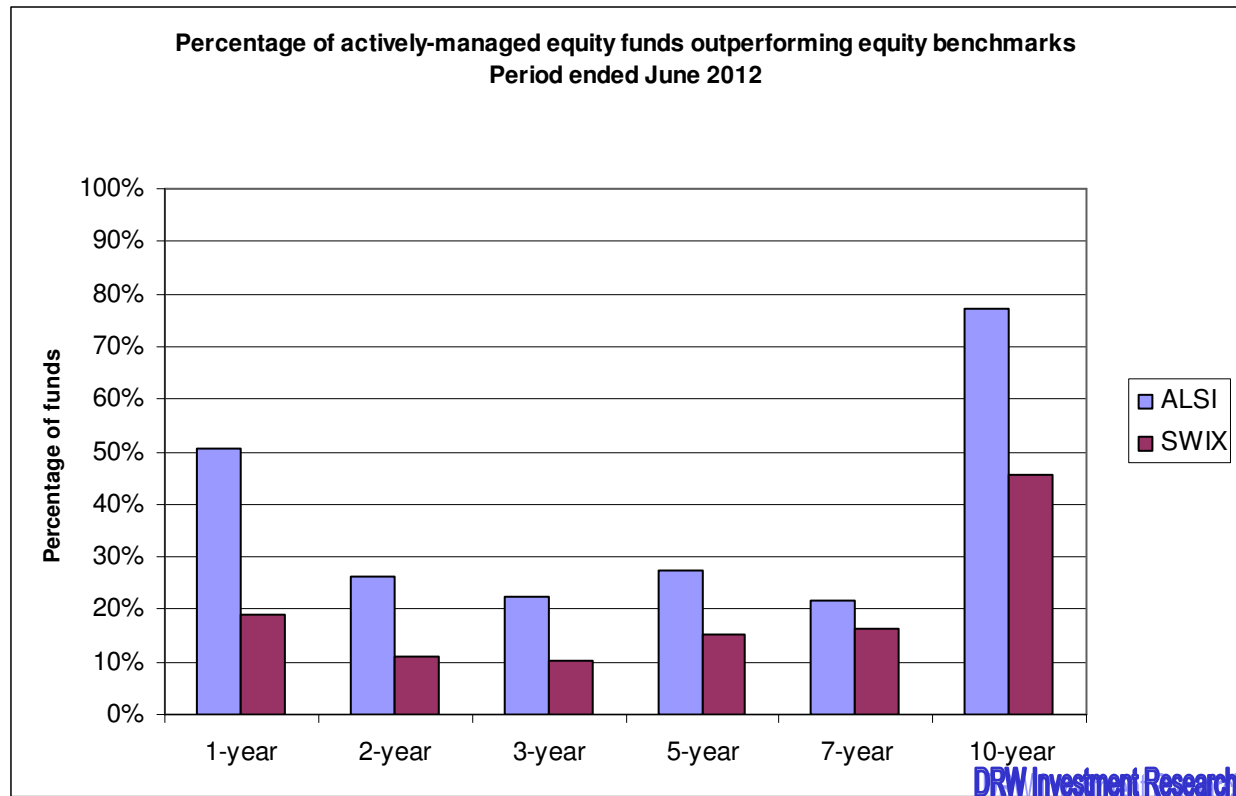
The game's composition

Based on simulated results (5,000 iterations) given the game's parameters

% Pro's playing the game	Average distance from pin (m)	% Pro's above- average
10%	6.05	100%
50%	3.10	89%
90%	1.76	55%



Beating the “average” Equity benchmarks



Skill or Luck?



- Reversion to the mean = the more luck is involved, the faster it will take place...
- Fierce competition = skill converges, luck plays bigger role...
- Social influences = skill not always fairly rewarded...
- Process = improving your process, improving your chances of success...
- Ultimate test for skill: Can you construct on purpose a portfolio of losers?

Stock market returns

Asymmetrical nature of market returns

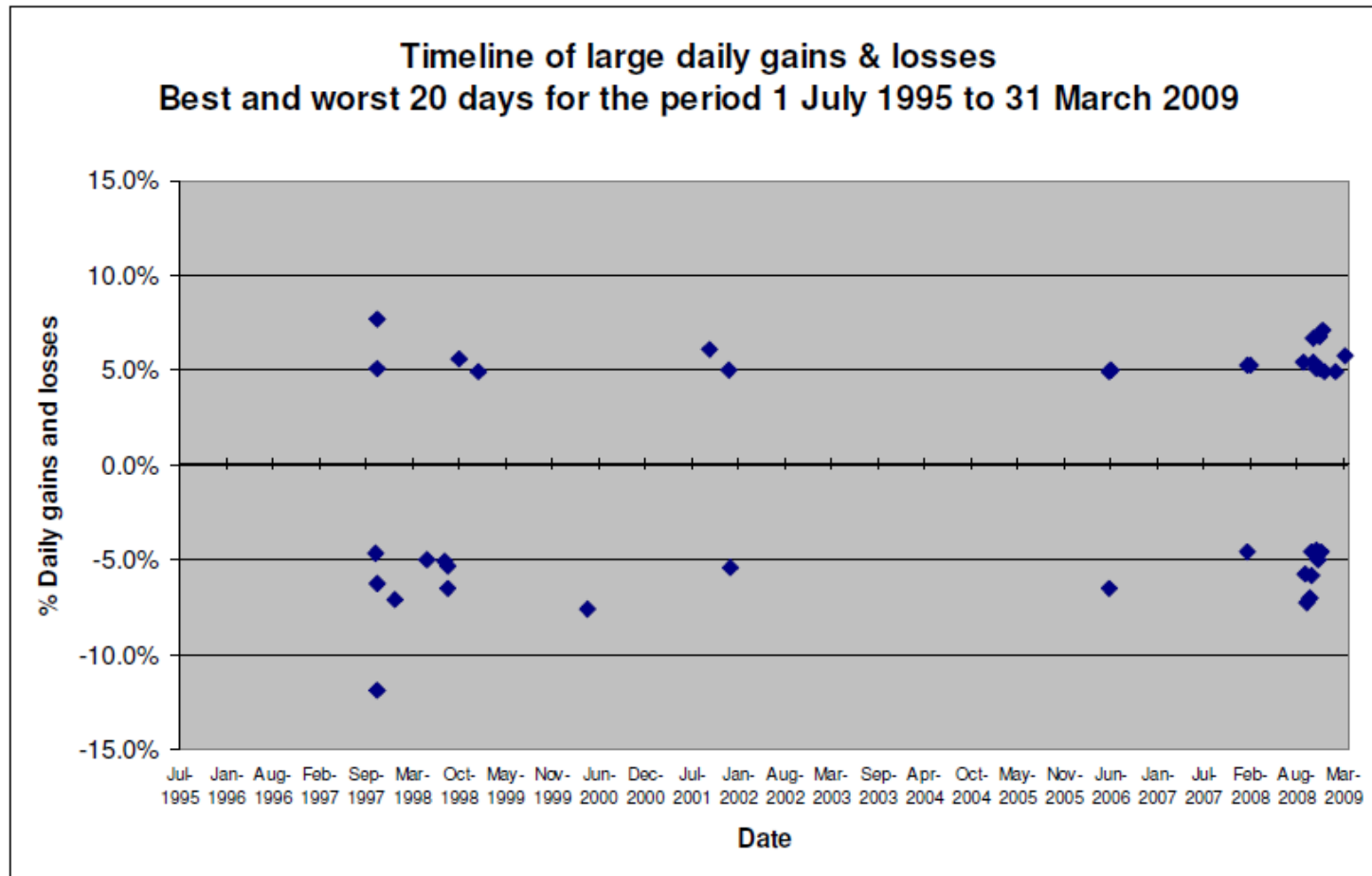
For the period 1 July 1995 – 31 March 2009:

- 3,422 trading days
- Annualised return = **11.5%** (dividends excl)
- Best 20 days > 4.78%
 - Missing the best 20 days = **2.5%** p.a. (div excl)
- Worst 20 days < -4.50%
 - Missing the worst 20 days = **24%** p.a. (div excl)

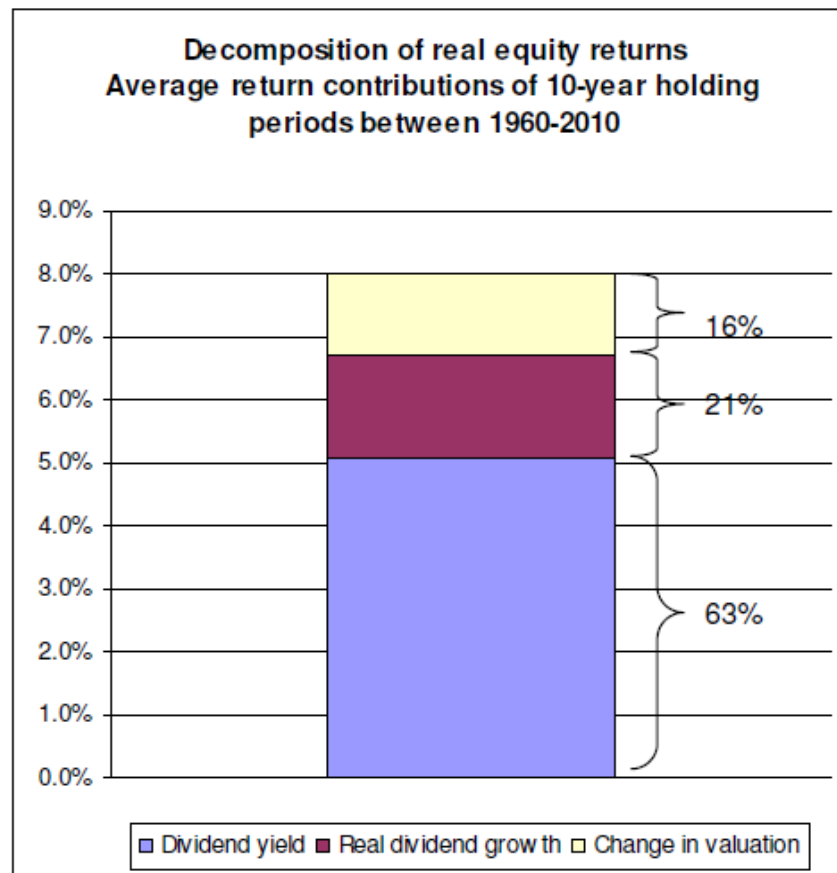
What does “average return” really mean? **Nothing!**

Market timing? **At your own peril**

Is market timing really a plausible idea?



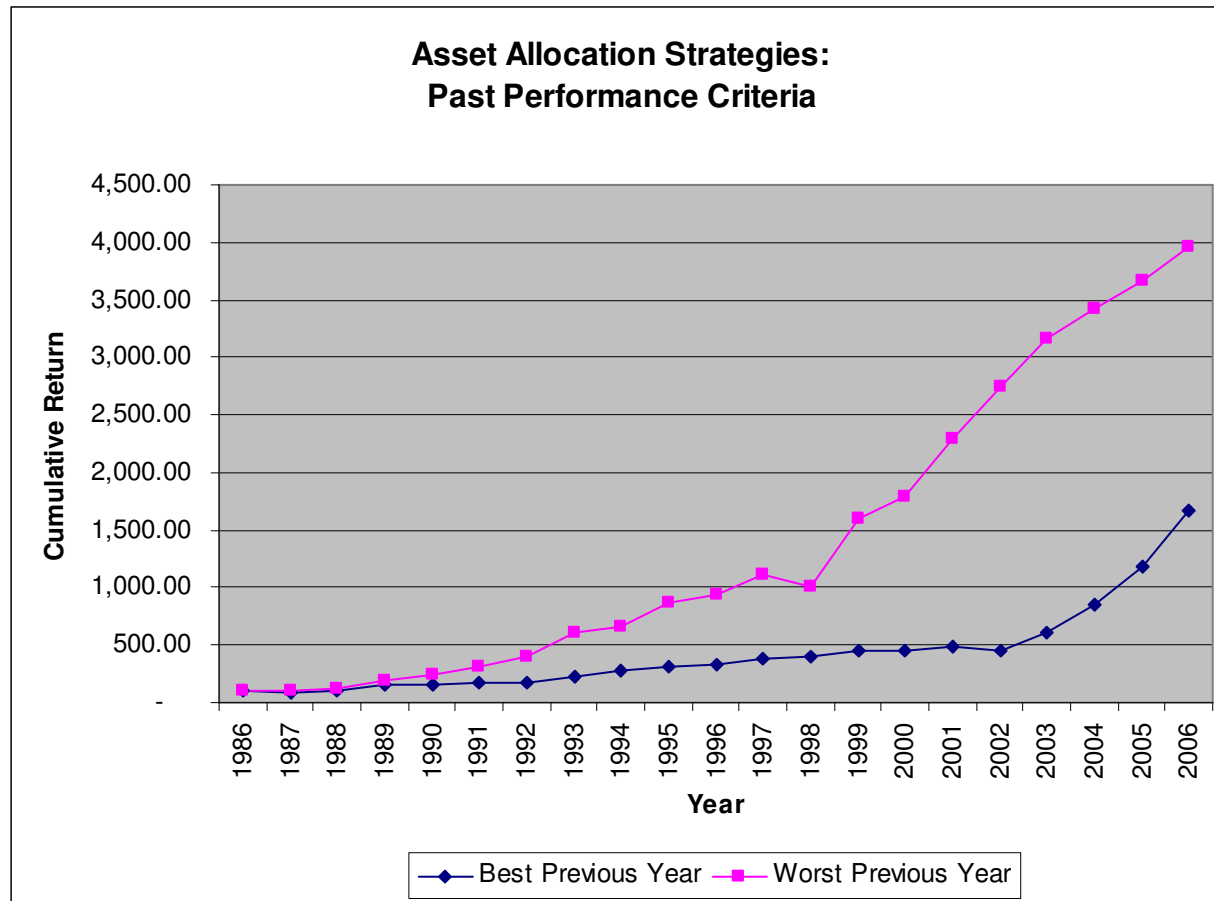
The real source of equity return over time...



Asset class returns

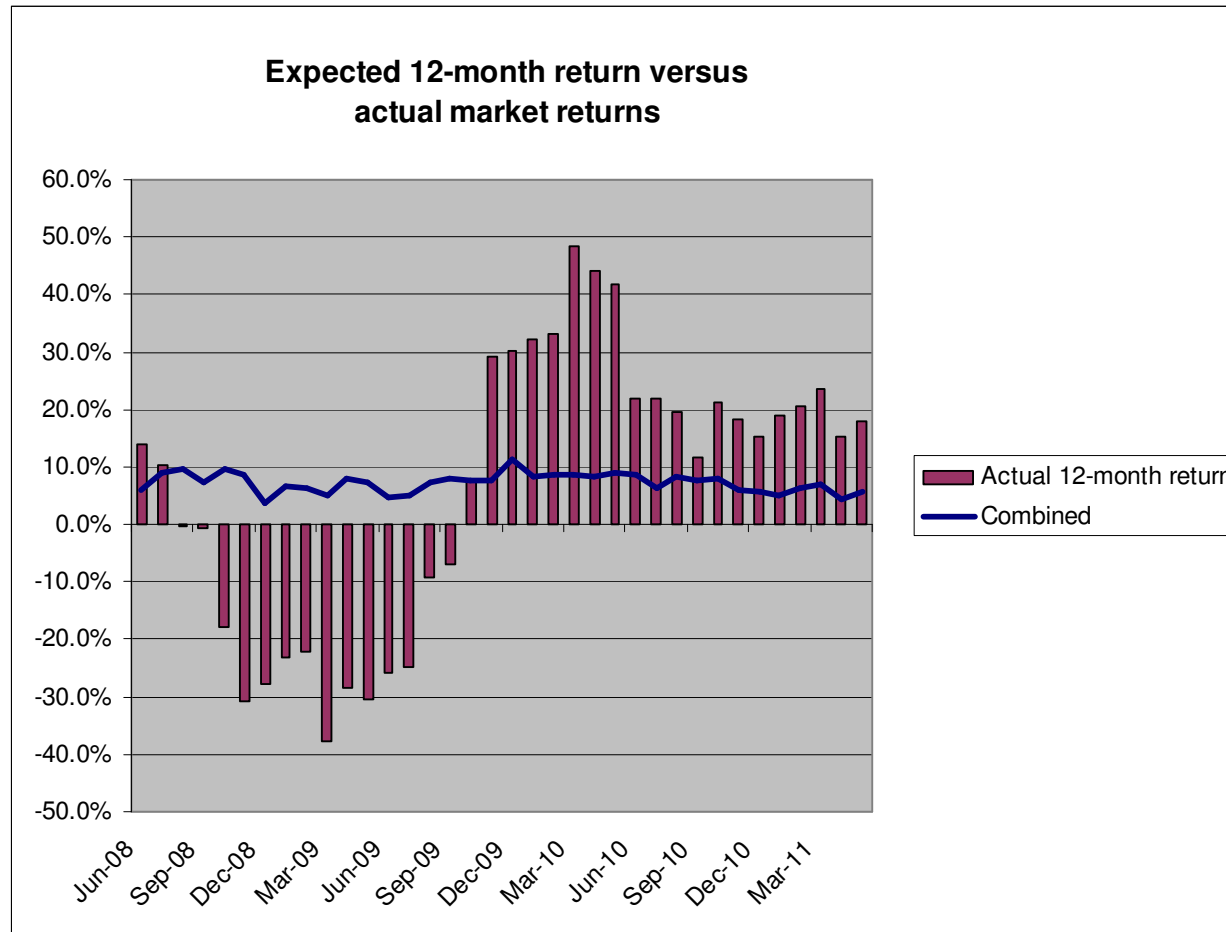
YEAR	BEST	2ND	3RD	WORST
1989	EQUITIES	PROPERTIES	BONDS	CASH
1990	BONDS	CASH	PROPERTIES	EQUITIES
1991	EQUITIES	PROPERTIES	BONDS	CASH
1992	BONDS	CASH	PROPERTIES	EQUITIES
1993	EQUITIES	BONDS	PROPERTIES	CASH
1994	EQUITIES	PROPERTIES	CASH	BONDS
1995	BONDS	CASH	PROPERTIES	EQUITIES
1996	CASH	EQUITIES	BONDS	PROPERTIES
1997	BONDS	CASH	PROPERTIES	EQUITIES
1998	CASH	BONDS	PROPERTIES	EQUITIES
1999	EQUITIES	PROPERTIES	BONDS	CASH
2000	PROPERTIES	BONDS	CASH	EQUITIES
2001	EQUITIES	BONDS	CASH	PROPERTIES
2002	PROPERTIES	BONDS	CASH	EQUITIES
2003	PROPERTIES	BONDS	EQUITIES	CASH
2004	PROPERTIES	EQUITIES	BONDS	CASH
2005	PROPERTIES	EQUITIES	BONDS	CASH
2006	EQUITIES	PROPERTIES	CASH	BONDS
2007	PROPERTIES	EQUITIES	CASH	BONDS
2008	BONDS	CASH	PROPERTIES	EQUITIES
2009	EQUITIES	PROPERTIES	CASH	BONDS
2010	PROPERTIES	EQUITIES	BONDS	CASH
2011	BONDS	PROPERTIES	CASH	EQUITIES

Rear-view mirror investing



Predicting future returns

IBFSA survey among institutional investors and financial advisors



Imagine the future..



- Very similar how we remember the past...
- We remember the key points/features and then fill in the detail by *re-weaving*, and *not retrieving*, of what actually happened in the past.
- Based on the current set of conditions/circumstances
- The narrower (immediate) the time frame, the more complete/detailed.

Understanding performance statistics (what it really means)

- An investment fund with an expected return of 15% p.a. and 12% volatility (standard deviation).

Reviewing your investment:

Annually – 90% of the time positive

Quarterly – 75% of the time positive

Monthly – 60% of the time positive

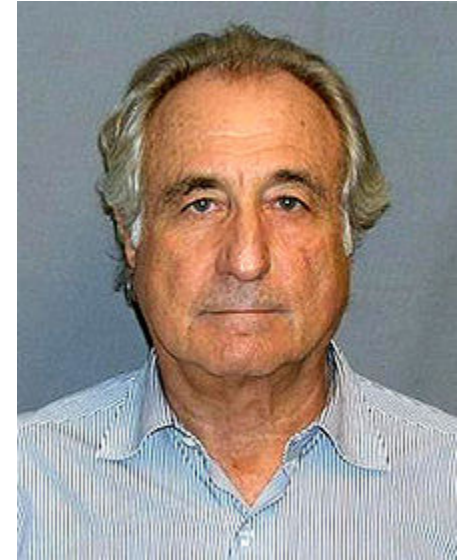
Weekly – 50% of the time positive

**BUT IT IS STILL THE SAME
INVESTMENT!
TIME FRAME!**



Investment scams

- Why do we fall for these scams?
- Situation – social context, exclusivity
- Cognition – lack of knowledge
- Personality – trusting or sceptical nature
- Emotion – fear, protecting wealth
 - » Stephen Greenspan, author of *Annals of Gullibility*, which lost 30% of his retirement assets through the Madoff scheme.



Bernard
Madoff

\$65 billion
fraudster

Buffett's Nine Rules to Investing

1. Know the numbers and what they mean

“You don’t need to be a rocket scientist. Investing is not a game where the guy with the 160 I.Q. beats the guy with the 130 I.Q. Rationality is essential.

2. Invest in products you understand

3. Read widely to value prospects

“Price is what you pay. Value is what you get.”

4. Always maintain a margin of safety

“Rule Number 1: Never lose money. Rule Number 2: Never forget Rule Number 1.”

“Look at stock market fluctuations as your friend rather than your enemy – profit from folly rather than participate in it.”

Buffett's Nine Rules

5. *Become a fanatic about investment*

6. *Avoid buying "popular" stocks*

7. *The secret of compound interest*

8. *Know when to invest*

"...but we know that the less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs."

9. *Never run with the street pack*

"Risk comes from not knowing what you are doing."

"Never ask the barber if you need a haircut."

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