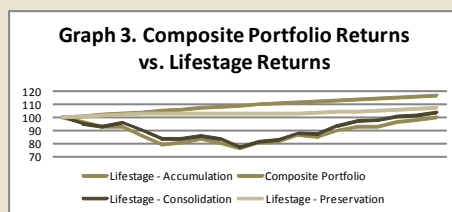
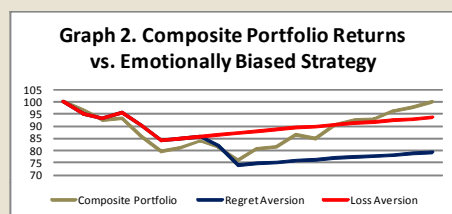
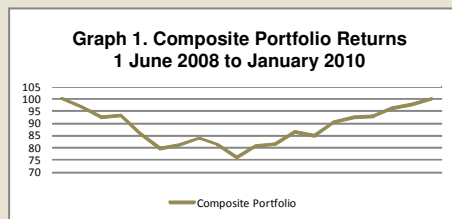


“Short-term investment strategies in the face of extreme volatility - especially in the hands of members - are likely to destroy value. An analysis of the performance of a typical Lifestage investment provides compelling evidence for such a strategy”



The Power of Lifestage Investing

The force of the recent financial crisis was particularly worrying for retirement investors who, in some cases, witnessed incredible losses on savings that had taken years to accumulate within a few months. This highlights two very relevant problems for members – the short-term volatility of the market and optimal strategies to limit this obvious risk.

We go back to the start of the crisis and explore a number of strategies with the aim of showing how some of those led to eroded value while others protected retirement savings. In particular, we look at the positive effect of a Lifestage strategy over the period in question in contrast to a member choice scenario where members actively switch portfolios.

Investors, Uncertainty and Emotion

In the face of partial information, members tend to exhibit a number of psychological biases which have been studied by behavioural economists. The phenomenon, called ‘loss aversion’ was first defended by the psychologists Kahneman and Tversky when their investigations led them to quantify investors’ losses as approximately twice as painful as their gains. Loss-averse investors are likely to hold onto loss-making investments for too long and sell profitable investments too quickly. For example, when an investment starts to make a profit, a loss-averse investor will sell it to lock in the gains that have been made and invest conservatively to protect these profits. This behaviour is primarily driven by a fear of losing the positive returns that have been made.

Regret Aversion

This is yet another emotional bias that is characterised by disappointment in the face of past decisions. Typically, the regret-averse investor does not change their investment strategy as the fear of making the wrong choice, in retrospect, is very strong. Such investors are characteristically indecisive.

In the face of market turmoil, these investors would deeply regret having taken money out of a guaranteed investment for example and investing it in equities. The exact opposite would apply when markets rally.

Behavioural Biases in Action

Given the description of the two biases in question, we proceed to explore their effect on returns in the face of the high

volatility exemplified by the recent financial crisis.

We make the very realistic assumption from the outset that no investor can time the market. Next, we consider the returns on a composite portfolio with an equity, bond and cash allocation of 70%, 20% and 10% respectively from 1 June 2008 to 1 January 2009 (plotted in Graph 1).

In Graph 2, we consider the returns of loss-averse investors who persistently or frequently “sell low and buy high”, seeking to limit loss. We also consider the case of a regret-averse investor who remained invested in loss-making equities for too long.

Lastly, we consider the respective returns for members with different risk profiles who invested in a Lifestage programme. We consider typical investment returns for members with 7+ years, 3-6 years and less than two years to retirement. We superimpose these returns on the original composite portfolio returns in Graph 3.

Conclusion

Graph 1 illustrates considerable volatility in the market over the analysis period.

Graph 2 shows that when switching between asset classes frequently, value is undoubtedly destroyed in comparison with the first. Likewise, the member who was too afraid to switch early is punished heavily as several months of equity loss convinces them to move to the security of cash. What is interesting is that the members invested in a typical, risk-appropriate Lifestage portfolio have emerged from the crisis ahead of the composite portfolio. Lifestage investing characteristically removes emotional risk from investment decisions and focuses on investing appropriately based on members’ durations to retirement with little intervention required by the member. In our case, this strategy has created value and has outperformed a biased investor by as much as 33%.

Importantly, Graph 3 indicates that members 7+ years from retirement survived the market turbulence with no requirement for emotive decision making.

In our view this is a further compelling argument for funds to adopt a lifestage strategy, preferably as a default.

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