GRAYISSUE

Use your head not your heart and think long term

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A key step when planning your investment is choosing the right unit trust based on your risk profile and priorities and then staying invested to reap the benefits of the investment manager's expertise. In order to do this, however, you need to:

1. Be clear on your investment objectives
2. Understand the objectives of the fund you choose and make sure they match your own
3. Understand how the investment manager aims to achieve the fund's objectives and how the fund is likely to behave over time

A well-planned investment strategy will help you remain focused on your long-term objectives, which means you are less likely to react to short-term market movements, giving your investment time to grow. However, many investors with very well thought-out investment strategies, forget to consider the universal human blind spot – emotion.

Reward-seeking and loss-avoiding behaviour often influences investment decisions. Some investors tend to wait for 'price confirmations' (or enough of a positive movement to reassure them that they won't get burnt by an unexpected downturn) before investing. Others flee the market as soon as prices dip. Of course, waiting for price confirmations could mean missing out on much of the positive price moves, while exiting at the wrong time locks in losses.

Emotion robs investors of returns

A good example of this is the investment behaviour apparent in many Allan Gray Stable Fund investors over the last two years to the end of September 2011. Over this period the Stable Fund delivered cumulative returns of 17.2%. The Fund's objective is to provide a high degree of capital stability and to minimise the risk of loss over any two-year period, while producing long-term returns that are superior to bank deposits on an after-tax basis. Despite the Fund delivering on its objective, when its short-term performance fell relative to other funds in the sector, many investors switched into other funds or withdrew their money.

Although it is understandable that this underperformance would have concerned investors, depending on both when they switched and the funds they switched into, these investors were likely to have done worse than investors who remained invested for the full two-year period.

Illustrating how investors tend to respond to recent return history, the Fund experienced outflows from February 2010 when its short-term returns diverged from the sector average. At this time, mindful of the Fund's capital preservation objectives, the Fund's net equity exposure was progressively reduced, reflecting our view that shares were expensive. This meant that the Stable Fund's asset allocation was very different from most funds in the sector. By the end of October 2010 the Stable Fund's one-year ranking had dropped to last in the sector, alarming many investors.

Remain focused on your objectives

The Fund's defensive positioning has since resulted in it delivering performance in excess of other funds in the sector. While there is no guarantee that this outperformance will continue, disciplined investors should benefit from the Fund achieving its objectives over the longer term.

Such discipline can seem easy when your investment is performing well but can be difficult to maintain when the going gets tough. When investor behaviour is driven by biases such as favouring recent performance over long-term performance, or reacting fearfully after a decline, investors end up buying and selling at the wrong time and thus fail to achieve all the returns of the funds they are invested in.

Although some investors may have benefited from switching out of the Stable Fund early and switching into a top-performing fund, our analysis shows that more than 80% of those who switched did so after the Fund underperformed in February 2010. Investors who switched into a fund which performed in line with the sector average during this two-year period may have experienced significantly less overall returns, as shown in **Table 1**, which uses three specific months to illustrate this point.

This example highlights the role emotions play in decision making. Once you have chosen an investment, your ability to make the most of it depends on whether you are able to remain committed for long enough to benefit from the potential returns, ride out the inevitable short-term ups and downs and allow the power of compound interest to increase the value of your money.

These steps may sound simple enough, but the gap between fund returns and investor returns shows that most of us find it difficult to put them into action. An independent financial adviser can assist you in formulating an investment strategy and help you to remain disciplined when your emotions are encouraging you to do otherwise.

Table 1 | Returns from the average fund in the sector versus the Allan Gray Stable Fund over two years

Month	October 2010	November 2010	December 2010
% of total number of investors who switched	6.2%	8.4%	5.5%
Difference in cumulative return compared to an investor in the Allan Gray Stable Fund throughout	-7.8%	-6.6%	-8.4%

Source: Allan Gray research

Commentary by Jeanette Marais, Director of distribution and client services, Allan Gray.