Insights, Tacit Thought | Weekly Investment Insights

Anxiety is rife, but investing still pays

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We regularly review the principles which underpin our investment approach, and as long-term objective-based investors, we must be cognisant of the dangers of recency bias in our decision making.

In behavioural economics, recency bias (also known as availability bias) is the tendency for people to overweight new information or events without considering the objective probabilities of those events over the long run.

Recency bias matters for the financial markets, as memory of recent market news or events can lead investors to irrationally believe that a similar event is more likely to occur again than its objective probability.

As a result, investors may make decisions to sell into bear markets, or buy into bubbles, since crashes and bubbles can be salient in the minds of individuals as they occur, and can be difficult to counteract because it plays on powerful human emotions of fear and greed.

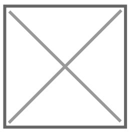
For investors, the best way to combat recency bias is to have an investment strategy and stick with it, regardless of short-term market volatility. Of course, this is often easier said than done, as people may become overwhelmed with the impulse to take some action based on current events.

The past three years have been a challenging environment for financial markets and we believe investors must be mindful of the influence of recency bias now, especially for risk averse clients, who are attracted to the safety of holding larger proportions of their wealth in cash.

Understandably, after a period of rising bank interest rates, current rates from cash deposits seem attractive over the short-term. Investment returns however are not delivered in a straight line and bank interest rates do not stay static.

Realised UK inflation has averaged over 4% per annum over the longer term (source: Barclays Equity Gilt Study data), and therefore this is the minimum return an investor needs to generate on average, after costs and taxes, to preserve their real purchasing power in the UK. A relatively short period of very high inflation has not broken this relationship.

As an example, the chart below shows the returns generated by our Real Return strategy over the past five years alongside the returns from cash deposits.



It is no surprise that the two periods of maximum anxiety when market returns where negative in 2023 were the ultimate test for investors as market returns were poor and bank cash rates were around 5%. A year later and things have changed materially.

There is no hiding from the fact that the past five years have generated poor absolute for real investment returns for UK investors in lower risk strategies. This is not always the case however and given time, investing in higher risk assets, such as equities significantly outperforms cash returns over the longer-term. The 10 year chart of the same strategy (below) illustrates this point very starkly.

The fact is that most investors need to invest. Patience and composure will pay out in the end. They always have.

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