INSIGHT

THE GREATEST WEALTH IS **YOUR PEACE OF MIND...**

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Beware of the recent past!

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Being an investor is not easy. You have to contend not only with the unpredictable short-term nature of markets but also the sometimes irrational way in which you will be tempted to think and behave. Benjamin Graham, one of the great investment minds of the twentieth century, famously stated:

> *The investor's chief problem – and even his worst enemy – is likely to be himself.*
>
> Graham and Dodd, 1996

One of the key behavioural biases that we suffer from is recency bias, which is nicely defined in the following quote:

> *Recency bias is the tendency to place too much emphasis on experiences that are freshest in your memory—even if they are not the most relevant or reliable. Would you want to go for a long ocean swim after watching Jaws? Probably not, even though the actual risk of being attacked by a shark is infinitesimally small.*
>
> Charles Schwab Asset Management

Recency bias manifests itself in investment behaviours like chasing markets, sectors or fund managers that have just performed well over a short-term timeframe, such as one to three years. Such performance data include a great deal of noise and provide little useful input into portfolio construction decisions.

It often tempts us to behave against our best interests. For example, over the past few years, the US market - more specifically US growth stocks - and, of late, the 'Magnificent' seven (Microsoft. Apple etc.) have significantly outperformed most other asset classes. Almost anything you owned outside of these assets detracted from relative performance. According to a recent piece of research, over the past 10 years the US market – as defined by the S&P 500 index - has delivered around 12% above cash, per year, which is in the top 10% of all 10-year outcomes since 1950[1], whilst the mean 10-year return above cash has been around 7% p.a. For US equities to deliver a similarly spectacular outcome over the next decade, extremely strong earnings growth and a further increase in the multiples that investors are willing to pay for them, are required. That is not impossible, but it is not enough to make a decision to overweight US equities in a portfolio.

Long-run market returns provide useful insight

On the other hand, long-term market returns do provide us with some useful, generalised indications of the types of returns patient investors might expect to gather over time, providing a basis on which to build a sensibly constructed, forward-looking portfolio. The long-term market data suggest that global equities have delivered around 5.1% per year above inflation – on average – since 1900, bonds around 1.5% and cash around 0.4%[2]. Given the limited number of data points that we have to hand – even though 123 years sounds like a long time - statistically we can only really be relatively sure that mean equity returns fall within the range of around 2% to 8%!

The tough challenge that investors face is to build portfolios that provide them with the greatest chance of a successful (or at least survivable) investment portfolio in the future, whatever investment storms they suffer and the ability to make hay when the investment sun shines. As Nicolas Taleb – a deep thinker and author on markets stated:

> *One cannot judge a performance in any given field (war, politics, medicine, investments) by the results, but by the costs of the alternative*
>
> *(i.e. if history played out in a different way).*
>
> Nassim Nicholas Taleb - Fooled by Randomness

No-one knows what the ‘best’ combination of assets will be in the next ten or twenty years, but it is unlikely to be the assets, styles, sectors or companies that are the most recent success stories in our recency-bias prone minds. Using long-term data insights provides a good starting point, whereas investing using the rear view mirror is unlikely to help. If the core of your portfolio has a broad exposure to the global markets it will include all of the recently stellar performing asset classes, markets, sectors, and stocks to some extent.

Be happy with that.

Don’t go there

Being swayed by recent performance is probably one of the most wealth destroying activities in investing, both on account of poor choices and timing decisions and the costs of buying and selling. As the late Charlie Munger once said:

> *The big money is not in the buying and selling, but in the waiting.*
>
> Charlie Munger, Berkshire Hathaway

End notes.

1.
AQR (2023), Driving with the Rear-View Mirror. Will we see a repeat of the past decade of U.S. equity returns? www.aqr.com

2.
In USD terms to 2022. Dimson, Marsh and Staunton, Credit Suisse Global Investment Returns Yearbook 2023, Credit Suisse Research Institute © All rights reserved.

Other notes and risk warnings

Use of Morningstar Direct© data

Risk warnings

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