Is your risk perception getting in the way of your investment success?

05 November 2020: Many investors choose to change their risk exposure during market uncertainty because their perception of risk has changed. But decisions made in a moment of heightened risk perception can be detrimental to achieving investment goals.

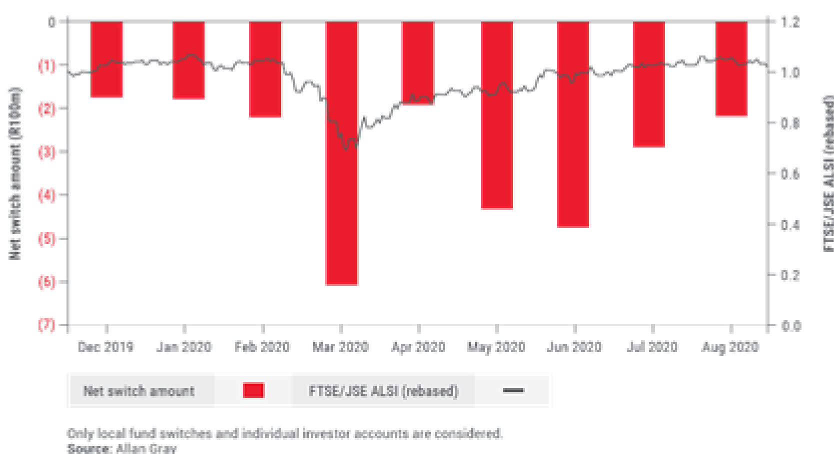
“This is because risk perception is our momentary, emotional sense of how much danger we are facing. It is not an objective assessment of risk, but incorporates the psychological aspects of the investor, and results in decisions being made based on *perceived* rather than *actual* risk,” explains Marise Bester, retail distribution specialist at Allan Gray.

A study conducted on the 2007-2008 global financial crisis by FinaMetrica showed that investors’ risk tolerance hardly changed; what changed dramatically, was investors’ perception of risk. 74% of the investors surveyed viewed the market as more risky after the crisis than before.

“Similarly, investors’ perception of risk changed as a result of the current pandemic, with investors on the Allan Gray platform having decreased their equity exposure during the market drawdown, which is a strikingly similar trend to that during the 2007-2008 global financial crisis,” says Bester.

As seen in Graph 1, high-equity funds experienced their highest net switch outflows in March 2020, when the FTSE/JSE All Share Index (ALSI) was at its lowest, fear was at its highest, and investors were scrambling to exit this volatile asset class. Investors continued this behaviour from April onwards, despite the ALSI showing strong signs of recovery.

Graph 1: Switches out of high-equity funds on the Allan Gray Local Investment Platform (Dec 2019 – Aug 2020)



“In hindsight, this behaviour seems completely irrational, yet at the time, investors acted on the heightened risk they felt they faced, perhaps expecting it to persist indefinitely.”

How to manage perceived risk

Bester suggests several ways to ensure that risk misperception does not lead to actions that could be detrimental to your investment outcome.

- **Be the driver of your investment, not a passenger**
  Spend time researching your investment and make sure you understand your options when you experience inevitable market volatility.

  A study on airline pilot decision-making has shown that accidents attributable to pilot behaviour are generally due to a misdiagnosis of the risk (i.e. risk perception), rather than an overly high tolerance for risk. These accidents are prevented by improved pilot education regarding risk identification and management.

  The same principle applies to investment behaviour. A financial adviser can play a crucial role in providing expert insight, support and direction.
- **Assess the probability of loss realistically**
  The likelihood of losing money is one of the most important drivers of perceived risk. Overestimating the probability or the extent of investment losses during market turbulence by looking at short-term risk and return measures can lead you astray.

  To obtain a realistic view, put current events, and your associated discomfort, into perspective by looking at how your chosen fund(s) have responded to similar events over the long term.

- **Accept that risk and volatility are necessary**
  To earn real returns, you need to take on some risk, which introduces volatility. The longer you remain invested, the better your chances of achieving real returns.

- **Follow your head, not your heart**
  Bester says it is unlikely that your risk tolerance will collapse or change drastically during market volatility. Instead, the more likely Achilles heel to be managed is risk perception.

  "We can positively influence our risk perception through deliberate efforts like awareness about our investment and risk management.

"If you find yourself on the verge of making a panicked decision to safeguard your investment, reflect on whether your personal circumstances, investment goals or time horizon have changed. If not, the best course of action might just be to do nothing at all," concludes Bester, adding that you should also consider talking to a good, independent financial adviser for direction.

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