Investor behaviour risky

Money Matters

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"Smart money" is used to describe institutional or professional investors, by default that makes the rest of us the "not so smart money".

What seems to distinguish the "smart" from the "not so smart" is the degree of emotional influence on decision making, particularly when it comes to understanding risk.

I vividly recall taking a client to an investment feedback presentation at which the manager referred to a recent loss as "only numbers". Needless to say the loss suffered by the client was not only numbers to him, but his hard earned cash going down the drain.

Of course what the manager was trying to say is that the loss was only temporary as a result of a fall in prices, which would recover given time; versus permanent loss of capital when you money is really gone.

When measuring risk the financial services industry confuses investors by treating temporary and permanent loss as one and the same. Surely risk refers to the probability of permanently losing your money and not a temporary drop in prices.

If that is so then a person could argue that a diversified share portfolio is risk free. I can just imagine the Regulator having a coronary reading this, but it all depends on how you define risk and, of course, the price you paid, which is the real risk and why we spend so much time debating the value of markets.

There are really only three ways to lose your money:

- ponzi scheme: I am sure most readers are familiar with this term;
- pay too much for a share; you get price and you get value, and very often these two disconnect from each other, with the market price either well above or below the underlying intrinsic value, if you overpay you will lose your money; and
- invest in a business, which goes bankrupt, which is why it makes sense to invest in a diversified portfolio of shares and never a single share.

Unfortunately, many investors lose their money through selling or switching during periods of temporary loss when influenced by their emotions, which is why the financial services industry wrongly defines risk as volatility of return, when it is the investor's behaviour that is the risk.

Irrational investor behaviour is a very real risk, so be honest with yourself and your advisor when determining your risk/return budget.
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