Michael Barr & Co. Ltd

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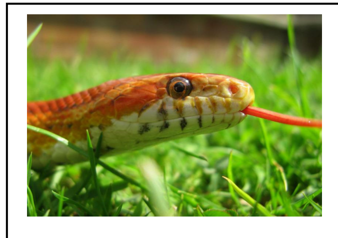
Money and investment behaviour

...deer or snake risk?



Inside-
National Savings exploit investor's fears

Your money and Your Brain

Is your brain matched to your investment behaviour?

The relatively new field of behavioural finance is discovering that money and the best of our brainpower is not always well matched.

In a recently published book, Your Money and Your Brain, Jason Zweig poses a couple of questions with no clear connection to investing. First, he asks which animal is responsible for the greatest number of human deaths each year in the United States: alligator, bear, deer, shark or snake? Next, Zweig asks the reader to match three causes of death – war, suicide and murder – with three numbers of annual worldwide fatalities: 310,000, 815,000 and 520,000.

No sharp teeth or claws

The answer to the first question is the deer. In a typical year, Bambi accounts for 130 times more deaths than the other four put together. Why? Although the deer has no sharp teeth or claws, it has the dangerous tendency to leap in front of people's cars.

In answer to the second question, the three numbers are actually in the right order. In most years, suicide totals are about the same as the total deaths from wars and murder put together.

If you are surprised by these two answers it is because, like most investors, you have judged the chances of an event happening based on that which you find the easiest to imagine. For most people, it's easier to think about another person dying violently than to imagine suicide, so deaths from war and murder top their own list.

Stock market crashes

We make similar mistakes with investments. It seems that every investor's worst nightmare is a stock market crash, and we tend to massively over-estimate the likelihood of one, particularly when the news we read feeds our fears. History shows that big falls of a third or more over the course of a year happen only about one in 50 years (2% of the time). However, a much bigger danger is that of inflation eating away at our savings, but a relatively small number of us worry about running out of money in later life.

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Steering away from danger

So, by focussing on the easy-to-visualise fear of an unlikely event (a stock market crash), most people overlook the much greater risk of the sure but unremarkable attack on their wealth posed by inflation.

...Our investing brain often has no logical sense ...

So for most of our daily life functions (breathing is a useful one!), our brains are superbly functioning machines, capable of instantly steering you away from danger while naturally guiding us to the basic rewards of life like food, shelter and love.

Unfortunately for us that brilliant brain will unwittingly lead us in the wrong direction when you are up against the challenges that the financial markets throw at us. Our investing brains often take us in a direction that has no logical sense but which can make sense when only our emotions are considered.

We go for what we *feel* is likely to be rewarding and turn our back on a course of action that *feels* risky. This results in our actions having the opposite effect from that which we were trying to achieve – we behave in a way that destroys wealth.

Investments we regret

We have observed that one of the greatest contributors to investment mistakes is our fear of regret. It is why new clients often decline the opportunity to dump poorly performing shares and funds. This is backed up by one analysis of 450,000 trades in 8,000 accounts at a discount brokerage which found that more than a fifth of investors had never sold a single share that had dropped in price.

As Daniel Kahneman, a Princeton university psychologist, said: "When you sell a loser, you don't just take a financial loss, you take a psychological loss from admitting you made a mistake."

If you recognise yourself in any of this, remember that your investments and your brain are not always in harmony, and you are in a fight with your emotions. The actions that are required for good investing - buy and hold, diversify, and rebalancing - at times are difficult disciplines but they always work, and give you the best chance of beating the long term danger of inflation.

National savings exploit investor's fears

Sometimes it can be second class only

... you are set to miss over 20% by not receiving any dividends ...

We have studied the latest guaranteed equity bond from National Savings & Investments. It's a five-year investment plan offering "growth potential linked to the FTSE 100 index".

Clients will know we have no affection for these guaranteed products. They appeal to our fears of stock market crashes, and with stock markets down this year we are sure we will see more and more of these products appear. So what is the problem?

This is issue 15 for National Savings and they have had great success collecting money with the previous issues. The reason is simple – the safety of your capital combined with stock market investing.

You put your money in for five years and at the end of that time you receive any growth in the FTSE 100 index (capped at 75% in this instance) but, and this is the main selling point, you are protected against stock market falls.

For a very few investors they may make sense, but once educated, they are far from ideal investments.

No dividends

A very big downside is that you miss out on all the dividends that are paid out by the stocks in the FTSE 100 index. The index only tracks share prices so it does not measure the market's total return. At the moment the average dividend is over 4%, so multiply this over five years and you are set to miss over 20% by not receiving any dividends. This represents a hidden charge of 4% a year which is very high when you consider traditional funds charge 1.5% and our recommended funds charging less than 0.5%.

This vital fact is not explained in the literature promoting the product. Certainly there is no explicit mention of these charges, although National Savings says the bond may not be appropriate for you if you "want to earn dividends by investing directly in shares or unit trusts". A bit circumspect when you are losing 20%!

Locked in

Unlike most investment funds you have no access to your investment at short notice. Although stock market investment is for the longer term what if you do need to cash in? The Guaranteed equity bonds do not give you this option.

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Death is no escape

What if you die within the five years, obviously not a planned event, but always a possibility? Well, this does not get you out. Your estate can either pass the bond on to somebody else, and it will continue until it matures, or your estate gets your initial investment back plus interest of just 1% a year! Bit naughty isn't it?

After five years you then have to take the maturity value. And, if the market is poor at this time, it is the wrong time to sell because you will miss the eventual recovery.

Averaging returns

There are a couple of other ideas with the product that make the guarantee to seem better than it is, and examination of the detail exposes the tricks used.

The end value of the FTSE 100 index is averaged over the last six months. Although this protects you against any last minute falls, it shortens the amount of time you have to make any gains.

Is the guarantee worthwhile?

Guaranteed bond holders have the comfort of knowing they will not lose any original capital, but what is this protection worth?

Well, the instances of any substantial fall in the stock market over five years are more unusual than you might think, once you take dividends into account. Over the last 80 years, there have been only seven (five-year) periods when you would have lost money, and during only two of these would you have lost more than 10%.

Also, because of our 'wrong behaviours' during market downturns, people tend to invest more money in these bonds after stock market falls. After these falls the chances of further heavy falls over the next five years are less.

Therefore the chances of the capital guarantee being of any significant value are quite small.

Reduced profits

If the market is good there is a cap on your maximum return. This limits the profit to a maximum of 75% of the original investment. This limit on the profit would have seen you miss out 27 times in the last 80 years - one in three times. So the capping of returns is far, far more likely to be the biggest factor rather than the capital guarantee.

Guaranteed equity bonds are not the worst financial product you can buy, but the way they are marketed, by playing on people's ignorance about stock market performance, dividends and tax, are a good example of how the financial services industry takes its customers for granted.

Guaranteed Bonds - too much tax to pay

The tax treatment of these bonds can be like a kick in the teeth. The profits are classed as income and they are taxed in the year of maturity rather than being spread over five. For some people this may push them into higher rates of tax.

With a normal investment, any capital gain is taxed at the new low rate of 18% and only once you have exceeded the annual exemption limit (£9,600 at the moment and possibly nearer £12,000 in five years' time).

Also, you would only pay further tax on your dividends if you were a higher rate taxpayer.

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