Galileo Quarterly Newsletter

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GENERAL NEWS & INFORMATION

Behavioural Finance and irrational investors

Introduction
Why do so many clever people regularly make repeated errors with their investments? Investing can be tricky, and all too often private investors might find themselves behaving like our investor in Figure 1 below. Beyond being plagued by indecisiveness, a lack of time, certain experiences and restricted information, our investor is driven by his own emotions and biases.

Fig. 1: Stock market development 1992-2007
Clever people make severe investment errors

Graph by UBS Private Bank

In the world of investing, we are supposed to act in a rational manner and only make financial decisions that make rational economic sense.

Modern Portfolio Theory

Modern Portfolio Theory (MPT) was introduced in 1952 and provides the groundwork according to which most modern investment portfolios are constructed. MPT assumes that all investors only make rational investment decisions. The problem with MPT is that we have noticed repeated evidence of irrational investment decisions by investors over the last 55 years since MPT was developed.

Irrational markets & investors

Stock market bubbles are an example of irrational investment behaviour by many people at one time as the majority of investors continue to buy even when they know that shares are significantly overvalued. Unfortunately irrational behaviour is not limited to large groups, we also see individual investors consistently making poor decisions that negatively affect their portfolio returns. Surprisingly, investors seem to lack rationality in very systematic ways. A simple example of this is that investors' expectations follow past performance. Strong returns in the equity markets over a 12 month period usually act as a catalyst for positive future market expectations. This strongly contrasts with the economic reality that periods of high returns result in less favourable valuations and subsequently lower returns in the following periods.

Behavioural Finance

Behavioural Finance is the field of research that combines insights both from psychology and economic theory in an attempt to understand this systematic irrational behaviour. It is clear that irrational investment behaviour are partially caused by behavioural biases. Some examples of these biases are listed below by way of explanation. Researchers are now attempting to understand exactly how behavioural biases influence financial decision-making so that the effect of behavioural biases on market prices and portfolio returns can be evaluated. Once we understand how these biases affect our decision-making we can take steps to mitigate or avoid negative effects on our investments. In fact, the results of behavioural research have shown that the first step in avoiding investment mistakes based on behavioural biases is to know of the existence of these biases and to understand how they work.

Typical Behavioural Biases to avoid

Groups: The people around us tend to affect our judgment; an example of which is called `groupthink´ where the thinking within a group of people is aligned. The mere fact that a group of people form a common theory does not mean that they are correct. This means that individual investors could be making irrational investors on the basis of a widely held opinion, which is wrong. `Herding behaviour', is when investors make decisions, without applying their minds and only copy what others are doing.

Pride and regret: These are very human characteristics that often explain why our investment decisions are not always in our best interests. A typical example is when we cannot admit to making a bad investment decision and therefore decide to "ride it out." Another example is when we decide to hold a bad investment until it has made up the losses at which point we will sell the investment. There is no logic to this thought process as we should be deciding where the best returns will be generated in future because past investment prices are not relevant in this instance.

Risk: Another situation in which we tend to harm ourselves is when we face risky decisions. When private investors face losses they are particularly prone to taking additional, excessive risk in an attempt to recover the losses.

Overconfidence: A frequent trait of individual investors is overconfidence: the belief of `knowing´ what will happen, or even just the belief of being more familiar with investment details, and more knowledgeable than they actually are. These investors risk suffering from reduced returns, through unexpected shortcomings in their judgments.

Research supplied by UBS Private Bank

DIRECT VS. BROKER INSURANCE – Is there really a difference?

We recently did some research on the short term insurance market to see if there really was a price difference between direct insurers and traditional insurers who work through brokers. Our own experience is that direct insurers are often not cheaper than traditional insurers, despite their advertising to the contrary. We wanted a proper price comparison to see who was the cheapest and whether there were any conditions attached to the lowest price providers. To make the comparison fair, we used the same set of information to obtain a quote from all the insurers in our survey. We tried to make the survey representative by using the largest traditional insurer i.e. Mutual & Federal, a large direct insurer, a specialist underwriter who sells via brokers and direct to clients and we used a small specialist insurer who focuses on the high net worth market in South Africa.

Our sample individual lives in a reasonably priced home in the Northern suburbs of Johannesburg and drives a reasonably priced vehicle. The insurance premium comparisons for this individual are set out in the table below. The relative size of each insurance company is noted in the "Description" column. Where there were variances in the terms of the individual policies (such as with the excess structure) we showed the values of the excess in below the premiums.

Insurer Type	**Description**	**House contents**	**Buildings**	**All Risks**	**Vehicles**	**Total Premium**
Direct Insurer	Well known direct insurer *Large*	R626.85 Excess R525	R861.91 Excess R525	R950.24 Excess R300	R1151.36 Excess R3000	R3589.36
Specialist high net worth insurer	You need house contents of R750k to qualify - *Small*	R343.00 Excess R1000	R308.00 Excess R1000	R543.63 Excess R0	R835 Excess R3000	R2029.63
Brokers & direct	*Medium size*	R504.00 Excess R500	R554.40 Excess R500	R556.02 Excess R350	R994.12 Excess R2500	R2608.54
Mutual & Federal	*Large*	R399.85 Excess R250	R481.12 Excess R500	R476.60 Excess R0	R938.65 Excess R2500	R2296.22

Our research yielded some interesting feedback - it seems that a large direct insurer is often more expensive than the traditional (broker based) insurers. In addition, you can save premiums by using a small, specialist insurer. The traditional insurer is second cheapest whilst the insurer that sells direct and via brokers is the second most expensive. It is clear that direct insurers are certainly not as cheap as they indicate in their adverts. Furthermore if you are prepared to take the risk of using a small insurance company you can save on premiums (provided the company does not disappear) whilst a large traditional insurer is still proving to be good value. By taking more risk yourself, i.e. opting for a higher excess structure – you can save on monthly premiums.

The second measure of the “value” of an insurer is whether they will actually pay out in the event of a claim - this is known as a claims ratio. As a consumer, this is very valuable information because a low premium is worthless if the insurer does not pay out when you claim. It seems that the insurance companies are extremely unwilling to provide this information and nothing is available from the industry association, the SAIA. As a result we have to rely on our own, anecdotal evidence. It seems that direct insurers are repudiating a higher proportion of claims than the traditional insurers. As there is no broker with industry knowledge to dispute the repudiation, many consumers are left in the lurch. In conclusion, we are satisfied that the traditional short term insurance business model still offers a price competitive advantage to our clients and a higher level of service when it counts…at claim time!

GALILEO CAPITAL NEWS

GALILEO CAPITAL CONSULTING

We recently launched a new division that focuses on providing advice on corporate transactions and project finance. We started this division in response to the growing demand from our corporate clients for advice on various transactions including:

- Property development finance
- Project finance transactions
- Sale of businesses
- Strategic franchise roll out programmes
- Corporate transactions including management buy-outs
- Empowerment transactions

In terms of the abovementioned transactions we provide the following services to our clients:

- Advising on buying or selling businesses or divisions
- Structuring of comprehensive business plans
- Feasibility studies
- Finance applications: property, project & working capital
- Valuation services for existing businesses
- Evaluate franchise opportunities
- Evaluate investment and business opportunities
- Corporate advisors on specific transactions

Our team consists of six highly motivated and qualified professionals with more than forty years of experience in a number of different industries including: Financial Services, Banking, Agriculture, Motor and Property.

STAFF NEWS

Hannes Combrinck recently joined us to take primary responsibility for the co-ordination of the Business Consulting and Financial Structuring services offered by Galileo Capital in our Consulting division. Hannes has a B.Comm(Hons),M.Comm.Econ and has been in the banking and financial sector for 20 years. He has a diversity of experience and has held positions such as trading desk economist and head of financial market trading at Santam Bank, Senior ALCO Consultant at ABSA, Senior Fund Manager at Commercial Union, Chief Dealer - Structured Products at Societe Generale and Head of Money Market and Commodities at Gensec Bank. Hannes is married to Bridgette and has four children with the youngest two in high school.