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perspectives

Don't Second *that emotion*

How to deal constructively with the highs and lows of offshore investments

Past performance is no guarantee of future results. We've seen this disclaimer many times in investment literature. Yet many investors continue to believe that historical patterns offer clues to future market performance. And they often let that belief influence their investment decisions.

Offshore investments are a good example. The MSCI World Index, the most commonly used benchmark for international shares, lost 11.7% in 2001 in New Zealand dollar terms. It has lost another 21.8% so far this year. So it's hardly surprising that investors, both personal and institutional, are questioning the merit of international investments.

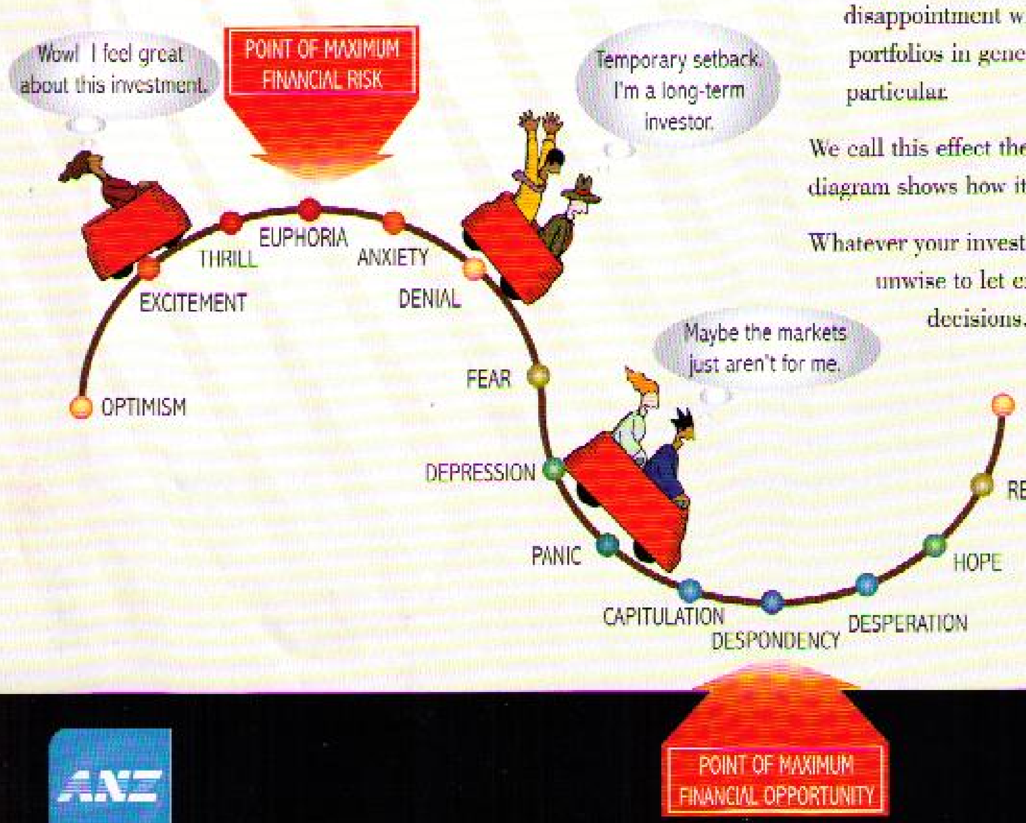
The arguments for investing internationally are clear and are supported by reams of evidence. Shares provide investors with the best returns over time. And a portfolio of internationally diversified shares is actually significantly less risky than a portfolio of New Zealand shares. So why all the angst?

Some of the answer lies in the field of behavioural finance, which examines how investors act and why. For example, researchers have found that investors are more distressed by losses than they are happy with equivalent gains. Other studies reveal that investors tend to be too optimistic when the market rises and too pessimistic when it falls. Yet more research reveals that investors prefer to invest in a company they know (i.e. local) rather than in one that is unfamiliar (i.e. overseas), even if on paper the two choices are of equal merit.

We see plenty of evidence of this irrational behaviour in the retail managed funds industry. The huge cash flows into cash and mortgage products provide one example. The recent proliferation of 'absolute return' or hedge funds is another. Both seem to be linked to investors' disappointment with returns from diversified portfolios in general, and international equities in particular.

We call this effect the 'investment roller coaster'. This diagram shows how it works.

Whatever your investment goals and responsibilities, it is unwise to let emotions govern your investment decisions. As the saying goes, emotions can cloud your judgement. That's why, at times when markets are volatile, it's a good idea to seek the opinion of someone with a more objective perspective before readjusting your investment portfolio.



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