

The true nature of risk in investing: beyond numbers to human behaviour

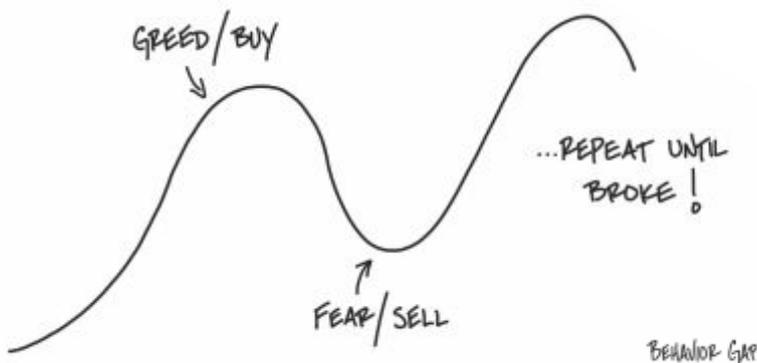


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In the world of finance, risk is often portrayed as a mathematical beast, tamed by sophisticated metrics like volatility, beta, or Value at Risk (VaR). These tools measure how much an investment's price swings or the potential for extreme losses in a portfolio. But for the average investor, true risk isn't found in spreadsheets or statistical models - it's lurking in the mind. Real risk emerges when poor performance triggers emotional reactions, leading investors to abandon sound strategies at precisely the wrong moments. It's not about the market's ups and downs; it's about how those fluctuations mess with our heads, prompting decisions driven by fear, greed, or regret rather than rational analysis.

This is best captured by Behavior Gap in the sketch below:

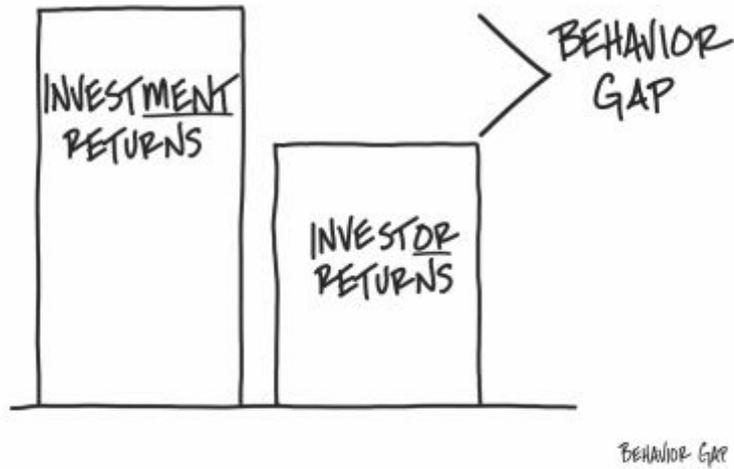


Consider volatility, the darling of modern portfolio theory. It quantifies price variability, assuming higher swings equal higher risk. Yet, for long-term investors, short-term volatility can be a friend, offering buying opportunities during dips. The real danger arises when a volatile period - say, a 20% market drop - instils panic. An investor who sells everything to "cut losses" misses the inevitable rebound, crystallising temporary paper losses into permanent ones. This isn't risk as defined by standard deviation; it's behavioural risk, where psychology amplifies market noise into self-inflicted wounds.

Value at Risk, another popular metric, estimates the worst case loss over a given period with a certain confidence level. For instance, a 5% VaR of R100,000 means there's a 5% chance of losing that much or more in a day. Sounds precise, right? But it fails to account for black swan events or, more critically, the human response to those losses. When VaR thresholds are breached, investors don't calmly reassess; they often overreact, switching to "safer" assets like cash during inflation or piling into trendy stocks during booms. History is littered with examples: the dot-com bust of 2000, where euphoria led to overbuying, followed by despair driven selling; or the 2008 financial crisis, when fear caused mass exits from equities just before a decade-long bull run.

At its core, this psychological risk stems from cognitive biases. Loss aversion, coined by psychologists Daniel Kahneman and Amos Tversky, shows we feel losses twice as painfully as equivalent gains. Recency bias makes us overweight recent events, ignoring long term trends. Herding instinct drives us to follow the crowd, buying high in manias and selling low in panics. These aren't abstract concepts - they manifest in real world behaviours that erode wealth. A study by DALBAR, analysing investor returns over 30 years, found that the average equity fund investor underperformed the S&P 500 by about 4% annually, largely due to poor timing decisions fuelled by emotions.

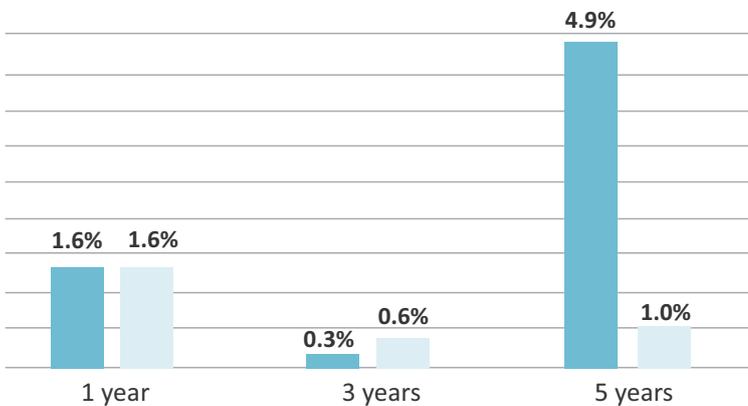
The result:



Thanks again to Behavior Gap for so neatly capturing the risk of psychological bias.

As an aside, in South Africa, despite this phenomenon, index tracking funds remain well under represented. One can argue that the South African market is different, but to such a degree? This is more advisor led in my opinion.

Motswedi Delta Equity Fund – continued outperformance versus its peers



Periods to the month ending 30 June 2025

- vs Alexforbes BEE Equity Manager Watch Survey Median™
- vs Alexforbes SA Equity Manager Watch Survey Median™

Get in touch



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