Using the 7 habits of successful investors

Content

The 7 habits of successful investors

Investing and accumulating wealth are no trivial matter, especially when investors are torn between avoiding risk and striving for returns. Seven simple habits can help to accumulate capital calmly and composedly. After all, your money should be working for you, not the other way around.

Investors are only human. When giving talks, I repeatedly encounter investors who ask questions or are facing problems that are wholly typical. And yet investing could be so simple. It all starts with habit no. 1: "Know yourself and challenge your intentions."

Habit no. 1: "Know yourself and challenge your intentions."

Lessons learned in behavioural economics repeatedly boil down to the one realisation: Our brain is the culmination of a development process that has been ongoing for thousands of years. As a result, we still tend to demonstrate prehistoric behavioural patterns that cannot always be rationally explained. For example, we often view the (investment) world in a frame, i.e. we see what we want to see and may be excluding better alternatives as a result. We tend to follow the crowd or be driven by sentiments that push investors, particularly, back and forth between fear and greed. Aversion to losses is just as typical: We suffer more pain when we make a loss than we enjoy the same amount of gain. Test yourself: If someone offers to play heads or tails with you and you risk losing 100 Euros on tails, how much do you want to have the chance of winning before you are willing to play the game? More than 100 Euros, am I right? Which is neither right nor wrong; it merely shows your preferences. This can be dangerous, however, if you leave all you have in a savings account as a result and, in doing so, forego potential returns that you urgently need, or if you back off from realising losses and starting again. "They're only losses on paper. I'll wait until share prices are back to where they were when I started and then sell" is deceptive.

Learn from the Dakota Indians

You are often better off heeding the wisdom of the Dakota Indians. They are alleged to have coined the following insight: "If the horse is dead, dismount." Even now, I still encounter investors who bought certain equities for 60 or 80 Euros after the turn of the millennium and are still waiting for the prices to return to the same level. If they had sold up and switched to a diversified

"If the horse is dead, dismount."

Chart 1: A classification of typical sources of behavioural patterns

Self Deception (Limits to learning)	Heuristic simplification (Information processing errors)	Emotion & Affect	Social
Overoptimism Illusion of control Illusion of knowledge	Representativeness	Mood	Imitation
Overconfidence	Framing	Self control	Contagion
Self Attribution bias	Anchoring	Fear & Greed	Herding
Confirmation bias	Availability bias	Regret	Cascades
Hindsight bias	Cue competition		
Cognitive dissonance	Loss aversion / Prospect theory		
Conservatism bias			

Sources: AllianzGI Capital Markets & Thematic Research
Based on David Hirschleifer (2001), "Investor Psychology and Asset Pricing".

basket of German or European equities, they would have more than made good the losses. Consequence: They have been foregoing price gains for more than a decade.

Therefore: "Know yourself and challenge your intentions."

Know yourself!

Behavioural finance is an approach that is gaining increasing popularity in capital investments. But what lies behind it, and how can it be used for investors? The foundations of behavioural finance theory are based on the work of Daniel Kahneman and Amos Tversky, whose Prospect Theory offered an alternative – from a psychological perspective – to the current hypothesis that "man" makes decisions on a purely rational basis as homo oeconomicus. They were able to demonstrate behavioural patterns which cannot be explained rationally. Prospect Theory probably gained currency in financial economics through Richard Thaler, who applied the insights of Daniel Kahneman and Amos Tversky to investments, which culminated in the emergence of behavioural finance theory.

Habit no. 2: Your investment decisions should be governed by "purchasing power preservation" rather than "security".

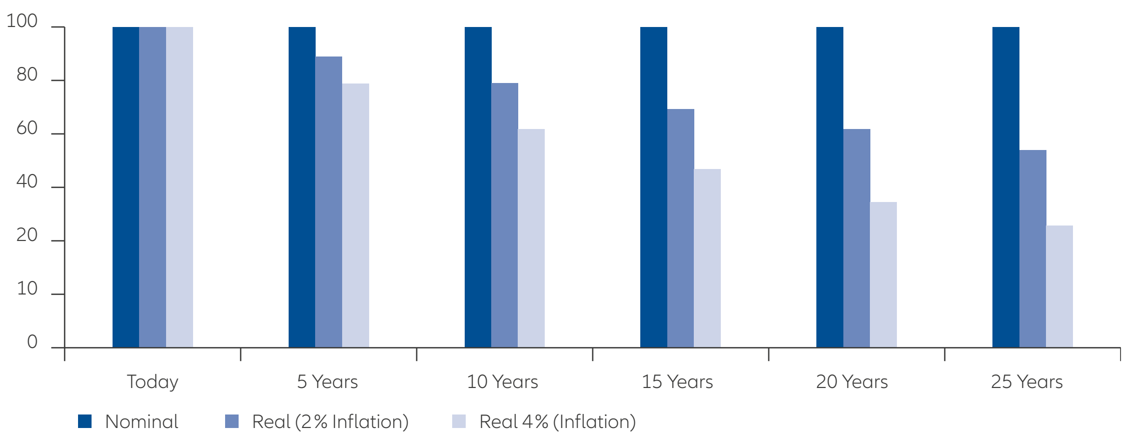
Everything seems to revolve around security, whereby "security" is often seen as synonymous with the absence of price fluctuations. In recent years, it has been the equity markets, particularly, that have sent us on a roller coaster ride. That investors want to avoid price fluctuations is more than understandable in the circumstances. In doing so, however, they overlook the risk of losing purchasing power – which is even more unpleasant considering that interest on savings is virtually zero at the current time. Government bonds are no longer the solution, either. In the end of March 2019, nearly 40% of all government bonds in the Eurozone had negative yields. The only "security" investors have is the knowledge that they are going to get less back than they invested.

If you want to preserve your capital you should therefore not focus primarily on the absence of price fluctuations. On the contrary, the minimum requirement for an investment should be "purchasing power preservation". The following calculation shows how fast inflation destroys purchasing power: Let's assume you hide 100 Euros under your pillow. Based on an inflation rate that is around the European Central Bank's medium-term target of just under 2% each year, you will only be able to purchase goods worth just over 80 Euros in ten years' time. Or less than 70 Euros after 20 years. If our hypothetical inflation rate rises to 4%, your money will be worth less than 70 Euros in just ten years' time. At the end of 20 years, you will not even be able to buy goods costing 50 Euros (cf. Chart 2).

Seen this way, the biggest risk may be not taking any risk.

Chart 2: Inflation leads to a loss in purchasing power

What will happen to 100 EUR if inflation is 2% and what will happen if it´s 4%? (Example calculation)



Source: AllianzGI Global Capital Markets & Thematic Research.

Habit no. 3: The fundamental law of capital investment: Go for risk premiums!

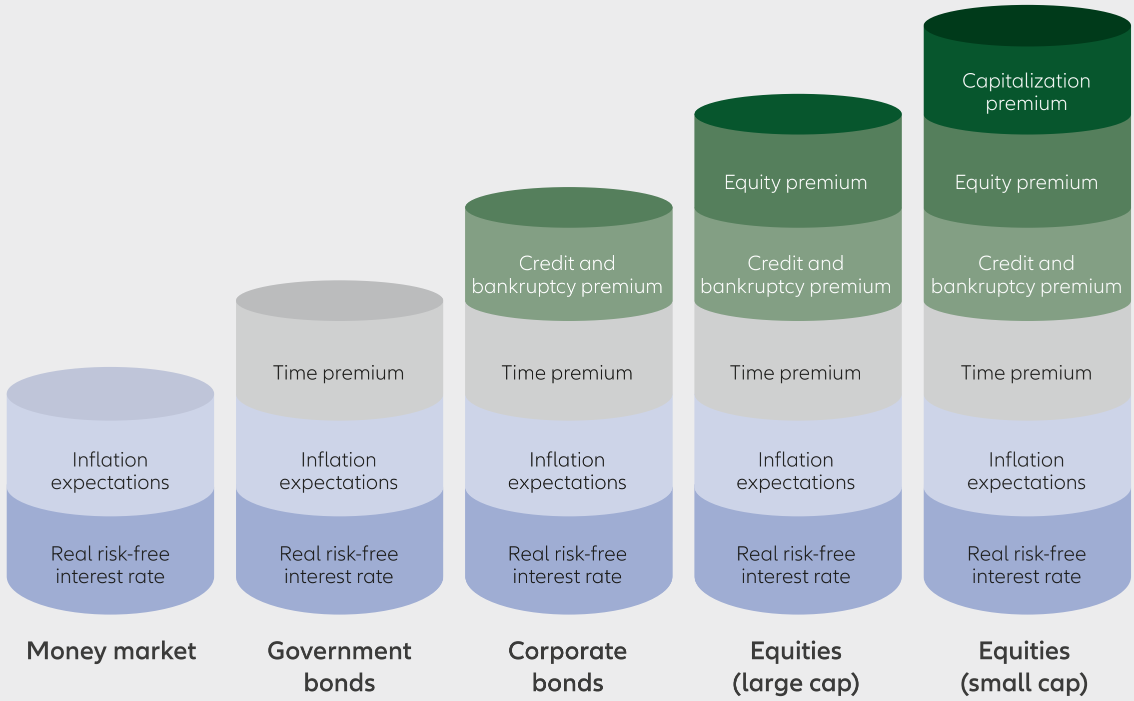
Successful investors know that they cannot earn risk premiums without taking risks. That is the fundamental law of capital investment. The logical explanation: Investments in riskier assets should be justified with the expectation that those investments will generate higher return potential over time than alternative investments with no risk exposure that thus offer less opportunity. Chart 3 shows the risk premiums that can be allocated to the individual asset classes. That's how it looks in theory. What does history tell us?

No risk, no risk premium.

Long historical time series – which are available for the US equity market, for example – show that expectations of risk premiums have not been disappointed, even though the reward for investing in US equities has not always been the same over all periods. If we compare the risk

Chart 3: No risk premium without risk. The theory.

Risk premium of various asset classes

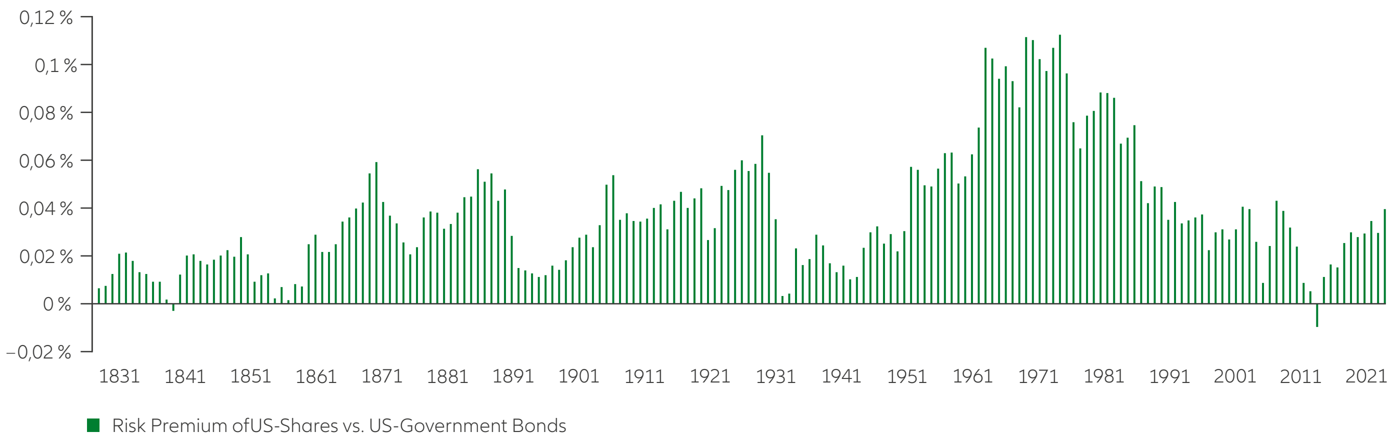


Source: Ibbotson & Siegel; Allianz Global Investors Capital Markets & Thematic Research

premium on US equities to 30-year US Treasuries over periods of 30 years from the start of the available time series (1801) to the end of 2018, we can see that a risk premium of 3.7 percentage points was generated on average over the 30-year periods. The weakest performing 30-year period was 1981 – 2011 with its average risk premium of –0.85 percentage points. The best period was 1943 – 1973 with a risk premium of 11 percentage points.

Chart 4: Investors' share in the risk premium

Risk premium on US stocks vs. US treasuries (rolling 30-year yields)



Past performance is not an indication of future results.
Source: Jeremy Siegel database 1801 – 1900 & Elroy Dimson, Paul Marsh, and Mike Staunton 1900 – 2009, Datastream, Allianz Global Investors Capital Markets & Thematic Research; Data as of 31 December 2021.

Studying the entire period from 1801 to the end of 2018 very clearly shows the effect that equity risk premiums had. If investors had invested one US Dollar in Treasuries in 1801, by the end of 2018 they would have earned somewhat more than 1,400 US Dollars after adjusting for purchasing power (!). Investing in equities over the same period would have earned them more than 1.8 million US Dollars. Of course, history doesn't repeat itself, but we can learn a lot from it.

The result: Taking greater risks on equities has historically been rewarded over the long-term. From a purchasing power perspective, equities have offered greater security than bonds.

Habit no. 4: Invest, don't speculate!

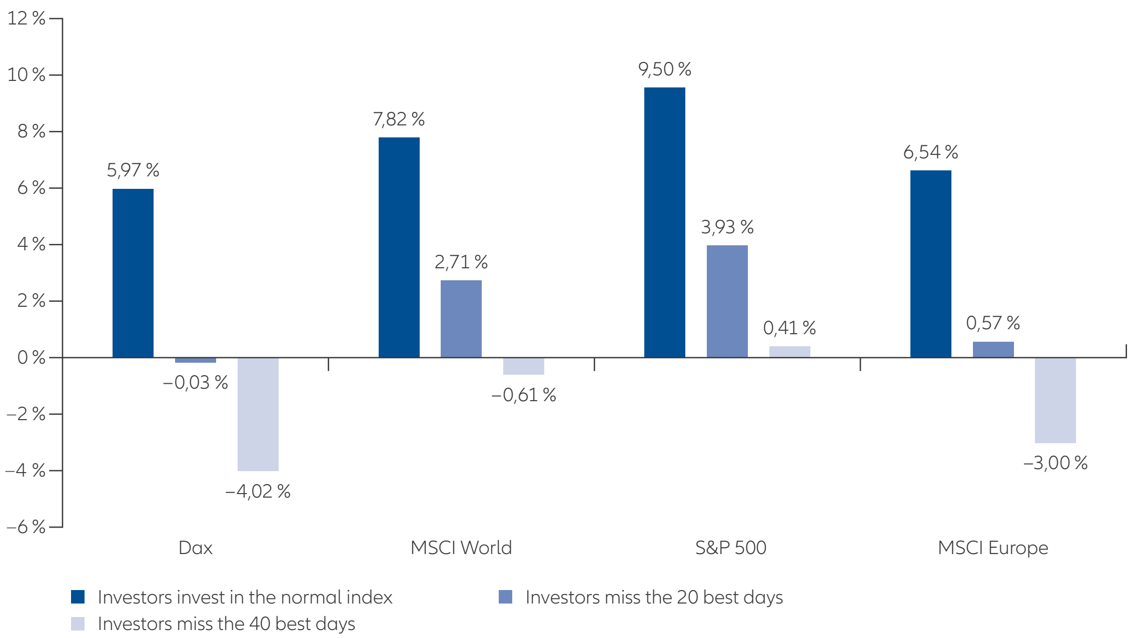
Nobody needs to be an expert and spend all their time tracking price movements and markets to find the right time to get in and out. No one calls and tells you it's time to invest in the equity market – unfortunately. Even my grandfather knew that. The good thing is that if you want to accumulate capital over the long term, you invest rather than speculate. Speculating is betting on price movements in the short term. Investing is putting your capital to work over the medium or longer term.

Chart 5 clearly illustrates this distinction based on various equity market segments. Take European equities for example: If you invested in a broadly diversified basket of European equities over the last 25 years, you earned nearly 7.1 % on average. If you missed the 20 best days on the equity market – while waiting for better starting prices, for example – you gained 1.2 %. If you missed the 40 best days, you actually made a loss of 2.5 % p. a. on average. Making your money work has usually been the better method. The risk of missing the best days on the capital markets is extremely high. Frequent motivations are uncertainty ("I don't know what lies ahead") and fear of price losses. Strategy beats tactics, which brings us to habit no. 5.

Please refer to our publication "Equities – the new safe option for portfolios" to learn more about risk premiums

Chart 5: Investing instead of gambling

Average return p. a. of selected equity indices over the past 25 years



Pastperformanceisnot an indicationoffutureresults. Source: Ibbotson & Siegel; Allianz Global Investors Capital Markets & Thematic Research, Data status: 22 February 2022. (Timeframe: February 1997 - February 2022).

Habit no. 5: Make a binding commitment.

Homer's hero in Greek mythology, Odysseus, was reputed to be the cleverest man of his time. He had to face a whole host of perils in the Odyssey named after him. One of his challenges was to pass the rock of the Sirens unscathed. These creatures were famous for their beautiful singing, whose only purpose was to lure sailors to shipwreck on their rocks and die. Odysseus wanted to survive but still wanted to hear the Sirens. His solution was to block the ears of his fellow sailors on the galley and have himself tied to the ship's mast. No matter how hard he pulled and tore at his bonds, his shipmates couldn't hear a thing, and steered the ship past the Sirens' rock.

Investors have three options for making a binding commitment:

1. Strategic/long-term aspects should govern allocation to the various asset classes.
2. The general rule to follow is never to put all your eggs in one basket, so: diversify.
3. Invest regularly

Strategy before tactics

Making a commitment – strategy before tactics – for investors that might mean deciding on a strategic allocation between equities and bonds that suits their risk profile and using it to steer through turbulence in the capital markets. A good guideline for the right amount of exposure to equities in a portfolio is the rule of thumb "100 – x", or "100 – age". So an investor who is 50 years old at present would allocate 50% to equities. Building on this, individual adjustments can then be made.

Learn more about this rule of thumb here: "Save smart, not hard – with life cycle investments"

Strategic allocation is easily implemented with balanced portfolios(i.e. portfolios consisting of equities and bonds) and multi asset strategies with their even broader investment spectrum. If actively managed, the portfolio managers can make tactical adjustments without investors having to worry about them.

Strategic allocation that answers the question "What do I want to achieve with my capital over the long term" protects against knee-jerk adjustments that can turn out to be expensive.

Diversification: Never put all your eggs in one basket

Most important is not putting all your eggs in one basket. Generally, there is little point in trying to find the right investment each time and continuously making changes to your portfolio. Chart 6 illustrates this quite clearly. It shows the hit list of ten different investment opportunities and their performance over the past 16 years. The resulting patchwork is not only a visual challenge; it also shows that what earned great returns one year quickly moved to the bottom of the pile one year later. Therefore: We believe one should invest money broadly, combining equities with bonds – and maybe other segments, as well. "Multi asset" makes it possible.

Chart 6: Diversification across all asset classes

Returns of several asset classes (in EUR and % p. a.)

Rank	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Q2 2022
1	26.07	16.66	73.44	38.33	14.78	30.07	26.88	29.09	12.86	14.95	21.00	6.70	34.06	14.51	54.65	75.52
2	22.60	8.45	32.55	27.48	10.40	18.09	26.68	19.68	10.40	14.94	12.87	4.78	26.88	11.35	36.61	20.92
3	19.76	–0.22	24.14	23.47	8.99	16.81	20.51	17.46	9.97	14.71	10.88	3.26	23.92	11.02	25.85	20.56
4	18.86	–3.54	23.18	17.17	7.96	15.32	5.18	14.08	8.78	12.22	7.08	1.40	21.07	8.89	13.95	18.75
5	3.17	–7.69	23.16	16.91	5.40	14.35	–4.22	11.85	8.49	11.68	6.67	0.88	20.84	3.02	12.47	9.95
6	–0.13	–33.88	22.61	15.76	3.38	9.36	–4.49	11.81	7.19	7.60	–1.08	0.31	19.78	1.21	5.20	4.46
7	–1.62	–42.67	15.46	13.37	1.87	4.91	–6.49	7.40	5.42	7.39	–2.42	–9.91	14.83	0.21	4.42	–0.86
8	–3.23	–43.29	9.52	12.98	–7.51	3.95	–6.71	2.76	–0.25	6.59	–4.04	–9.97	13.49	–2.20	3.68	–2.43
9	–3.54	–44.78	–0.93	11.75	–14.69	0.19	–8.47	2.54	–4.87	4.78	–6.45	–10.00	9.06	–2.82	3.32	–6.25
10	–4.37	–50.76	–1.79	2.15	–15.44	–1.68	–30.48	–24.65	–26.10	3.22	–7.33	–17.69	7.41	–32.52	0.21	–7.12
Average	**7.76**	**–20.17**	**22.13**	**17.94**	**1.51**	**11.14**	**1.84**	**9.20**	**3.19**	**9.81**	**3.72**	**–3.02**	**19.13**	**1.27**	**16.04**	**13.35**

- Equities Germany
- Equities USA
- Equities Emerging Markets
- Equities Europe
- Gold
- Government Bonds Emerging Markets
- Corporate Bonds
- Government Bonds Advanced Economies
- Commodities (ex. precious metals)
- Real Estate

Source: Thomson Reuters Datastream, Allianz Global Investors, Benchmarks: Germany MSCI Germany TR, USA: MSCI USA TR, Equities Emerging Markets: MSCI EM TR, Bonds Developed countries: JPM Global Govt. Bond Index TR, Bonds Emerging Markets: JPM EMBI Global Composite TR, Corporates: BofA ML Broad Corp. Index TR, Real Estate: Real Estate Europace Hedonic House Price Composite Index, Commodities: S&P GSCI Non. Precious Metals TR, Gold: €/Feinunze; all returns in USD (TR = Total Return Index, NAV = Net Asset Value). Data as of 27 June 2022.

Invest regularly: save on saving
The same applies to savings plans: Risk premiums can only be earned by taking risks. Although specific performance cannot be guaranteed, three effects can be cleverly combined with each other:

1. The diversification effect: Investing regularly in portfolios allows you to diversify into a whole basket of equities and/or bonds. Savings can also go into numerous multi asset strategies.

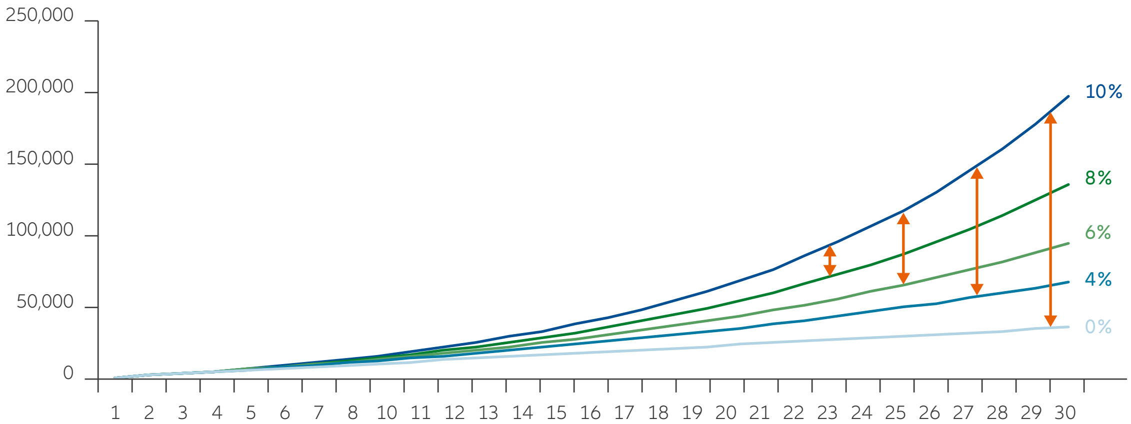
2. The average cost effect: Paying the same amount regularly into a savings plan means that shares are purchased at different prices as they fluctuate in line with trends on the capital markets. In practical terms, this means that if you pay in the same amount all the time, you buy fewer units at high prices and more at lower prices.

3. The compound interest effect: If you save over longer periods, you can benefit from the compound interest effect by simply reinvesting distributions. Chart 7 illustrates this effect in simplified form for various hypothetical average annual returns. After paying in 100 Euros each month for 20 years, 24,000 Euros have been saved in total. This amount grows to almost 40,000 Euros at a hypothetical return of 4%, or even nearly 50,000 Euros at 6%. A return of 8% produces a final amount in excess of 60,000 Euros.

Don't miss our publication "Capital Income for the second machine age".

Chart 7: Illustrative savings plan performance with an investment horizon of 20 years

Potential growing performance advantage for savings plan (EUR 100 / month) over time due to compound interest effect.



The above chart is illustrative in nature and is not a forecast of possible future performance of an investment in a fund.
Source: AllianzGI Global Capital Markets & Thematic Research

Habit no. 6: Don't put off till tomorrow what you can do today.

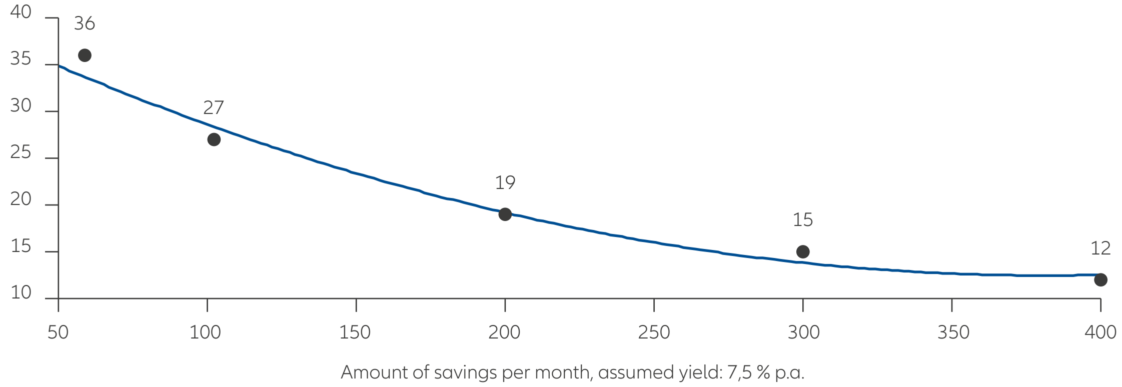
Billions of euros are slumbering in savings books and bank deposit accounts despite the fact that one of the key drivers of investment success is the investment horizon in conjunction with the compound interest effect.

In the case of a savings plan, the compound interest effect can be clearly shown again from a different perspective. Example: An investor wants to have 100,000 Euros at their disposal – when they retire, for example. If they start very early and have 36 years to reach this goal, saving 50 Euros each month is sufficient at an average return of 7.50 %. If they only have 12 years to go, they have to put aside 400 Euros each month.

Of course, you have spotted that there is a noticeable potential risk premium factored into the return of 7.5 %. Not one that can be achieved with a savings book.

Chart 8: Goal: EUR 100,000 – better to save „early and little" than „late and much".

Example calculation: If one wants to save 100.000 Euro and has an investment horizon of 15 years with an assumed yield of 7.5 % p. a., one has to save 300 Euro every month.



The above chart is illustrative in nature and is not a forecast of possible future performance of an investment in a fund.
Source: Allianz Global Investors Global Capital Markets & Thematic Research.

Habit no. 7: Consider active management.

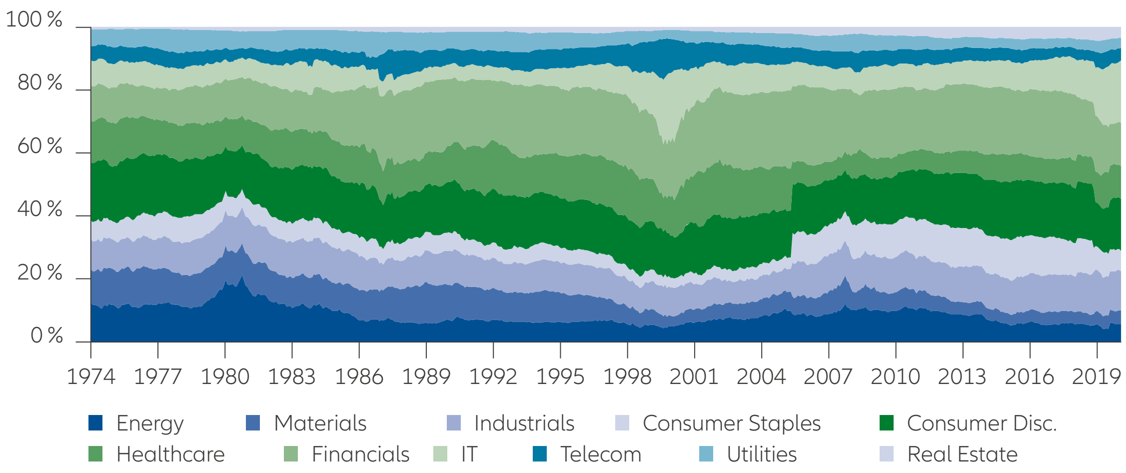
Anyone who opts for active management not only hopes the experts will earn them additional returns, they are also exposing themselves to less risk of the deadweight of one-time darlings of the equity market cluttering up their portfolios. After all, passive management only maps yesterday's world. Chart 9 illustrates this quite clearly. It shows how the importance of individual sectors in the global equity market has developed over the decades. What is remarkable is that when certain sectors were fashionable, their share in the relevant indices grew as the market capitalisation of the corresponding equities increased. If this trend is unchanged, some sectors may end up accounting for a large share of a passively managed portfolio just when we least want them. Just think back to when the technology-media-telecom bubble burst at the turn of the millennium, or the US housing crisis that had a particularly adverse impact on financial securities around 2008. It's better to counter-steer.

So investing may be easier than you think, isn't it? Don't put it off. Heed habit no. 6.

Hans-Jörg Naumer
Global Head of Capital Markets & Thematic Research AllianzGI

Chart 9: Passive investments track the world of yesterday

Weight of different industries in the world market (Datastream Index)



Source: AllianzGI Global Capital Markets & Thematic Research. Data as of 24 February 2021