SERIOUS MONEY

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Optimistic investors need to get real

By Elaine Moore

Time to remove the rose-tinted spectacles, says Elaine Moore

As summer draws to an end and we shake off the happy daze brought on by the Olympics an upcoming anniversary is on its way to sober us up.

Five years ago, on September 14 2007, Northern Rock admitted that the Bank of England had stepped in to provide it with support, triggering the first run on a UK bank in more than 100 years.

In spite of the changes and upheavals since, a recent survey of banking customers found that three-quarters of those questioned didn't believe banks had "learnt their lesson" since the start of the financial crisis.

Perhaps this is the case – but have any of us?

The US fund house Vanguard published a paper last year called "Market Bubbles and Investor Psychology", which suggested that the same investor psychological traits that led to the South Sea Bubble in 1720 also caused the financial crisis in 2007. The characteristics are so commonplace, it pointed out, that they could contribute to the formation and collapse of a future bubble.

The starting point is optimism. It is more enjoyable to think about investment decisions that will perform well than those that will do badly, and this skewed view of the future is compounded by overconfidence in our own abilities.

A similar state of affairs is present in all sorts of other odd areas, according to those who study behavioural science.

In her book *The Optimism Bias* (2011), neuroscientist Tali Sharot found that even if we are collectively pessimistic about the future of the eurozone, for example, or the UK's austerity regime, we still tend to be resolutely upbeat about our own futures.

We might believe statistical probabilities apply to the wider population, but we put a positive spin on our own chances. Ninety per cent of people believe they are above-average drivers and few investors would say they are sub-par.

The government knows all about the optimism bias. The Olympic Games only came in "under budget" because Whitehall added a huge contingency fund – as it does for all big projects, to compensate for overly optimistic project managers.

And the tendency to accentuate the positive is given as a reason that most investors are loath to short stocks. Of the thousands of investors who use financial spread bets, most prefer to go long, even when prices are falling.

This week, the financial regulator sounded a warning bell in an attempt to save private investors from succumbing to schemes that seem too good to be true.

Despite repeatedly raising the alarm about unregulated, esoteric investment schemes that promise double-digit returns, investors keep pouring in money. In some cases the Financial Services Authority (FSA) found that investors were giving up final salary pensions for the chance to put their retirement savings into the schemes.

It now plans to crack down on the promotion of so-called "unregulated collective investment schemes" in areas such as bamboo fields, Brazilian social housing and even graveyards to ordinary investors.

And the regulator has another change up its sleeve that should give even the most giddily upbeat of us pause for thought.

The estimated returns that providers tell investors to expect are soon going to change and it's about time.

An independent report from PwC found that investors were sold inflated ideas about the potential returns they would receive from pensions and life insurance products, and that these unrealistic claims led to disappointment later on.

Annual returns for an "average" portfolio of two-thirds equity and one-third bonds are marketed at 7 per cent. In fact, in light of low interest rates and bond yields and unimpressive equity returns, the FSA is considering cutting projected returns to 5 per cent.

To put that into pounds and pence, imagine a lump sum of £250,000 invested over 25 years. If the annual investment return was 7 per cent, the final pension pot would be £1.35m. Cut the annual return to 5 per cent and the final pot is £846,000.

The UK is not alone in its optimistic view of long-term investment returns.

In California, there is a fierce debate about whether the state retirement system can hit its predicted 7.5 per cent rate of return. Many experts say no.

In the UK, we won't know what the new projected rates of return will be until the end of the year. This means investors are still being sold the idea of unrealistically high returns on their money.

Bad news for savers in general. But not for me, of course – I'm sure my investments will be just fine.

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