HISTORICAL RETURNS AND INVESTORS' PERCEPTION OF RISKS AND FUTURE RETURNS

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ABSTRACT

This survey focused on better understanding if investor perception of risk, both within portfolios and within securities, is affected by the presentation of portfolio data. This perception of risk and returns is directly related to the formation of bubbles within the financial markets. The survey offers the participants three portfolios from which to choose their best answer to questions posed by the researcher. The questions address topics such as diversification, trends, momentum investing, framing, and the concept of risk-adjusted returns. Two separate survey groups were formed. The variable was one group was provided the actual five year annualized returns for each of the three portfolios, while the other only received the securities contained within the portfolios. The results indicate that investor perception of risk and expected returns is affected by the information presented and that the investor perceives a decreased level of risk in light of recent positive returns. The investors' perceptions of diversification were not statistically significant between groups.

METHODOLOGY

The purpose of this research was to better understand consumer perceptions of risk in regarding their investment environment. The potential investors were asked to answer five survey questions that required them to assess the risk and returns of three portfolios provided in the survey. The survey was formulated using an online survey tool, www.zoomerang.com. Participants were initially screened according to their investing experience, age, and whether they considered themselves individual or personal investors. Investors were then presented with three separate portfolios containing U.S. equity securities. Participants were instructed that each security held an equal weight within the portfolio. The survey then asked five questions pertaining to expected returns, expected risk and standard deviation, and to assess the level of diversification within each portfolio.

CONCLUSIONS

After analyzing survey data, it appears the ability of individual investors to properly assess risk and choose the optimal portfolio remains questionable. Investor decisions were swayed by the historical returns of the portfolios provided and investors extrapolated that past returns were indicative of future returns. When presented with positive historical returns; investors assessed a lower risk level to that portfolio. Despite the best efforts of investors, they fail to accurately assess levels of diversification within a portfolio. When investors perceive less risk based on historical returns the likelihood of bubble formation increases. Being aware that investors do perceive less risk in an asset when framed in terms of its recent positive gains, investors can apply this knowledge to prevent investment risks that are not properly compensated with returns