Behavioral Bias and Investing

Hey… we're only human….

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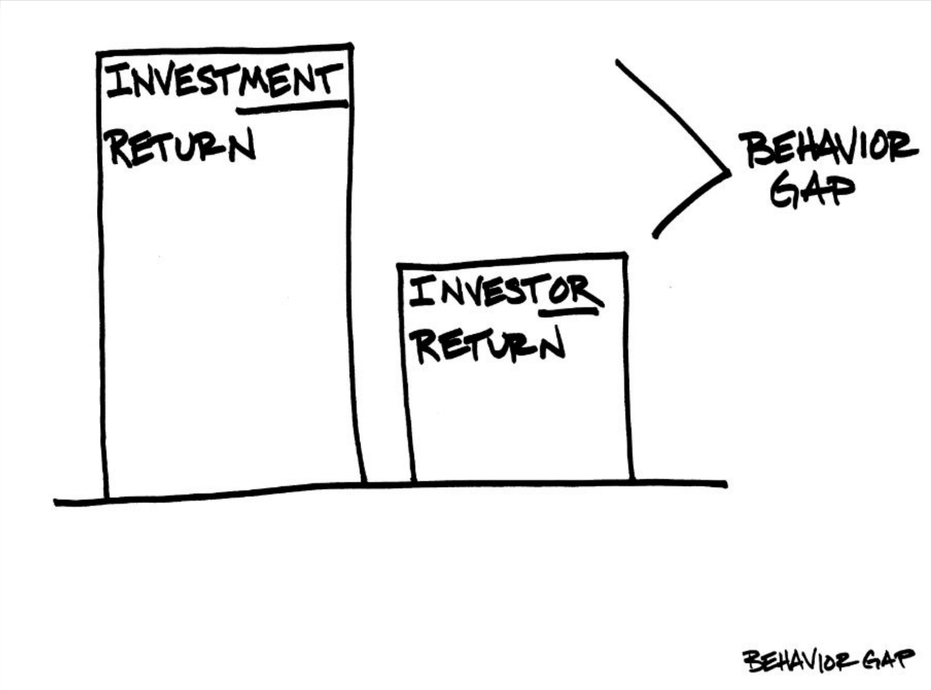
Some simple but important things to remember

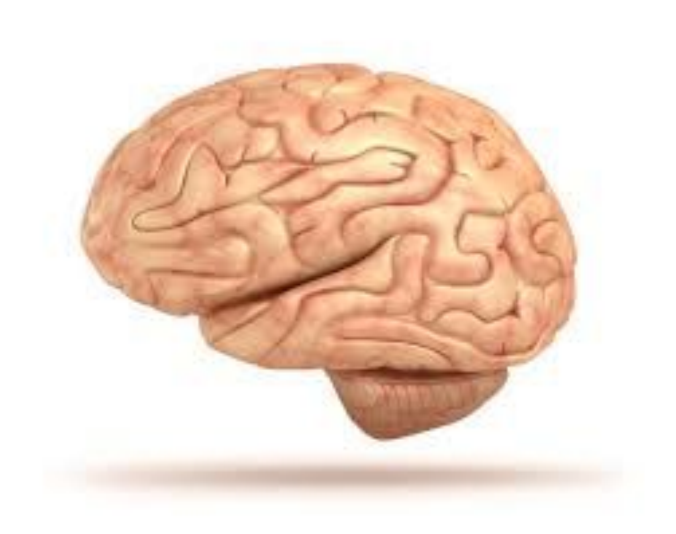
- Ensure your have a designated beneficiary on all registered accounts.
    - This includes RSPs \ RIFs \ LIRAs \ LIFs and TFSAs
- If possible have all cash assets joint with rights of survivorship.
- What do you want your estate to look like? What are you planning for?

The Behavior Gap



This is your brain on money...

Jason Zweig, “Your money and your brain” summarizes some key findings in neuroeconomics;



Jason Zweig “Your money and your brain”, Simon and Shuster, 2007

This is your brain on money...

- Neural activity of someone whose investments are making money are the same as someone who is high on morphine or cocaine.
- Patterns are established after even only two repetitions.
- Expecting good or bad events is often more intense than experiencing them.
- Financial losses are processed in the same areas of the brain that respond to mortal danger.

Overconfidence

Examples;

81% of new business owners think their business has at least a 70% chance of success.
What percent of business owners think any business like theirs would be successful?

ONLY 39%

*Source: Whitney Tilson, "Applying Behavioral Finance to value investing,

Overconfidence

What percentage of people believe they are above average in driving skill, sense of humor and interpersonal skills?

Over 90%

*Source: Whitney Tilson, "Applying Behavioral Finance to value investing,

Overconfidence

Investor Characteristics	Concentration in specific sectors or stocks
	Under diversification in portfolios
	Excessive trading, leading to lower returns due to increased transaction costs
	Often try to "time the market"

Loss Aversion - “Prospect Theory”

Example: Given two choices, which would you chose?

1) Win $7,500

   OR

2) Accept a 75% chance winning $10,000 and 25% chance winning nothing

Source: Daniel Kahneman and Amos Tversky (1979)

Loss Aversion - “Prospect Theory”

Example: Given two choices, which would you chose?

1) Accept a sure loss of $7,500

   OR

2) Accept a 75% chance losing $10,000 and a 25% chance of losing nothing

Source: Daniel Kahneman and Amos Tversky (1979)

Loss Aversion

In example 1 ; 84% of people chose to take the sure gain

In example 2;   69% of people chose to gamble (and try to avoid the sure loss)

Source: Daniel Kahneman and Amos Tversky (1979)

Myopic Loss Aversion

Greater sensitivity to losses than to gains + a tendency to evaluate outcomes frequently.

The more frequency clients review their portfolios the more risk averse they become due to the greater frequency they observe losses occurring.

Time Horizon		S&P/TSX Composite Returns (1956 – 2007) (% of periods of negative returns)*
One Day		46%** (**years 2008 & 2009)
One Month		39%
One Year		26%
Five Year		2%
Ten Year		0%

Herding

Examples:

Frenzied buying (greed) during market bubbles or selling (fear) in market crashes

The tendency for individuals to mimic the actions (rational or irrational) of a larger group.

Herding

Investor Characteristics	Concentrated portfolios in “popular” sectors or companies
	Excessive trading, leading to lower returns due to increased transaction costs

Recency

Examples:

If a person is asked to recall the names of the last 30 people they met, they will usually remember the names of the people they most recently met first

When a person is looking for a new investment opportunity and searches for those that have performed the best in the last calendar year

Recency

Investor Characteristics	Buying high, and selling low
	Doubting your investment strategy during times of market volatility
	Chasing performance

Overreaction

When flipping a coin, which of the following sequences is more likely to occur?

HHHTTT

HTHTTH

BOTH ARE EQUALY PROBABLE

Overreaction

Investor Misconceptions

Past performance is indicative of future performance

Leads to the hot hand fallacy

Confirmation Bias

- Tendency to search for, interpret, favour, and recall information in a way that confirms one's preexisting beliefs.

- Example; I AM SURE A MARKET CORRECTION IS COMING!!. (i.e. searching for bad news \ listening to bear market warnings \ concentrating on the negative and ignoring the positive)

Hindsight Bias

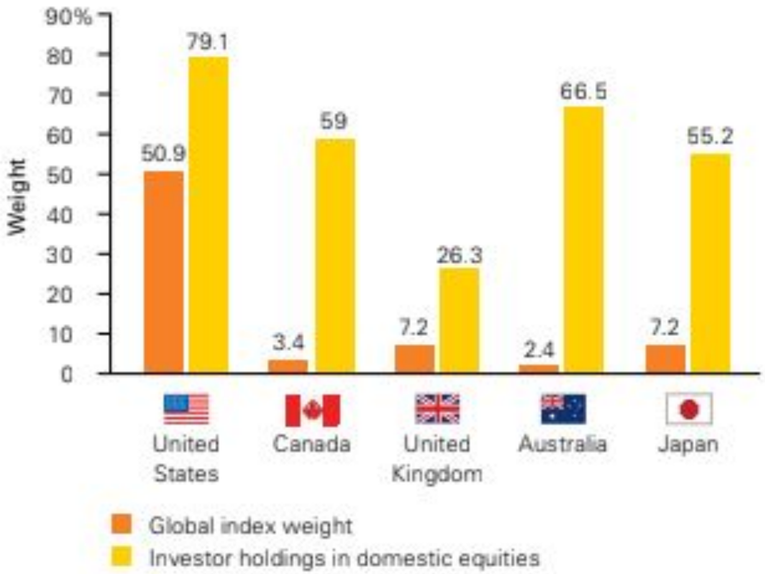
- Tendency of people of overestimate their ability to have predicted an outcome that could not have been predicted.

- Example; I TOLD EVERYONE THE MARKET WAS GOING TO CRASH!

Home Country Bias

- Tendency for investors to favour companies from their own country over other countries or regions.

Figure 5. Equity market home bias by country



Notes: Data as of December 31, 2014 (the latest available from the International Monetary Fund, or IMF) in U.S. dollars. Domestic investment is calculated by subtracting total foreign investment (as reported by the IMF) in a given country from its market capitalization in the MSCI All Country World Index. Given that the IMF data is voluntary, there may be some discrepancies between the market values in the survey and the MSCI ACWI.

Sources: Vanguard, based on data from the IMF's Coordinated Portfolio Investment Survey (2014), Barclays, Thomson Reuters Datastream, and FactSet.

Why investors fail

- Lack of Discipline
- Excessive Costs (Fees and Commissions)
- Lack of Diversification
- Overconfidence
- Deviating from Strategy
- Relying on Forecasts and Market Predictions
- Emotional Decision Making

Advice

-Recognize that biases exist

-Avoid Impulse decisions

-Be able to separate strategy vs outcome

-Don’t monitor results too frequently

-Make a long term commitment to a sound investment plan

-Have a realistic view of the odds

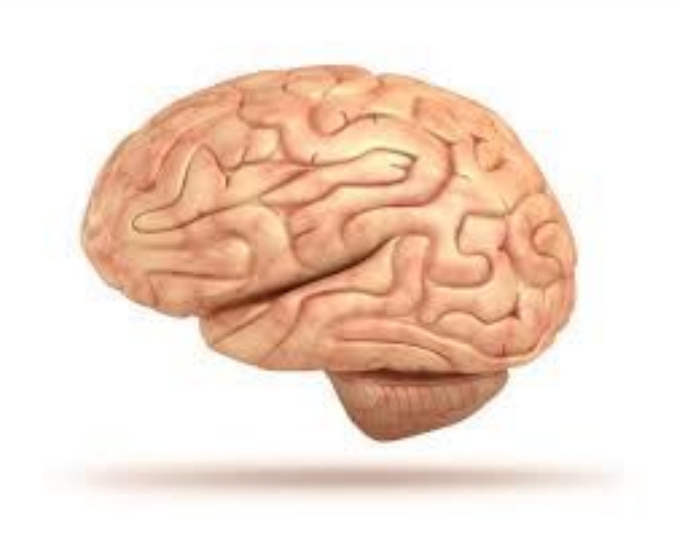
Advice

- Control what is controllable
    - Risk
    - Diversification
    - Costs
    - Behavior

Keep calm and ignore the noise

As long as you have a good strategy, a proper asset allocation, aren't paying too much in fees, your accounts are set up properly, being kept informed, aren't looking too often, watching the news, worrying, staying awake nights, getting ulcers, losing your hair, pulling out your hair, occasionally weeping, rocking gently in the corner drooling....

Maybe just hire an Advisor to do all that for you...



Questions?