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Stu's View

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Timing isn't everything

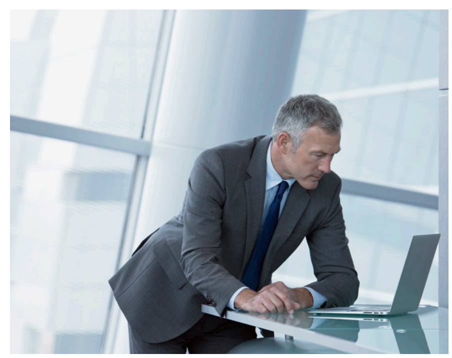
Part two: Emotional buying and selling, and how to reduce the impact of behavioural biases

In this two-part series dedicated to the topic of market timing, we take a look at the topic of market timing from different approaches. In part one, we discuss the difficulty with market timing, and why it is not necessary to achieving your financial goals and objectives. In part two, we discuss the behavioural biases that lead to emotional investment decisions, and we offer up a few nudges to help improve potential outcomes. We stress the importance of the Investment Policy Statement (IPS) in the process, and reiterate the preference for a goals-based approach to investing.

Emotional buying and selling, and how to reduce the impact of behavioural biases

We are at times our worst enemies when it comes to investing. In his book titled The Behavioural Investor, author Dr. Daniel Crosby discusses how as humans, our brains have remained relatively stagnant over the last 150,000 years. Yet the world has become much more complex, with formal markets like the stock market only 400 years old. As he put it, our mental hardware has not caught up to the times.

More modern financial theories and processes have begun to incorporate many of the principles of behavioural investing. Behavioural investing – also known as behavioural economics, or behavioural finance, is a field of study that was formed as economists attempted to explain a litany of biases, heuristics and inefficiencies present in financial markets. It has its roots in the 1980s, but has been referenced in different ways going back over a century. It's important to recognize the various sociological, psychological and neurological factors that influence our investment decisions. And once we do, we need to have some practical ways to improve outcomes (e.g. financial outcomes, achieving goals/objectives), which are called "nudges."



Here are a few common behavioural biases that most investors are prone to, and some nudges to help reduce their impact on the investment process:

- **Recency bias:** Read each of the headlines in the following chart and really ask yourself if you would have felt like selling positions in

Continued on page 2

Timing isn't everything

Continued from page 1

the stock market then? Headlines and accompanying stories in the market can turn our emotions against us, and leave our better judgement aside. The human brain tends to react to new information and we want to form scenarios in our minds, typically worst-case scenarios as we're hardwired to avoid uncertainty and risk.

- **Nudges:** Chart two shows that over a decent period that stocks have averaged around 10% per year. It's not a straight line, though, so you need to do your best to avoid the short-term noise. Reduce time spent checking online balances, limit time spent focusing on short-term performance, and stop listening to financial news media who will tell you "this time is different." Following a goals-based approach to investing where you aren't concerned with what everyone else is doing, and focusing instead on what is in your control (i.e. your strategic asset allocation) is a great nudge.

- **Loss aversion / Regret:** Loss aversion refers to our instinctive preference to avoid losing versus gaining the equivalent amount. The pain of losing is psychologically twice as powerful as the pleasure of gaining. The disposition effect – the tendency among investors to sell stock market winners too soon and hold on to losers too long – has also been attributed to loss aversion. And with a decision comes the very real possibility that we'll make the wrong one. Sticking with the status quo feels much better even if we know it's costing us money. For investors who are especially loss averse, the financial consequences of an emotional reaction can be serious.

Chart 1. S&P 500 price return March 2009 through July 2020, accompanied by major news headlines

Source: S&P 500 Index, total return March 2009 through December 2019, in USD. Bloomberg, RBC Phillips, Hager & North Investment Counsel Inc.

  - **Nudges:** Using a rules-based system for buying and selling decisions in order to avoid status-quo bias brought on by loss aversion and regret. Sometimes a little bit of procrastination when it comes to investment decisions can be a good thing, especially when emotions are running high (i.e. this year post-COVID). Diversification is also a way to reduce feelings of loss aversion/regret, by reducing portfolio volatility over time provided the asset allocation reflects asset classes with varying degrees of correlation.

- **Confirmation bias:** Confirmation bias is the tendency to seek out information that supports your beliefs and ignore information that contradicts them. We tend to believe we have profound insights from simple observations. Investors tend to spend most of their time looking for strategies that "work" or evidence that supports their existing investment philosophy.

  - **Nudges:** Check your ego at the door, to begin with. Similar to nudges offered for other biases above, following a systematic investment process which is rules-based would reduce the chances of increased portfolio risk associated with confirmation bias. Part of that investment process should involve time spent looking for evidence that conflicts with your way of thinking. That is what a good evidence-based investment approach is all about. A quality decision-making process requires good supporting evidence, but the presence of evidence that conflicts with your investment philosophy isn't a bad thing either. The important thing is to keep an open mind because evidence

Continued on page 3

Timing isn't everything
Continued from page 2

tends to cut in multiple directions and understanding all perspectives reduces the chances of error.

- **Overconfidence bias:** Overconfidence is an emotional bias, and an egotistical belief that we're better than we actually are. Overconfident investors might believe they have more control over their investments than they truly do. Since investing involves complex forecasts of the future, overconfident investors may overestimate their abilities to identify successful investments, make forecasts and predict the future.
  - **Nudges:** While confidence is considered a strength in many situations, in investing, it tends to be a weakness. Careful risk management is critical to successful investing. But being mistakenly overconfident in our investment decisions interferes with our ability to practice good risk management. The overconfidence bias often leads us to view our investment decisions as less risky than they actually are. As with the other biases above, diversification helps ward off overconfidence bias. It's a way of admitting that we cannot know it all, or build/protect wealth with just one investment given the varying degrees of luck and uncertainty with investing.

The Investment Policy Statement – a critical component in the investment process

So market-timing doesn't work and instead the focus for investors should be around setting the appropriate strategic asset allocation mix, and revisiting it from time to time. But how do you go about doing so? Next, we discuss the Investment Policy Statement (IPS), which is at the heart of the investment process, and we explain why adhering to the IPS is so important.

While every IPS will be different based on the unique needs and circumstances of the individual, a comprehensive IPS reflects:

- The specific goals and objectives for the portfolio, related to the investor(s)
- Defined roles of the client and Investment Counsellor(s)
- Performance and risk expectations and targets
- Benchmark or nominal rate of return for goals-based investors
- The strategic asset allocation mix, or asset allocation targets and ranges for each asset class or investment style
- Any relevant investment guidelines, policies, restrictions, and constraints including portfolio rebalancing policies and procedures
- The exact types of assets, fund structures and investment styles the fund will and will not invest in
- When investment performance will be reviewed and how investments will be evaluated

As you can see, the IPS is a guidepost for investors and their Investment Counsellors to navigate financial markets over time. Given the important role the IPS plays in the investment process, you should periodically review your IPS with your Investment Counsellor. That's not to suggest you need to make changes at each review, as that would defeat the purpose. You should only make changes when necessary.

From a behavioural perspective, reviewing your IPS is a positive nudge as it serves to remind you why you're investing in the first place. If your IPS is set up correctly, going over it reminds all parties involved about its original goals. It can be a conversation starter – or conversation ender – and act as a benchmark to assess whether or not your investment program is successful.

Systematic rebalancing the portfolio over time

As we've discussed, one of the most important decisions investors will ever make is their asset allocation mix. One problem with this decision is that once it's made, the asset allocation tends to change. Stocks, bonds and other financial instruments fluctuate in value over time, which can alter the asset mix percentages originally agreed upon in order to achieve one's financial goals/objectives. As mentioned above, in the IPS we specify guidelines for how often and by how much we would rebalance the portfolio once the initial asset mix is set. One of the benefits of rebalancing is that it encourages you to buy low and sell high. It's primarily about managing risk by keeping your asset allocation more or less consistent.

Another benefit of systematic rebalancing is that it helps to control certain behaviour (i.e. takes the emotion out of the decision-making process). If there is additional money moving into the portfolio, you need to make a decision about where to allocate those new funds. If you're like most investors who simply follow their emotions, you'll likely add the money to whatever asset class is hot. A disciplined rebalancing schedule – preferably written down in an IPS – can help to avoid this trap.

At RBC PH&N Investment Counsel, our Investment Counsellors work closely with you to ensure a customized

Continued on page 4

Timing isn't everything
Continued from page 3

approach to rebalancing your portfolio(s). Each person's situation will depend on a number of factors, including the specific goals/objectives for the portfolio, their investment time horizon and the magnitude of divergence from strategy asset allocation.

Goals-based investing – no market-timing prerequisite

In our July 17, 2020 article "What's in an index anyway? An introduction to goals-based investing," we introduced goals-based investing principles that look to focus the investment process on the individual investor, versus "beating the market." As such, market-timing decisions don't fit well with a goals-based investment approach. Instead, investors are more concerned with how their portfolio growth is tracking relative to their goals/objectives.

Please reach out to your Investment Counsellor if you have any questions about this article or your portfolio.

Be well,
Stu

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S&P 500 Index: The S&P 500 Index includes 500 companies across many sectors of the U.S. economy. The index is weighted by market capitalization so bigger companies make up a larger proportion of the index than smaller companies. The index is designed to measure performance of the broad US economy through changes in the aggregate market value of the largest US companies.