A Behavioural Point of View

Cory Bruner, CFA®, CFP®
Associate Investment Advisor

Behavioural finance is an interesting topic and one that I became familiar with en route to obtaining the CFA charter. Given the recent market volatility, which is often a trigger for certain behaviours and biases to become more prominent in our investment decisions, I thought it would be useful to describe the theory and point out two common biases, their consequences, and strategies to attempt to mitigate them. The ultimate goal of identifying these behaviours is a part of the investment management process of gathering information and Knowing Your Client (KYC) which is then used to develop an Investment Policy Statement and Strategic Asset Allocation.

Behavioural finance is grounded in psychology and not economic theory. Economic theory suggests that when individuals make decisions they perform complex probability calculations with the goal of optimizing their utility. Therefore, decisions are always rational and optimal.

Behavioural finance posits a different approach. People exhibit certain biases and behaviours that affect their decisions. Investors don't have the time or the cognitive ability to make complicated calculations and therefore outcomes are not always rational. At its core, behavioural finance is about attempting to explain how people ACTUALLY behave as opposed to how they SHOULD behave.

There are two categories of biases investors display when making decisions: cognitive and emotional. Cognitive biases result in decisions based on faulty thinking or reasoning. They tend to be more easily moderated through education, information and advice. Emotional biases result in decisions that stem from feelings, emotions, perceptions or beliefs. Thus, they tend to be more difficult to moderate or eliminate.

There are fifteen cognitive and emotional biases that investors display and I wanted to highlight two very common ones.

Hindsight bias is one of the most prevalent cognitive biases. It could also be known as the 'should have, could have, would have' or 'after-the-fact' bias. This bias suggests that investors look at past events as predictable or reasonable to expect. In addition, they tend to believe their predictions of the future are more accurate than they are.

As an example, I remember having a conversation with a client regarding real estate investment back in 2012. In 2014, the client was commenting that he thought he 'should have' invested in real estate instead of mutual funds because real estate had performed better. This was a classic case of "hindsight is always 20/20". First of all, we can only determine which investment had superior performance after the event/after the fact. Also, we make investment decisions with the information we have at the time. When the decision was made to invest in mutual funds in 2012, there were serious concerns about the

real estate market. There was talk in research papers and the press about whether there would be a correction and whether rates were on the rise.

One consequence of displaying hindsight for investors is that they overestimate the degree to which they predicted an investment outcome. This leads to overconfidence in their ability to make money-making decisions and results in taking on excessive risk in their portfolio. A good way to keep ourselves in check is to keep detailed records of our analysis and then compare them to the outcome after the fact.

Another is that we sometimes unfairly assess money managers; the manager didn't perform well so the fund should be sold. However, we should assess a manager not only on ex-post performance but also on what their assumptions were at that time.

Self-control bias is an emotional bias and one that recurs in the field of financial planning. The idea is that people fail to reach their long-term financial goals because of lack of self-discipline and pursuit of short-term satisfaction. We want to spend today rather than save for tomorrow. We see this in rising consumer debt levels as a result of low rates and the availability and ease of online shopping both of which have resulted in increased spending today over long-term savings.

These actions can result in not saving sufficiently for the future and are often one of the main sources of longevity risk. As a result, one may increase risk in the portfolio to make up for lack of saving. The key to overcoming this behaviour is to have proper investment and financial plans in place and to review them regularly to ensure they are still on target.

The goal was to introduce the topic of behavioral finance and its effect on investment decisions. What was presented was by no means exhaustive but just an overview of some of the interesting research in the field. As stated earlier, the purpose is to integrate behavioral finance and traditional finance to result in better economic decisions and ultimately more appropriate portfolios.

This information has been prepared by Cory Bruner who is an Associate Investment Advisor for HollisWealth® and does not necessarily reflect the opinion of HollisWealth. The information contained in this article comes from sources we believe reliable, but we cannot guarantee its accuracy or reliability. The opinions expressed are based on an analysis and interpretation dating from the date of publication and are subject to change without notice. Furthermore, they do not constitute an offer or solicitation to buy or sell any of the securities mentioned. The information contained herein may not apply to all types of investors. The Investment Advisor can open accounts only in the provinces in which they are registered. HollisWealth® is a division of Industrial Alliance Securities Inc., a member of the Canadian Investor Protection Fund and the Investment Industry Regulatory Organization of Canada.

Polson
Bourbonniere
Derby
WEALTH MANAGEMENT

HollisWealth®