

From The Desk

Observations, thoughts and theories from
the world of global portfolio management

Behavioural Finance

Is Bad Behaviour
affecting your
portfolio?

August 2010

Behavioural finance is a relatively new but exploding field of research in the investment management sphere. Work in this field really only began in the 70's with the efforts of professor Amos Tversky, while of course capital markets have been in existence for centuries. In essence, Behavioural Finance is the study of the influence of psychology and behavior of financial market participants on the markets. This area of research is of interest because it attempts to explain why markets may not be efficient, and leads to methods to take advantage of these realities. Dozens of different theories have been studied and conclusions reached, many of which show that humans are often their own worst enemies when it comes to investing.

From every tragedy comes opportunity though, and it is this **irrationality** of others that the active investment manager (as opposed to a manager that simply buys an index) hopes to take advantage. Those that can keep their wits, when everyone around them is losing theirs, is bound to prosper as the old saw goes. The famous Warren Buffett is probably the quintessential calm, cool collected investor. One need look no further than the last round of market malaise in 2008/2009 to see how he came to the rescue of several firms (i.e., Goldman Sachs and Wrigley's) with capital that gave Buffett and his investors incredible upside to his returns.

Knowing oneself is likely the first key to preventing mistakes and, further, to taking advantage of the mistakes of others. So simply knowing that our brains are fallible and prone to error allows the 'rational'

person to set boundaries to limit and correct mistakes. Indeed many successful investment managers have created systematic and repeatable quantitative systems to allow them to remove their unwanted and detrimental biases from the security selection and portfolio construction process.

Interestingly, a recent study showed that patients with certain kinds of brain injuries make better investors. This study, conducted by a team of researchers from Stanford University, Carnegie Mellon University, and the University of Iowa, analyzed the investment decisions made by people who were unable to feel emotions due to brain lesions. Specifically, those with this type of injury were able to avoid irrational decisions that lead to short-term and long-term performance downfalls. In our own experiences with regard to portfolio management, it has often been the case that the investors who have seemingly known their own limits and kept their strategies simple have shown the greatest wealth accumulation over time and, therefore, the best performance of all investors. Anecdotally, these investors don't seem to bother themselves with the news media and are content to be "buy-and-hold" investors. They buy companies that have seemingly solid franchises, a history of solid growth and pay dividends that tend to rise over time. Perhaps, unwittingly, they manage to free themselves of the vices that destroy many an investor and portfolio manager too. In fact, another study looked at this very topic and found that too much information is often a bad thing. In the study the researchers looked at two groups of investors. One group was given constant information about the



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economy and companies while the other group was given no news. It turned out that the group with no news outperformed the group with continuous news by a factor of two!

One behavioural bias that we spend a great deal of time on with investors is **loss aversion**. It has been documented that people feel the pain of loss twice as intensely as they do the joy of gains. As applied to portfolios, clients will be much more negatively affected emotionally by a 20% loss of capital than their emotional pleasure from a 20% gain. Naturally this leads us to helping clients decide when to dial down the aggressiveness of their portfolios.

Confirmation bias (also known as the Illusion of Validity) is a very common error that we are all prone to. This is where we consciously and subconsciously seek out information or data that supports our view, while also shutting out any opposing views. A good method for correcting this, in addition to just being aware that it exists, is to actively seek out contrary opinions and research. Informally, and in our Investment Committees at Guardian, we are constantly challenging our assumptions as devil's advocates and outlining worst-case-scenario planning.

Overconfidence is something that most individuals suffer from in some way, shape or form. One of the most common examples of this is when a sizable group of people is asked who believes that they are an above-average driver. Inevitably a majority of the group will say that they are indeed above

average (usually this number is around 80%!). Clearly, it is impossible for everyone to be above average, but many are overconfident in their own abilities. This phenomenon strikes investors as well. Most wealthy individuals have acquired their wealth through excellence of some sort in the business world. And it is only natural that they believe that they can apply this excellence to other arenas, including the investing arena. It is useful to remember that a certain element of fortunate timing is usually involved in all success stories, and the ability to recreate that timing may not be as easy as one thinks. Thus, taking a more moderate approach with one's wealth is often a wise choice.

Greed and ego are two of the most basic personal behavioural adversaries that we face. There is a story of a real estate investor in the UK that owned a condominium complex. He was convinced that rents would skyrocket as they had over the past years, and so instead of finishing the building with fixtures and the like that would need refreshing, he simply sat on the building (as it was unfinished and thus unrentable) for years waiting for higher rents. Not only did the rents not come, but prices even reversed and he was forced to finish the building and rent it out at much lower rents than he could have originally earned. Ultimately, the attempt to 'time the market' and make outsized gains cost the investor dearly. Greed and ego in this sense show up in the investing world all the time. Being humble by accepting mistakes and cutting losses, and recognizing that there are many unknowns in the world are specific ways to deal with this problem.



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A **representative heuristic** is something that dogs many an investor as well. This is where we unknowingly and unreasonably extrapolate one 'known' to another unknown. The most common example is assuming that a good company is also a good investment. While they often go hand-in-hand, one can't always say that a good company is a good investment. Buying IBM at \$100 can be a lot different than buying IBM at \$250, even though it is still just IBM.

Adding insult to injury is the fact that humans aren't even very good at correcting their behavioural mistakes. We seem to make them over and over again. Worse, we have an amazing ability to even forget our mistakes by recreating the past! This is known as **cognitive dissonance** and is often seen when investors brag about their past returns while leaving out the losses that they sustained – and believing it too!

The passive investor says that on balance the market is always correct, while the active investor says that the emotional overreactions (both positive and negative) of the collective market is something to be taken advantage of. It is hard to argue that the market doesn't provide the opportunity to benefit from mis-pricings – the challenge is to do it systematically and repeatedly. Warren Buffett was also famously quoted as saying that "if the market was efficient I'd be a beggar on the street with a tin cup"

In conclusion, we believe that the platform that we have created at Guardian Capital Advisors allows us to acknowledge and limit our weaknesses, while taking advantage of many of the aforementioned behavioural errors of others in the marketplace. By systematically screening stocks for good growth, value, stability, dividends and price appreciation, which allows for both timely "buy" and "sell" decisions, we believe that our equity portfolios will continue to outperform with less volatility over time. Moreover, we feel that our overall approach of being adaptive to changing market conditions while challenging consensus views, seeking out contrary external opinions, and playing devil's advocate lends itself to stable and lasting wealth for our clients.

**Guardian Capital Advisors
Investment Committee**



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