

PERSPECTIVE

MAKING DECISIONS THAT DRIVE RESULTS

LOOKING FOR CLARITY IN THE NEW YEAR

PROGRESS DESPITE VOLATILITY

WHEN EMOTIONS RUN HIGH

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Behavioural Finance tells all

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How do you make a decision? Seems a simple question given the myriad of choices we make in a day. Some decisions arise out of habit; others result from careful consideration of facts, while others are purely impulsive.



In the world of investing, there are two streams of thought about how people make decisions. Not surprisingly, they align with the age-old debate as to whether we humans are fundamentally rational or irrational beings.

Modern Portfolio Theory (MPT), which was pioneered in the mid-1950s by Harry Markowitz, remains core to today's investment management practices and finance theory courses taught in business schools. MPT has been critical in identifying the quantitative relationship between risk and return, correlation and the benefits of diversification. MPT also assumes investors are rational in their decision making and can easily calibrate the tradeoff between risk and return.

And yet, over centuries irrational investment decisions have given rise to incidents such as the 17th century tulip craze in the Netherlands to the Technology-

Media-Telecommunications bubble of the late 1990s. The field of Behavioural Finance questions investors' rationality and seeks to understand market anomalies that are difficult to explain using standard finance theory.

From a Behavioural Finance perspective, investors may look rationally at an opportunity but various emotional factors also figure into the equation. Some behaviours appear obvious, while others are more subtle. For example:

- **Anchoring**
People default to what they know, which may or may not be consistent with reality. For instance, they may extrapolate on recent trends, though that may go against long-term patterns. Alternatively, they fixate on an aging piece of information such as the price paid for the stock. Using specific data points can lead to a reluctance to

purchase a stock or reinforce the inclination to sell a stock trading at a 52-week high.

- **Loss Aversion and Regret**
People have a propensity to keep losers and sell winners. This propensity can be attributed to the feelings of regret, anger and disappointment that can accompany the decision to sell. These are feelings people would naturally prefer to avoid and do so by holding onto losers. The story of Nortel shares after the company's implosion in 2000 provides a classic example.
- **Mental Accounting**
Consciously or unconsciously, people compartmentalize assets for downside protection and those for upside potential, rather than seeing the strengths and potential weaknesses of their whole portfolio.

■ **Overconfidence**

Most investors tend to think they have a much greater ability to forecast inherently unpredictable events than is actually the case. Overconfidence, in an investment context, stoked by the availability of information and ease of execution, often manifests itself in overtrading and, in turn, poor performance.

Decidedly Opportunistic

Taking a step back, you can see how emotional behaviours can influence one's decision making, perhaps even your own. We think the "truth"—behind the multitude of individual investment decisions that

happen daily—lies in the middle between rational and irrational thinking. The result is a somewhat inefficient market, which creates opportunities for us to add value through our active investment management approach. As part of this process, we continue to employ many of the core principles of standard finance theory while acknowledging the key findings of Behavioural Finance research.

As investment managers, we employ a comprehensive, disciplined process of decision making. It is designed to neutralize individual biases and emotions and focuses on meeting your long-term goals.

In managing your investments, we recognize your portfolio represents not

only a plan to maximize return at a given level of risk, but as importantly, an engine for helping you reach important goals and dreams. Your *Investment Policy Statement* and the advice provided by your investment counsellor and financial advisor(s) are critical to translating your aspirations into results. This combination of guidance and policy provides a firm foundation for making sound decisions in a complex and, at times, irrational world.

We invite you to watch for future articles on Behavioural Finance where we will examine specific emotions, patterns and investor decisions that drive the markets.

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