Davidson Professional Wealth Management

Portfolio Matters

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April 2012

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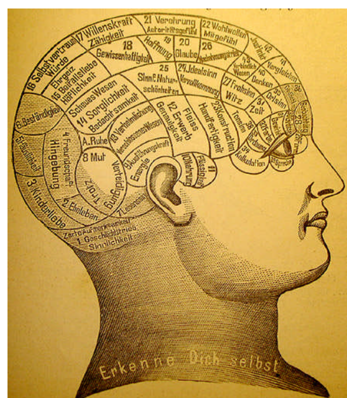
Behavioural Finance



A relatively new field of academic study has emerged that combines psychology and finance to try to understand investor behaviour. Much of what Behavioural Finance has found is that investors' decisions tend to follow identifiable patterns, leading to predictable and at times self-defeating behaviours.

Recency Bias- An irrational expectation that what has occurred in the recent past will continue into the future. Whether it be a rising stock market or a market correction, investors tend to want to position their portfolios as if the future will necessarily be a continuation of the recent past. One result is a high aversion to risk as we emerge from market corrections, thereby failing to capitalize on what is often one of the best periods for stocks; or, a high or growing risk tolerance after a period of rising markets, only to suffer unexpected loss when expectations fail to materialize.

Studies document that the most successful investment managers resist recency bias by positioning their portfolios more aggressively after periods of poor performance. Conversely, less successful managers fall victim by becoming more defensive in their portfolios thereby failing to capture the opportunity that is ahead.

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Loss aversion- this is a first principle for many investors, and particularly seasoned investment professionals. Warren Buffet's adage: "The first rule of investing is 'don't lose money' and the second is 'don't forget the first rule' comes to mind. Researchers have concluded that investment losses leave much greater impressions on investors than do gains of similar magnitude.

Consistent with this observation, we find that investors who suffered recent losses will have the greatest difficulty in moving away from a defensive posture in their portfolios, especially when conditions require doing otherwise.

Hindsight bias- the unfolding of events is much easier to understand when viewed in hindsight. This often leads us equally to believe that they were more predictable than in fact they really were. The effect can be overconfidence in our forecasting of future events, or an unrealistic assessment of what we should have done in the past since the optimal course has become so obvious.

Armed with these observations, we can recognize when we fall into familiar patterns that, although seemingly intuitive, can be at cross purposes to our objectives. In effect, they support the contention that a successful investor often has contrarian tendencies that allow them to take advantage of the real opportunities in investment markets.

Diversification

Putting your eggs in more than one basket-

The act of spreading risk by not putting all of one's eggs in a single basket is tried and true. What often goes unacknowledged is that while diversification spreads risk it inevitably dilutes performance. An undiversified portfolio of a single security will generate the undiluted (pure) performance of that single security. If that single security appreciates by 100%, so too does the portfolio. Adding successive securities serves to spread the performance as well as the risk.

Dilution of performance aside, we need to be clear about what we expect to achieve through diversification. Diversifying our portfolio from one bank stock to two bank stocks will not likely achieve the intended benefit of spreading risk in the event of another banking crisis. Both banks can be expected to suffer similar fates.

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Similarly buying companies domiciled in the same geographical region may suffer similar fates, based on common economic or political conditions.

Instead, what is needed is diversification to non-correlated securities: securities that tend not to move in tandem. For example, during the financial crisis of 2008 / 2009, while the value of bank stocks literally plummeted, the value of 10 year AAA government bonds actually rose dramatically. These two assets showed a strong negative correlation, and when one took a drubbing, the other preserved the value of the portfolio.

Conversely, when the market began to recover, bank stocks regained much of their losses while the value of the government bonds declined. The effect on performance was that these assets did not move together and resulted in diluted performance during both the decline and the subsequent recovery. The result is a smoother trajectory of the portfolio's value.

This gives rise to another benefit of diversification, the opportunity to rebalance. Having target allocations for the various asset classes allows an investor to take profits on one class of investments while redeploying those profits to an underperforming sector. This affords the opportunity to sell high and buy low and should be a core strategy in any portfolio management process. Such is the benefit and reality of diversifying with assets that are non-correlated.

Welcome Greg!

We have the great pleasure of announcing the arrival of our newest team member, Greg McQueen, who will be our marketing and research associate. Greg has joined us to help expand our research capabilities as well as uncover new client opportunities. He has been in the financial field for the past 5 years and is known for his positive attitude and ambitious character. Greg's outgoing personality and fresh perspective will enable our business to grow, while working and communicating efficiently. Please join us in welcoming Greg to our team.

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Canadian Sector Performance	YTD	2011
Energy	-0.1%	-12.3%
Materials	1.6%	-21.8%
Industrials	3.4%	2.0%
Consumer Discretionary	14.3%	-17.9%
Consumer Staples	7.8%	4.8%
Health Care	16.4%	49.6%
Financials	10.5%	-6.6%
Information Technology	6.2%	-52.6%
Telecommunication Services	-1.5%	19.0%
Utilities	0.4%	1.6%

Number Crunching

Year to date performance as of Mar 31st, 2012 of select currency and equity indices. All returns are in local currencies.

Equity Indices	YTD	2011
S&P/TSX Composite Index Total Return	4.4%	-8.7%
Dow Jones Industrial Average	8.6%	5.5%
S&P 500 Index	12.8%	0.0%
NASDAQ Composite Index	19.8%	-1.8%
MSCI EAFE	10.0%	-14.8%
Currencies (in Cdn $)	**YTD**	**2011**
US Dollar	5.2%	-5.2%
Euro	5.2%	-11.5%

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E-Newsletter!

We are pleased to now offer our quarterly newsletter in electronic format. If you would prefer this method of delivery please email us at chris.emms@rbc.com.

Source: RBC Dominion Securities

Tax Planning Update:

2012 RRSP Contribution Limit: 18% of earned income to a maximum of $22,970

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