

Planning Matters



 **Leith Wheeler**
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FALL 2017 EDITION

Ignore the Noise!

Emotions Interfere with Investment Decisions

We all believe we are better than average drivers, have higher than average intelligence, and are better than average investors... Sorry, but...

Clearly, it's impossible for a majority of drivers to be "better than average," and it is equally impossible for most to be better than average investors. One of the main tenets of the Efficient Market Hypothesis taught in classrooms around the world is that people are "rational wealth maximizers," who will process all available information in a logical manner and make sound decisions. Unfortunately, investors often succumb to

powerful behavioural biases, which cloud the "rational" part of decision-making and result in sub-optimal outcomes. At Leith Wheeler, part of our process is to challenge one another in a structured and candid way to ensure we don't fall prey to these behavioural biases when making investment decisions. This edition of Planning Matters discusses a handful of the most common decision-making pitfalls, and how to avoid them.

Confirmation Bias

People tend to look for evidence or opinions that confirm what they already think. Evidence against prevailing views is often ignored, and makes us feel uncomfortable or sometimes even annoyed.

For example, investors may hold a winning investment for too long, feeling overly confident in their original decision and ignoring changing circumstances. Even if the investment is reviewed, investors are drawn to data that confirms their positive view and discount information that highlights the flaws in their thinking.

Regular portfolio rebalancing and diversifying holdings to avoid too much concentration are common ways of managing this bias. Another more broadly applicable approach is to make sure the case against an existing view is properly tested by a knowledgeable and objective peer group. Having a good understanding of the opposing argument is a great start in fighting confirmation bias.

Bandwagon Bias (Herding)

Everyone likes a winner and wants to be part of a winning conversation! Bandwagon bias is a tendency to want to belong in the crowd, to do things because others are doing them or believe them. The investing world is littered with examples of Bandwagon bias, such as: Nifty 50, Nortel, Bre-X, Blackberry and dot com stocks. In challenging this bias, an investor must recognize that something is not true simply because everyone seems to say so. The press loves to fuel bandwagons, and it is therefore critical to treat hype (positive or negative) with a healthy dose of skepticism.

Anchoring (and Recency) Bias

People often allow unrelated or irrelevant information to affect a decision. This tendency is particularly prevalent when the decision being made is unfamiliar or uncertain. For example, when a stock exhibits strong returns for a period, we may anchor on that as we assess its future return potential. The dot com bubble had investors anchored on the enormous promise of future profit, making them prepared to pay far more than they should for even non-internet companies. More recently in Canada, a healthcare stock rose to over \$200 per share and then quickly fell on bad news. Once the stock had fallen below \$100 many investors saw it as cheap regardless of its prospects, because they remained anchored on the old \$200 price tag (It's now below \$20). Anchoring and Bandwagon biases are closely related.

The solution to anchoring is to analyse historical data, but not to rely on historical conclusions (i.e. a stock's appropriate value should be determined based on current information, its fundamental outlook, and business characteristics; while its historical trading price should be ignored). It's also good practice to routinely go through a "pre-mortem" where an investor identifies ways in which their decision could turn out to be wrong and consider the implications of those scenarios in advance.

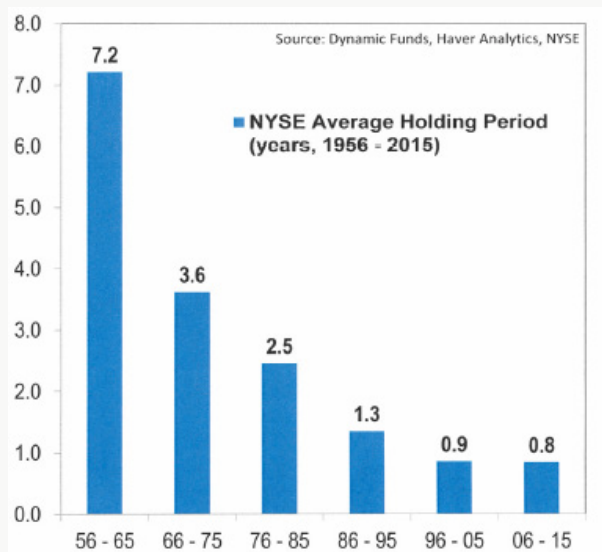
Loss Aversion Bias

Finally, Loss Aversion Bias is a tendency to dislike losing more than enjoying winning. How this impacts investment decisions is twofold: Firstly, the inability to sell a position and "realize" a loss. As described above, a holding in a stock should be evaluated regularly within the context of the current pricing environment and fundamental outlook. If, following an unbiased review of the position, the stock appears overvalued relative to its longer term prospects, the position should be sold with the proceeds re-invested in a better opportunity, regardless of whether the sale results in a loss. By way of example, on occasion we speak with clients who have individual holdings in a "fun" trading account, who upon follow up, may admit that "the stock is down, but I'm a long term investor"! Loss aversion bias changes the investor's perspective on a company from a quick profit to a long term hold. Secondly, Loss Aversion Bias can be very powerful in a very negative stock market environment, which can lead to panic selling and the withdrawal of capital at the worst possible time – again ignoring company fundamentals.



Too Much Efficiency and Too Much Noise!

In today's investing world, there is no shortage of information that bombards us every nano-second on any given topic, with thousands of perspectives. All of this information from tweets, real and fake news and media alerts fools investors into thinking that they are able to make decisions based on "better" information. Sadly, this has not proven to be true. The graphic below illustrates the average holding period for a stock over the past several decades. Clearly, the abundance of information combined with the relatively low cost of trading allows investors to react (i.e. trade) more easily and frequently than at any other time in history. We believe that this shorter attention span and inability to commit to longer term decisions, creates opportunity for long-term patient value investors.



How do we Combat Behavioural Biases at Leith Wheeler?

We recognize that process is the one thing in investing that is in our control – returns are not.

Our process focuses on patience and discipline, making independent decisions based on our long term perspective of a company's potential, and tends to discount (and mostly ignore) the vast amount of market noise that bombards us daily. We structure our decision-making in committees of diverse peers with different areas of expertise, to candidly bring different points of view to the table, thereby capturing our collective intelligence. We hold ourselves accountable to following our process, which frees us from worrying about aspects that we have no control over, such as market behaviour and return.

As a result, we enter into investments with an outlook focussed several years into the future, rather than to the next earnings call. The outcome of this process is reflected in the table below, which illustrates the length of time we have owned our current positions in our Canadian equity strategy:

Holding Periods as at Dec. 31/2016

Years Held	% of Canadian Equity Strategy
> 15 Years	39%
5 – 15 Years	29%
< 5 Years	32%

During inevitable periods of heightened noise, and underperformance compared to the index, pressure always builds to compromise our process and react differently. A real example of this can be found during the tech bubble, where we avoided making investments in Nortel, JDS Uniphase and other Bandwagon stocks. While our critics told us we were out of sync at the time, ultimately our conviction in our process proved us correct over the long run.

An acute awareness of behavioural biases is often the most important first step in combating them, while a sound process that can be applied equally through periods of market calmness and calamity is an excellent way to remain focused. We remain committed to our long term investment process, which has led to over 35 years of success in value investing.

About the Author:

Mike Baker, CFA joined Leith Wheeler's Toronto office in 2016 with over 20 years of experience as the trusted advisor to wealthy families and institutions with responsibility for the guidance, oversight, construction and implementation of best-of-breed, multi-manager investment strategies. Mike is responsible for managing discretionary portfolios for Leith Wheeler's private and Foundation clients across Canada. In his prior role, Mike was a Board member, VP/ Investment Counsellor and Senior Director with an independent Advisory (consulting) boutique subsequently acquired by a multinational financial institution. While there he was a member of both the Investment Strategy Committee, and the International Investment Committee. No matter the level of client sophistication, Mike has been praised by his clients and peers alike as being an effective communicator of investment strategy and perspective so that investors fully understand their portfolios. He holds a Chartered Financial Analyst (CFA) designation and is a member of the Toronto CFA Society.

About the Editor:

Michael Job, CFA joined Leith Wheeler in September 2007 after graduating from Dalhousie University with a Bachelor of Commerce degree. While at Dalhousie, Michael majored in finance and completed co-op placements in equity research and investment banking at a major Canadian bank. At Leith Wheeler, Michael is responsible for managing both Private and Institutional clients, including Foundations and First Nations. Michael sits on the CFA Vancouver Board of Directors and holds a Chartered Financial Analyst (CFA) designation.

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