

## **Behavioral Finance & Making Investment Decisions**

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Everyone knows someone who has panicked and sold their investments at the worst possible time when the market has sold off, only to later regret that decision, or someone who has procrastinated on investing wanting to wait until the “ideal time” to invest. We also know others who stay invested regardless of the ups and downs of the market and reap the benefits with strong long-term returns. What makes these investors different? Part of the answer can be found in Behavioral Finance and the subtle psychological factors that make us do the things we do. In this article we will talk about a few of the common behavioral biases that can impact your investment decisions, and what you can do about them when making investment decisions.

### **What is Behavioral Finance?**

Behavioral finance is a field of study, closely related to behavioral economics, which studies the impact of emotion, cognitive biases and other psychological factors on financial decision making. Behavioral finance emphasizes the role such factors play in irrational investment behavior and its consequences in market fluctuations. The study of behavioral finance took foot in the early 1980s and is considered a legitimate field of study in finance and economics. (APA Dictionary of Psychology)

### **The Illusion of Control**

The term “illusion of control” was coined in 1975 by US social psychologist Ellen Langer and is the false belief that external events result from, or are governed by, one’s own actions or choices. The illusion of control leads us to overestimate our odds of succeeding or getting a positive outcome, and to invent explanations linking our behaviour to some result. In investing, this bias is the tendency for investors to believe that they have a certain degree of control over the outcomes of investment markets and can compel investors to trade their portfolios more than is prudent. The act of trading (buying and selling) can give investors a false sense of control, and in most cases is detrimental to the long term returns of their portfolio compared to a buy and hold approach. Past research has shown that up to 90% of amateurs lose money in the markets. (Barber, B. et al, 2009. Just how much do individual investors lose by trading? (*The Review of Financial Studies*, 22(2), 609-632.))

What can we do about it? The most important thing to realize when it comes to investing is there is no certainty. We are making decisions based on past and current information and forecasting future probabilities that can take years for businesses to play out. When doing your investment analysis, it is important to take a long-term view and to avoid making unnecessary trades to your portfolio simply to feel like you are more in control. A lot of time, being patient is the best choice of all.

### **Loss Aversion**

Loss aversion is the tendency to prefer avoiding losses to acquiring equivalent gains. Some studies have suggested that losses are twice as powerful, psychologically, as gains. Loss aversion was first identified by Amos Tversky and Daniel Kahneman. (Kahneman, D. & Tversky, A. (1979). “Prospect Theory: An Analysis of Decision under Risk”.) An investor who chooses to put their long-term money in a savings account or a GIC because the risk of loss far outweighs

the potential long-term gains of the stock market is an example of loss aversion. Investors who are more prone to loss aversion will watch the performance of their portfolios more closely and more often. They tend to be more apt to sell when a market declines or more nervous about market declines if they are high on the loss aversion scale.

What can we do about it? To combat this bias, investors must be aware of the long-term goals they desire from their investment portfolio and be aware that it is **time** in the market and **not timing** the market that allows them to build wealth. It would also serve investors well to be familiar with Myopic Loss Aversion, as discussed below.

### **Myopic Loss Aversion**

Myopic Loss Aversion occurs when investors take a view of their investments that is strongly focused on the short-term, leading them to react too negatively to recent losses, which may be at the expense of long-term benefits (Thaler et al., 1997). A large-scale field experiment has shown that individuals who receive information about their investment performance too frequently tend to underinvest in riskier assets, losing out on the potential for better long-term gains (Larson et al., 2016). Myopic loss aversion is a form of myopic behaviour which is based on the pursuit of short-term results and actions focused on what one wants now (or one fears in the moment), without considering any future consequences.

What can we do about it? The most important thing you can do as an investor who tends to focus on the short-term news and events and short-term stock fluctuations is to remind yourself that you are investing for the long term and that stocks will fluctuate, at times significantly, in the short-term. Shifts in the market in the short-term should not be cause of panic. During times of volatility, seasoned investor Warren Buffett says it is best to stay calm and to stick to the basics, buy-and-hold for the long term. Buffett shared in his 2017 Berkshire Hathaway shareholder letter the following 19<sup>th</sup> century poem by Rudyard Kipling "If" - which helps illustrate this point:

*If you can keep your head when all about you are losing theirs ...  
If you can wait and not be tired by waiting ...  
If you can think – and not make thoughts your aim ...  
If you can trust yourself when all men doubt you ...  
Yours is the Earth and everything that's in it.*

### **Confirmation Bias**

Confirmation bias is the tendency to search for and recall information in a way that confirms or supports one's prior beliefs or values. (Nickerson, Raymond S., 1998 "Confirmation bias: A ubiquitous phenomenon in many guises", *Review of General Psychology*) People display this bias when they select information that supports their views, ignoring contrary information. We tend to think of ourselves as open-minded and interested in finding the facts and truth, but many experiments have confirmed that people tend to test hypotheses in a one-sided way, by searching for evidence consistent with their pre-held beliefs. (Kunda, Ziva, *Social cognition: Making sense of people*, MIT Press, 1999)

What can we do about it? Be careful not to spend all your time focused on the positives or supporting ideas of your views or beliefs and challenge yourself to focus on the potential negatives too. Having an independent peer group such as a financial advisor or investment manager you trust to review your ideas and provide feedback without the knowledge of where you may stand on the subject is important for a more neutral perspective.

### **Familiarity Bias**

Familiarity bias simply describes the tendency of people to return to what they know and are comfortable with. It discourages affected people from exploring new options and may limit their ability to find an optimal solution. ("10

cognitive biases that can lead to investment mistakes". *Magellan Financial Group*. Retrieved September 21, 2020.) Investors with familiarity bias tend to focus only on what they know and are familiar with. This is not necessarily a bad thing in that the investor should be knowledgeable about the stocks or sectors that they follow but if taken to an extreme can cause an investor to only focus on those securities or sectors that they are most comfortable with which can potentially lead to an investment portfolio with an inappropriate asset allocation and a greater risk of loss.

What can we do about it? In everyday life, have a little fun with this bias and challenge yourself to try new things or different approaches to doing things that you otherwise may not have tried. Maybe take another route home from work or order something different off the menu. This will train your brain to be open to the unfamiliar and you may surprise yourself with what you discover. As it relates to investing, ensure you have an investment policy and framework for investing that is diversified across several sectors and asset classes and be mindful of your own bias and comfort zone that could cause you to be taking excessive risk in one area or another simply due to familiarity.

### **Conclusion**

We touched on only a few of the behavioral biases that researchers have uncovered over the last several decades. It seems that people are not as rational in their decision making as we may have thought, and that subliminal biases could be driving or at least influencing many of the decisions that we make in life. The good news from all of this is gaining more awareness. The better job we can do as individuals to be aware of our own biases, the better job we will be able to do with the important decisions not only with our investments but in life.

## **Global Energy Security – The Accelerated Green Transition**

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First and foremost, we would like to begin by extending our thoughts to those impacted by Russia's unprovoked invasion of Ukraine. We have been deeply saddened by the size and scale of the humanitarian disaster brought on by these events and continue to hope for a resolution to this devastating and tragic conflict. While our immediate concern is with those directly impacted by this horrible conflict, there have also been many questions regarding the economic consequences of these events, most notably what it means for capital markets and global energy security.

In the opening weeks of the conflict, oil prices surged to their highest level since 2008 as concern around global energy supply has been called into question. The impact of this sudden volatility has been felt by consumers around the world as fuel prices have surged, and increased transportation costs add to already above average inflation across a range of sectors. The driving force behind this sudden instability in global energy prices is Russia's position in global oil and gas production. Russia is the world's third largest oil producer, and largest oil exporter to global markets with 60% of exports going to OECD Europe. Furthermore, Russia currently accounts for 40% of the European Union's natural gas imports used for heat and power.

As the international community coordinates economic sanctions to be imposed on Russia, the biggest challenge for Europe is overcoming their dependence on Russian energy supply without causing an energy crisis at home. The objective of overcoming this reliance is two-fold: 1) economically hit Russia where it hurts most, and severely hamper their financial/economic ability to wage war, and 2) improve energy independence, security, and stability across Europe and the world. What is clear is that Europe now recognizes the urgent need to move away from their reliance on Russian oil and gas with Germany halting Nord Stream 2, the United Kingdom banning the import of Russian oil by the end of 2022, and EU leaders agreeing in principle to eliminate the bloc's dependence on Russian energy by 2027.

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As Europe and much of the world begin to shift away from Russian energy, a broader theme of energy independence and security is being considered, as they seek sustainable alternatives that do not present the same geopolitical risks and vulnerabilities that oil has historically shown. One option that Europe is focusing on is renewable energy. While leaders in Europe have been working to secure oil and gas supplies from alternative sources outside of Russia, many leaders are also renewing their commitment to an accelerated green transition. British Prime Minister Boris Johnson recently advocated for new drilling in the North Sea, while also doubling down on renewables such as wind and solar.

While wind and solar energy have not been immune from recent inflationary pressures brought about by supply chain issues and surging steel prices the last several months, technological improvements over the course of the last decade have greatly improved the economics of wind and solar, making it an attractive and increasingly cheaper alternative to conventional energy sources. While recent disruptions from supply chain issues will slow the pace of falling prices in renewables, the expectation is that this general trajectory will continue through to 2030.

Of course, the green transition in Europe and North America will not be without challenges. The scale of this transition is immense and will require long-term strategic planning beyond adding renewable generating capacity. This transition will also require significant investments in grid modernization of transmission and distribution, and energy storage infrastructure to allow for the sustainable and reliable interconnection of renewables. Despite these challenges, as recent geopolitical tensions have demonstrated, the transition towards renewable energy not only serves environmental objectives but can also be the key to achieving greater energy independence, stability, and security which has come under threat in recent months. While conventional energy continues to be critical to global energy security and will remain so for some time, it is clear the theme of accelerated transition towards renewables continues to gain traction.

As this energy transition accelerates, we continue to believe that the runway for long-term sustainable growth in renewables is strong. We continue to see positive results from this sector within several of our Canadian and United States Equity Model holdings. Northland Power (TSE: NPI) has identified significant growth opportunities for continued development in offshore wind, including in Europe where existing offshore wind development targets are significant. At Dominion Energy Inc. (NYSE: D), we continue to monitor progress in the Virginia Coastal Offshore Wind Project, a \$9.8 billion project which is expected to add 2.6 GW (gigawatts) of generating capacity in Virginia by 2026 and is the largest project of its kind in the United States. Furthermore, Dominion expects to add 10.5 GW of solar generating capacity by 2035. At Fortis Inc.'s (TSE: FTS) International Transmission Company (ITC), the business sees a \$30-100 billion opportunity in transmission and distribution investments across the Midcontinent Independent System Operator (MISO), which includes significant renewable transmission interconnection opportunities.

As these businesses demonstrate, our team has identified several opportunities which allow us to participate in this historic transition, and we continue to evaluate prudent and disciplined ways to take part in this green revolution. We believe that recent global events have reinforced the need to make continued investments in energy security and independence, and renewables can play a significant role in securing stable energy needs for the future alongside delivering on environmental sustainability.