Normal vs. Rational

QPW Perspectives – June 2021

Earlier this month, Quadrant Private Wealth was again privileged to be the title sponsor of the Quadrant Private Wealth Behavioral Finance Conference. The conference, which is hosted by the University of Manitoba's Asper School of Business, brought together academics and practitioners from around the world in a virtual platform to connect on new and emerging issues regarding behavioral finance.

The study of behavioral finance examines the "less than rational" side of investor behavior. Bluntly put, behavioral finance seeks to explain people's behaviors when it comes to financial decision making. As much as everyone seeks to be rational and disciplined, human psychology can make this a challenge. Investors are not always rational, have limits to their self-control, are influenced by their own biases and can make cognitive errors that can lead to wrong decisions. In other words, investors are normal people.

These types of behaviors can interfere with, or confuse, the best laid long term investment plan. Awareness is the first step towards ensuring behavioral biases do not compromise sound portfolio management.

Awareness of Biases

The following are a few of the biases most common among investors. You may see a bit of yourself in some of these. Which of these resonate with you?

1. Recency Bias – the tendency to overemphasize the importance of recent events or place too much emphasis on experiences that are freshest in your memory, even if they are not the most relevant or reliable. This would include being influenced by recent news, events or experiences. An example would be expecting a stock price to continue increasing after several quarters of strong growth in returns without the basis of any solid fundamental analysis. This is also sometimes referred to as "performance chasing" and can cause an investor to buy or sell at the worst time.

2. Loss Aversion – the tendency to emphasize the avoidance of losses over achieving equivalent gains. People feel pain from losses more acutely than they feel pleasure from gains of the same size. Loss aversion can result in avoiding risk to such a degree that it can lead to an overly conservative portfolio that cannot meet its long term financial goals. Loss aversion can also lead to the decision to sell investments during market downturns simply to avoid further downturns, which means they could miss out on subsequent gains. The pandemic sell-off in equity markets during March 2020 is a recent example. Conversely, loss aversion can result in an investor continuing to hold onto an investment with negative returns to avoid realizing a loss in their portfolio, even when selling is the prudent decision.

3. Overconfidence – the tendency to hold a misleading assessment of one's skills, intellect or talent. It's an egotistical belief that a person is better than they actually are. These individuals often feel they have the ability to make superior decisions regarding investments or the timing of investments. A classic example of overconfidence is the fact that the vast majority of people with driver's licences feel they are above average drivers.

4. Herd Mentality – the tendency to follow and copy what other investors are doing (a.k.a. fear of missing out). Decisions are largely influenced by emotion and perceived instinct, rather than by independent financial analysis. The dot com bubble and bitcoin are two examples. Meme stocks

would also fall into this category as these are stocks which experience an increase in volume due to hype on social media as opposed to company performance. Gamestop is a notable example from earlier this year as a group of investors drove its price up on social media, putting pressure on short sellers.

5. Confirmation Bias – the tendency to seek information that reinforces one's pre-existing beliefs while ignoring contradictory information. Put another way, it is people's tendencies to cherry-pick information that supports their existing beliefs. As an example, a group of friends at a party mention a great investment you should buy. You are intrigued and search for more information when you get home. Unfortunately, you are biased by your friends' comments and unwittingly will focus on information you find that supports the investment, placing a lower priority on data that goes against it. Another example is that people often seek out information that aligns with their political beliefs while ignoring information that contradicts those beliefs.

Biases such as loss aversion and overconfidence are driven by hard wired emotions while the other biases are cognitive and caused by the way people's brains process information. Both emotional and cognitive biases can impact, often negatively, the achievement of long term financial objectives.

Rational Solutions

Having access to objective and competent professional advice and maintaining a comprehensive long term financial plan are important in understanding and managing behavioral biases. Having a long term view, a systematic process and goals-based planning are effective ways to mitigate harmful decisions that can arise from behavioral biases.

At Quadrant, the first step towards ensuring a comprehensive long term financial plan is the development of a personalized Investment Policy Statement (IPS). An IPS accounts for an investor's personal financial circumstances, goals and risk tolerance as well as provides a framework for portfolio asset mix and rebalancing. A deliberate and systematic IPS process offers a rules based approach to investing and ensures the plan is executed in a rational and deliberate manner. During periods of uncertainty, the IPS can be relied upon to provide an unemotional and rational overview of an investor's individual circumstances and long term goals (The IPS is Your GPS).

The 4Ds (Diversification, Discipline, Detachment, and Dedication) is something we talk about often at Quadrant as it reflects the very essence of our portfolio management philosophy which also seeks to remove any behavioral influences. They can be viewed on our website but 1 D is worth highlighting.

- Detachment – We act on analysis and evidence, consistent with your personalized IPS. We do not act based on bias or emotion.

By engaging Quadrant as portfolio manager, our clients create a structural detachment between decisions respecting their investment portfolio and their emotions or behavioral biases. Quadrant has a fiduciary responsibility to each client to ensure that investment decisions are suitable to their personal financial circumstances, investment objectives, time horizon and risk tolerance. It is our duty to exclude behavioral biases from our decisions on behalf of clients.

In addition, Quadrant's investment management processes are designed to ensure knowledgeable and rational decision making. Key to our approach is the structural detachment created by the provision of asset class management from external sources. As a result, Quadrant is not bound to any investment style or approach. This structural detachment limits Quadrant's exposure to

behavioral biases respecting asset class selection and execution and removes conflicts of interest with our clients' investment needs and objectives.

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Disciplined. Compassionate. Effective.

Quadrant Private Wealth is an independent, comprehensive, integrated wealth management firm committed to your financial well-being and peace of mind. We take the time to understand your complete financial picture. We tie all of your information together, including tax planning, to paint a picture of what your financial future could look like. And we aim to earn your complete confidence in the process.

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