Wealth Management
Dominion Securities

Wealth Management Review

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Bryan Wealth Management Group of RBC Dominion Securities

Robert Bryan, B.Comm, FMA, CIM, FCSI
Branch Director, Senior Portfolio Manager & Investment Advisor
robert.bryan@rbc.com

Dean McKelvie, PFP
Associate Advisor
dean.mckelvie@rbc.com

Sherrie Parsons
Associate
sherrie.parsons@rbc.com

Extended wealth management team

Steve Wiffen, CLU, CFP, CH.F.C
Estate Planning Specialist
RBC Wealth Management Financial Services

Shannon Row-Ewing, BA, LL.B
Will & Estate Consultant
RBC Wealth Management Services

Scott VanEngen
Financial Planning Specialist
RBC Wealth Management Services

Susan MacDonald, TEP, MTI
Senior Trust Advisor
RBC Royal Trust

RBC Dominion Securities
187 Ontario St.
Stratford, ON N5A 3H3

Phone: 519-271-4611
Toll-free: 1-800-265-4596
robertbryan.ca

eStatements

How investor psychology can impact investment decisions[1]

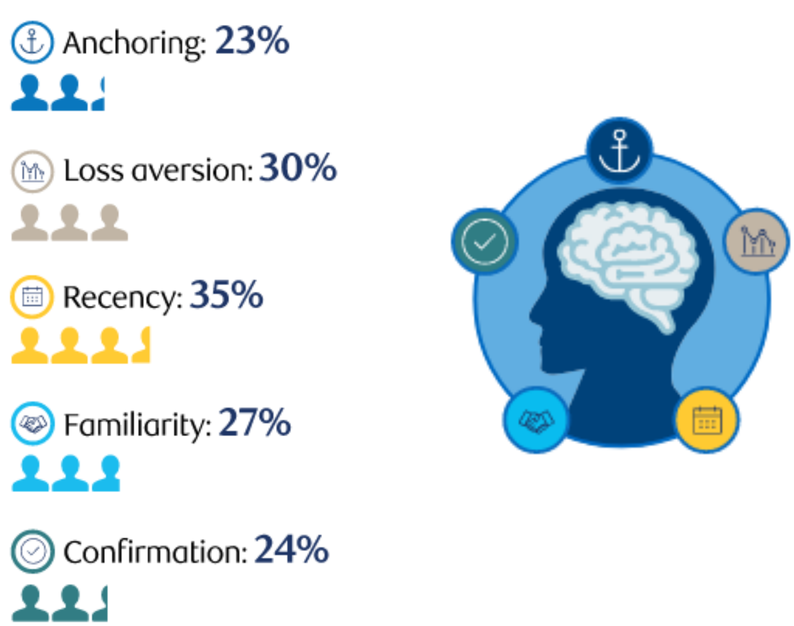
The human brain uses shortcuts and patterns to process information and make decisions quickly. This can be effective when learning a new language, picking up a new skill or making dinner plans. However, it can lead to behavioural biases that can cause us to think and act in curious ways, particularly when it comes to investing.

Biases can shape many of the investment decisions an investor makes. If left unchecked, these biases lead to deviations from plans – particularly when markets are moving dramatically.

Understanding investor bias

Research shows that most people exhibit some bias in their investment decisions. Knowing about these biases, and understanding their influence on investor behaviour is the first step toward curbing their impact on your portfolio.

Let's explore these five common biases[2] and how they affect investors.



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How investor psychology can impact investment decisions
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Anchoring

What it is:

Fixating on a specific reference point, like the price paid for an investment or market index level, and basing decisions around that one number.

How it affects investors:

Can cause investors to overvalue, or undervalue, asset prices or market performance based on an arbitrary number drawn from past experience.

Loss Aversion

What it is:

Feeling losses much more intensely than feeling the reward from an equivalent gain.

How it affects investors:

By prioritizing the avoidance of short-term losses over long-term gains, investors may put the success of their long-term goals in jeopardy.

Recency

What it is:

Placing too much emphasis on experiences that are freshest in one's memory — even if they're not the most relevant or reliable.

How it affects investors:

Believing that short-term trends will continue into the future may lead investors to ignore new information and be slow to react to changes in investment markets.

Familiarity

What it is:

Preferring to invest in what is familiar. – especially from domestic markets. For instance, the average Canadian has 92% of their wealth in Canada.[3]

How it affects investors:

Leads to concentrated portfolios that hold only the most familiar investments – especially from domestic markets. This can increase portfolio risk and lead to a bumpier investment experience.

Confirmation

What it is:

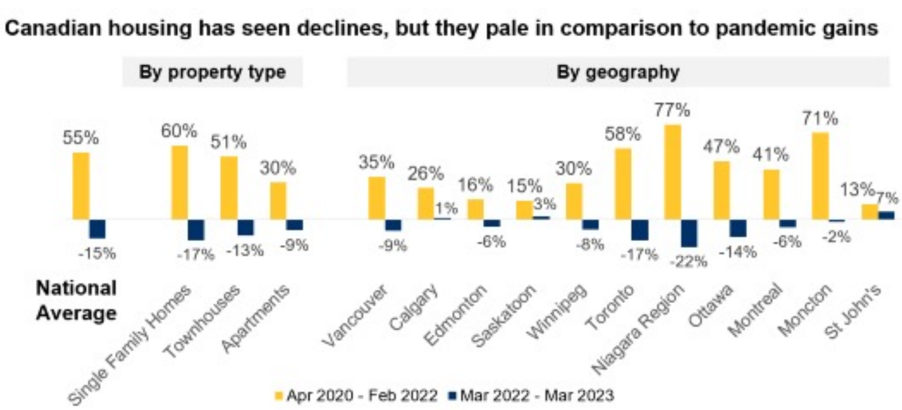
Seeking, or accepting, only information that supports what one already believes.

How it affects investors:

By ignoring information that doesn't support one's decisions, an investor can form unrealistic expectations that can lead to portfolio concentration and increased risk.

[1]*How to avoid behavioural bias as an investor, Global Asset Management. https://www.rbcgam.com/en/ca/learn-plan/investment-basics/how-to-avoid-behavioural-bias-as-an-investor/detail*
[2]*The Evolving Role of Behavioral Finance in 2020.*
[3]*Investor Economics: Household Balance Sheet Report- Canada, 2021.*

Canadian housing update



Source: CREA, RBC GAM. MLS Home Price Index (seasonally adjusted).

For many Canadians, owning property is in their DNA. On a seasonally adjusted basis, home prices rose by a whopping 55% through the pandemic (yellow bars below). Gains were fueled by a mixture of low mortgage rates, an appetite for real assets and – arguably – too much time spent idle at home unable to travel. However, the degree of price appreciation varied significantly by geography. Large gains were seen in markets that were already facing stretched affordability (e.g. Toronto, Vancouver).

Housing affordability is very stretched

Since interest rates started rising in March 2022, tailwinds have turned into headwinds and many markets have seen a correction in prices.

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Canadian housing update
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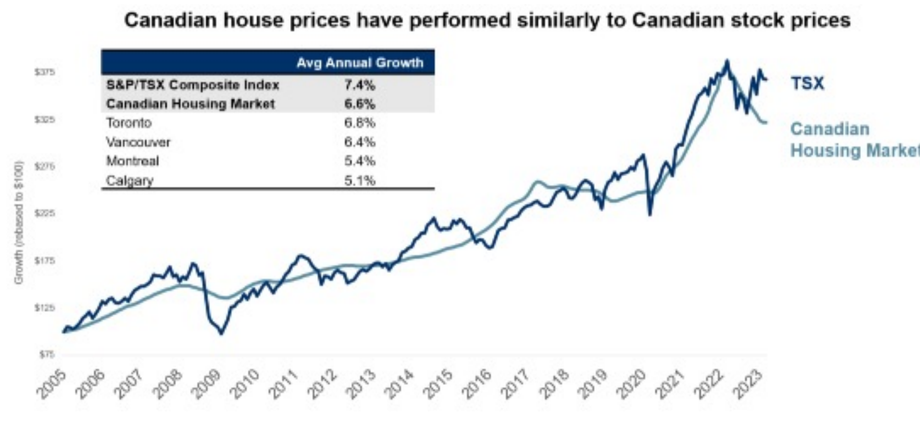
However, price declines haven't offset rising costs, driven by an increase in mortgage rates. Furthermore, many mortgages are on fixed terms that haven't come up for renewal yet. The toll of rising interest rates takes time to work into the system.

The chart to the right maps the performance of the Canadian housing market back to 2005. As can be seen, house prices have delivered gains similar to those of Canadian equities. But they have delivered those gains with lower volatility. That can largely be chalked up to the complexities and time involved in buying/selling real estate and lower visibility on price.



Source: RBC GAM, Morningstar, CREA.
MLS Home Price Index (seasonally adjusted). As of Mar 31, 2023.

Not out of the woods[1]

The U.S. equity market has held up reasonably well recently — all things considered.

No "one size fits all"

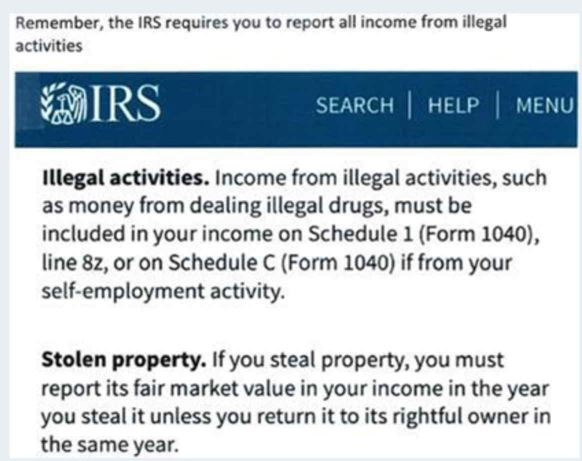
All economic expansions eventually end as recessions are an ordinary part of the business cycle. But, it is important to keep in mind that recessions are relatively brief and bring about a wide spectrum of market outcomes. Our analysis of the U.S. business cycles since 1945 shows there have been 13 recessions. This means investors should expect to experience a downturn once every six to seven years and lasting between two and 18 months, with a 10-month average. In contrast, U.S. expansions have endured 62 months on average. Growth is the regular state of the economy, and over the past eight decades the U.S. economy has spent nearly 90 percent of the time in expansion mode. As recessions can vary greatly in length and severity, so too can the equity market responses during recessions. While the S&P 500's average decline was 32 percent around the previous 13 recessions, magnitudes ranged from 15 to 57 percent.

A recession looks more likely

Our U.S. leading economic indicators continue to point toward a domestic recession starting in the second half of the year, possibly in the summer. Three of our seven indicators have been pointing in this direction for months, and two started flashing yellow caution signals recently. If (or when) economic data deteriorate further, the market's path could be bumpy again. For market participants to contemplate a recession — like they have for many months — is one thing, but to see economic weakness revealed in the data is quite another.

File under "I can't make this stuff up"

An interesting excerpt from the IRS website:


Remember, the IRS requires you to report all income from illegal activities

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Illegal activities. Income from illegal activities, such as money from dealing illegal drugs, must be included in your income on Schedule 1 (Form 1040), line 8z, or on Schedule C (Form 1040) if from your self-employment activity.

Stolen property. If you steal property, you must report its fair market value in your income in the year you steal it unless you return it to its rightful owner in the same year.

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Not out of the woods
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Historical U.S. market performance when Fed policy shifts

Before and after the final rate hike in a Fed tightening cycle:
Downside risk right before the Fed pauses, but typically gains afterward

S&P 500 performance Final Fed rate hike	Before final rate hike			After final rate hike		
	6 months	3 months	1 month	1 month	3 months	6 months
Median 1970 – 1979	-1.0%	-2.5%	-4.5%	2.6%	-4.4%	2.8%
Median 1980 – 1989	9.0%	7.3%	-0.5%	1.2%	1.4%	8.0%
Median 1990 – 2018	2.4%	2.3%	1.0%	0.6%	7.2%	13.3%
Median since 1970	**2.9%**	**0.5%**	**-0.7%**	**1.0%**	**1.7%**	**5.9%**

Before and after first rate cut in a Fed loosening cycle:
Stocks typically rise, including at an above-average rate 6 months later

S&P 500 performance First Fed rate cut	Before first rate cut			After first rate cut		
	6 months	3 months	1 month	1 month	3 months	6 months
Median 1970 – 1979	0.1%	-0.1%	-0.2%	1.2%	9.6%	8.5%
Median 1980 – 1989	7.1%	4.5%	1.9%	-0.2%	7.5%	10.0%
Median 1990 – 2020	5.9%	0.5%	1.7%	0.1%	1.7%	8.8%
Median since 1970	**5.7%**	**1.3%**	**1.2%**	**0.1%**	**4.2%**	**9.0%**

Source - RBC Capital Markets U.S. Equity Strategy, Bloomberg; periods of positive performance shaded in green, periods with negative performance shaded in red

There are two silver linings

Due to lingering headwinds, we think the risk-reward outlook for the market is more challenging over the near term, and the S&P 500 is vulnerable to additional volatility and downside. But it's important to keep two things in mind: (1) The S&P 500 typically bottoms well before economic conditions improve, and often when headlines and investor sentiment are still rather negative; and (2) A shift in U.S. Federal Reserve (the Fed) policy could support the market over time. Historical data show there has often been downside risk to the S&P 500 right before the Fed paused its rate hike cycle, but gains typically occurred in the months afterward.

[1] *"Not out of the woods," Global Insight Weekly, May 11, 2023.*