Portfolio advisor

Psyched out

Avoiding the psychological pitfalls of investing

Do you get anxious when the stock markets are volatile? Or do you feel optimistic that everything will turn out fine? Both reactions – natural parts of your psychological makeup – can actually impede your progress towards your investment goals.

The good news is that you can gain some control over your psychological responses – unlike the financial markets. Following are seven psychological pitfalls of investing – and how you can avoid them.

1. Optimism

People have a natural tendency to overestimate the likelihood of positive results on everything from the weather to investing. This largely explains why people are so often disappointed by their investment performance – they simply felt they would do better based on this psychological bias.

Avoiding the feeling of disappointment is only one good reason why you should consciously compensate for this natural optimism. If you base your financial goals on unrealistically positive expectations, you will almost certainly fall short of these goals. This can affect your anticipated retirement date, amount of retirement income, or the value of your estate.

How much should you compensate for this bias? Some people are better calibrated than others, but studies indicate that in general if you feel there is a 99% chance of something happening, the actual odds are closer to 85%.

2. Overconfidence

Another powerful psychological bias is overconfidence. Just as people tend to be overly optimistic about the probability of positive results, they also tend to be overconfident about their own talents. Some investors think that they can "outsmart the market" – and even control largely unpredictable events such as stock market volatility.

This leads to one of the most common pitfalls of investing – market timing. Confident in their own abilities, many investors try to time the market so that they always buy low and sell high – despite the fact that not even the most accomplished professional investors can do this consistently.

Recognizing this tendency towards overconfidence is the first step towards dealing with it. Try to be honest about your abilities, and if you find yourself falling into traps such as market timing, take a step back and rethink your approach.

3. Hindsight

Hindsight is the tendency to believe that after something has happened, you knew all along that it would – even though you didn't. This tendency can lead you to believe that events are far more predictable than they really are, raising unrealistic expectations about how well your investments will perform and your advisor's ability to foretell the future, among other things.

If you find yourself confidently declaring that you "knew it all along" ask yourself whether you really did. As with optimism and over confidence, you may have to consciously compensate for hindsight.

4. Obsession

Do you follow the performance of your investments minute-by-minute on TV or the Internet? Do you dwell on short-term changes in the market value of your investments? Do you fixate on the negative performance of a single investment, even when your overall portfolio is doing well? These can all be signs of obsessive behaviour commonly displayed by investors.

Take a step back and look at the big picture. Are you on track to achieving your longer-term goals? Are you comfortable with the level of investment risk in your portfolio? If not, you may have to make adjustments to stop obsessing about short-term events.

5. Denial

When stock markets go down, investors can sometimes panic and sell what is still fundamentally a good investment. The flipside of this is denial – when investors continue to hold an investment that has gone bad, thinking it will eventually come back. It can be hard, but when an investment has fundamentally deteriorated, it may be time to sell. Having an investment discipline in place with specific, rational criteria for buying and selling can help you overcome this tendency.

Successful investing over the long term is less about how the markets are doing than how we react to what the markets are doing. Unfortunately, many of our natural psychological reactions – like denial, panic or greed – can impede our long-term success.

6. Greed

The desire to "get rich quick" compels many investors to take bigger risks than they should, such as investing too much in a single investment. When the risk doesn't pay off, it can jeopardize their financial security. That doesn't mean you should never take a risk – it's a normal part of investing. The key is to take well-calculated risks within a properly diversified investment portfolio, which is designed with your personal risk tolerance in mind. That way, when the occasional risk doesn't pay off, the impact is mitigated by the other investments in your portfolio.

7. Herd instinct

When we see other people doing something, we have a natural tendency to think that it must be a good thing and we should do it too. This "herd instinct" is often behind sharp ups and downs in the financial markets. When other people are buying, propelling the market upwards, we buy too, sending the market even higher. Similarly, when other people sell in a panic, sending the market downwards, we sell too, fueling the decline. Unfortunately, this often results in buying at the height of the market euphoria, or selling close to the depths of the panic. Instead of following the herd, follow a disciplined investment strategy based on logic and reason.

We can show you how a disciplined approach that removes the emotions and guesswork from investing can help you avoid these psychological pitfalls of investing. Please contact us for more information.

Split personality

The Canadian stock market has had a split personality so far in 2008, repeatedly rising to set new record highs, then falling back again sharply. It's left many investors wondering whether it's a bull market – or a bear market. In many ways, it's both.

A closer examination of the benchmark Canadian stock index, the S&P/TSX, shows that the strong performance is dominated by a handful of stocks. Take away the top 15 performers and the TSX, instead of being up around 600 points, would be down 600 points. In other words, the TSX's top 15 stocks are up 1,200 points, while the remaining 285 stocks, in aggregate, are down 600 points.

What's more, these top 15 stocks are all from just two sectors of the economy – the energy and materials sectors – reflecting the burgeoning global demand for commodities such as metals, forest products, gold, oil and gas. These two sectors were up 21.9% and 13.3% respectively halfway through 2008. Meanwhile, the financial sector – which together with the energy and materials sectors accounts for over three-quarters of the TSX – was down 3.1%. Most other sectors were also down.

So even while the TSX sets new record highs, most Canadian investors are experiencing poor returns because their investment portfolios are diversified across many sectors, not just the materials and energy sectors. Furthermore, many investors purposely limit their exposure to these two particular sectors, which can be very volatile, in favour of normally less volatile sectors like the financial sector.

The top 15 performers

Company	Closing price	Price change	Composite point contribution	Sector
1. Potash	$236.57	$93.08	280.97	Materials
2. Encana	$93.36	$25.86	186.02	Energy
3. Canadian Nat Resources	$100.84	$28.26	146.00	Energy
4. Goldcorp	$47.01	$13.21	89.57	Materials
5. Canadian Oil Sands	$55.00	$16.29	74.69	Energy
6. Fording Coal	$97.50	$59.12	67.50	Materials
7. Agrium	$109.95	$38.28	57.83	Materials
8. Teck Cominco	$49.17	$13.74	57.49	Materials
9. Suncor	$59.20	$5.25	46.50	Energy
10. Nexen	$40.66	$8.56	43.18	Energy
11. Talisman	$22.58	$4.19	40.74	Energy
12. Barrick Gold	$46.61	$4.83	39.95	Materials
13. Kinross	$24.10	$5.80	33.71	Materials
14. Agnico Eagle	$76.49	$22.07	30.24	Materials
15. Penn West Petroleum	$34.48	$8.64	28.40	Energy
Total of top 15			1,222.78	

Source: Bloomberg. As of June 30, 2008.

Coping with the market's split personality

Seeing their portfolio performance lag behind the TSX, many investors are wondering whether there's anything they should do. Following are some strategies to manage the market's swings:

- Don't try to time the market. Avoid the temptation to try to time the markets – or sell on the highs and buy on the lows. History shows that the long-term direction of the market is always up. But over shorter time periods, it's impossible to predict with any accuracy what the markets will do. Not even the most successful investment professionals can do this consistently.
- Keep some cash on the sidelines. With the markets so uncertain, it may be wise to increase your allocation to cash and other liquid investments. This way, when the market's direction becomes clearer, you will have some cash on hand to take advantage of potential opportunities.
- Stay properly diversified. Loading up on stocks from the energy and material sectors because they're "hot" now – while excluding the rest – is a risky proposition. Just because these sectors are outperforming now doesn't mean they will be tomorrow. A properly diversified portfolio holds stocks from a range of sectors to reduce the impact of any one particular sector performing poorly.

We can help you determine if your portfolio is properly diversified for today's markets. Please contact us for more information.

The family vacation home

As you relax at your home away from home, enjoying time with your family, you might think to yourself "How can I make this moment last forever?" While you can't freeze the moment in time, you can take steps to make sure that your family will enjoy moments just like it for generations to come.

Keeping the family vacation home in the family from one generation to the next is a goal that many families have. But for a variety of reasons – some financial and others personal – the next generation is often forced to sell the family vacation home. Following are some strategies to help you prevent this from happening.

Minimizing the tax burden

When you pass on your vacation home to your children, you are potentially passing on a very large tax bill as well. The property that your family purchased for thousands of dollars several decades ago could be worth hundreds of thousands of dollars now. This increase in value is a taxable capital gain that is triggered when you pass along your property to anyone other than your spouse (assuming you cannot or chose not to claim a principal residence exemption). In addition, there may also be probate taxes payable when your estate is settled.

Selling the property may be the only way to cover these tax bills. However, there are ways you can reduce or defer this tax burden – and help keep the family vacation home in the family.

- Consider giving the vacation property to your children ahead of time, either directly or through a family trust if you want to maintain control. While this triggers a taxable capital gain, it should be smaller than it would be later, since property values tend to rise. Plus it avoids probate taxes, although you may incur land transfer tax, which in some provinces can be similar to probate tax.
- Cover the capital gains tax bill with an insurance policy. You can take out a policy that provides your beneficiaries with a sum equal to the expected tax bill when your estate is settled. Your beneficiaries may even be willing to pay the insurance premiums since they will ultimately benefit.
- Enter into a joint tenancy with right of survivorship ownership agreement. With this type of ownership, you own a share of the property together with other individuals. If the agreement is properly structured, when one person passes away, their share of the property passes to the others, bypassing probate (not applicable in Quebec).

Maintaining family harmony

If you intend to pass along the property to more than one family member, it's a good idea to establish some ground rules to avoid disputes over issues such as paying taxes and other expenses, handling maintenance, and accessing the property. A formal co-ownership agreement can help minimize the conflicts that all too often arise over these issues.

Get expert advice

Qualified tax and legal advisors can help you design a plan to pass along your family vacation home, while minimizing taxes and family conflict. For more information, please contact us.

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