NetWorth

Make better investment choices by understanding and reducing bias.

Investors are often subject to behavioural biases that can lead to flawed decisions and choices. Being aware of these biases – and understanding how they arise from your background and life experiences – can help you make better investing decisions and achieve your financial goals.

When we make important decisions about the future, we start with the information and data available to us now and rely on our experiences, education and intuition to come up with the best possible answers. When we don't have the right information up front, or place too much weight on the wrong factors, decisions may not work out as well as we expect.

In Canada, public companies from a range of industries in the high tech, automotive, energy and consumer goods sectors have corporate offices or production facilities in smaller cities and towns. In such areas, the company is often the main employer and a major contributor to the region's economic wellbeing. Employees and their neighbours often purchase shares in the company for reasons that include their familiarity with the company, the good things that it does for the community and sometimes just because many local people talk about the company. The high level of share ownership is evidence of confirmation bias and, perhaps, home bias. These biases can increase risk, because the decision to invest is based more on local information than on the prospects for the company as a whole.

Our biases are shaped and reinforced by our experiences. People that have similar characteristics, such as age range, gender or economic background, tend to demonstrate similar biases.

Market movements and bias

It would be nice if our investments grew at a steady, predictable rate over the long term. Unfortunately, markets go up, go down and sometimes stay relatively unchanged. How savers and investors react to these changes depends considerably on the investment approach they choose. A recent quantitative analysis examined why many investors do not achieve the investment returns they expect, and noted that investment results depend more on investor behaviour than on the way their funds perform. Benjamin Graham, an investor and professor of finance who influenced the investment strategies of Sir John Templeton, Charlie Munger and Warren Buffet, said that the investor's chief problem – and even his worst enemy – is likely to be himself.

Let's connect

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How each of us works through our investment decisions and the emotional ups-and-downs that result from changing market values depends largely on our behavioural biases. When markets are going up we have a tendency to buy in, and when they are in decline, fear can lead us to premature selling.

Overcome bias by a portfolio approach

Adopting a portfolio approach to investing is one way to address these biases. A portfolio approach spreads investments out over a number of areas, so that you don't have all of your eggs in one basket. Risk is reduced through a more diversified portfolio, and owning a greater variety of securities helps to reduce attention bias. Home bias can also be reduced by specifically including regional representation beyond locally known companies. Disposition bias is addressed by looking at how the portfolio functions as a whole so that selling a single poor-performing security is less of a concern.

Follow a wealth planning strategy

The many reasons why we choose to invest our savings are very personal. We often invest to be able to afford a comfortable retirement lifestyle. We also invest for goals such as home improvement, buying a car, a special vacation or to help children or grandchildren attend college or university.

Including all of your goals in a well-constructed wealth plan allows you to have a better idea of how much you should save, and how your investment choices can affect how these funds can grow. Depending on your current investments and your ability to save, your financial goals may be on the right track or have already been attained by following your wealth plan. When this happens, the need to earn a specific return may be reduced, allowing the focus to shift from actively seeking growth to risk reduction in order to preserve your investments for your long-term personal goals.

A wealth plan is designed to balance your ability to save with the investments that you make to achieve your personal goals. While the return that you earn on your investment portfolio is always important, investing is the means to achieving your goals, and returns should not be the goal itself. Focus on your long-term personal goals, rather than the regular movements of your investments. When a plan is on track it is easier to be more confident about your financial future.

Reducing bias

Working with a financial professional is a great way to reduce the negative impact that personal biases can have on your investment portfolio and your ability to reach your personal financial goals. Furthermore, working with a financial professional and having a plan can prevent some of those biases from creeping in when information is complex or decisions involve risk or uncertainty.

Confirmation bias is best addressed by looking for and considering alternative scenarios or options. A financial professional can help by explaining differing investment points of view and by sharing information and research from a variety of sources. Looking at alternatives to your initial investment beliefs may allow you to be more objective.

Attention bias limits investment opportunities because the options that are immediately apparent are preferred. Adopting a portfolio approach that explicitly includes a wider variety of investment options ensures that your investment choices are broader and more balanced.

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Home bias is similar to attention bias in that investment alternatives that are familiar and local are given priority. When considering investments from another geographical location, industry or sector, your financial professional can help you to take advantage of other opportunities. Financial professionals can help you learn about different investment options, and help with putting these options together in the broader context of your personal wealth plan. Adopting a broader portfolio approach also helps to reduce investment risk. This is especially important if your investment portfolio is disproportionately represented by companies and industries that are closely located and very familiar to you.

Anchoring bias often results in focusing on a factor such as the initial purchase price that is not relevant to the future performance of an investment. Focus instead on the current prospects for an investment to help determine how best to move forward. A financial professional is in good position to evaluate investments as they have the resources to do this analysis based on the investments' current fundamentals. In this way emotions about movement relative to initial purchase prices will become less of a factor.

Hindsight bias – while looking backwards to learn from your investment history is a very important tool for your future success, believing that past results were easily predictable should be avoided. The objective voice of a financial professional can help you to discuss past investment decisions in their historical context. This will help to limit the tendency to look back with a greater degree of certainty that was originally present.

Fear of missing out bias – there are so many investment options available and choosing those that are appropriate in your circumstances requires being selective. This will mean that not all opportunities can be taken. Working with a financial professional will help you to find the investment alternatives that work within your portfolio and are best suited to your specific goals, balancing your investment objectives with your risk tolerance, liquidity needs and time horizon.

Disposition bias can be reduced by thinking about when to sell a security when making the original purchase decision. Within a well-constructed portfolio, these decisions have to be made on a regular basis as newer investment ideas and strategies replace older ones that have had their day. A financial professional can work with you to assess the regular need to make changes to keep your investment portfolio on track to meet your personal goals.

Representativeness bias often manifests when chasing a long-established investment trend. Working with a financial professional to look at future prospects for investment choices is wise because past performance is not necessarily a good indicator of future results.

To save and invest effectively, it is important to overcome the behavioural biases that influence rational decision making. A financial professional can keep you focused and on track with your financial goals by addressing behavioural biases that you may not even realize are influencing your investment decisions.

Conclusion

Reducing the impact of your personal biases is an important part of achieving a better risk-reward balance when it comes to saving and investing for your future. Contact me today to learn how saving and investing can help you achieve your personal financial goals.

Source: Make better investment choices by understanding and reducing bias. BMO Wealth Management. October 2017. BMO Wealth Planning. Retrieved from http://bmo.com/wealthreports

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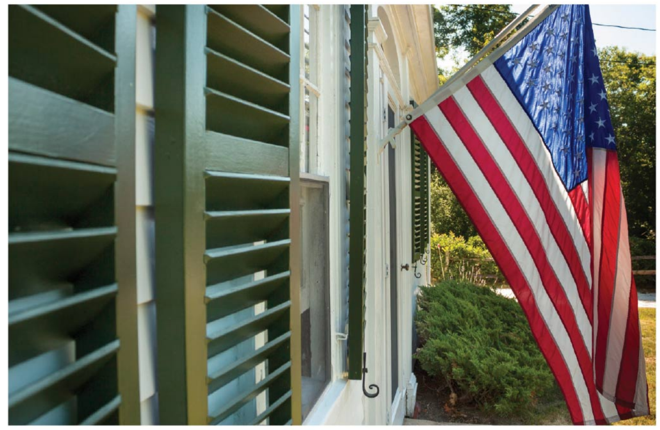
US Estate Tax – Impact to Canadians of recent US Tax Reform

As a Canadian who is not a U.S. citizen or U.S. Greencard holder, you may be unaware that your estate could be impacted by U.S. estate tax if you own U.S. "situs" assets (U.S. assets) at the time of your death.



The most common U.S. assets are U.S. real estate (i.e., U.S. vacation home) and shares of U.S. corporations. Shares of U.S. corporations are included in your estate for U.S. estate tax purposes even if they are held in registered accounts-such as Registered Retirement Savings Plans (RRSPs), Registered Retirement Income Funds (RRIFs) and Tax-Free Savings Accounts (TFSAs).

The estate of a Canadian resident individual may be subject to U.S. estate tax on their U.S. assets if the fair market value of those U.S. assets is in excess of US$60,000, and the value of their worldwide assets exceeds the U.S. estate tax exclusion amount applicable in the year of their death. Recent U.S. tax reform increased the 2018 estate tax exclusion amount to U.S. $11.18 million (from the previous 2018 inflation adjusted amount of U.S. $5.6 million). While the increased exemption may eliminate (or reduce) the U.S. estate tax exposure for many estates, it is important to note that the increased exclusion amount is only effective until the end of 2025 when it is scheduled to revert back to the inflation adjusted amount of U.S. $5 million.

U.S. estate tax is calculated in two steps:

Step 1: the value of the taxable estate (i.e. the fair market value of the U.S. assets) is multiplied by the applicable graduated tax rates of 18% to 40%. The 40% rate applies to taxable estate assets with a value over U.S. $1 million.

Step 2: The amount calculated in Step 1 is then reduced by an estate tax credit called the unified credit. The Canada/U.S. income tax treaty (the Treaty) allows Canadian residents to benefit from the unified credit available to U.S. citizens on the proportion of the value of their U.S. estate assets relative to the value of their worldwide assets. The unified credit amount available to U.S. Citizens in 2018 is U.S. $4,417,800. For example, if the value of a Canadian resident's U.S. assets represented 20% of the value of his or her worldwide assets, he or she would be entitled to a unified credit of U.S. $883,560 (20% of the U.S. $4,417,800 unified credit available to U.S. citizens). In this manner, for 2018, Canadian residents would not have a U.S. estate tax liability if their worldwide assets do not exceed U.S. $11.18 million, since the value of the credit would exceed the tax liabilities for estates up to this level. The Treaty also provides a marital credit if the U.S. assets are left to a surviving spouse. The marital credit is equal to the unified credit (in our example, an additional U.S $883,560 would be applied in calculating the final U.S. estate tax liability).

It is important to note that even if no tax is payable, your executor may still be required to file a U.S. estate tax return if the fair market value of your U.S. assets owned at death exceed U.S. $60,000. Failure to file a U.S. estate tax return can result in a denial of Treaty benefits and credits. In addition an estate beneficiary or surviving joint owner may not be able to sell U.S. real property without proof that a U.S. estate tax return has been filed.

For more information, please ask me for a copy of our publication entitled U.S. Estate Tax for Canadians, and/or speak to your tax advisor.

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