WEALTH
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Markets have mood swings too

The SAD effect on stocks

Can markets suffer from depression, just like people do? The surprising answer is yes, according to researchers at the University of Toronto's Rotman School of Management.

Professor Lisa Kramer and her colleagues discovered that annual market downturns worldwide coincide with the onset of SAD, or seasonal affective disorder, a type of depression that usually occurs in the fall and winter, when there's less daylight.

Wealth Advisor spoke with Professor Kramer about her findings.

Can you outline what you uncovered about moods and markets?

Extensive clinical research on SAD[1] has shown that millions of individuals all over the globe experience increased risk aversion when the hours of daylight shrink in the fall. As the days lengthen in the winter and spring, they become more tolerant of risk. Our research is the first to show there is direct evidence of SAD-related investing behaviour by individual investors.

How can an individual investor's mood impact market behaviour?

When masses of people become less tolerant of financial risk as fall sets in, the overall appetite for risk becomes lower and returns on financial securities can respond. We observe in the fall months equity returns are lower and when we start turning to winter and spring, the returns rebound.

The interesting thing about these findings is the effects appear to be more dramatic at more extreme latitudes. Financial markets in countries like Sweden, for example, have larger swings in their seasonal returns. In the southern hemisphere, countries where the seasons are six months out of synch, so are the seasonal patterns. When we look at safe securities like government bonds, we find an opposite seasonal pattern: during the seasons when risky securities have high returns, government securities have low returns. We factored in other influences like past performance and advertising; the results were the same. *(continued on next page)*

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In fact, I would conjecture that it's not a coincidence that historically so many financial market crashes happened in the month of October. Not to say that seasonal depression causes market crashes, but rather when economic news is very poor at that time of year, the natural inclination of investors is to react more negatively.

Is there a direct causal connection?

We can't prove a causal connection, but we can say the evidence is consistent with what we are hypothesizing.

If we extrapolate, would you say as the daylight increases, people become more risk tolerant and there's a better chance the markets will start to move up?

When daylight is becoming more abundant, moods tend to become more cheery. I think that does lend buoyancy to the market. Will that cause a recovery in the market? Based on our research, it is a helpful influence.

Do you agree that the big questions underpinning any market recovery relate to the economy?

Yes, fundamentals are key. If the fundamentals don't cooperate, then we're going to be in this situation for some time to come.

> *"It's not a coincidence that historically so many financial market crashes happened in the month of October."*

How should investors use your findings?

My research tells us when a financial crisis happens in the fall, it's exacerbated by our emotional state. Studies in psychology have shown that depressed individuals, such as those afflicted with SAD, experience heightened risk aversion. That's something to keep in mind; you don't want to do anything drastic any time, but particularly when you're already predisposed to feel more risk averse.

So the market downturn, coupled with the SAD phenomenon, creates a potent mix for some investors?

Exactly. Feelings of panic at a time like this are completely natural. We're all told about diversification and sensible financial planning and holding for the long term. Yet we have these urges when the market plummets to do something very impulsive and we're made to feel that that's wrong. I think it's very natural, but sometimes what comes naturally is not in our best financial interest.

What the research uncovered

A hypothetical investor split her portfolio equally between investments at northern and southern points on the globe – the Swedish and Australian equity markets.

ALLOCATION	50/50 split in the equity index for Sweden and Australia, with no movement in or out of these markets	Pro-SAD portfolio strategy: reallocate 100% twice a year, buying once into Swedish stock index in Swedish fall (when stock prices there are low); then shifting holdings into Australian stock index in Australian fall (when Australian stock prices are typically low).	Anti-SAD portfolio strategy: reallocate 100% twice a year, in Swedish spring buying into Swedish stock index (when stock prices there are high); then shifting into Australian stock index in Australian spring (when Australian stock prices are typically high).
AVERAGE ANNUAL RETURN OVER 20 YEARS, BEGINNING IN EARLY 1980s	13.2%	21.1%	5.2%

The natural inclination for investors right now is to want to sell everything and to shift holdings completely into cash, which is what a lot of people are doing.

Some sage investors actually recommend doing the exact opposite. I'm thinking of Warren Buffett, who says when people act fearful, he tries to act greedy. Statistics aren't able to guarantee that markets won't decline further than they already have, but if investors lock in capital losses at very low prices by converting their holdings into cash, they'll likely miss out on some of the gains as the market turns up.

Do you agree that if investors' time horizons are longer than five years, they don't need to be immediately concerned about the markets?

Yes, that is right. Somebody who has the luxury of several more years in the workforce, or who doesn't need to touch their investments, really shouldn't be panicking right now because there are still years left to recover. History tells us those who plan for the long term are rewarded.

I think information is power: the more investors understand about behavioural finance[2], the better they understand the inclinations they have when it comes to making financial decisions.

During tumultuous times like these – or anytime – it's a good idea to carefully consider your next move and seek advice from people who can guide you through sound financial planning. Contact your BMO Harris Private Banking client advisor.

[1] *Healthy Ontario "http://www.healthyontario.com/FeatureDetails.aspx?feature_id=4025"*
[1] *Psychology Today "http://www.psychologytoday.com/conditions/sad.html"*
[2] *Behavioural finance combines economics and psychology to explain how and why investors act, and how their behaviour affects market prices and returns.*

When the best offence is defence

How to profit from the mistakes of elite soccer goalkeepers

An analysis of 286 penalty kicks in top soccer leagues internationally found the best strategy for goalies is to stay in the centre of the onion bag. Diving brings a one-in-seven chance of a save; standing still, a one-in-three chance.

Yet goalkeepers held the centre just 6.3 per cent of the time. The reason: they have a bias for action, the study found.[3] Despite their vast experience and huge financial incentives to succeed, they make the split-second decision to jump more often than is optimal because they "feel worse" about a goal scored when it follows inaction (standing still) rather than action (diving).

Don't just do something – stand there!

Chief Investment Officer for BMO Harris Private Banking Paul Taylor notes: "In life, whenever we face a situation of tremendous adversity, we have an emotional need to take control – even if the situation is inherently uncontrollable. It's natural to think that the way to take control is to take action. The challenge is to make sure the action is prudent."

Since September, investors across the globe have experienced painful reductions in the value of their portfolios. Currently, their focus is avoiding further losses.

"In most other down cycles, there were greater opportunities for us to rotate into sectors that would be less vulnerable," Paul says. "This cycle has been atypical in that the sell-off has been indiscriminate. All sectors are down, and almost all individual stocks are down. Unless you came into this period with a very low equity weight, there was no time to react. The market dropped too quickly."

Portfolios have different mixes of cash, bonds and equities depending on how conservative or aggressive they are. Cash, the best preserver of capital, is worst at providing a return that keeps up with inflation. Bonds may offset volatility, but can also drop in value. Equities, with greater growth potential, tend to be riskier and more volatile.

"There is no one perfect investment strategy. Over the last year, we repositioned portfolios into a more defensive posture in varying degrees dependent on each client's risk tolerance. While this moderated the downside, regrettably it did not avoid capital losses."

Repositioning for confidence

The question is when to get back into the game, not whether, since the momentum will likely begin swinging back without much notice. During almost every downturn after WWII, the equity markets sniffed out the recovery well ahead of other economic indicators and were higher coming out than they were going in.

"All signs indicate an economic turnaround for as early as the end of 2009 or as late as 2011. We recently purchased additional shares in some of the best Canadian companies – including Shoppers Drug Mart, Tim Hortons, SNC Lavalin, TD Bank Financial Group, Research In Motion, Manulife Financial, and Sun Life Financial – that have suffered share price declines along with the rest of the market."

Once the markets regain confidence, "prices will accurately reflect the fundamental value of these companies," Paul says.

Although we cannot control the stock market, the bond market, or the economy, we can control our responses. Like successful goalkeeping, investing requires a disciplined, flexible strategy that balances taking action with holding the centre.

To discuss how your portfolio is positioned, contact your BMO Harris Private Banking client advisor.

[3] *Journal of Economic Psychology, Vol. 28, Issue 5, 606-621*

The shape of things to come

Market Outlook by Paul Taylor, Chief Investment Officer

An economic recovery usually comes in one of three shapes: V, U, or L.

V-shaped: the economy bottoms out and bounces back quickly.

U-shaped: the economy recuperates tepidly over several years.

L-shaped: economic growth falls hard and fast, taking a long time to convalesce.

Our view is that the recovery will take a modified U-shape (a bit slower than a typical U).

Here's why:

- Some stability has returned to capital markets
  - credit markets seem to be thawing
  - equity market volatility is decreasing (now almost half of its November peak, as per the VIX implied volatility index)
- U.S. and world government actions aimed at returning liquidity to the markets are beginning to work their way into the system
- Equities are at rock-bottom valuation levels
  - equity prices are trading at unjustifiably low valuation levels
  - an incredibly high level of cash is sitting on the sidelines

At the same time, the following indicators suggest a deeper, more prolonged downturn:

- U.S. home sales and prices are still dropping, foreclosures are up
- U.S. and global unemployment levels are rising (although unemployment tells us where the economy has been, not where it's going)
- Worldwide, leading economic indicators are still in free fall

The expected outcome: equity markets will rally sustainably, or at least move sideways over the next couple of years; inflation concerns will return by 2011; and investors will slowly regain some confidence and risk appetite after a short period of shunning risk in favour of wealth-protection strategies.

Canada's Situation

We do not expect the Canadian equity market to advance materially until the U.S. shows signs of economic recovery. We also expect the Canadian housing market to weaken further, but not as badly as in the U.S.

Canada was one of the last industrialized nations to enter into a downturn for two reasons: our sturdy banking sector is less burdened by consumer debt than the U.S. sector; high commodity prices through to June 2008 supported our economy.

The Last Word

We strongly believe that a solid market rally will presage an economic recovery between late 2009 and late 2011.

We expect a modified U-shaped recovery, but whether it turns out to be a V, U, L or swinging W (that's for another article), we're treading cautiously in managing client portfolios.

Majoring in money...

If your son or daughter (age 18 to 25) could benefit from a course in Money 101, one of our 2009 BMO Harris Private Banking Financial Fluency seminars might be just the thing.

Back by popular demand, these one-day, parent-free retreats teach everything from basic budgeting to building an investment portfolio. Using team games and interactive learning, the course is led by a money coach who's tutored the offspring of celebrities and royalty.

The seminars will take place April 28 to May 14 in the following cities:

Toronto **Halifax**
Waterloo **Calgary**
Vancouver

For graduates of last spring's Financial Fluency course, an advanced course will be held in Toronto this year.

To find out more about the seminar nearest to you, and to register your young adult children, please contact your client advisor.

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