WEALTH
# Advisor

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# Know thyself

## How to make wise investment decisions in uncertain times

The field of behavioural finance can help investors understand how human emotion factored into the economic meltdown, and offers lessons for the future.

Wealth Advisor asked decision expert Richard Zeckhauser, a professor of political economy at Harvard's Kennedy School of Government, to share his insights on how to make good decisions.


### Wealth Advisor: Are people generally good at making decisions?

People are terrible at calibrating probabilities. My specialty is helping people think through problems to achieve better outcomes in terms of their goals, especially when uncertainties are great. Warren Buffett, one of my heroes, says that contract bridge, where you make 500 decisions in a two-hour game, is the best practice for sound decision-making. People are not going to make good investment decisions until they get comfortable making decisions in general. When you get better at thinking about probabilities, you think better about the full range of all possible outcomes, even those with only a modest chance of occurring. Then you understand why portfolio diversification is so important, both within and across asset classes.

### Can you elaborate?

Even though stocks, on average, have paid more than bonds over the last 100 years, I should also have bonds, real estate and maybe some commodities in my portfolio because even if return levels are constant, the addition of each new asset works to reduce my risk. That's a non-obvious concept.

### Is that why many individual investors aggressively bought equities in the mid-2000s and then dumped them beginning in the fall of 2008?

That was a typical example of herding. First, everybody was reaching for the excess return they believed stocks offered, forgetting that stocks are riskier than bonds and that if the market goes down dramatically, *(continued on next page)*

THIS
## Issue



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all stocks tend to go down together. Then everyone panicked and moved back to holding significant levels of cash, ahead of the stock market's recent rally. They were making two mistakes: getting market advice from friends and trying to time the market. Warren Buffett once said, "The market timing hall of fame has zero members." It's too hard to know when the stock market is going to do terrifically and when it's going to do poorly. That's a good argument for consistently having significant diversification across asset classes.

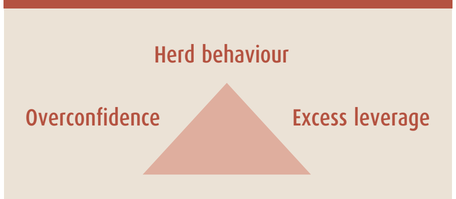
### Can behavioural finance help explain why many people are currently nervous about investing in equities?

One of the contributions I've made to behavioural finance is a concept called status quo bias. Your first choice is the one you stick with, even though there's no reason you should: 85 per cent of people will do that.

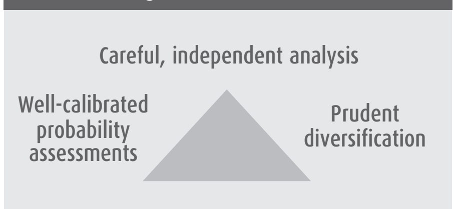
We looked at the retirement portfolios of Harvard employees. Virtually none of them had made any shifts in their asset allocations for many years. If they made a change and it resulted in a poor outcome, that would make them feel worse than just sticking with what they've always done, which is the psychologically safe strategy. People tend to value losses more than gains. And, faced with conflicting information, most people retreat to paralysis and make no decision at all.

People should consider the long-term return trends in the market and ask

**Poisonous Triangle** (figure 1)




**Healthful Triangle** (figure 2)




themselves when they are going to regain confidence in the equity market. I call this the barn-door-closing phenomenon – after the horse has left. People like to do today what they should have done yesterday. It's hard to find a 20-year period where you wouldn't have done quite well with a diversified portfolio.

### What is the "poisonous triangle" and how does it help explain the market meltdown?

Herd behaviour, overconfidence and excess leverage are the three points of the triangle that built on each other and drove the recession and market meltdown. With regard to herding, the cocktail party is not the place to get your investment advice. Herding can lead to panic. Next, people are overconfident about when to invest in stocks and their ability to pick stocks – it's a terrible problem. Third, people need to understand and be true to their own degree of risk tolerance. If they don't, they can become seriously overleveraged, like those who borrowed significantly against their homes and lost almost everything during the meltdown (see figure 1).

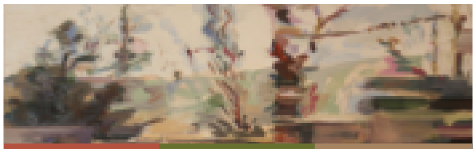
### What's the behavioural opposite of the poisonous triangle?

A "healthful" triangle might replace herd behaviour with decisions based on careful, independent analysis. Overconfidence would become well-calibrated assessments of potential outcomes. And third, replace excess leverage with prudent diversification. Know your risk tolerance and borrow and invest to an appropriate risk level for your current stage in life (see figure 2).

### Do you have a final word of advice?

Understand your own behavioural tendencies and, where they are dysfunctional, fight against them. Self-knowledge is the first step in making good decisions with confidence.

*If you would like to discuss your portfolio's asset class diversification, contact your client advisor.*



## Too much to do, too little time

Being in two places at once: impossible.

In fact, the impossible is within reach for clients who use the newly enhanced enCircle® program. enCircle is designed to help meet a wide variety of your needs, including running personal errands, helping you put a nutritional plan together, or arranging a much-needed vacation.

The comprehensive, all-in-one program offers a suite of financial and personal services to assist in the management of your busy life. Now enCircle offers Lifestyle Services, which includes health/wellness solutions and personal assistant services. Clients anywhere in Canada can call the dedicated 1-800 number, or go to a new personalized website, both accessible 24/7.

When the Ventura[1] family realized their 86-year-old father, who speaks little English, was no longer able to get out to the local social club and felt lonely and isolated, enCircle Lifestyle Services was able to help. The Venturas used Wellness Solutions to find the perfect seniors villa. Personal Assistant Services co-ordinated the move and, to ease the transition, helped plan a family reunion trip to their father's village in Bari, Italy, where he could reconnect with relatives and old friends.

*To find out how you can benefit from enCircle, please contact your client advisor.*

*[1]Client names and details have been changed to protect their privacy.*

# Charity begins at home

## How random acts of kindness can become a strategic plan for giving

The scenario plays out at dinnertime in Canadian kitchens from St. John's to Victoria. As the family gathers, a charity calls, asking for a donation.

If it's a worthy cause, mum or dad either reluctantly agrees to write a cheque, or says no, feeling slightly guilty and resentful.

"No one wants to feel like a miser, but you can't give to every worthy cause," says Marvi Ricker, vice president and managing director of philanthropic services for BMO Harris Private Banking.

Nevertheless, Marvi says it is possible to go from charity burnout to strategic giving by following the route one client has taken.

### From burnout to benevolence

Whenever Sarah Berry[2] receives a call from a charity, she explains that each spring the family selects one charity to receive a major donation. Since their current focus is youth programs, she suggests that each caller representing a charity within that area send written material the family will consider next year.

Says Marvi: "This approach works well for many reasons. Sarah is in control of the situation – she doesn't have to dodge phone calls. It's also respectful to the charity callers and allows Sarah to gracefully decline. She's not caught off guard and isn't pressured by a phone pitch."

"Best of all, the call is a teachable moment for her children."

### Involving the kids

Sarah adds: "Last fall after one of those calls at dinnertime, I explained to my children that charitable giving is built into the family budget each year. Now we've invited our daughters to make suggestions and help decide. I feel that it helped us connect as

a family. This could also work for grandparents who want to involve their older grandkids in giving."

In the BMO Retirement Institute philanthropy survey[3] conducted last August, 44 per cent of respondents said they donate on impulse without a plan or budget. Although 89 per cent said that charitable giving ranked high as a way of teaching family values, only 15 per cent of parents involve children in the decision-making process.

This is a missed opportunity, Marvi says. "Research shows that if parents are engaged in charitable activity, the kids will likely follow suit. The survey indicated that people want their giving to reflect their values and be a more significant activity in the family, but they don't know how to do that."

### Make the most of gifts

Just one per cent of respondents indicated their financial advisor helps them plan their charitable contributions, largely because they thought this was only appropriate for people who have a lot of money to give. Participants also said they would like to be able to give more.

Tina Di Vito, director of the BMO Retirement Institute, says, "even if you only give a few thousand dollars, your advisor is a valuable resource. He may suggest donating shares, or giving in a way that works with your overall tax strategies."

"Bequeathing money is not your only option if you want to give a large amount to your favourite charity; your advisor might find a way so you can do it now. Then you have the joy of seeing the impact of your donation during your lifetime."

"Planning doesn't preclude spontaneous giving and random acts of kindness; however, a deeper level of satisfaction comes from knowing you are taking care of the charities that matter most to you."

Becoming a strategic giver offers many advantages. Tina points out, "Having a plan alters the whole dynamic."

*If you would like to ensure you are maximizing the benefits of your charitable giving, your client advisor would be happy to talk to you. More information on the survey and report is available at www.bmo.com/RetirementInstitute.*

*[2]Client names and details have been changed to protect their privacy.*

*[3]Conducted by Ipsos Reid on behalf of the BMO Retirement Institute, the survey polled respondents over 45 with household assets of at least $50,000 who donated to charity in the last 12 months.*

Market Outlook

# Bulls dominate – for now at least

*by Paul Taylor, Chief Investment Officer*

Students of the Chinese zodiac know that the year of the tiger has roared in. They wonder how that will influence the markets, just as most investors are focused on what the bulls and bears will be doing for the rest of 2010.

Over at least the next 12 months, we expect equities to outperform bonds and cash as a moderate economic recovery continues.

To reach this conclusion, we examined all the factors that are influencing the Canadian and global economies. We then considered the probability of occurrence for a number of scenarios during the next few quarters.

Several key factors point to a recovery that is gaining momentum. In particular, we are focused on the improving leading economic indicators such as manufacturing activity, retail spending and consumer confidence. Central banks have indicated they will keep interest rates low and stable. With inflation not expected to be an issue, we expect central banks to remain on the sidelines for most of the year, responding with rate changes only if economic conditions warrant intervention. Good news also comes from the corporate sector, where profits are expected to grow. In addition, equity market valuations continue to be reasonable. The U.S. economy could actually start creating net new jobs over the comings months; job creation is very important to our outlook for a sustainable recovery, so we're closely monitoring improvements in employment data.

In 2009, the global economy was saved from Armageddon by governments in the major industrial nations, which pumped stimulus money into their economies and, in some cases, rescued their financial sectors. Confidence in our financial system returned and economic activity revived.

Globally, equity markets experienced meaningful gains, both over the fourth quarter of 2009 and for the year as a whole. In Canada, the equity market volatility of the past year allowed us to add to our Canadian holdings at very attractive prices.

Right now, we see that a sustainable, global economic recovery is in progress, bolstered by the factors outlined above. We expect the magnitude of this recovery to be modest, however, because of the

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excessive levels of private and public debt globally. It will take many years to reduce this debt, which will continue to exert a drag on growth.

What does this outlook mean for our approach to managing client portfolios? For now, we will position our portfolios with a higher allocation to equities, particularly emphasizing higher-quality companies with good long-term prospects, in sectors that are more cyclically oriented – those that tend to prosper more during a recovering/growing economy.

We're closely monitoring these concrete signals and risk factors (not the ones prognosticators find in the Chinese zodiac). If those signals start to change, we stand ready to "de-risk" our portfolios (and lighten up on equities) in response. We continue to stick to our strategy of using a disciplined approach to investing and managing risk across our clients' portfolios.



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