Stewart Financial

Thoughts that count

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Lessons from my wife's best friend

I have always been a dog person. Many of my earliest memories include canines. Growing up, we always had a dog in our home, and I fondly recall the excited daily post-school greetings at our front door. My wife is also a dog person, so after our kids were old enough to help with pet chores, we decided to add a four-legged family member. Owning a pet has been a wonderful family experience, except for finding out my kids are much better at acknowledging that chores are required than they are at chore execution.

Our first dog, *Hobbes*, is an energetic, medium sized mutt. He's a great family pet, though to my chagrin, my wife is his favourite. He excelled at obedience school training and is eager to follow commands. Hobbes loves to run, especially if being called for dinner, and I have never seen an animal consume food as quickly as he does. He is protective and displays empathy; without prompting he will comfort a family member if he senses distress. He is shy around unfamiliar people and can be especially grumpy at bedtime. He is a wonderful family companion.

We enjoyed having Hobbes around so much, we decided to get him a brother. In anticipation of the arrival of our new puppy, *Zurich*, we purchased some dog paraphernalia. Given what we knew about our current dog, we bought duplications of things Hobbes liked; a medium size sleeping crate, some plush toys and a standard dog bowl. I was fully prepared for the arrival of our new pup; in my mind we were getting Hobbes version 2.0. I couldn't have been more wrong, and less prepared. What we got was not a duplication of our first dog, it was his opposite.

Shortly after Zurich arrived, it became obvious he was a different hound. Where Hobbes was medium sized, within weeks Zurich grew into a giant. His obedience school training was a mild disaster; he wasn't purposely misbehaving, but lessons were party time with his new canine friends. Rather than shy, Zurich has yet to meet any person or animal he doesn't want to play with. He takes forever to eat, dislikes running and seems generally oblivious to what is happening around him. The dog gear we purchased was useless for Zurich; he needed an extra-large sleeping crate, destroyed the plush toys within minutes and needed a giant dog bowl. He is a cherished part of our family, but he is far from what I was expecting.

How could I have been so wrong about what to expect with Zurich's arrival? It turns out I had succumbed to a common thinking flaw called *availability bias*. Availability bias occurs when we assume recent information or trends are certain to be repeated. This error is made because our brains disproportionately rely on recent information. Our minds like short cuts. Taking time to judge circumstances objectively by pulling in multiple sources of information takes significant effort. It's easier to simply assume what has happened recently will occur again; I already have a dog, I know what he is like, therefore I am prepared for the next dog. My error in assuming a new dog would be the same size, have the same temperament and exhibit the same behaviours is obvious in hindsight. Unfortunately for me, hindsight was only available after the dog didn't fit in the sleeping crate, had destroyed the toys and didn't like the dog bowl.

Availability bias is one of the most common mistakes investors make. Its prevalence is amplified because it's not obvious. On the surface it may seem reasonable to assume current trends are likely to continue, but often last year's circumstances are not relevant to the period ahead.

As an example, let's assume it's the beginning of 2022 and an investor is thinking about where to invest for the upcoming year. A typical strategy would be to look at the previous year's returns and allocate funds to those investments which performed the best over the past 12 months. The chart (at left below) lists the returns during 2021 for major asset classes, in descending order.

2021
Real Estate (+35.1%)
US stocks (+28.7%)
Commodities (+27.1%)
Canadian stocks (+25.1%)
Int'l stocks (+19.2%)
Cash (+0.2%)
EM stocks (+0.1%)
Bonds (-2.5%)

During 2021, the best performing asset class was Real Estate, which generated 35.1% over the year. The second-best performer was US stocks (+28.7%), followed by Commodities (+27.1%), Canadian stocks (+25.1%), International stocks (+19.1%), Cash (0.2%), Emerging Market stocks (0.1%), and finally Bonds, which was the only asset class to lose money during 2021 (-2.5%).

It would be common for an investor to look at these 2021 returns for clues about how they should position their portfolio for the following year, 2022. This is the influence of availability bias. An investor looking at 2021 returns would allocate a significant portion of their 2022 portfolio into Real Estate and US stocks and would avoid the assets at the bottom of the list: Cash, Emerging Market stocks and Bonds.

The asset class returns for the subsequent year, 2022, are listed to the right. Unfortunately for the investor influenced by recent information, their preferred asset classes finished in the bottom quartile (Real Estate and US stocks), while one of the worst performers in 2021, Cash, finished near the top in 2022. The effect of availability bias meant missing opportunities because of a focus on the immediate past.

2022
Commodities (+13.8%)
Cash (+1.5%)
Canadian stocks (-5.8%)
Int'l stocks (-6.5%)
Bonds (-10.3%)
EM stocks (-15.2%)
Real Estate (-17%)
US stocks (-18.1%)

The last 2 years are not an anomaly. This pattern of asset class outperformance followed by underperformance is typical. Below is a list of the returns by asset class over the past 10 years. As you can see, there is rarely a time when a year's winning asset class repeats in a subsequent year, and many instances of significant outperformance following weak growth.

2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
US stocks (+32.4%)	US stocks (+13.7%)	Int'l stocks (+5.8%)	Canadian stocks (+21.1%)	EM stocks (+31%)	Real Estate (+6.3%)	US stocks (+31.5%)	EM stocks (+19.5%)	Real Estate (+35.1%)	Commodities (+13.8%)
Int'l stocks (+27.5%)	Canadian stocks (+10.6%)	Bonds (+3.5%)	Real Estate (+17.6%)	US stocks (+21.8%)	Cash (+1.4%)	Canadian stocks (+22.9%)	US stocks (+18.4%)	US stocks (+28.7%)	Cash (+1.5%)
Canadian stocks (+13%)	Real Estate (+10.4%)	US stocks (+1.4%)	US stocks (+12%)	Int'l stocks (+15.8%)	Bonds (+1.4%)	Real Estate (+22.8%)	Bonds (+8.7%)	Commodities (+27.1%)	Canadian stocks (-5.8%)
EM stocks (+3.8%)	Bonds (+8.8%)	Cash (+0.6%)	Commodities (+11.4%)	Real Estate (+9.9%)	US stocks (-4.4%)	Int'l stocks (+22.3%)	Canadian stocks (+5.6%)	Canadian stocks (+25.1%)	Int'l stocks (-6.5%)
Cash (+1%)	Int'l stocks (+6.4%)	Real Estate (-4.8%)	EM stocks (+10.1%)	Canadian stocks (+9.1%)	Canadian stocks (-8.9%)	EM stocks (+18.5%)	Int'l stocks (+1.3%)	Int'l stocks (+19.2%)	Bonds (-10.3%)
Bonds (-1.2%)	EM stocks (+5.6%)	EM stocks (-5.4%)	Int'l stocks (+5.9%)	Bonds (+2.5%)	EM stocks (-9.7%)	Bonds (+6.9%)	Cash (+0.9%)	Cash (+0.2%)	EM stocks (-15.2%)
Real Estate (-5.4%)	Cash (+0.9%)	Canadian stocks (-10.6%)	Bonds (+1.7%)	Commodities (+0.7%)	Int'l stocks (-10.5%)	Commodities (+5.4%)	Commodities (-3.5%)	EM stocks (+0.1%)	Real Estate (-17%)
Commodities (-9.6%)	Commodities (-17%)	Commodities (-24.7%)	Cash (+0.5%)	Cash (+0.6%)	Commodities (-13%)	Cash (+1.6%)	Real Estate (-13.5%)	Bonds (-2.5%)	US stocks (-18.1%)

So how does an investor fight against availability bias? One of the most powerful concepts in investing is *reversion to the mean*; over time asset class returns revert to their long-term average level.

As an example of this type of thinking;

- US stocks have returned 10% per year over the long-term,
- Last year US stocks returned 28.7%,
- Therefore, US stocks will likely return significantly less in the medium term, given returns need to fall in line with the long-term average.

When any asset class performs at the top of the group in a given year, it is highly probable it will not repeat. Similarly, when an asset class disappoints, it is likely to rebound in the period ahead. Investors are wise to consider these long-term averages, rather than just focusing on last year's returns.

Investment markets in general had a poor 2022, mostly due to the pace and magnitude of interest rate increases. While this was a significant change for investment markets last year, interest rate increases are nearing their peak. This presents opportunities for 2023 and beyond that did not exist in recent history. For example, we can hold conservative instruments (bonds, cash and cash equivalents) that generate significant yields not seen in more than a decade. As well, some asset classes (for example international stocks and emerging markets) are showing catalysts for a rebound after several years of underperformance.

Studying the bigger picture allows investors to make more thoughtful strategic decisions. Despite the uncertainty ahead there will be lots of opportunities this year as we stick to the main pillars of our investment strategy – protecting the downside and providing a sustainable return.

Your *using availability bias to determine I do not need a third dog* portfolio manager,

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