PWL

SEVEN DEADLY SINS OF INVESTING

PWL Capital Inc.

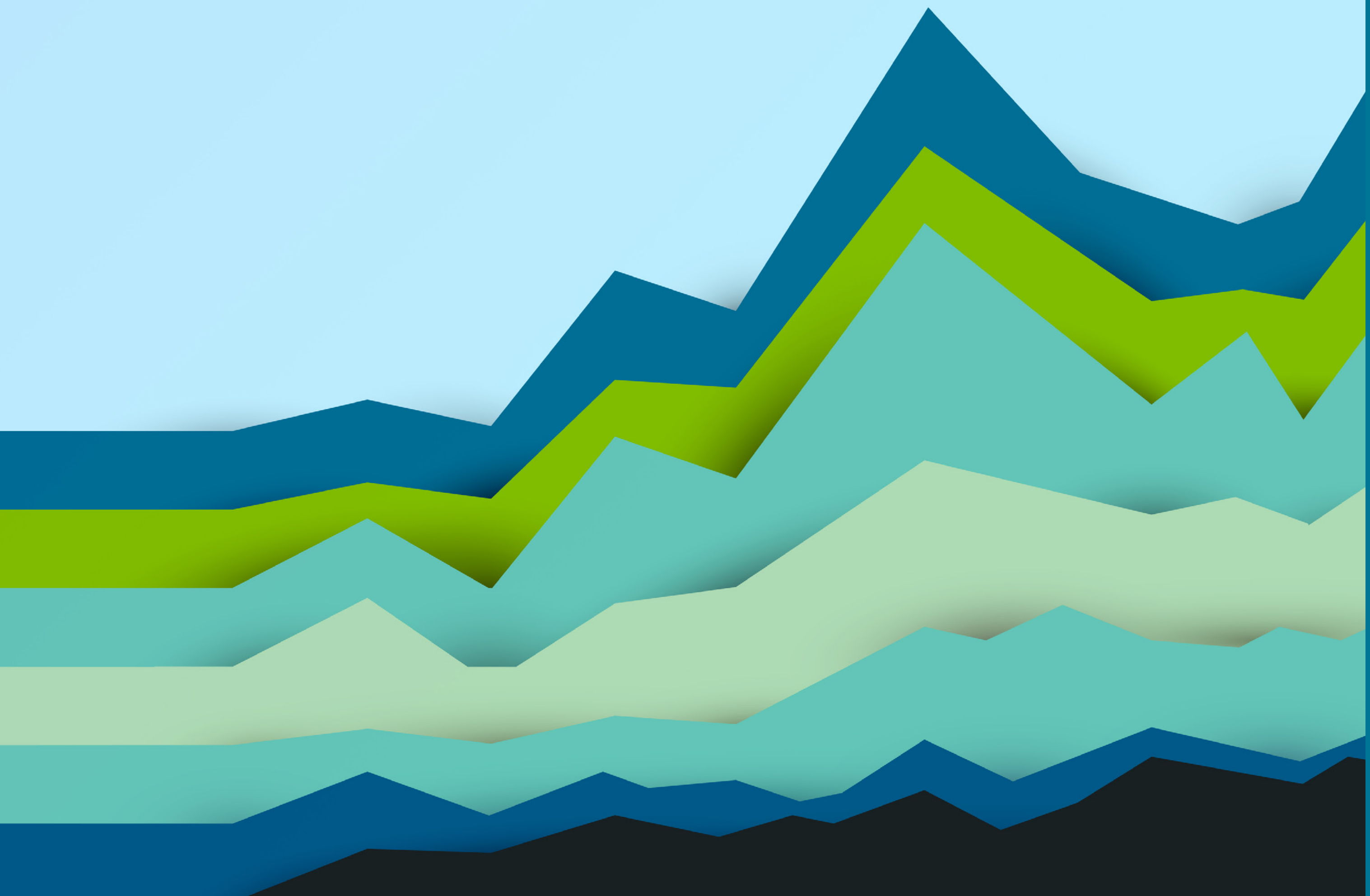


Table of contents

Introduction

The principles of smart investing are well known, thanks to many years of academic research into market history, asset characteristics and human behaviour.

Yet, investors often don't benefit from this research because they are either unaware of it or are led astray by the media, the investment industry or their own emotions. The result is poor investment decisions that can lead to a serious loss of wealth with real consequences for your lifestyle, including a less comfortable retirement.

We've called this eBook the ***7 Deadly Sins of Investing*** not because we blame people for falling victim to the pitfalls of investing, but because the "sins" are so easy to fall prey to. We understand it's often hard to know which choices will be best for building your wealth.

By avoiding these stumbling blocks and gaining a better understanding of the principles of good investing, you can put the best chances of financial success on your side. We hope this eBook will provide you with the foundation you need to make the right decisions for your financial good health.

Sin 1

Trying to outguess the market

Sin 1 - Trying to outguess the market

The temptation to try to beat the market is strong, especially because the investment industry and the media are constantly reinforcing the idea you can pick mutual funds or individual stocks that will outperform the market indices.

But consider the difficulties of choosing individual securities, or actively managed funds, that will outperform an index such as the S&P/TSX Composite or the S&P 500.

You or your fund manager will be competing against millions of sophisticated investors around the world who buy and sell securities every day. Collectively, they instantaneously process all available information and expectations about securities. Their trading decisions set market prices that reflect all that information. Of course, new information and events will cause prices to change, but these are inherently unknowable before they occur.

The evidence is overwhelming that the vast majority of active managers do not beat the index.

> For example, in Canada, 98.63% of active fund managers failed to beat the S&P/TSX Composite Index in the five years to December 31, 2020, according to **S&P SPIVA Scorecard**. In the U.S. it's a similar story—75.27% of active managers failed to beat the S&P 500 in the same time period.

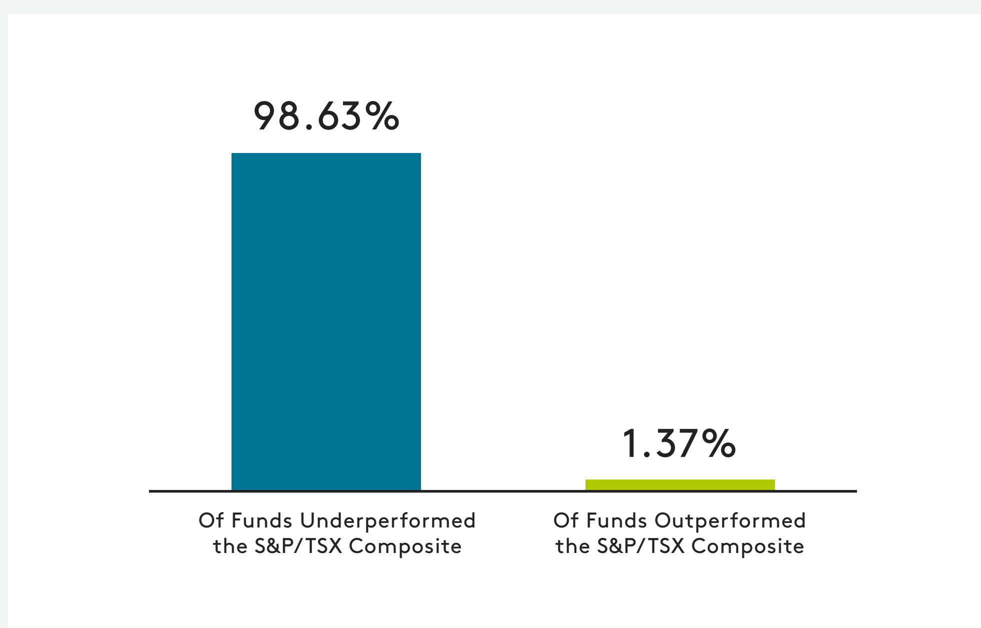
It's often challenging for bright, successful people to accept that they should aim to earn market returns.

However, truly intelligent investing isn't about outguessing the markets. It's about patiently sticking to an investment plan that allows you to capture market returns over the long term.

CANADA

PERCENTAGE OF CANADIAN EQUITY FUNDS THAT UNDERPERFORMED THE S&P/TSX COMPOSITE

Source: S&P SPIVA Scorecard
Displaying five-year data, Data as of Dec 31, 2020



Sin 2

Losing control of your emotions

Sin 2 - Losing control of your emotions

Think back to how you felt about your investments at the beginning of the COVID-19 pandemic in early 2020. The initial stock market plunge understandably provoked fear in many, especially because it came at a time of great uncertainty in other areas of our lives, as we navigated a health and economic crisis.

Some panicked investors sold their stock holdings out of concern the bear market was going to get worse. Then they watched from the sidelines as a lightening fast recovery took hold.

> By June, stocks were 38% higher in Canada and 40% higher in the U.S. than the lows reached in March 2020.

When fear fades, regret often takes over. In this case, some cursed their decision to sell while others wondered why they hadn't seized the opportunity of the market pullback to buy more. Emotions can be a powerful force if left unchecked.

The regret many felt was made all the worse because, as behavioural economists have discovered, we experience the pain of losses much more acutely than the joy of gains. Indeed, an aversion to losses can lead people to avoid the stock market altogether despite evidence that equities have consistently generated higher returns than other asset classes over the long run. On the other hand, the prospect of making huge profits can lead investors to make risky bets on hot stocks or sectors.

To manage your emotions during bouts of market volatility, the first step is to be aware of what you are feeling and the psychological biases you may be falling prey to. It helps to recall that a well-diversified portfolio is designed to buffer market setbacks. The advice of a trusted investment advisor can be invaluable both in preparing yourself for market turbulence and in riding it out when it inevitably arrives.

Sin 3

Failing to diversify

Sin 3 - Failing to diversify

For most people, it's easy to understand that owning just a few stocks can lead to a permanent loss of capital if one or more of those businesses does poorly or simply loses favour with investors. However, a lack of diversification across sectors, asset classes or geographies can also lead to significant portfolio underperformance.

For example, U.S. stocks have been on a tear over the last decade.

> The S&P 500 Index had an annualized compound return of 13.9% from 2011 to 2020. That compared to 4.7% for the S&P/TSX Composite, 5.7% for developed markets outside the U.S. (MSCI World ex USA Index), and just 4.0% for the MSCI Emerging Markets Index.

However, you only have to look a bit further back in history to understand why it's important to not become transfixed by recent returns in any one market. When the dot.com bubble of the 1990s burst, there followed a period from 2000-2009 that came to be known as the lost decade for the U.S. stocks

> In those years, the S&P 500 Index recorded one of its worst 10-year performances with a total compound return of −9.1%. By contrast, the MSCI Emerging Markets Index produced a total cumulative return of +154.3%.

This illustrates how diversification works for you—**when one market performs poorly another performs well**.

Portfolio diversification has been called the only free lunch in investing because when you combine asset classes whose performances are not well correlated you lower your overall risk without reducing your expected returns. Robust, global diversification works and, fortunately, there are passively managed funds that allow you to achieve it at a very low cost.

GLOBAL INDEX RETURNS

Source: Dimensional

Note: January 2000 - December 2009

Equity Index	Total Cumulative Return (%)
S&P 500	-9.10
MSCI World ex USA	17.47
MSCI World ex USA Value	48.71
MSCI World ex USA Small Cap	94.33
MSCI Emerging Markets Index	154.28
MSCI Emerging Markets Value Index	212.72

Sin 4

Timing the market

Sin 4 - Timing the market

One of the worst wealth-destroying mistakes an investor can make is to jump in and out of investments in an effort to avoid losses and maximize profits.

Driven by emotion, investors often buy when markets are rising and sell when they are falling. In effect, they buy high and sell low. It's called market timing and is a major reason why investor returns underperform market returns by a wide margin.

Market timing can take a heavy toll on your wealth, as shown by the Dalbar research firm.

> **It found** that poor trading decisions caused the average U.S. equity fund investor to earn annual returns that were 4.7 percentage points below those from the S&P 500 index in the 20 years to the end of 2015.

Market timing is the product of emotional reactions to market volatility and a misguided belief that market movements can be predicted. The reality is the no one can forecast what the markets will do.

What's more, to successfully jump on board a rising investment, you have to know not only the optimal time to buy but also the best time to sell. The same goes in reverse for avoiding losses. In trying to achieve this feat, investors amplify their losses and miss out on returns.

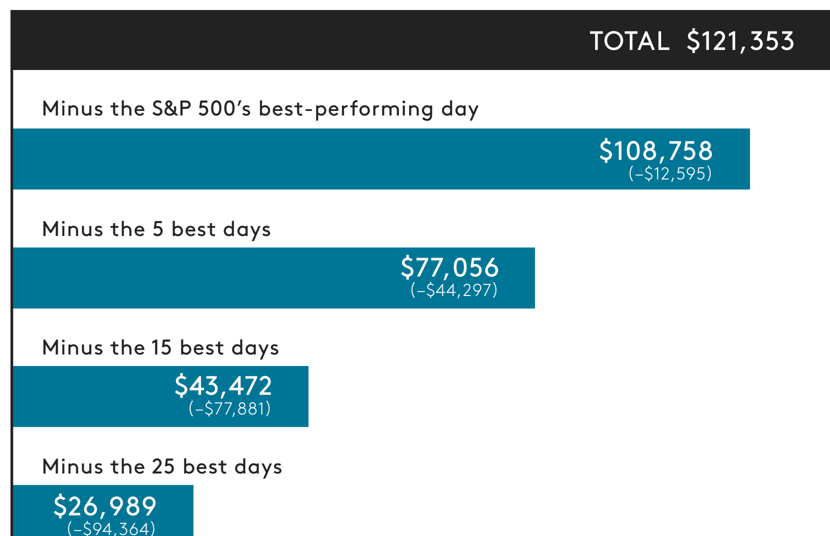
If you're tempted to time the market, it's a good practice to think about the person on the other side of the trade from you. They are making the opposite bet you are. Why? Do you have some special insight they don't?

Market timing is a **losing game**. The best way to build wealth is to patiently hold a broadly diversified portfolio and rebalance periodically back to your target asset mix.

HYPOTHETICAL GROWTH OF $1,000 INVESTED IN US STOCKS IN 1970

Source: Dimensional

Note: Based on the total return of the S&P 500 from January 1, 1970 to March 17, 2020



Sin 5

Getting caught up in the headlines

Sin 5 - Getting caught up in the headlines

Every day in the media, you can find predictions from stock analysts, professional investors and economists about what's going to happen in the markets. These forecasts are persuasively argued, pointing to "fundamentals," market history and various data points. And they are often wrong.

The evidence is clear that the experts are no better at seeing into the future than you are. Their predictions have been proven to be wholly unreliable as demonstrated by **research on forecasts** by Wall Street strategists between 2000 and the end of 2019 for the New York Times.

> The study found the median forecast missed the actual market return by an average of 4.3% percentage points in those years, an error of almost 45%.

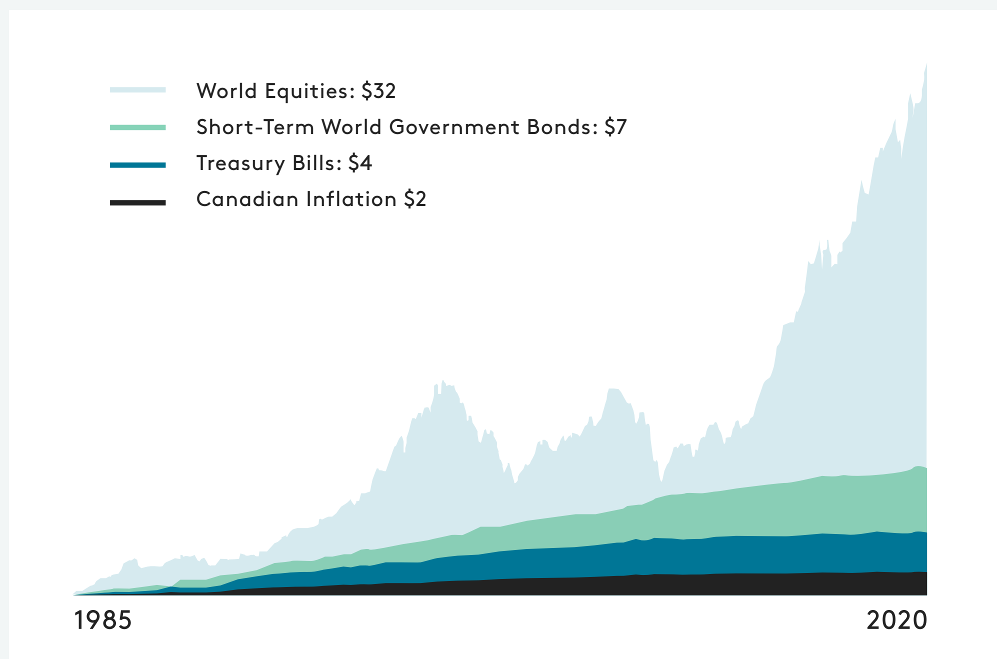
In fact, listening to market predictions can easily throw your investment plan off track. To better understand the danger, you only have to think back to the dire headlines at the time the market was falling in February and March 2020 in response to the pandemic crisis. For example, **a headline** in the Globe and Mail on March 12, 2020 warned *A significant bear market is just starting*. We know in hindsight the market would bottom just 11 days later when the markets began a powerful rally that lasted the rest of the year.

We just don't know what's going to happen and neither does anyone else. However, we do know that $1,000 invested in world equity markets in 1985 would have **turned into $32,000** by the end of 2020. That's why it's so important to tune out the day-to-day noise and focus on long-term returns.

CAPITAL MARKETS HAVE REWARDED LONG-TERM INVESTORS

Source: Dimensional

Note: Growth of $1 CAD, Jan. 1985–Dec. 2020



Sin 6

Chasing past performance

Sin 6 - Chasing past performance

Most people are familiar with the fine print at the bottom of mutual fund marketing materials that states: “Past performance is not an indicator of future results.”

Unfortunately, too many investors don’t take this warning seriously and choose funds that are highly rated on the basis of their past performance. They are likely to be disappointed with the results.

The reality is that relying on past performance to choose investments is like driving your car looking in the rear-view mirror. It doesn’t work (unless you’re driving in reverse). The evidence clearly shows that past fund performance is not a reliable guide to superior future returns. The vast majority of actively managed funds do not beat the market and studying their past performance only gives you the illusion they can.

Research by S&P shows that, regardless of asset class or style focus, few Canadian fund managers consistently outperform their peers over time. This suggests top-ranked funds are often the beneficiaries of luck, not skill.

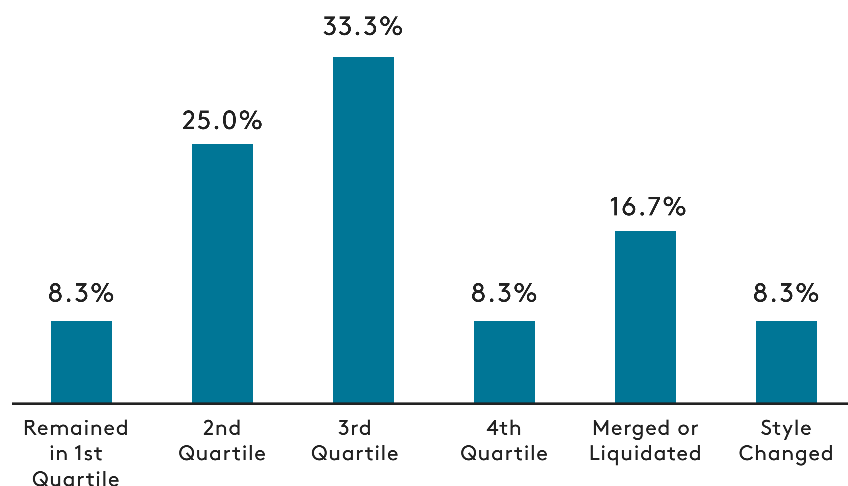
> Of the Canadian equity funds that finished in the top quartile in terms of cumulative returns from June 2010 to June 2015, only 8.3% finished in the top quartile for the period from June 2015 to June 2020, according to S&P.

Indeed, it was more likely for a top-quartile fund to disappear or change style than to remain in the top quartile.

That’s why it makes sense to use passively managed index funds to build a broadly diversified, low-cost portfolio. It allows you to give up the futile search for market-beating funds and take a sure bet that you’ll reap the returns the markets are offering.

OUTCOMES OF THE TOP-QUARTILE DOMESTIC FUNDS FROM JUNE 2010 TO JUNE 2015 OVER THE NEXT FIVE-YEAR PERIOD

Source: S&P Dow Jones Indices LLC, Fundata Canada Inc. Data as of June 30, 2020. CIFSC categorizations are used. Financial information provided by Fundata Canada Inc. Chart is provided for illustrative purposes. Past performance is no guarantee of future results.



Sin 7

Ignoring factors under your control

Sin 7 - Ignoring factors under your control

We know investors have no control over the markets and can't predict what direction they'll take. That's why you need to carefully manage the factors that are under your control to reduce your risk and increase your returns.

We've already looked at some of those factors, including diversifying your portfolio and controlling your emotions to remain disciplined through market swings.

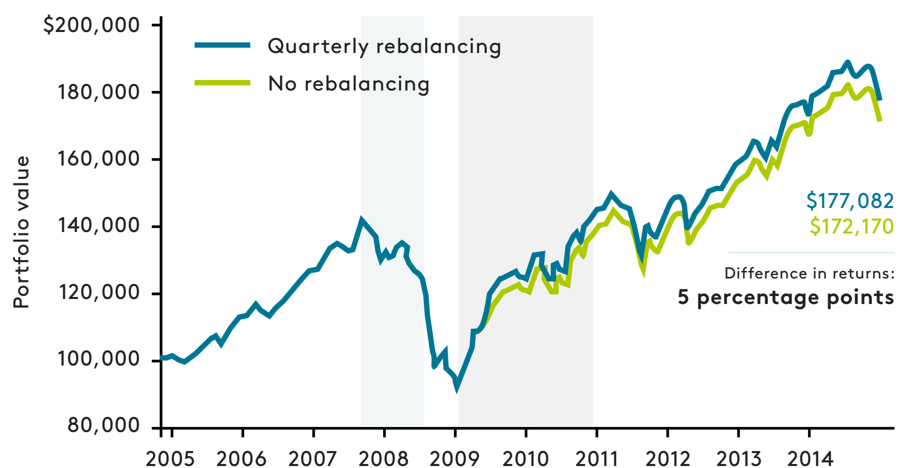
Here are some other ways you can add value:

- **Create a long-term investment plan** based on your goals, the expected returns of different asset classes and your risk tolerance. A plan helps to keep you on track during periods of volatility and disciplined about sticking to your target asset mix.
- **Manage your expenses, turnover and taxes** by investing in broadly diversified, low-fee index funds, minimizing trading and using tax deferred or non-taxable accounts such as RRSPs and TFSAs. High fees, trading commissions and other costs can significantly reduce your returns.
- **Rebalance your portfolio** periodically back to your target asset allocation. As markets move up or down, the composition of your portfolio strays from the asset allocation you've set out in your plan. To rebalance, you return to target weightings by selling assets that have risen in price and buying those that have done less well. It's the disciplined way to buy low and sell high and has been proven to provide higher returns and lower risk.
- **Capture return premiums.** Research has shown that stocks with certain characteristics have historically delivered above market returns. For example, value stocks outperformed growth stocks 4.5% annually in the U.S. from 1928 to 2019. Small cap stocks are another type of equity that has historically delivered premium returns. By tilting your portfolio towards stocks that deliver premium returns, you can increase your expected returns.

A CONSISTENT REBALANCING RULE REMOVES THE EMOTIONS

Source: Vanguard

Notes: Return data cover January 1, 2005, through December 31, 2014. The shaded "Overweight during correction" area corresponds to the period from October 2007 to September 2008. The shaded "Underweight during recovery" area corresponds to the period from March 2009 to December 2010.



Conclusion

Committing the seven “deadly sins” highlighted in this eBook can be costly to not only your wealth, but also your psychological well-being. Although they’ve been confirmed by years of academic research, the sins are not easy to avoid because they reflect deep-seated behavioural biases that are often exploited for profit by the investment industry.

Fortunately, we are living in an era when we can take advantage of the wealth of knowledge about investing developed over the years. The maxim “to be forewarned is to be forearmed” was never truer than it is in this domain.

At PWL, we take a scientific, evidence-based approach to advising our clients and managing their portfolios. We devote a great deal of resources to conducting our own research and keeping abreast of the latest discoveries by others. We then use this research to design client portfolios based on scientifically verified and time-tested principles.

Investing can seem complicated and risky, but with the right guidance, you can avoid the pitfalls and stay on course to reaching your financial goals through all market conditions.

The Author

James Parkyn CIM®, FCSI, F.PI
Portfolio Manager

James is a founding partner and Portfolio Manager at PWL Capital Inc. in Montreal with over 25 years of experience helping clients achieve their financial goals.

James and his team members provide unsurpassed service and honest, well-thought-out advice, driven by an investment philosophy that explains why he has the privilege of acting as a long-standing advisor to many of Canada's corporate elite, private business owners and retirees.

For more information: www.pwlcapital.com/james-parkyn

Portfolio Management and brokerage services are offered by **PWL Capital Inc.**, which is regulated by Investment Industry Regulatory Organization of Canada (IIROC), and is a member of the Canadian Investor Protection Fund (CIPF).

Financial planning and insurance products are offered by **PWL Advisors Inc.**, and is regulated in Ontario by Financial Services Commission of Ontario (FSCO) and in Quebec by *the Autorité des marchés financiers* (AMF). PWL Advisors Inc. is not a member of CIPF.

Regulated by
Investment Industry Regulatory
Organization of Canada

GLOBAL ASSOCIATION *of*
INDEPENDENT ADVISORS™

This paper was written by James Parkyn. The ideas, opinions, and recommendations contained in this document are those of the author and do not necessarily represent the views of PWL Capital Inc.

© PWL Capital Inc.

All rights reserved. No part of this publication may be reproduced without prior written approval of the author and/or PWL Capital. PWL Capital would appreciate receiving a copy of any publication or material that uses this document as a source. Please cite this document as:

James Parkyn, *Portfolio Manager*, PWL Capital Inc., “Seven Deadly Sins of Investing”.

For more information about this or other publications from PWL Capital, contact:

PWL Capital – Montreal, 3400 de Maisonneuve Ouest, Suite 1501, Montreal, Quebec H3Z 3B8

Tel 514-875-7566 • 1-800-875-7566   Fax 514-875-9611
www.pwlcapital.com/teams/parkyn-doyon-la-rochelle

Updated Date: May 19, 2021