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10 Behavioural Biases That Hurt Us

More than I'm sure you and I both care to admit, we both and those around us, have tendencies that sabotage our success. Here are 10 of them.

Confirmation Bias— We like to think that we carefully gather and evaluate facts and data before coming to a conclusion. The truth is, we actually don't. Instead, we tend to lean toward what we believe to be true first and then gather facts to support our pre-conceived conclusions.

Optimism Bias— I've heard that 80% of drivers think they are above average in their driving skills. How is that possible? Can't only 50% can be better than average. But we say, I AM in the top 50%. Are the "others" simply bad judges of their own abilities and you and I are such accurate judges of our own? We are applying subjective confidence over objective accuracy.

Loss Aversion— This makes us tend to do nothing when we are presented with a variety of choices. After we have compiled hard facts and data, when it comes time for us to act, biases 2 and 3 – unjustified optimism and unreasonable risk aversion, conflict. As a consequence, we tend to make bold forecasts based on the information but our choices are timid.

Self-Serving Bias— Makes us see the world such that the good stuff that happens is because of me while the bad stuff is almost always someone else's fault.

Planning Fallacy— The tendency to underestimate the time, cost and risk of future actions while at the same time overestimate the benefits. This is partly why we underestimate the potential for bad results. It's why it often takes us longer to accomplish something than what we expected and why the results we end up achieving aren't as good as what we expected.

Choice Paralysis— We think the more choices we have the better. In fact, the opposite is true. Too many choices actually inhibits us from making a choice. Choice works against us.

Herding— We seem to believe we are independent thinkers however we all run in herds. We buy what our friends buy, we do what most other people are doing. Anything else could make us look foolish. Sadly, this is very evident when it comes down to affinity fraud or investment manias. We did the wrong thing that had huge cost but at least we didn't look foolish because so many others did it as well.

Stories— These are always more exciting than data and thorough analysis. Objectivity is hard to apply when you hear a good story. That is why they say, stories sell… because they do.

Recency Bias— We tend to extrapolate recent events or trends into the future indefinitely. If something good is happening it will happen forever. Being in the dark time of bad circumstances makes it seem they will never end.

Bias Blind-Spot— The inability to recognize that we suffer from the same cognitive distortions that plague other people. We are ALL very much alike.

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Investments That Pay You Monthly or Quarterly

There is strong demand for investments that payout interest, dividends or some other distribution on a regular basis. This demand isn't surprising. You have interest rates that are expected to remain low for a few years at least and a demographic shift in the developed world that is having more and more people retiring, creating a increasing demand for investments that pay out income to their owners consistently. Here are a few categories of those investments:

Corporate Bonds— There are several kinds of bonds that I'll put under this category. Floating Rate bonds which are short term loans to companies, Investment Grade bonds which are issued by companies with strong financials and High Yield bonds, those being offered by companies whose financials are less than stellar. Interest rates around 6%.

Emerging Market Government Bonds— Interest rates in the more developed countries are low however their debt is generally on the high side. Government bonds of other countries such as those in Eastern Europe, South America and Africa offer much higher interest rates AND their governments as a whole are in much better financial shape than the bigger countries. A mix of bonds within the emerging markets pay approximately 3—4%.

Real Estate Investment Trusts— These are pools of real estate assets including office buildings, shopping malls and multi family residential buildings. The rents that come first pay all the expenses of the buildings and the remainder is paid out to investors. Net income paid out is in the 6—7% range.

Infrastructure— Airports, bridges, highways, water and sewage facilities, ports and even universities, hospitals and prisons. Governments are deeply in debt and they are partnering with private companies to run these. The private company in simple terms get a piece of the revenue and this is passed on to owners of the infrastructure company. We are currently seeing the biggest sale of infrastructure assets by governments in Europe (Milan Airport is a recent example). This is a sign of the times where governments are way behind in upgrading their infrastructure, much like the 50's and 60's and you as a person with money to invest can participate. Yields in this sector average around 4—5%.

Dividend Paying Companies— These are generally big name companies that you are familiar with. Companies that supply all of us, in Canada or around the world, food (Nestle), banking and mortgages (TD), software (Microsoft), drugs (GlaxoSmithKline), transportation (Toyota), entertainment (Disney), holidays (Carnival Cruises), coffee shops (Starbucks) etc. Virtually everything anyone in the world spends money on is to a company that pays a dividend. Because everything we pay for slowly goes up in price, so do company dividends… along with the share price. Owning these is a basic wealth creating engine that has been with us for 100's of years. Dividends average 3%.

Of course, it is very time consuming to go through an in depth process to make sure you are getting investments that are sound and not overpriced and you shouldn't just focus on yield. Also, it is very hard to take emotion out choosing the right investments. It is for these reasons, there are portfolios available that will fit with what works best for you, so you can diversify your investment dollars and enjoy a steady paying monthly income that should increase over time.

Determining The Investment Value Of A Property

Our homes. Most of us would agree, that owning a home is the single best investment that one can make. History and our experience of it, has shown that a home can be expected to increase in value over time.

When buying a home you can't look at it from a pure valuation perspective however. It is bought for reasons that are more about lifestyle and a good, stable place to raise a family as well as the fact you will probably own it for most of your life. If you pay too much for it, that really shouldn't matter much because it will have 20 to 50 years or more to spread out what you paid and what it was really worth. Also, when you sell your own home, the gains you make are completely tax free which adds to the significant benefits of owning a home

When making an investment strictly for that singular purpose of making money there are various valuation calculations that should be made prior. This is something that is not often done since the attractiveness of a property (location, how we feel when we are there, and the fact we can talk about it) is usually done from a purely emotional level.

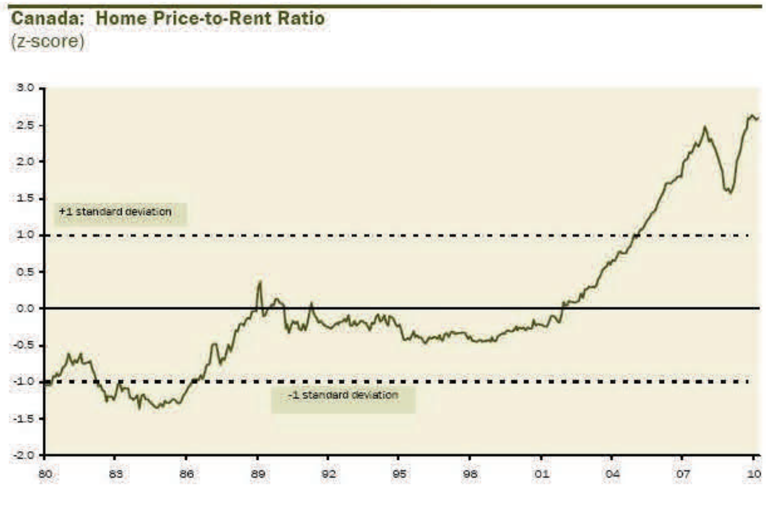
When buying a property for rental purposes, a more detailed financial analysis must be done in order for the investment to have a higher potential to work in your favour. In other words, what is the true value of this property when applying very important, fundamental investment ratios?

The easiest calculation you can use with residential property is the Home Price to Rent ratio. This is simply the rent you will collect on an annual basis versus what the property is priced at. In commercial property a more detailed variation of this calculation is used, the sum of which is called a "Cap Rate". This is the net operating income of the property (the actual income after paying ALL expenses related to the property) divided by the price of the property. It is the

(Continued from page 2)

"cap rate" (capitalization rate) that is used to determine the value of a property. Usually properties that are older and have 1 or only a few small tenants, as well as properties in smaller, less economically diversified cities have higher cap rates because that income is less stable. These factors should be worked into the analysis of ANY rental property.

To the right is a chart that shows Home Price-to-Rent ratio for the Canadian market as a whole going back to 1980. As you can see, the residential real estate market over the past 10 years has shot way past normal levels. If you were to look at Vancouver in isolation, it is off the chart when compared to ANY U.S. city at it's peak price. When contrasted with any country in the world, Canada as a whole has the highest House Price-to-Rent ratios… anywhere.



Source: CREA, Statistics Canada, Gluskin Sheff

The main drivers of such euphoric residential property prices has been a combination of interest rates at unprecedented, ultra low levels for such a long period of time and the fact that we didn't go through a banking crisis like many other countries did. People kept on borrowing and buying. When interest rates rise, many people will be higher carrying costs on their mortgaged properties and if the ratios are stretched at todays low interest rate levels, people may be forced to sell properties they can't afford to hold onto anymore or prices will remain flat until rents and incomes catch up. How it will play out, remains to be seen.

How Should I Pay Myself, Salary or Dividends?

As an owner and active "employee" of an incorporated small business, one thing you have to tackle is how to get money out of the company and paid to you, so you can use it for your personal expenses. Of course, you want to do that in as tax effective a way as possible.

With a salary you pay yourself just like any other employee is paid by a company. CPP contributions have to go to the government and you personally, have to pay the appropriate amount of tax. The difference is that, with you being the owner of the company and the employee, you have to pay both halves of the required CPP contributions (4.95% of paid income x 2 for a total of 9.9%).

Because of this, I often come across the misconception that dividends should be taken instead of salary. "Why would anyone pay CPP contributions if they don't have to? Plus, taxes on dividends are lower." Those are both true however, salary is a tax deduction to the company whereas dividends are not. So, although you are paying lower tax personally, your own company is paying more tax. Yes, corporate and personal taxes on the dividends are lower on salary but it isn't as simple as just that.

The largest part of the extra expense of taking salary versus taking dividends is the CPP contributions you have to make when taking salary. Sure, CPP contributions are an expense, but unlike income tax, with CPP contributions you accumulate a future benefit; being able to collect CPP income when you are retired. When you only take dividends and aren't making CPP contributions and thus you won't collect CPP later on in life. Taking dividends requires a discipline to set aside the money you are not making in CPP contributions so as to create the same kind of income you would get from CPP.

There are a few additional considerations to take into account, including the option of taking a combination of both salary and dividends. However the deciding factors are a) if you think you can earn a better return than the Canada Pension Plan can and b) expect not to need retirement income as long as the average person because you'll be working longer or are betting you will die prematurely, dividends may suit you just fine. Remember however, you have to be right on all counts if dividends are to be proven as your best option.

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Www.lawdepot.ca — Getting to a Lawyer or Notary to do up a legal document is an often procrastinated "must do". I always advise my clients to seek the personal advice of professional however, sometimes you need something done NOW, when you think of it and are motivated to do it. Lawdepot is a site where you can create customized legal documents very quickly. Remember, this is only a stop gap measure until you get face to face advice.

Hhhhhmmmmm……

Unlike Europe, the US has elevated government spending and maintained low tax levels. This has actually allowed economic growth to continue and households to pay down their debts. The net positive is a declining level of US total debt (the sum of all household and government debt), which now sits at a 6 year low.

The highest unemployment rate in Europe is Spain at 25.8%. Austria has the lowest with 4.4% followed closely by Germany at 5.4%. Canada in comparison is 7.4% while the U.S. is experiencing 7.9% unemployment. Globe & Mail, Nov. 2012

Spain's financial problems did not stem from government overspending, as in Greece's case, but from losses that its banks incurred after a property sector crash, much like in the U.S. Globe & Mail, Nov. 2012

Dividends being paid on European domiciled companies is higher than their 10 year average, despite the financial struggles that Europe is going through.

Everyone is buying government bonds today. They are essentially paying $108 to $115 for $100 bills so they can get 1.5 to 2% per year for the next few years and get $100 when the bond matures. They are doing this because they don't want to lose money. Bob Swanson, Cambridge Advisors (Boston)

Individuals are selling their shares and buying bonds. Companies are selling their bonds and buying the shares that the public is selling. Who is more likely to be right in what they are doing? Bob Swanson

Undisciplined investing (ie. buying just because everyone else is) can only be lucky; It can never be correct.

When everyone is concerned about the same thing it rarely turns out to be the right thing to be concerned about.

By 2017 the U.S. will surpass Saudi Arabia as the world's largest oil producer and will become virtually energy self-reliant (good if you are an American, not so much if you are a Canadian). All in all, this is likely positive for equities as it will keep consumer's costs down. Bloomberg, Nov. 2012

This summer, Sony's stock fell below $12.50 U.S. for the first time since 1980 when the Walkman was the iPod of it's day.

Sharp (the Japanese electronics company) said it has put up it's real estate ownership, including it's Osaka headquarters, as collateral for bank loans so it could keep the 100 year old company going. Globe & Mail, Nov. 2012

Income tax for someone earning $60,000 in B.C. has dropped from $12,330 in 2008 to $11,656 in 2012. The 5.5% drop has been larger on a percentage basis for lower income earners than it has been for higher income earners. Taxtips.ca

Cell phones are getting bigger and tablets are getting smaller. It seems increasingly conceivable that some time in the future one may ultimately replace the other.

If a foreigner sends his family to Canada, buys a home in Canada in his name, but he stays to work in their home country, the breadwinner isn't considered a Canadian resident therefore he avoids paying tax in Canada despite the rest of the family living here. Advisor.ca

Rubbermaid Fast Track garage storage system for my garage; at Home Depot in the U.S. is $199.49. The exact same thing in Canada is 86% more expensive at $371.80. Ironically, the Home Depot website doesn't except Canadian issued credit cards. Lowes prices between their US and Canadian stores is virtually the same.

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