Weekly Trends

PRIVATE CLIENT SOLUTIONS

Jason Castelli, CFA

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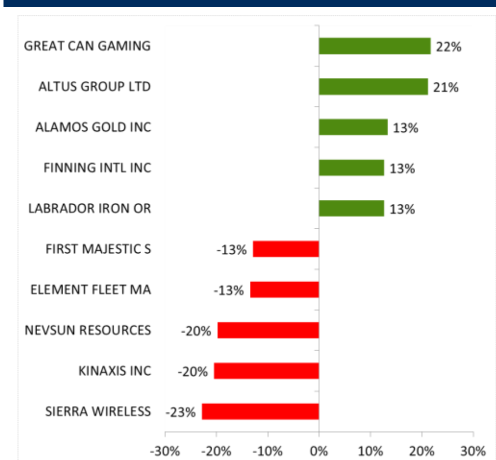
Don’t Psych Yourself Out

It’s been an uneventful start to August, at least from a historical perspective. August has offered up a few financial markets surprises in the past: Chinese currency devaluation in 2015 when China's central bank devalued the yuan by lowering its daily mid-point trading price against the US dollar; the Standard & Poor’s downgrade of US debt in 2011, the first time the US government was given a rating below AAA; the 2007 subprime mortgage crisis spread to global financials as subprime MBS were discovered in portfolios of banks and hedge funds around the world; and in 1997 the Asian financial crisis which saw a series of currency devaluations across South Asia that caused market turmoil.

In this context, August has been good thus far. The big wildcard of course is the heightened geopolitical tensions surrounding North Korea. If we’re to receive an August surprise this seems to be the most likely candidate. North Korea continues to provoke the US and its allies outlining a detailed plan to fire 4 missiles near the US Pacific territory of Guam by mid-August. Both Japan and South Korea have warned of a strong response if it follows through with the plan given the missiles would fly over both countries in order to reach Gaum.

The ‘war of words’ has hit risk sentiment and weighed on the market; however, corporate earnings continue to be a bright spot. The S&P 500 is tracking to have its first back-to-back quarter of double-digit EPS growth since 2011. Canadian corporate earnings have also been robust, with ~65% of the S&P/TSX members reporting sales and earnings that have been running above analysts’ estimates by 1.5% and 11%, respectively. Thus far the TSX is on track to report yoy growth of 9.7% in revenue and 65.7% in earnings. As earnings season wraps up, economic data and geopolitical events will have greater influence on market direction. With many heading for their final summer vacation, volumes will be thin and volatility could rise.

S&P/TSX Top 5 Gainers/Laggards*

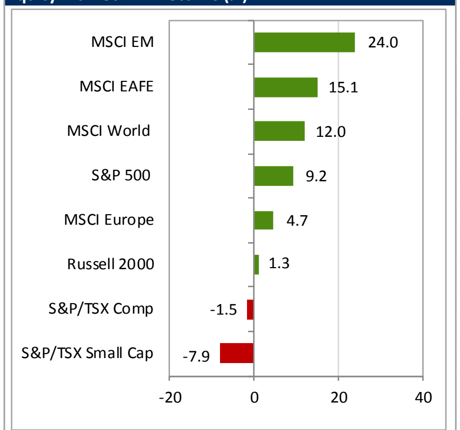


S&P/TSX Market Internals

Weekly Advance	117	47%
Weekly Decline	131	52%
Advance-Decline	-14	
New 52 wk high	7	3%
New 52 wk low	7	3%
No. Stocks Above 50-d	96	38%
No. Stocks Above 200-d	111	44%
Arms Weekly Index	1.19	Neutral
RSI (14-day)	50.6	Neutral
50-DMA	15,240	Downtrend
200-DMA	15,343	Downtrend

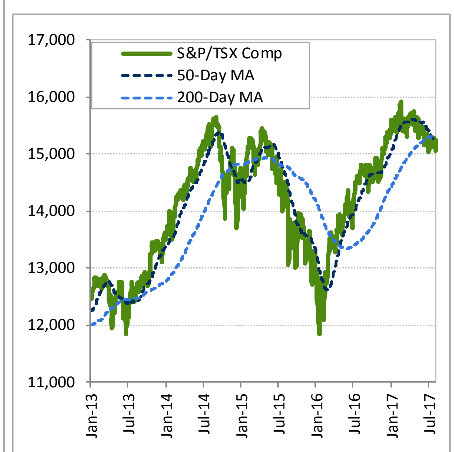
Source: Bloomberg, Raymond James Ltd; * 5-day price return

Equity Market YTD Returns (%)



Canadian Sectors	Weight	Recommendation
Consumer Discretionary	5.3	Market weight
Consumer Staples	3.8	Market weight
Energy	20.2	Overweight
Financials	34.5	Overweight
Health Care	0.6	Underweight
Industrials	9.4	Overweight
Technology	3.2	Market weight
Materials	11.8	Market weight
Communications	5.0	Underweight
Utilities	3.3	Market weight
Real Estate	2.9	Market weight

Technical Considerations	Level	Target
S&P/TSX Composite	15,063	16,500



Source: Bloomberg, Raymond James Ltd.
Sectors are based on Bloomberg classifications

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Raymond James Ltd. 5300-40 King St W. | Toronto ON Canada M5H 3Y2.
2200-925 West Georgia Street | Vancouver BC Canada V6C 3L2.

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The Psychology of Investing

Contributed by: Ian Nakamoto, MBA, CFA

It is easy to think of the stock market as possessing humanistic qualities at times; everything can appear steady at first, but can swing to a period of irrationality in an instant. However, at the end of the day the market is simply the collective conscious of millions of individual investors. Psychologists and economists had worked together to study how people make decisions and from this body of work, a new discipline called Behavioural Finance (BF) was created. For investors who are curious about how emotions and biases drive share prices, BF offers some interesting descriptions and explanations. This is the topic of this week's commentary.

BF Background

Behavioral finance uses psychological experimentation to develop theories about human decision making and has identified a range of biases to describe how people think and feel. In the 1960s, cognitive psychologists began to shed some light on the brain as an information processing device. In the 1970's two psychologists, Amos Tversky from Stanford University and Daniel Kahneman from Princeton University, began to compare their cognitive models of decision making under risk and uncertainty to economic models. Professor Kahneman won a Nobel Prize in 2002 for his work. The idea that psychology drives share price movements contradicts established economic theories that advocate the notion that markets are efficient and investors act rationally. For investors that have lived through the internet or US housing bubble, the notion that markets are efficient and rationale is difficult to believe. Below we list some of the most common biases investors have and how to overcome them to make better investment decisions.

Loss Aversion

Loss aversion refers to a person's tendency to prefer avoiding losses more than acquiring perceived gains even when the end result is the same. The two university professors (Tversky and Kahneman) found avoiding losses was twice as powerful a force than an equivalent gain. Professor Kahneman showed in a coin toss study that students need to potentially win $2 for every $1 that was put at risk before taking on the bet. In today's environment there are individuals that choose to keep their money in low-interest guaranteed bank deposits rather than investing in the stock market which may have a higher expected return but also increases the chance of a loss. There is no simple solution to overcoming this loss aversion, but building a diversified portfolio across asset classes can mitigate the downside risks. As an example, during a recession when equities fall due to declining corporate profits, government bond prices rise as interest rates fall.

Cognitive Dissonance

This is the uncomfortable feeling experienced by a person who simultaneously holds two or more contradictory beliefs or values. People engage in a process to reconcile the differences. An example of cognitive dissonance is eating unhealthy food. The person realizes the food is unhealthy but rationalizes eating a small amount will not affect them. There are various examples of cognitive dissonance in the investment field. An investor may decide that a particular stock is over-valued at the current level, however, if it dropped by 10% it would be under-valued and provide a good entry point. Unfortunately, the stock continues to rise. In order to ease their feeling of cognitive dissonance, they purchase the stock at an over-valued price, justifying the action by arguing the stock will continue to rise.

Herd Mentality

Herd mentality describes how an individual's thinking is affected by the actions of others. Researchers at Leeds University have shown it only takes a small amount (5%) of people that seemingly know what they are doing to influence the actions of the other 95%. When the stock market is moving up or down many investors are subject to a fear that others know more or have more information than they do. As a consequence, investors feel a strong impulse to do what others are doing. Two instances when following the herd hurt investors are the 1999/2000 technology boom in equities and the late stages of the 2000 to 2008 US housing bubble. Whether following a trend or not, investors should make informed decisions rather than relying solely on one's emotions (e.g. others are buying, so I should also). Using tools such as percentage guidelines to allocate one's financial resources to equities / bonds / cash or any one security limits the damage if one investment does not work out.

Overconfidence

Confidence can be good, but overconfidence can have a devastating effect on one's portfolio. It can lead to taking more risk than one's financial resources allow. Investors that are overconfident tend to believe they are more skilled at choosing the best securities. Misattributing past stock market wins to skill rather than luck can lead to overconfidence. One should always look at the risk of being wrong and be certain that absorbing a loss in a few miscalculations would not drastically alter their financial goals.

Sunk Cost Feeling

This is money that is spent and cannot be recovered. An example is a company may have invested a million dollars in a new plant only to realize the market for their product has changed and their product has become obsolete. For investors, a sunk cost occurs if an investor purchases a stock and it falls significantly from the purchase price. It may be only a timing issue and stock rises, but if the company's fundamentals have changed it is best to admit to a mistake, sell the stock and look for alternatives.

Confirmation Bias

This is the tendency of people to favour information that confirms their bias. Psychologists find confirmation bias is especially true for emotionally held beliefs. For instance, once a stock is purchased, investors tend to look for information that confirms their purchase and either ignore or downplay information that does not confirm their purchase. In order to overcome this bias investors should be open minded to all information and weight the positives and negatives regardless if they purchased the stock.

Conclusion

It is human nature to experience these and other psychological biases when investing, but recognizing and managing it is key to making better investment decisions. We stress that maintaining a disciplined approach and diversifying is one way to mitigate some of the common behavioural pitfalls we all experience from time to time.

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