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Smart Money: These good times are here to stay, right?

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Brad Brain: "Some people will look at past performance and extrapolate what has happened out into the future. They think the recent trend of good performance will continue without interruption, and they jump in because they want a piece of the

action too." | Getty Images

2021 has been a great year for many investments. Short-term performance has been exceptional. Some investments have a one-year return of 45%. That's great. And that got me to thinking. After an extended run of above-average performance, some people have never seen a bear market.

A bear market is when investments come down by 20%. Technically we had a bear market in 2020, but that was the shortest bear market in history. It's hard to fully experience the typical anguish that accompanies a bear market when the whole thing is over in a few weeks. For context, the painful 2008 bear market was relentless grind that lasted a year and a half.

Basically, some newer investors have only seen good times. The potential implication is that they could have a distorted view of investing, and that can lead to bad decisions.

Regardless of how seasoned an investor is, here are some of the ways an extended run of good performance can be dangerous.

Some people will look at past performance and extrapolate what has happened out into the future. They think the recent trend of good performance will continue without interruption, and they jump in because they want a piece of the action too.

But trends don't last forever. Just because an investment has already appreciated is no assurance that it will continue to appreciate. Basing your actions solely on past events will eventually end in disappointment.

Another potential problem is that good past performance can set a person up for artificially high expectations from their investments. This can lead to some people scorning perfectly acceptable investments, not because the investment itself was inferior, but because the expectation was unrealistic.

Here is a bit of sobriety. Every year the Financial Planning Standard Council of Canada puts out recommendations that professional financial planners will use in producing a financial plan. Believe it or not, the standard to use is projecting the future growth of Canadian equities is a mere 6.2%, and it isn't much higher for foreign equities. The point is, when past performance is 45%, but the prudent forecast for future growth is 6%, there is the potential for a disconnection between expectations and realism.

A common mistake is to get greedy when times are good. This is especially tempting in the current low interest environment. People look at the meagre returns from Guaranteed Investment Certificates, and they wonder what else is out there. This isn't a problem when something other than a GIC is a better

solution to help you reach your financial goal. The problem is when a safe – but low yielding – investment is the most appropriate, but the focus comes off the safety and on to the low yield.

Never mind 45%, even four or five per cent can look tempting when your GICs are paying less than one per cent. But there is a famous quote in the investment industry: “More money has been lost reaching for yield than at the point of a gun.”

If you consider better paying alternatives just make sure that they are consistent with your financial objectives. Everybody is looking for a return on their money right up until the point where it becomes doubtful whether you get a return of your money.

Here is the takeaway from this. In extended times of good performance, people develop short memories. They might be enticed by past performance, they might be susceptible to unrealistic expectations, and they might be tempted to chase yield.

Don’t get distracted by past performance. That’s what happened last year. The real question is not what did this investment do last year, the real question is does this help me reach my financial goals?

Brad Brain, CFP, R.F.P., CIM, TEP is a Certified Financial Planner in Fort St John. This material is prepared for general circulation and may not reflect your individual financial circumstances. Brad can be reached at www.bradbrainfinancial.com.

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