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ODLUM BROWN REPORT

05 2024

ODLUM BROWN
Investing for Generations®

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How We Think: A Tribute to Daniel Kahneman

"If owning stocks is a long-term project for you, following their changes constantly is a very, very bad idea. It's the worst possible thing you can do because people are so sensitive to short-term losses. If you count your money every day, you'll be miserable." – Daniel Kahneman

The world of business, economics and finance recently lost one of its intellectual giants – Daniel Kahneman, who passed away in March. Mr. Kahneman was a well-known psychologist, economist and author, and his contributions reshaped what we know about behavioural economics and the science of decision-making. His groundbreaking work expanded our understanding of how our minds work.

Born in Tel Aviv in 1934, Mr. Kahneman rose to prominence in part thanks to his long-time collaboration with Amos Tversky. The duo conducted behavioural experiments, which included seemingly innocent question-and-answer sessions that shone a light on our natural tendencies toward superficial and naïve thinking.

Here's an example. An individual has been described by a neighbour as follows:

> Steve is very shy and withdrawn, invariably helpful but with very little interest in people or in the world of reality. A meek and tidy soul, he has a need for order and structure, and a passion for detail. Is Steve more likely to be a librarian or a farmer?

Most people believe Steve is more likely to be a librarian, given the ease with which we can picture him in our minds. What we fail to realize is that, in the United States, there are roughly five times as many farmers as there are librarians and even more male farmers than male librarians. So, Steve is more likely a farmer.

Together, Kahneman and Tversky developed a framework called prospect theory, which garnered Kahneman the 2002 Nobel Prize in Economics. (Sadly, Tversky passed away before the prize was awarded.) Prospect theory challenged the prevailing academic assumption that individuals are rational and that we make choices based on what will maximize our self-interest and provide the highest benefit. Through their experiments, Kahneman and Tversky discovered a much different truth.

Instead, prospect theory suggests that people tend to be irrational when making decisions due to cognitive biases and mental shortcuts. The theory includes the concept of loss aversion. It describes how we emotionally experience loss more severely than we experience an equivalent gain. Kahneman is quoted as saying, "An investment said to have an 80% chance of success sounds far more attractive than one with a 20% chance of failure. The mind can't easily recognize that they are the same." According to Kahneman and Tversky, the psychological pain we feel from losses is twice as strong as the joy we get from gains. Consequently, we are biased to make choices geared to avoid pain instead of what might actually be optimal and rational.

Have you ever held a stock despite a permanent deterioration in the underlying business and reasoned that "it's not a loss until I sell it"? Or have you "locked in a profit" only to later regret selling a great business too soon? These are good examples of the way fear of loss can cause investors to make suboptimal decisions.

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YMCA BC

YMCA BC Kids Walk for COMMUNITY May 29, 2024 | Across BC

Odlum Brown is proud to be the Presenting Sponsor of the YMCA BC Kids Walk for COMMUNITY, which will be held at YMCA locations across the province on Wednesday, May 29.

The YMCA provides essential programs and services that positively impact its local communities' most pressing social issues, including health and wellness, affordable child care, mental health, employment and newcomer integration.

The Kids Walk for COMMUNITY will include over 130 child care centres and over 4,000 children walking, fundraising and raising awareness for the YMCA, followed by fun activities and a celebration! Funds raised will go toward giving local children and families facing financial barriers the opportunity to access their local Y programs.

For more information on YMCA BC, visit gv.ymca.ca.

On any given day, the odds of stocks being up are not much better than a coin flip, according to historical data for the S&P 500 Index. Given this fact and considering that losses make most of us feel twice as bad as gains make us feel good, it's not a great idea to check share price performance on a daily basis. Not only will we feel the pain of loss almost half the time, but those negative feelings will also make us more susceptible to emotional mistakes.

Over longer time periods, the odds of making money on stocks increase considerably. In fact, the longer the horizon, the better the odds.

It stands to reason that investors will make fewer mistakes and achieve better returns if they monitor stock movements less frequently – and will feel better along the way, too. Of course, altering our behaviour is easier said than done. In fact, Mr. Kahneman himself noted how difficult it is to avoid our inherent blind spots. In an interview in March 2019 with Sam Harris, he was asked if he behaved any differently given what he's learned about behavioural science. His answer was somewhat surprising:

> "Not at all. In terms of my intuitions being better than they were – no. And furthermore, I have to confess, I'm also very overconfident… It's hard to get rid of those things. I've been studying (this) stuff for over 50 years, and I don't think my intuition has really significantly improved."

Perhaps not the most encouraging words from a Nobel laureate!

That said, Kahneman's 2011 book – *Thinking, Fast and Slow* – is widely considered the bible of behavioural finance. It's not an easy read but worthwhile if you want to learn more about the science of decision-making. In it, Kahneman describes the distinction between two separate systems of thinking. System 1 is automatic and intuitive; this is "fast" thinking, the kind that just comes to you. For example, the level of thought you put into tying your shoelaces. In contrast, System 2 thinking is slow, analytical and deliberate. Solving a complex math problem calls upon a completely different system of thinking than, say, stopping at a red light. It requires a lot more mental energy.

One highly publicized study in the book looked at 10,000 different brokerage accounts to see how trading activity impacted investment performance. Researchers studied 163,000 trades over a seven-year period to compare the returns of a stock an individual sold to the returns of the stock purchased in its place, over the course of one year following the transaction. The results were not great. On average, the sold stocks did 3.2% better per year than the newly bought ones.

Our brains are naturally wired to use System 1 thinking first, which in investing might look more like a hunch than a well-formulated thesis. Shortcut thinking has its merits, but it can lead to poor outcomes when applied to complicated situations. System 1 thinking is why we suffer from loss aversion or overconfidence. It causes us to think and act in extremes, which is the basis for market booms and busts.

At our 2024 Annual Address, Executive Vice President and Director of Investment Research Murray Leith highlighted the perils of forecasting. He referenced a great quote from Mark Twain: "It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so." He used this quote to preface a present-day example of System 1 versus System 2 thinking. Most stock market pundits assumed in 2016 that a Donald Trump presidency would be negative for the economy and the markets. As did we. This was System 1 thinking. Thanks to stimulative fiscal and monetary policies, the U.S. stock market returned 24% in President Trump's first year in office and 70% over his four-year term.

As investors, we can aim to reduce errors by recognizing when we are applying System 1 thinking incorrectly. System 2 thinking acknowledges that sustainable investment gains are more easily made by sticking with a long-term plan and employing better habits, such as checking your investment accounts less frequently.

Thank you, Mr. Kahneman, for your wisdom and for helping us better understand ourselves.

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2024 Federal Budget Highlights

On April 16, 2024, Minister of Finance Chrystia Freeland delivered the government's 2024 Federal Budget, forecasting a deficit of $40 billion for the 2023-2024 fiscal year, $39.8 billion for 2024-2025, and $38.9 billion for 2025-2026. Here is a brief overview, including the changes to capital gains and some notable proposals affecting individuals and businesses.

Note that personal and corporate tax rates remain unchanged.

Capital Gains

Under the current rules, 50% of gains on the sale or disposition of capital property is taxable. The most notable exception is your principal residence. Budget 2024 proposes to increase the inclusion rate from 50% to two-thirds (66.67%) on capital gains realized on or after **June 25, 2024.**

For individuals, the inclusion rate on the first $250,000 of capital gains will remain at 50%. Any gains in excess of this threshold would be subject to the 66.67% inclusion rate. The threshold applies to capital gains realized by an individual, either directly or indirectly via a partnership or trust, net of any capital losses from the current or prior years applied to reduce current-year capital gains.

Effective June 25, 2024, private corporations and trusts will also be subject to the 66.67% inclusion rate. This will apply to all capital gains; they will not be eligible for the $250,000 exemption.

For additional discussion and analysis of the potential impact of these changes, please request our article "Budget 2024: Capital Gains Inclusion Rate" from your Odlum Brown Investment Advisor or Portfolio Manager.

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Individuals

Lifetime Capital Gains Exemption (LCGE)

The LCGE is an exemption from capital gains tax on the disposition of shares of a Qualified Small Business Corporation or Qualified Farm or Fishing Property. The amount of gain that can be sheltered under this exemption is currently $1,016,836. Budget 2024 proposes to increase the exemption amount to $1,250,000. The exemption amount will be indexed annually, commencing in 2026.

Canadian Entrepreneurs' Incentive

Budget 2024 proposes an additional incentive for Canadian entrepreneurs, providing a one-third (33.33%) capital gain inclusion rate on the disposition of certain qualifying shares. The reduced inclusion rate will be subject to a lifetime limit of $2,000,000, to be phased in gradually in increments of $200,000 per year, beginning in 2025. Qualifying shares will need to meet a number of criteria, similar to the requirements for shares eligible for the LCGE, but will also include a requirement that the taxpayer was a founding investor of the corporation when it was originally established, be actively engaged in the activities of the business, and must have held the shares for a minimum of five years prior to the disposition. Furthermore, the shares can not have a direct or indirect interest in certain corporations, including professional corporations.

The incentive will be in addition to the LCGE, assuming the taxpayer meets the criteria to claim both exemptions.

Alternative Minimum Tax (AMT)

In August 2023, the government released a legislative proposal to amend the calculation of the AMT. The AMT is an alternative calculation of taxes owing to ensure a minimum amount of tax is paid when an individual taxpayer has claimed a significant level of preferential tax deductions or credits, such as donation credits, or earns a significant portion of their income from tax-preferred income, such as capital gains.

The proposed changes to the calculation had the potential to result in the application of AMT where an individual made significant in-kind donations of securities to registered charities. Budget 2024 proposes to amend the calculation to limit the application of the AMT in most such cases. Specifically, the AMT calculation will allow 80% of charitable donations to be claimed instead of 50%, as originally proposed. Furthermore, the Budget confirms that 30% of the capital gains of publicly listed securities, as well as the employee stock option benefit where the underlying publicly listed security is donated to charity, will be included in the calculation of AMT, as previously announced.

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These changes are effective January 1, 2024.

Home Buyers' Plan

The Home Buyers' Plan is a program that allows first-time home buyers[1] to withdraw up to $35,000, tax-deferred, from their RRSP to acquire a qualifying home. Taxpayers are required to recontribute the draws beginning in the second year after the withdrawal and must have their draws fully repaid by the end of the 15th year. The Budget proposes to increase the withdrawal limit to $60,000 and will defer the start of the recontributions until the fifth year.

Businesses

Accelerated Capital Cost Allowance (CCA)

CCA is a form of deductible depreciation, allowing business to reduce their taxable income by a portion of the cost of certain capital property. Budget 2024 proposes to give businesses an accelerated CCA deduction for new purpose-built rental projects, patents, and certain data network infrastructure and electronic processing equipment. The accelerated deductions will be available for the above-noted property, subject to various conditions, acquired on or after April 16, 2024.

Canada Carbon Rebate for Small Businesses

The Budget proposes a new carbon rebate for eligible small businesses. The rebate would be automatic and available to Canadian-controlled private corporations which file their 2023 tax return by July 15, 2024. The rebate will be based on the province in which the corporation had employees, based on a per-employee rate determined by the government, and would cover the 2019-2020 to 2023-2024 fiscal years.

Eligible corporations can have no more than 499 employees throughout Canada at the start of the relevant calendar year.

Clean Energy Investment Tax Credit

Budget 2024 proposes a new investment tax credit for certain clean energy property including solar or geothermal energy generators and power storage, equivalent to 15% of the cost of such property. Eligible taxpayers include taxable Canadian corporations. The tax credit will be eligible for property acquired on or after April 16, 2024, and before 2035.

Budget 2024 can be viewed online in its entirety on the Department of Finance Canada's website[2] and is subject to parliamentary approval.

For more information, please contact your Odlum Brown Investment Advisor or Portfolio Manager.

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[1] You are considered a first-time home buyer if you did not, at any time in the current calendar year before the withdrawal (except the 30 days immediately before the withdrawal) or at any time in the preceding four calendar years, live in a qualifying home (or what would be a qualifying home if located in Canada) as your principal place of residence that either you owned or jointly owned, or your current spouse or common-law partner (at the time of the withdrawal) owned or jointly owned. For example, if you are making a withdrawal on July 31, 2024, you cannot have lived in a home as your principal place of residence that either you or your spouse or common-law partner owned or co-owned from January 1, 2020, to June 30, 2024.

[2] budget.canada.ca/2024/report-rapport/toc-tdm-en.html