The Stan Clark Financial Team's

PERSPECTIVES

In this issue...

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In this month's behavioral finance article, I explore the dangerous power of stories in investing. Like the mythical Sirens, stories filled with wonderful forecasts lure investors to expensive stocks – while ignoring statistical evidence to the contrary. Michael Chu discusses why we should stick with value investing despite the recent underperformance. And Sylvia Ellis advises how you can save taxes on investments by making a prescribed rate loan to a lower-earning family member.

Stan

CIBC Wood Gundy

Behavioral finance

The Siren song of stories

By Stan Clark - Senior Investment Advisor

One of the most seductive dangers investors face is called *the Siren song of stories*. Remember the Sirens from your school days? In Homer's *Odyssey*, they were island creatures who lured nearby sailors with their irresistible songs, causing the sailors to crash their ships on the rocky coast. No man could hear Siren songs without perishing.

For humans, it seems *stories* are equally irresistible. If we're not careful, stories can lure us into making big investing mistakes.

Consider this interesting psychological example cited in James Montier's excellent *The Little Book of Behavioral Investing*. In a study, organizers gave participants statistical information on the effectiveness of a treatment for a fictitious serious disease. Organizers also gave participants a story: positive, negative or ambiguous. They then asked if participants would want to undergo the treatment. The result? When participants heard a positive or negative story, they almost totally ignored statistical information in favour of the story. For example, when participants heard the treatment was 90% effective, but they also heard a negative story about it, only 39% opted for the treatment. However, when they understood the treatment was only 30% effective, but it came with a good story, 78% opted for the treatment.

Why do we find stories so compelling? Well, when you think about our past, it makes perfect sense. For most of our evolution, we were storytellers. Before we had writing, we passed knowledge on through stories. If our ancestors didn't heed the lessons in the stories, they often didn't survive. This trait of paying attention to stories is deeply embedded in our psyches.

Statistics, on the other hand, just don't connect with us the same way. "Sorry," our emotions say, "I can't relate to those numbers. Give me a story instead."

What does this have to do with investing? One of the puzzles of investing is: *Why do most people underperform market averages over the long term when there is ample evidence of simple ways to outperform them?* For example, as Michael Chu notes in his article this issue, "The value of value," companies with low ratios of prices compared to intrinsic value (for example, low price-to-earnings or P/E ratio) tend to do better than companies with high ratios. If that's the case, and the evidence is overwhelming, why would anyone buy companies selling at high price ratios?

It turns out that most companies with high price ratios have very attractive stories behind them. The stories often include forecasts of wonderful things to come in the future, compared to how things are now. Even if investors know that forecasts are unreliable – and even if they know that stocks with high ratios tend to do poorly – they still go ahead and buy those stocks. That's because the stories have influenced them in ways the statistics can't. And if initial stories come true to some extent, the stories cascade and multiply, providing the rationale for buying more at even higher prices. This can work for a while – until it doesn't.

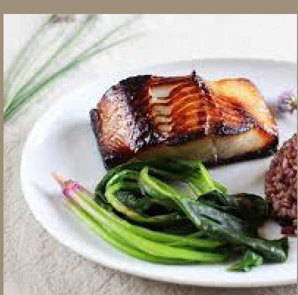
We're all human, and it's just so darned hard to resist a good story, especially when it sounds so convincing!

What should we do about this, and how do we avoid getting lured into these investing rocks? As with many behavioral finance problems, just being aware of a bias helps – but it's often not enough. Our human brain is exquisitely skilled at fooling ourselves into thinking we're acting rationally, even when we're not. It might also help to resist seeking out the stories, which is hard to do with the Internet and media constantly bombarding us. Try to either tune out the tempting stories, or at least listen to them with skepticism. Be wary when someone tries to influence you with a good story. And when you do hear a good story, focus on the facts, and invest where the numbers make sense – not where the story sounds good. ▪

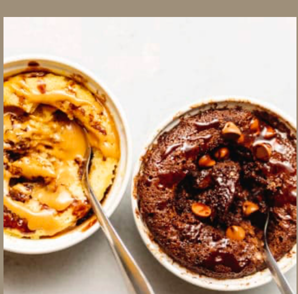
Team Talk:

This month, we've decided to do something a bit different with our Team Talk section. During the Covid-19 quarantine, many of us have been rediscovering our joy of cooking, and we'd like to take this opportunity to share some of our favourite recipes with you! Johnny, Sylvia and Elaine's recipes can be found at the end of this issue of Perspectives. Here are some teaser photos...

Johnny's Boating breakfast



Sylvia's sweet-and-savoury fish



Elaine's Keto mug cakes

You'll find the complete ready-to-print recipes and the stories behind them at the end of this issue.

Investing

The value of value

By Michael Chu, Investment Advisor

***Value investing* is buying out-of-favour stocks that are well priced compared to their underlying, intrinsic value. Historically, value investing has resulted in better-than-market returns, which makes it a bedrock principle for many astute investors. Value investing works because forecasters and investors often underestimate the ability of these companies to revert to higher profitability and growth.**

But no investment style works all the time. Despite its long successful track record, value investing has underperformed for the last 10 years, especially the last two years. History shows us that bad periods have been more than made up for in later years. Still, that doesn't make it easier when you're actually going through one of those periods.

Let's look at it from an academic viewpoint. The most basic way to measure value is by using gauges like price-to-earnings, price-to-cash flow and price-to-book value. Just by systematically investing in the cheapest 20% of companies using these simple variables, this method has strongly outperformed the S&P 500 over the last 69 years (since 1951). Over those years, value investing returned 14.3% vs. 10.8% for the S&P 500. Because the outperformance lasted so long, had we invested $1000 at the beginning, value investing would have resulted in about $9.7 million vs. $1.2 million for the S&P 500.

Based on this track record, it certainly seems like value investing is the way to go. However, long-term returns don't tell the whole story. Few people invest with 50-year time frames and the shorter-term paths are also very important.

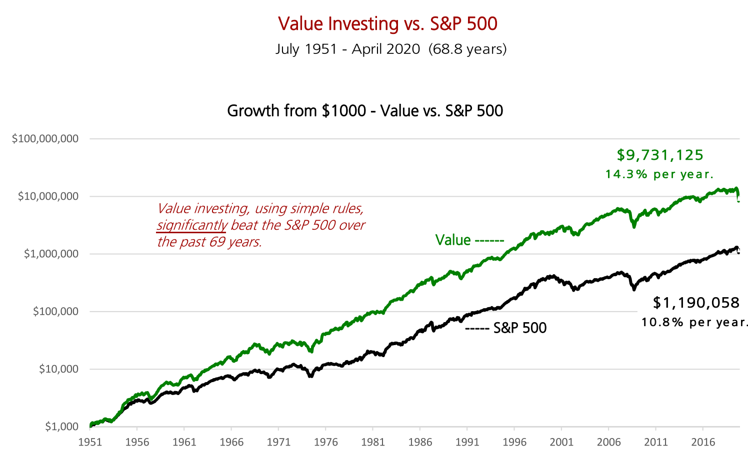


Figure 1: Growth generated by pure value stocks and the S&P 500 total return.

Figure 2, combines the two lines in Figure 1 to show when value is doing better or worse than the S&P 500. When the line goes up, value is doing better. When it goes down, value is doing worse. As you can see, overall the line is upward. But there were many down periods, including some big ones that coincided with major economic events like the dot-com bubble of the late 1990s and the great financial crisis of 2007-08. Every down period eventually reversed with strong outperformance.

You can also see that, in the last 10 years, value significantly underperformed. Using the basic measures of value discussed earlier, value underperformed the S&P 500 by 44% over this time. (Note: the extra value returns in the graph include the most recent drop.)

So, what now? Ten years of underperformance is a long time. Does it mean value investing is permanently broken? Or that value investing is just temporarily out of favour, and could come roaring back? We believe it is the latter and will discuss the reasons next.

Is it crowded out there?

One worry about investment strategies is: If they're so good, what happens if everyone uses them? If overcrowding were a danger, value stocks would go up in price and there would be no more cheap stocks, causing the extra returns to disappear. The benefit would get arbitraged away. It's like TVs or cordless drills being offered at a really good price in a Black Friday sale; then everyone discovers the deals and they flock to buy. Soon there are no deals left. So, again, are there too many value investors, thereby reducing the benefits?

Let's look at something called the *value of value*. Basically, this is a measurement of how cheap value stocks are vs. the average stock.

Figure 3, shows that value stocks, using the simple definition from earlier, are typically priced at about a 40% discount from the average stock. This average discount resulted in the extra 3.4% per year returns from Figure 2. You can also see that this discount – the value of value – changes, but is range-bound. Today, value stocks are an unprecedented 60% cheaper than the average stock. Most of this drop occurred in the past two years. So, value stocks are now at extremely good value. If value investing wasn't working due to becoming too popular, you wouldn't see this. Rather you would see the opposite, with value stocks becoming more expensive than normal.

Based on the above, it seems very clear that value hasn't been arbitraged away. And this bodes well for value investing going forward.

Other studies

Notable hedge fund manager Cliff Asness of AQR Capital Management recently discussed a very extensive study on value investing that showed value investing is still very much alive. The study used similar value measures to those discussed earlier, but it also used different tests to see if the conclusions would change. They did not. For example, the study systematically excluded certain industries (like technology), mega-sized companies and the most expensive stocks. The story was always the same: value is exceptionally cheap and "neither the tech bubble nor the great financial crisis can claim to be the cheapest value

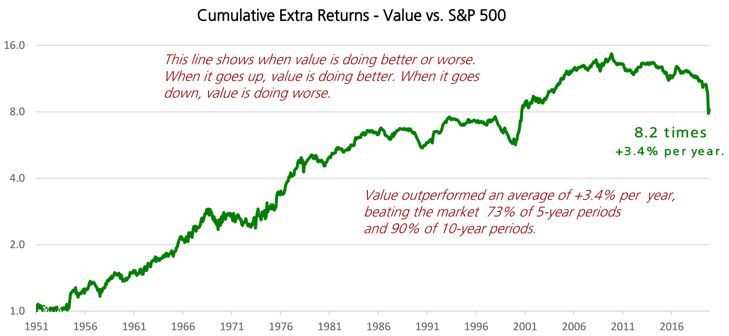


Figure 2: Cumulative growth of value stocks relative to the S&P 500.

of value anymore." Asness also concluded that "investors are paying way more for the companies they love vs. the ones they hate and doing it highly diversified, way up and down the cross-section of stocks." The value phenomenon is pervasive.

Rob Arnott from Research Affiliates and others looked closely at the various *narratives*, or stories, that investors use to justify buying popular-growth stocks. Arnott et al. examined the actual facts behind these stories. They found most of the stories simply did not stand up, and determined that value's recent underperformance was "more due to growth stocks getting more expensive relative to value stocks." They also concluded that "today's value vs. growth valuation gap is at an extreme [100th percentile of historical valuations and] the stage is set for historic outperformance of relative growth over the coming decade."

Are we there yet?

Now that we know value is looking very cheap, the question is: When will things get better? It could come quickly in the next few months or slowly over the next few years. We simply don't know. But good investing does not depend on certainty and precise timing. Good investing is about improving your odds of success and sticking with good strategies that help you do this.

No method of investing can perform perfectly consistently all the time. If such a method existed, everyone would use it, and then it would stop giving good returns. Any approach that works over the long term must have ups and downs in the shorter terms. A key to benefitting from the upswings is being resilient enough to get through the tough times.

Value investing is a big component in our investment strategies. Fortunately, our strategies use more nuanced measures of value than are used in the simple academic definitions used above. As well, they incorporate other factors such as momentum, volatility and earnings growth. These helped us strongly outperform the indexes for the first eight of the past 10 years, even though value was not doing well. However, the extraordinary headwinds of the past two years, driven by the investing herd's move away from value, have caused us to give back some of those extra returns.

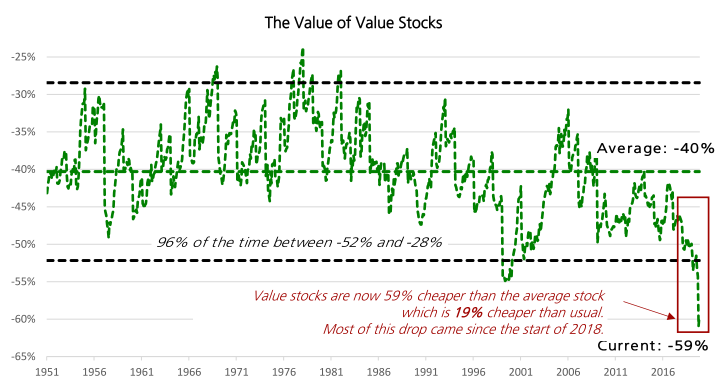


Figure 3: Average valuation of value stocks relative to valuation of the *average* stock.
The lower the line, the better the discount.

We take pride in doing better than the indexes. It's always tough for us to give back some of our extra returns. We have made minor changes that are helping protect our relative performance this year. But going forward, a value approach to investing has never looked better and we remain very committed to this approach. It's important to be positioned to benefit strongly when value eventually returns to favour.

We feel fortunate to remain ahead of the indexes over the past 10 years, even though value has underperformed by nearly 50%. Sticking with a defined process is the only way to achieve long-term success. We also know that sticking with something that is good through its occasional bad times and being a contrarian is difficult. But persevering through that difficulty is how long-term investors get rewarded. ■

Source for graphs: Kenneth French, CRSP, Standard and Poors

Michael Chu is a Portfolio Manager and Investment Advisor for the Stan Clark Financial Team at CIBC Wood Gundy. Michael is a specialist in investment research and information technology.

Financial Planning

Prescribed rate loans

By Sylvia Ellis, Senior Estate Planning Advisor

Were you aware that you can save family taxes by having a high-income family member lend cash to a lower-income family member, like a spouse, minor children or grandchildren?

Money that you earn from your job, or through investing, is deemed to be yours for tax purposes. In most circumstances, it cannot be given to your family members, as described above, to invest, without triggering attribution. This means that any income or gains earned on the money transferred may need to be reported on your income tax return, not theirs. But, there is a way to avoid these rules by way of a prescribed rate loan (PRL).

The prescribed rates, set by the Canada Revenue Agency (CRA) quarterly, will be reduced this July to 1%. Tied directly to the yield on Government of Canada three-month Treasury Bills, the new rate will then be the lowest it can possibly be.

For loans put into place between July 1, 2020 and the end of September 2020 (and possibly longer, depending on what happens to the prescribed rate in future quarters), the 1% rate would be locked in for the duration of the loan without being affected by any future increases.

You can use this to your advantage by either making a loan directly to your spouse, or in the case of minor children or grandchildren, via a family trust which can have multiple beneficiaries. It's a great way to help fund their education, activities, etc.

Remember, the objective is to shift future investment income from a higher-income earner to a lower-income earner, to take advantage of the latter's lower marginal tax rates. This results in more after-tax income for the family. The greater the difference in marginal tax rates, the greater the savings.

The process is fairly simple:

- Make a demand loan to your lower-income spouse, minor child or grandchild via a trust
- The loan is backed by a promissory note and a loan agreement which sets out the terms
- Lend money from an account in your name to one in their name (vs. joint)
- The lower-income family member or trust invests the funds
- Annual interest payments are made no later than January 30th of the following year.

There will be legal costs associated with having a loan document properly prepared outlining the terms. In addition, where a family trust is used as part of a PRL arrangement, there may be costs associated with establishing and maintaining the family trust structure, such as legal fees and annual accounting and tax filing fees for the family trust.

Let's consider the following example.

David is in a 50% tax bracket and his spouse Susan in a 20% one. David has $1,000,000 cash and wants to utilize a loan at the 1% prescribed rate to split income with Susan. Susan invests the $1,000,000 and is able to generate an annual return of 5%. The tax savings per year is $12,000, as shown in the table.

	Without a Spousal Loan Strategy	With a Spousal Loan Strategy	
	David	David	Susan
Initial Investment	$1,000,000	$0	$1,000,000
Income earned @ 5%	$50,000	$0	$50,000
Interest on loan @ 1%	n/a	$10,000	($10,000)
Pre-tax income	$50,000	$10,000	$40,000
Taxes payable @ 50%/20%	$25,000	$5,000	$8,000
Total tax	**$25,000**	**$13,000**	
Tax savings 1st year	**$12,000**		

Over a 10- or 20-year period, the tax savings could be significant, as there is no limit on how long the loan can be in place, as long as the interest due is paid on time.

Borrowed funds do not necessarily need to be invested and can be used for other purposes; however, income splitting and tax minimization can only be achieved if the funds borrowed are used for investment purposes and generate investment income. If the funds are used for investment purposes, the annual interest on the borrowed funds can be deducted as an expense against the earned income.

As always, we recommend that you obtain tax and legal advice before implementation, to determine the best way to structure and operate this type of arrangement. If you have any questions or would like to discuss this further, please let us know. ■

SCFT Trivia

Play our trivia – support the cure!

For every correct entry we receive in our trivia contest, the Stan Clark Financial Team will contribute $1 to CIBC's "Run for the Cure" to raise money for breast cancer research. Each correct entry will also be entered into the draw for this month's prize. Email or phone in your entry today.

Answer all four questions to be entered into the draw for this month's prize. Hint: You can find the answers inside this newsletter.

1. Even when glowing stories about stocks aren't backed up by evidence, we want to believe such stories because:
   a) For most of our evolution, we were storytellers. Before we had writing, we passed knowledge on with stories.
   b) Those ancient stories contained survival lessons. Our ancestors learned to ignore the stories at their peril.
   c) Stories just naturally appeal to us in a way that statistics, even though containing valuable evidence, don't.
   d) All of the above.
2. In his *Little Book of Behavioral Investing*, James Montier describes a study in which organizers gave participants statistical information on the effectiveness of a treatment for a fictitious serious disease. Participants reacted by:
   a) Asking for even more in-depth statistical information.
   b) Ignoring the statistics in favour of the wonderful stories organizers gave them about the fictitious disease.
   c) Thoughtfully balancing the compelling stories against the equally compelling statistics.
   d) Requesting more details about the disease.
3. *Value investing*, or buying out-of-favour stocks that are well priced compared to their intrinsic value, works because forecasters and investors often underestimate the ability of these companies to revert to higher profitability and growth:
   a) True. b) False.
4. Money that you earn from your job or through investing is deemed to be yours for tax purposes. Therefore:
   a) There's no way you can avoid paying taxes on it.
   b) You can reduce taxes on investments by making a prescribed rate loan to a lower-earning family member.
   c) You can avoid paying taxes simply by giving that money outright to a lower-earning family member.
   d) You can decide not to earn so much money next year.

Email answers to: **stanclarkfinancialteam@cibc.ca**
or call (604) 641-4361

One prize winner will be chosen by a draw from all those who submit correct answers. The draw will take place on June 30, 2020.

Trivia challenge runs June 1 - 29, 2020. No purchase necessary. There is one prize to be won. Simply complete the trivia questions correctly to be entered in the draw. Limit 1 entry per person.

Chances of winning depend on number of eligible entries and whether you correctly answer the trivia questions. Open to adult Canadian residents (excluding Quebec). For full challenge rules, write to: The Stan Clark Financial Team, CIBC Wood Gundy 400-1285 West Pender St, Vancouver, BC V6E 4B1. © Stan Clark 2020

CIBC Wood Gundy
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Boating breakfast

Shared by Johnny Lyall

Four years ago for Christmas, my grandmother gave the whole family a cookbook that she had been secretly working on. Marigold's Recipes is 140 pages filled with dishes she famously cooked for our family over the years.

One of my favourite things about the cookbook is that each recipe comes with a backstory. My grandmother describes how she came across the recipe, the era, and who she would serve it to. It's a special thing for our family to have and remember her by, every time we use it.

The recipe I chose is definitely the simplest but trust me, it's good! Every summer Erin and I do a few camping trips by boat. We made this recipe last summer on a small propane stove after waking up on Gambier Island. As well as being delicious, it had us thinking of Marigold as we sat looking out to the morning sun on the ocean. If you plan to do any camping trips this summer – or are just in the campout-cooking mood at home! – give this a try for breakfast.

Ingredients

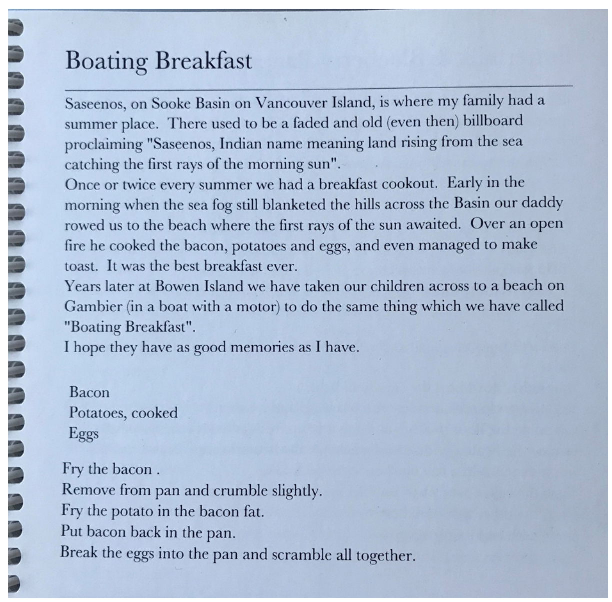
- Bacon
- Potatoes, cooked
- Eggs

Instructions

First cut the potato into 1/2 inch pieces and boil. Fry the bacon. Remove from the pan and crumble slightly. Fry the potato in the bacon fat. Put the bacon back in the pan.

Break the eggs in the pan and scramble everything together.

Enjoy!



Boating Breakfast

Saseenos, on Sooke Basin on Vancouver Island, is where my family had a summer place. There used to be a faded and old (even then) billboard proclaiming "Saseenos, Indian name meaning land rising from the sea catching the first rays of the morning sun".
Once or twice every summer we had a breakfast cookout. Early in the morning when the sea fog still blanketed the hills across the Basin our daddy rowed us to the beach where the first rays of the sun awaited. Over an open fire he cooked the bacon, potatoes and eggs, and even managed to make toast. It was the best breakfast ever.
Years later at Bowen Island we have taken our children across to a beach on Gambier (in a boat with a motor) to do the same thing which we have called "Boating Breakfast".
I hope they have as good memories as I have.

Bacon
Potatoes, cooked
Eggs

Fry the bacon .
Remove from pan and crumble slightly.
Fry the potato in the bacon fat.
Put bacon back in the pan.
Break the eggs into the pan and scramble all together.

The perfect sweet-and-savoury fish dish

Shared by Sylvia Ellis

For years, this dish has never let me down while entertaining. Yes, it has sugar, but that's just for the marinade. Since you don't retain the marinade as a sauce, the sugar content is definitely less than it sounds. I marinate mine for two days, then accompany it with a vegetable like bok choy, carrots, broccolini, or with a salad and rice. I sometimes also make a wasabi cream sauce to dot on the sides.

Recipe credit: famed Japanese celebrity chef Nobu Matsuhisa. To quote the Lummis Island Wild website, "…a signature at Nobu restaurants, this sweet-savoury fish dish has been cloned by chefs all over the world. Nobu marinates the black cod in a good deal of the sake-miso marinade for two to three days, but the fish is also spectacular if you marinate it only overnight in just enough sake and miso to coat."

Ingredients

- 3 tablespoons mirin
- 3 tbsp sake
- 1/2 cup white miso paste
- 1/3 cup sugar
- Six 6- to 7-ounce skinless black cod fillets, about 1-1/2 inches thick
- Vegetable oil, for grilling
- Pickled ginger, for serving

Instructions

From the Food and Wine website:

In a small saucepan, bring the mirin and sake to a boil. Whisk in the miso until dissolved. Add the sugar and cook over moderate heat, whisking, just until dissolved. Transfer the marinade to a large baking dish and let cool. Add the fish and turn to coat. Cover and refrigerate overnight.

Preheat the oven to 400°. Heat a grill pan and oil it. Scrape the marinade off the fish. Add the fish and cook over high heat until browned, about 2 minutes. Flip the fish onto a heavy rimmed baking sheet and roast for 10 minutes, until flaky. Transfer to plates and serve with pickled ginger.

Keto mug cake – chocolate, vanilla or peanut butter!

Shared by Elaine Loo

I am not a baker by nature, but definitely find myself baking a lot more during this time, much to my kids liking! When searching for good but simple cake recipes, I stumbled upon this one online and it's been my 'go-to' ever since. My favorite is to make the Vanilla one but swirl in a tablespoon of peanut butter. I suggest keeping it in the refrigerator overnight as well. This makes it more moist and tastier. If you have nut allergies, simply use coconut flour instead of almond flour and skip the peanut butter. Give it a try and let me know what you think of it!

Recipe and photo credit: Jennifer Banz

Ingredients

- *1 Tablespoon Butter, melted*
- *1 Tablespoon Coconut flour or 3 Tbsp Almond flour – I used almond flour*
- *2 Tablespoons Granular Sweetener – I used monk fruit sweetener*
- *1 Tablespoons Cocoa powder (For Chocolate Version)*
- *1 Tablespoon Sugar free Peanut butter (For Peanut Butter Version)*
- *1/2 teaspoon Baking powder*
- *1 Egg, beaten*
- *Splash of vanilla*
- *1 Tablespoon Sugar free Chocolate Chips (optional)*

Instructions

For Vanilla:

In a microwave safe coffee mug, melt the butter in the microwave for 10 seconds. Add the coconut flour or almond flour, sweetener, baking powder, vanilla and beaten egg. Mix well. Microwave on high for 60 seconds, being sure not to overcook. If you overcook it, it will be dry. Top with sugar free chocolate chips of desired or mix in before cooking.

For Chocolate, add in the cocoa powder along with rest of ingredients before mixing.

For Peanut Butter, swirl in the peanut butter after mixing and before microwaving.

If you prefer to bake instead of microwave, then use an oven safe ramekin and bake at 350 F for 15-20 minutes.