

THE STAN CLARK FINANCIAL TEAM'S

# PERSPECTIVES

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Success is often random. You can have a string of wins, whether in coin tosses or investments. But with the latter, as I discuss in this issue's behavioral finance article, don't mistake short-term luck for reliability. Instead, look at long-term track records of stocks' performance. In a new series, Michael Chu explains the strategies we use to make decisions best suited to your portfolios. And Tom Cowans explains how estate planning and insurance help ensure your loved ones will be taken care of should something happen to you.

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## Behavioral Finance

### FOOLED BY RANDOMNESS

By Stan Clark, Senior Wealth Advisor

When is your birthday? And, speaking of which, did you know that, in any random group of just 23 people, there's a 50% chance two of them will have the same birthday?

Yes, that surprised me, too. After all, with 365 days in a year, you'd assume a random group would have to be much larger to find two people with the same birthday. But, in fact, you do only need 23 people. That's because you're not just comparing your birthday to those of 22 others – everyone is making their own comparisons too. So, a group of 23 actually has 253 comparisons or chances for a matching birthday. This bumps up the odds, which at first intuitively seem improbable, to 50%.

It's hard not to think that two friends at a party finding out they share a birthday is just luck. The math says otherwise: The chance is actually counterintuitively high.

The problem with such occurrences is that they can lead us to misinterpret randomness in our perceptions and decisions.

Over the years, I've given talks on behavioral finance to a variety of groups. As part of my talks, I usually conduct an experiment. First, I ask people to imagine flipping a coin 50 times. Then, to write on a piece of paper what they think the results would be. From their imagined coin flips, we look at the longest string of heads or tails. Inevitably, every time, participants dramatically underestimate how often strings of five, six or seven heads or tails in a row would occur with random flips.

We then conduct an *actual* demonstration of 50 flips. Invariably, one or more of these long strings occur – to the surprise of everyone.

The lesson we draw from the experiment is this: We dramatically underestimate how often longer strings occur in situations that we know are purely random.

In his 2012 book *The Success Equation*, Michael Mauboussin examines the relative contribution of skill and luck, or randomness, in business, sports and investing. Mauboussin finds there is far more randomness in all these areas than most people think. Randomness plays a much bigger role than most investors believe, certainly over the very short term – but also over longer periods.

In an earlier book, *Foiled by Randomness*, Nassim Taleb discusses in detail the hidden role of chance in our lives. Emphasizing the role of luck and randomness in success, Taleb cautions against attributing success solely to skill or effort. He also discusses the human tendency to create stories that explain random events as non-random.

Understanding these concepts can help us better assess our own risks and uncertainties. I highly recommend both books.

What does all this mean for investing? Simply this. If we see a stock, mutual fund or fund manager having three, four or five years in a row of really good performance, our natural inclination is to think it's been caused by skill. Therefore, we believe it's likely to be repeated.

In reality, there's a good chance the continued good performance was in large part luck, like the toss of a coin. When you buy stocks, it's important not to put too much money into any single company. Diversification is key. And, when looking at a fund manager or investment strategy, look at far longer track records than those of just several years. Only then make meaningful conclusions.

Be careful not to get fooled by randomness.



## TEAM TALK

**Heather Guzak**

Wealth Advisor



Tulum, Mexico

### How are the kids?

Quentin who just turned 11 is doing amazing. He has been busy with school, friends and is finishing off his first year on the Maple Ridge Competitive Swim Team. Tayla who just turned 9 has been busy acting like she is 15. She also recently made her gymnastic club's competitive team AND the same Maple Ridge Competitive Swim Team as her brother. So fights will only get more and more intense and competitive around the house.

### Have you been anywhere cool recently?

This winter we took the kids to Tulum, Mexico where we got to enjoy 7 days in the sun, with no cooking and cleaning and just building memories together. We got to take them to visit Chichen Itza, and to see the amazement through their eyes was something we will never forget. In May, my best friend and I ventured out on a road trip, with 5 children, stopping at the Oregon, San Francisco, Palm Springs, Las Vegas and Boise.

### Behind the Numbers:

## INTRODUCTION TO A SERIES ON OUR INVESTMENT STRATEGIES - AND HOW THEY WORK

By Michael Chu, Senior Wealth Advisor

At the Stan Clark Financial Team, we use rules-based strategies that we believe will help you achieve higher returns with lower risk. In this *Behind the Numbers* series of articles, we'll discuss these strategies.

We'll explore a variety of topics, from the rationale behind specific variables to how we rank companies, and finally to how we integrate the strategies into your portfolio. We hope this series will give you a better idea of our investment process.

More than a quarter century ago, a computer shocked the world by beating Garry Kasparov – considered the best chess player of all time. Since then computer achievements have continued to stack up. These days, we're hearing a lot about artificial intelligence taking over all sorts of human jobs. So, for our investment strategies, should we just do what the computer says? After all, as the old saying goes, "If you can't beat 'em, join 'em."

Following that epic chess match in 1997, Kasparov suggested new rules where human players could make use of computers for help. However, the humans would still have the final decision.

A new game using these rules occurred. Surprisingly, the final four players were neither computers nor humans – but human-machine pairings. In other words, humans aided by computers came out winners.

Today, with computers' capabilities continuing to improve, we believe that those who can synergize with computers and data will be best positioned to do well. As that chess tournament showed, we can't rely solely on computers to do our thinking.

On our team we instead embrace a combined intelligence, where decision-making is enhanced by computer-aided people. The beauty of this approach is that computers and people can capitalize on each other's strengths while compensating for each other's weaknesses. With respect to our investment decisions, computers help us greatly – but we still apply our expertise and experience in making the final decisions.

For your portfolio, we use wide range of strategies or methods to determine what to invest in. Our stock strategies cover approximately 3,000 companies between Canada and the U.S. For our international strategies, we rank 23 different countries located around the world.

With that many potential investments to consider, we have to scour a lot of information to determine which are best suited for your portfolio. Some of the data we look at include: price-to-earnings ratios,

dividends, book values, price trends and more.

To do this effectively, we need accurate and timely data. We work with independent financial data vendors who provide us with clean data that has been reviewed for consistency and accuracy. For example, if a company has a one-time event that temporarily boosted earnings, we want to factor that out when evaluating growth prospects.

Our data providers also give us ratings and earnings estimates from many analysts in Canada and the U.S. These are industry experts providing their detailed company fundamental analysis. Having multiple analysts means that, when evaluating a company, we're not reliant on just one expert's opinion. This allows us to remove the personal biases of any single analyst – the result being a more objective view.

At this point, it may seem that we have a lot of information to process. But a benefit of having defined rules is that we can automate the process as much as possible. If we were doing everything by hand, it would take weeks to do all the calculations. With our computer systems, we can rank thousands of companies, and re-evaluate them on a daily basis as new information comes in.

One of the key points to our strategies is avoiding the proverbial "black box" – a system where the inputs and outputs are defined, but not the internal workings or processes. An example of this is the subjective decision-making of the human mind. We know what goes in and what comes out, but we aren't always sure how biases and emotions can affect the results. This gives us inconsistent results – exactly what we want to avoid when dealing with investments. By having a rigid and clearly defined process, we achieve consistency in our decisions, which should give us better results over time.

While we try to make our strategies as objective as possible, we're still very involved in making the final decisions. In upcoming issues of *Perspectives*, we'll take a deeper look at our investment process.



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

## Estate planning and insurance

# SURE, WE'RE LIVING LONGER – BUT LIFE IS UNPREDICTABLE!

By Tom Cowans, Wealth Advisor

Famed math professor John Allen Paulos once said, "Uncertainty is the only certainty there is, and knowing how to live with insecurity is the only security." When you're young, the idea of mortality isn't something you consider too often. But look at it this way: Life at any age has its uncertainties.

To prepare for surprises the future may spring, you can take several important steps. Along with saving and investing for your future self, estate planning and insurance are key to helping ensure your loved ones will be taken care of should something happen to you. And, that your assets will be distributed as you would wish when you die.

All this isn't being morbid. It's ensuring peace of mind!

### Insurance

There are different types of insurance that may be worth looking into, depending on: who earns income in your family; what your goals are for your estate; and what stage of life you are at.

1) Life insurance provides a tax-free, lump-sum cash payment in the event of death. It is used: to replace income; to pay off debts (e.g., mortgage); for business continuation; or in estate planning when taxes are due upon the death of the surviving spouse. Life insurance can have many different benefits or features, but usually falls under two types:

- a. *Term* – bought for a pre-determined period such as 10 or 20 years, or
- b. *Permanent* – such as whole life or universal life. As the name suggests these are intended to be permanent, and often involve a savings component. Permanent will be the more expensive of the two types.

2) Disability insurance provides financial security by replacing part of your earnings should an accident or illness cause you to become disabled and unable to work. If you have disability insurance through your work, it often makes sense to supplement this with a personal policy. This will better bridge the gap between income and expenses during a disability.

3) Critical-illness insurance provides a tax-free, lump-sum cash benefit if you are diagnosed with one of the covered conditions, such as heart attack, stroke or cancer. Critical-illness insurance is designed to help pay costs and protect your investments so you

won't need to liquidate assets if you have an unexpected serious illness.

*Note: You should also ensure you have sufficient homeowner insurance and liability insurance to cover your home, cars and other major assets.*

### Estate planning

Here are some key items we recommend every individual consider putting in place. We strongly urge using a qualified lawyer or notary public to assist with the creation of these documents.

1) **Will:** The purpose of a will is to provide for the orderly distribution of your assets and settlement of your liabilities or debts, and to express your wishes about guardianship of any minor children after your death. If you die without a will, your wishes may not be followed, even if they are known. Instead, your estate will be distributed according to provincial law. It may be necessary to update an existing will should you marry or have children.

2) **Designate beneficiaries for all registered accounts and insurance policies:** Designating your spouse/partner or a financially dependent child as a beneficiary for your Registered Retirement Savings Plans (RRSPs) and Tax-Free Savings Accounts (TFSA) will allow the proceeds to be paid directly to them on a tax-free, rollover basis and will allow the proceeds to avoid probate. (Note: Only a spouse/partner can be a successor holder for a TFSA). Also, if the beneficiary of your RRSP or Registered Retirement Income Fund (RRIF) is your spouse, they can transfer the assets into their own RRSP or RRIF and the amounts will not be included as income on your final tax return. We also recommend designating alternate beneficiaries where possible.

3) **Power of attorney:** Whereas your will takes effect on your death, a power of attorney (enduring or limited) is used to appoint someone to look after your financial affairs if you are alive but incapable of dealing with them on your own. However, it is important to note that in many provinces a power of attorney cannot be used for health and personal care decisions. Rather, a representation agreement (or equivalent – see below) is used for this.

4) **Representation agreement:** Consider appointing a representative through a legally enforceable document with authority to make health decisions (e.g., life or death, types of healthcare on offer) and personal-care

decisions in the event you become unable to do so on your own. In British Columbia this document is called a *representation agreement*. Other provinces have similar documents under different titles, such as: Personal Directive (AB and NS); Health Care Directive (SK and MB); and Power of Attorney for Personal Care (ON). If you do not have a representation agreement, a set of rules is followed to determine who would make healthcare and personal care decisions for you if you are unable. A representation agreement is particularly useful if you would prefer those decisions to be made by someone of your choosing.



Tom Cowans is a Portfolio Manager and Wealth Advisor for the Stan Clark Financial Team at CIBC Wood Gundy.

## SCFT Trivia

### Trivia Time!

Thank you for reading this month's newsletter. Test your knowledge with our trivia questions! Each question relates to one of the articles featured in this edition. See how many you can get right, and check your answers at the bottom of the page. Good luck and happy quizzing!

*Hint: You can find the answers inside this newsletter.*

1. In his book *Fooled by Randomness*, Nassim Taleb advises being aware of:
  - a) The role of luck and randomness in success.
  - b) The need to be careful about attributing success solely to skill or effort.
  - c) Our human tendency to create stories that explain random events as non-random.
  - d) All of the above.
  
2. In 1997, a computer shocked the world by defeating on top-rated player Garry Kasparov in a chess game. Kasparov responded by:
  - a) Demanding the computer be disqualified.
  - b) Feeling disillusioned and giving up on chess.
  - c) Suggesting new rules where human players could make use of computers for help.
  - d) Suing the company that made the computer.
  
3. In working on client portfolios, the Stan Clark Financial Team embraces an approach of "combined intelligence," meaning:
  - a) Our decisions are computer-aided, but in making them we still apply our insights and experience.
  - b) We rely solely on our own intelligence plus lots of guesswork.
  - c) We ask computers for help, but we also toss coins: Heads, we make one decision; tails, another.
  - d) "Combined intelligence" just means we combine the results of different computer programs.
  
4. Since life at any age has uncertainties, it's important to save and invest for your future self. But, in addition to that, estate planning and insurance will help ensure your loved ones are taken care of should something happen to you.
  - a) True
  - b) False

Answers: 1, D, 2, C, 3, A, 4, A

**CIBC WOOD GUNDY**

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