

THE STAN CLARK FINANCIAL TEAM'S

# PERSPECTIVES

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In this month's behavioral finance article, I explore the dangers of letting the instinctive mind prevail – and how instead to heed the rational. In Part 4 of his "Behind the Numbers" series, Michael Chu looks at the earnings momentum method of measuring a company's growth. In discussing stocks vs. bonds, Elaine Loo explains that, contrary to Aesop's advice, slow and steady is not always the wisest strategy. And Tom Cowans takes on a topic many Canadians are wondering about: the effects of President Trump's tariffs.

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Behavioral Finance

## THE RIDER OR THE ELEPHANT: WHO IS REALLY IN CONTROL?

By Stan Clark, Senior Wealth Advisor

In previous behavioral finance articles, I've discussed how the human mind can be thought of as *two* minds. The first is our instinctive, intuitive mind; the second, our rational, deliberate mind. In this article, we will look at the first as an elephant and the second as the rider on the elephant. The intriguing question then arises: Who is really in control, the rider or the elephant?

The mind having two or more parts is not a new concept. Circa 400 BC, Plato used a chariot analogy, with the chariot driver trying to control two winged horses. The driver was our rational mind. The horses were our emotions and passions, both good and bad.

Buddha referred to a trainer trying to control an elephant. Freud suggested the mind was composed of the ego, the superego and the id.

In all these writings, the different parts of the mind are in conflict. The challenge for the rational mind is to control the instinctive mind, especially our instincts to do things that damage ourselves or others. We know smoking, over-eating, over-drinking, gambling and procrastinating are bad for us. So, why do we keep doing them?

When Plato, Buddha and Freud lived, almost everyone had direct experiences with horses and other large animals, and could relate to the challenge of controlling something more powerful. In the 20th century, with the inventions of cars, airplanes and computers, we felt more in control. Accordingly, we shifted to the idea of the rational mind being in control of the instinctive mind. That approach dominated psychology, economics and finance from the 1960s to the end of the century.

Recent findings in behavioral finance and brain research, however, show that our instinctive mind has far more power and control over our thoughts and actions than we assumed. This is really a re-discovery of a truth known for centuries.

Prominent psychologist Jonathan Haidt has done considerable research on current and ancient wisdom. In his wonderful book *The Happiness Hypothesis*, Haidt asks: "Why do people keep doing such stupid things?"

Haidt's favourite metaphor is the instinctive, intuitive mind as the elephant; the rational mind as the rider. The rider keeps the elephant walking up a path, but there are limits to the rider's control. If the elephant is starving and sees food, or is thirsty and sees water – or even a terrifying mouse – it will ignore the rider and do what it wants. If the thirsty elephant bolts for the river, the rider may fool himself and others into thinking he wanted the elephant to go there. But he would be rationalizing.

Following up with another best-seller, *The Righteous Mind*, Haidt argues that we derive our moral judgments not from logical reason, but rather gut feelings. Humans, he says, allow themselves to be led by their intuition first and their reasoning second.

Staying with Haidt's metaphor, the rider is supposed to steer the large elephant. Instead, when the elephant acts by intuition and goes off-path, the rider comes up with reasons for allowing such gut-instinct behavior.

In investing, we are exposed to many temptations from our inner elephant that can lead us astray. Our elephant likes to follow the crowd and buy into



## TEAM TALK

**Sylvia Ellis**

*Senior Estate Planning Advisor*



*Sylvia, Craig and Kobe Hiking, Sunshine Coast*

### This issue I'd thought I do a "My Favorite" column...

**Leisure activity:** Taking Kobe (our adopted Pom) to the seawall for a walk. We live in Yaletown so it's super close and beautiful all year round. We discovered he's not much of a hiker. During a trip to the Sunshine Coast, we had to carry him and now we either do that part way or put him in a doggy back-pack if we want to take him with us.

**Music:** I enjoy all types of music. For example, this year we're going to see Jesse Cook (Canadian Flamenco/Jazz acoustic guitarist), Paul Simon (need I say more?) and Teddy Swims (soul, country and pop). All very different!

**Favorite sports to watch live or on TV:** For live, back when we had the Grizzlies it was basketball. Now it's soccer! And on TV, NFL and the Superbowl. I'm usually in two pools throughout the Season and enjoy watching the big game. Craig and I have had the good fortune of being to the Superbowl twice.

**Vacation:** Any place with a balance of culture, food and nature (and a bit of shopping.)

popular fads; it is terrified by short-term declines.

Trying to control the elephant once it latches onto a desire is almost futile. Far better to keep the elephant from being tempted in the first place. That's why, when you use a disciplined approach to investing, be wary about over-analyzing the strategy recommendations. The risk is that, in doing so, your inner elephant will get a whiff of bananas or perhaps a peek at the mouse – and you as the rider will find it very difficult to stay on the path to success.

### Investing

## BEHIND THE NUMBERS - PART 4: EARNINGS MOMENTUM

*By Michael Chu, Senior Wealth Advisor*

There are many ways to measure growth. For a young child, we might first think of using changes in height. But there are other ways, such as physical coordination or speaking ability.

Similarly, there is more than one way to measure a company's growth. In this fourth part of our series "Behind the Numbers," we are going to discuss *earnings momentum* – which refers to the growth in earnings of a company. When evaluating companies on growth, we focus on three things: quarterly earnings momentum, earnings surprises and estimate revisions.

*Quarterly earnings momentum* is the quarterly rate of change in annual earnings. For example, let's say a company's annual earnings were \$2.20 per share. And, a quarter ago, the annual earnings were \$2.00. This implies that annual earnings have grown 10% during the quarter. In the short term, stocks with strong earnings growth generally outperform those with weak earnings growth.

*Earnings surprises* looks at how much the most recent earnings were above or below expected earnings. In other words, how much analysts were surprised. Suppose a company recently reported earnings of 70 cents per quarter, resulting in clean earnings of 66 cents, after adjusting for one-time gains (or losses). If analysts had expected earnings of 60 cents, then this company had an earnings surprise of 10%. In the short term, stocks that beat expectations generally outperform those that miss expectations.

You will have noticed in this last example that the earnings number needed adjusting. This is why having clean numbers is important! Without the adjustment, the earnings growth would have been overstated. Usually the numbers we see in the newspaper or on the Internet are unadjusted. While we can still use those numbers for discussions, it's generally not a good idea to use them for making decisions, as they may not be accurate.

*Estimate revisions* looks at how analysts' earnings estimates have changed. Have their estimates increased, decreased or stayed the same? In our



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previous example, the company had good earnings that were above expectations. This could result in analysts revising their future estimates upward. The analysts might have been expecting \$3 per share for next year. But now, after the seeing the latest results, they might revise their future expectations higher – perhaps to \$3.30, resulting in a positive earnings revision and a 10% increase in their estimates. In the short term, stocks with increasing earnings expectations generally outperform those with decreasing expectations.

In a long-term study using these three growth variables, we divided all Canadian stocks into five groups, sorted by earnings momentum, and calculated the returns generated by each group. Here's how the returns looked from 1985 to 2024 (39 years):

Looking at quarterly-earnings momentum variables, the top group (stocks with the highest earnings momentum) had returns of 12%, vs. 8.2% for the bottom group (stocks with the worst earnings momentum). The TSX Index returned 8.5%.

Looking at earnings surprises, the top high-momentum group had returns of 14.7%, vs. 7.8% for the bottom low-momentum group.

Finally, looking at estimate revisions, the top group had returns of 14.7%, vs. 8.3% for the bottom group.

So, the overall results from investing in high-earnings momentum stocks (the top group) are very good, as they outperformed lower-earnings momentum stocks as well as the market.

Now this might make momentum investing look easy: Just buy high momentum and avoid low momentum. But keep in mind that, unlike value investing, which is slow and steady, using only momentum variables also means experiencing high volatility and high turnover – which might make it hard to stick with the strategy. This is why we use a combination of variables, including value and momentum, to get the best of both worlds. We'll talk about this some more next time.

Asset Allocation

# STOCKS VS. BONDS OVER THE PAST 154 YEARS

By Elaine Loo, Wealth Advisor

In Aesop’s fable *The Tortoise and the Hare*, slow and steady wins the race. But is that really how it works in life? When it comes to investing, slow and steady can be a recipe for near-certain losses.

Reliable performance data first became available in 1871. So, let’s look at stocks-vs.-bonds returns in the 154 years since. Think of as a story about asset allocation: of bonds, which appreciate slowly and appear reliable; and of stocks, which can appreciate strongly and quickly, but appear risky. Which is your best bet? The answer depends on what kind of race you’re running.

The past 154 years have been wildly volatile: inflation, deflation, a deep depression, two global financial crises, explosive growth, two World Wars, embargoes, assassinations and worldwide pandemics. We often forget how frightening things seemed at such times. Although the world may seem scary now, it’s likely that the period ahead won’t be all that different from some of the periods we’ve experienced in the past. History repeats itself; you just don’t know which part of the past you’re going to get! But the past informs the future. By studying history, you can get a good idea of the range of possible outcomes going forward.

Data shows that, over the past 154 years, if you owned equal amounts of Canadian and U.S. stocks you would have enjoyed average annual growth of 9.6% (in Canadian dollars) for an inflation-adjusted (real) return of 7.5%. Over the same period, Canadian bonds averaged 4.5%, or real returns of just 2.4% per year.

Here’s a graph showing 154 years of growth in stocks vs. bonds. If you started with \$1,000 in each, you would now have over \$58 million with stocks – but only about \$38 thousand with bonds. Remember that these are in “real” dollars, that is, adjusted for inflation. The average annual real returns from stocks were more than three times higher than those of bonds. However, because of compounding, the difference in returns grows to more than six times after 20 years: a profit of \$303,638 for stocks vs. only \$49,067 for bonds, on an initial \$100,000 investment. So, the benefit from stocks grows as the time horizon gets longer.

Now you may be asking: But aren’t stocks much riskier than bonds? Yes and no. The stock market is volatile in the short term, making stocks seem risky. But if you invest

## 154-Year Returns

### Growth in stocks vs. bonds 1871 to 2024

	Average Nominal Returns	Average Real* Returns	Average real growth from \$100,000**				
			1 Year	5 Years	10 Years	15 Years	20 Years
Stocks	9.6%	7.5%	\$7,493	\$45,629	\$111,748	\$189,347	\$303,638
Bonds	4.5%	2.4%	\$2,400	\$9,837	\$19,749	\$30,190	\$49,067
Inflation	2.1%						
Difference in growth (\$)			+\$5,093	+\$35,792	+\$92,000	+\$159,157	+\$254,570
Difference in growth	2.1x	3.1x	3.1x	4.6x	5.7x	6.3x	6.2x

Source: Siegel, Shiller, CRSP, Cdn Institute of Actuaries, TSX, Bank of Canada.

\* “Real” returns are nominal returns after subtracting inflation.

\*\* “Real growth from \$100,000” for 5 to 20 years is the median real growth, showing the effect of compounding.

for the longer term, that is, more than five or 10 years, history shows that down markets have almost always been more than offset by up markets, giving reliable returns for stocks after inflation.

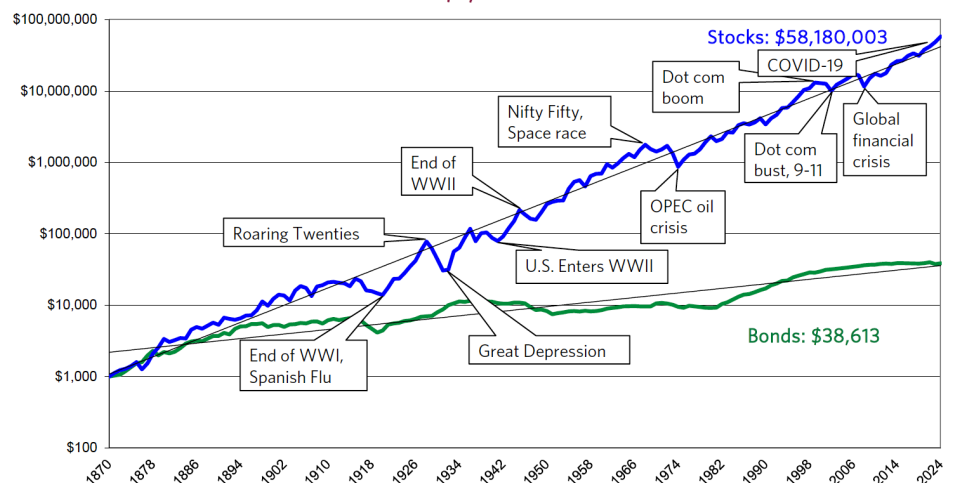
Inflation can actually make bonds riskier than stocks over the long term. The worst 10-year period for bonds was about the same as the worst 10-year period for stocks, yet the average returns for bonds were only a third as much as for stocks. The chance of losing money over any 10-year period was more than four times greater for bonds than it was for stocks. Over any 10-year period, stocks did better than bonds 89% of the time. And, over 15- and 20-year periods, stocks beat bonds nearly every time and rarely failed to beat

inflation. So, based on history, the longer your investment horizon, the less risky stocks are, and the riskier bonds become. At the same time, the extra returns from stocks vs. bonds grow dramatically.

The key takeaway here is that one type of asset isn’t always better. How long your money is likely to be invested is critical in determining the right mix for you. If you only have a few years to invest, then consider that most of your money should be in bonds. If you have savings earmarked for needs five to 10 years or more from now, consider investing more of those savings into stocks.

Please note that rate of return projections are for demonstration purposes only. They are based on a number of assumptions and consequently actual results may differ, possibly to a material degree.

### Real Growth from \$1,000 - 1871 to 2024



Source: Siegel, Shiller, CRSP, Cdn Institute of Actuaries, TSX, Bank of Canada.

Economics

# TARIFF TIME OR TEMPORARY REPRIEVE (AGAIN)?

By Tom Cowans, Wealth Advisor

After a collective sigh of relief on February 3, we are now in the midst of an active trade war with the U.S. The Trump administration had granted 30-day extensions at the 11th hour to the promised 25% tariff (10% on energy) nearly a month ago, thanks to promises made by Canada and Mexico relating to increased border security. Yet here we are again, with Trump now imposing these tariffs as of March 4th, “for an abuse,” so he claims, “that took place for many, many years.”

**It is likely that Canada will feel the pain of any trade war more than the U.S., due to our percentage of exports to the U.S. being far greater than vice versa.**

Canada and Mexico have promised their own sets of retaliatory tariffs. However, economist Ed Yardeni believes that the U.S. is aiming more for reciprocal tariffs as opposed to a full-on trade war. The use of tariffs, says Yardeni, would be to negotiate lower or no tariffs (especially with the European Union) from what the U.S. currently perceives as an unfair or imbalanced relationship.

It is likely that Canada will feel the pain of any trade war more than the U.S., due to our percentage of exports to the U.S. being far greater than vice versa. Our ability to have an impact with retaliatory tariffs is not as great, but we have already seen some other tools Canada can use. Boycotting of U.S. brands and products, as well as changing of travel plans, have already started to affect the U.S. economy. Similar boycotting efforts by other developed economies of the world would compound this. And, a weaker loonie would provide some support by increasing the competitiveness of Canadian exports.

As we have mentioned before, and as stated by Wharton Professor of Finance Jeremy Siegel, Trump views the stock market as a gauge of how he is performing. Given the increasing level of uncertainty from corporate North America about the future of trade, any prolonged weakness in the stock market would be felt by Trump and his administration. The tariff implementation will quickly result in price increases being passed onto the consumer, while the (debatable) benefits of these policies would take a longer time to have an impact.

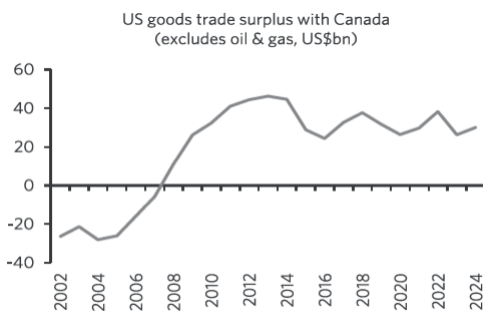
Supply and infrastructure chains that have taken decades to develop would not change overnight. Again, it would be the U.S. consumer (and voter) who would feel the impact right away – and such a slowdown in economic activity would be reflected in the stock market.

It is believed that Trump is also looking to quickly renegotiate the *United States-Mexico-Canada Agreement (USMCA)*, which the three countries signed during his first term. Renegotiation would most likely occur once the next Canadian prime minister is voted in.

The U.S. will want further commitments for us to purchase more of its goods, so the tariff threat will likely loom over our economy until this happens. The long-term impacts of the current U.S. administration remain to be seen, but the threats have certainly sparked a lot of discussion about how tightly linked the Canadian and U.S. economies will be in the future – and whether Canada should try to diversify its trade partners.

Approximately 50% of the revenues of the TSX60 and S&P500 come from outside their respective Canadian and U.S. markets. These companies choose to diversify their businesses, so as not to be too reliant on any one market. They also adapt to new circumstances quickly (COVID being a recent example), in order to maintain profitability for their shareholders.

Somewhat similarly, we believe that owning a group of companies selected using disciplined strategies, as well as being diversified by country and industry, is the best way to navigate this uncertain future.



Source: Census Bureau, CIBC

When we dive a little deeper into this “abuse,” we see that the U.S. does actually run a trade surplus with Canada, if you exclude oil and gas. And a large portion of American refineries rely on these Canadian energy imports to then sell on (for a profit) to domestic and international markets. If tariffs were to be added to any Canadian energy exports, U.S. consumers would feel this immediately at the pump.

With inflation still lingering above the U.S. Federal Reserve’s 2% target, and inflation being one of the key issues for voters in the last election, we believe that those closest to President Trump are aware of the potential effects of these moves. We still view the tariffs as more of a bargaining position – to enable “wins” on border security, immigration, defence spending and *reshoring* (encouraging U.S. multinationals to bring production back home).

Chart: Canada more exposed to trade with US



Source: Statistics Canada, BEA, CIBC



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## 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. Circa 400 BC, Plato used a chariot analogy to explain how the human mind in fact consists of two minds: instinctive and rational. Plato described a chariot driver trying to control two winged horses. Which would be the rational mind: the driver or the horses?
  - a) The horses, because they're full of energy and can reach a destination fast.
  - b) The driver, because a driver has to rein horses in when they get excited or distracted.
  - c) Neither driver nor horses, because both are involved in an unending contest of wills.
  - d) Driver and horses, because both have the same purpose: to get a move on.
2. One method of measuring a company's growth is earnings momentum, that is, the growth in a company's earnings. When evaluating companies on growth, the Stan Clark Team focuses on quarterly earnings momentum, earnings surprises and estimate revisions:
  - a) True.
  - b) False.
3. In weighing investments in stocks vs. bonds, best to:
  - a) Avoid stocks, as they're much more volatile.
  - b) Consider how long you're investing for. In the short term, bonds are more reliable. In the long term, stocks are less risky compared to bonds. And, the extra returns from stocks vs. bonds grow dramatically.
  - c) Always invest equally in both stocks and bonds.
  - d) Avoid bonds entirely.
4. If U.S. President Donald Trump follows through on his threat of imposing tariffs, Canada would likely:
  - a) Feel the pain more than the U.S., due to our percentage of exports to the U.S. being far greater than vice versa.
  - b) Continue what we've already started: boycotting U.S. brands, products and travel destinations.
  - c) Experience a weaker loonie – though this would have the benefit increasing the competitiveness of Canadian exports.
  - d) All of the above.

Answers: 1. B, 2. A, 3. B, 4. D

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