The Stan Clark Financial Team's

PERSPECTIVES

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Senior Investment Advisor

As I relate in this month's behavioral finance article, we prefer what we've been exposed to: the familiar over the unknown. The danger of the *mere-exposure effect* is that we may opt for stocks we've heard about – and miss out on other, more promising ones. Michael Chu and I look at how *earnings yield*, a stock's earnings divided by its price, can help forecast market returns. In "Behind The Numbers," Michael explains how we integrate our strategies to work for your portfolio. And Sylvia Ellis discusses when to start drawing on your Canada Pension Plan.

Stan

Behavioral finance

Mere-Exposure Effect: How familiarity affects your financial decisions

By Stan Clark - Senior Investment Advisor

You're faced with a choice. One, you can buy shares in a company where you know the brand very well and the numbers look okay. Or two, you can buy shares in a company you don't know well, but where the numbers look quite good. Which one would you be more likely to invest in?

Readers of my behavioral finance articles will probably guess correctly that many people would choose to buy shares in the brand-name company. The reason: They're familiar with the company, even if its numbers aren't as good.

In this issue, we'll look at how familiarity affects your financial decisions.

It's quite natural that we develop a preference for things we are familiar with. This preference is a psychological bias known as the *familiarity principle*, or the *mere-exposure effect*. Psychologists have been aware of this bias, and studying it through tests, since the late 19th century. The mere-exposure effect explains a lot about our personal choices in many areas – including where and how we invest our money.

The bias explains why your next car will most likely be the same make as your current one. It also explains why people tend to fall in love or become friends with people they see repeatedly. In advertising, the mere-exposure effect is the reason why so much advertising money is spent to build awareness and familiarity with brands. That's why, when you buy cornflakes, you'll most likely buy Kellogg's.

The mere-exposure effect is likely rooted in an ancient part of our brain – the amygdala – where basic emotions such as fear and contentment arise. Seeing or doing something that is even just fleetingly familiar makes us feel good.

Investing in domestic companies makes us feel safer and more at ease than investing overseas. This explains why Americans invest mostly in U.S. stocks, Europeans invest mostly in Europe and Canadians invest mostly in Canada. Yet in a globally linked economy, there is no rational reason for people in different countries to have such wildly different mixes.

When it comes to investing in individual stocks, it's good to know why the effect is called "mere-exposure." You don't need to have good reasons to like a company; merely being familiar with something is enough to bias you in its favour. The reasons can come later. This may sound like I've got things backward. But experiments have shown that we often first come to like something unconsciously. Then we consciously build up the reasons for *why* we like it.

> *When it comes to investing in individual stocks, it's good to know why the effect is called "mere-exposure." You don't need to have good reasons to like a company; merely being familiar with something is enough to bias you in its favour.*

Thanks to the mere-exposure effect, we tend to invest in stocks that are familiar to us in some way. More often than not, investing based heavily on familiarity can hurt your investment returns.

In his 2008 book *Your Money and Your Brain: How the New Science of Neuroeconomics Can Help Make You Rich*, Jason Zweig points out that popular, or "celebrity," stocks usually end up overexposed, overpriced and somewhat risky. They tend to underperform the market by 2% to 5% annually. Nevertheless, many people continue to buy such stocks and ignore better-valued ones that are not as familiar.

Therein lies the danger. The mere-exposure effect can keep you from being objective in allocating your investments and in selecting stocks. That's why it helps to invest according to a set of rules based on reliable, objective information. And equally important, it's why you need to be disciplined about sticking to those rules. ■

Team Talk:

Heather Guzak

Associate Investment Advisor

Wild Education in Aldergrove, May 2021

Besides working from home, what have you been up to?

Fortunately, I have been able to spend a lot of time with my two children, Quentin and Tayla. I have really been taking a step back and cherishing this time that I have with them while working from home. I am able to actually drop and pick them up from school, be there for all of their after school activities and enjoy taking them for a trail ride on our bikes without feeling too rushed.

We have been trying to do something "new" each month just to keep things as fun and interesting as possible. Whether that means going for a late night bike ride, taking our movie nights outside and watching it on our garage door or doing something completely new and having a one on one with various reptiles.

They are growing up so fast and doing so in such a crazy time that we are trying to make each day count and be as special as it can be.

Investing

Behind the Numbers, Part 6: Putting our strategies to work

By Michael Chu, Investment Advisor

In this series, we've discussed in detail how and why the Stan Clark Financial Team's strategies work. We've also talked about how our team uses a wide range of information, including price-to-earnings ratios, dividend yield, earnings momentum and price momentum. Now, in the final part of "Behind the Numbers," we look at how we integrate those strategies into your portfolio.

Individually, each of our strategies has good long-term results. This is a must, because we want each strategy to be able to stand the test of time. We use 15 different strategies to choose between 30 and 60 stocks for your portfolio. There are two important points to make here. Even though each strategy has a good long-term track record, each strategy will still underperform from time to time. So, it's important that we use different types of strategies. If one underperforms, then the other strategies can compensate.

The second point is that we invest in many different stocks to achieve a well-diversified portfolio. By selecting companies with strong characteristics, we improve the odds of success. However, the world is too uncertain for us know exactly which stocks will succeed and which will disappoint. Owning a well-diversified portfolio makes it more likely that your overall returns will beat the market.

We select the top-ranked stocks from each strategy to form a portfolio of 30 to 60 stocks. At first, all the stocks will be rated at the top. But over time, as things change, some stocks are bound to move down in the rankings. If a stock ranks near the top, we will continue to hold it – it doesn't make sense to sell a stock just because it has fallen a few spots in ranking.

However, if a stock falls in ranking below a predetermined threshold, say the top 20% of all stocks, then it makes sense to upgrade to one that's better ranked. The stock that has fallen in rank would be ranked as a "sell." This doesn't mean that the stock is bad or will imminently drop in price. It just means that there are many other higher-ranked stocks that have a better chance of performing well.

When we are deciding to sell a stock, one thing we don't look at is whether it generated a gain or loss. It might make us *feel* better to hold on to a loser than sell it, but we know this is just an emotional bias. Based on our long-term results, stocks that are ranked higher have a better chance of doing well. So, it's better to own a higher-ranked stock rather than merely hope that a lower-ranked stock will recover.

When buying or replacing stocks, we buy the highest-ranked stock that isn't already owned but also fits with the other stocks in the portfolio. This ensures that your portfolio remains diversified. Since we have many strategies to choose from, we can always find a stock that fits your portfolio.

As mentioned, the strategies we use have excellent track records. They incorporate a wide range of useful and timely information and research. There isn't much we can add to them. But, if there ever should be, we would add it to our rules. We advise our clients (and ourselves) against trying to add personal judgments to the rankings. That would add bias and emotion to the selection process – and would most likely not make for better decisions or returns.

When buying or replacing stocks, we buy the highest-ranked stock that isn't already owned but also fits with the other stocks in the portfolio. This ensures that your portfolio remains diversified.

While our strategies have had good returns over the long term, they don't always work. They will underperform from time to time, but those periods are typically followed by periods of very strong, above-market performance. That's why we use many different strategies for a diversified approach. By combining all our strategies, we have consistently beat market averages over almost all rolling three-, four- and five-year periods.

In keeping with our goal of delivering exceptional growth during up markets, we've had considerably fewer losing periods, to soften the blows and ease the stress of down markets. The key is to use our strategies properly – that is, with discipline!

Please contact us for more information about our stock strategies and returns. ■

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.

Asset Allocation

How earnings yield helps forecast stock market returns

By Michael Chu, Investment Advisor, and Stan Clark, Senior Investment Advisor

As part of our "Behind the Numbers" series, we discuss how the price-to-earnings (P/E) ratio can be a good predictor of individual stock returns. You might ask: "Can P/E ratios be used to tell us something about the overall market?" Good question! The overall market consists of all the individual companies grouped together. So, if we calculate an overall market P/E, it might just give us some insight into stock market returns.

According to Jeremy Siegel, professor of Finance at the University of Pennsylvania's Wharton School, and author of *Stocks for the Long Run*, investors can project their returns with techniques similar to those a bond investor would use. A bond promises to pay a fixed amount per year, so the expected return of the bond is the coupon divided by the price of the bond. For example, let's say you have a bond that is selling for $1,000. It pays you $20 per year. That works out to an expected return on that bond of 2%. While stockholders have nothing guaranteed, they do have a claim on all future earnings of the company. Some of these earnings are paid out as dividends, while the rest are reinvested in the company to increase its value. So, just like the expected bond return we calculated earlier, the expected stock return should be similar to the stock's *earnings yield*.

Let's take a closer look at concept of earnings yield. The earnings yield of a stock is the earnings divided by the stock price. Sound familiar? It should. It's the inverse of the P/E ratio, which is price divided by earnings. It's the same thing, really – but stating it this way makes the concept easier to grasp. The earnings yield for the stock market is the sum of all companies' earnings divided by the value of the stock market.

There is a big difference between bond yields and stock earnings yields. No matter whether there is significant economic growth or massive inflation, the bond payments will not increase. Stock earnings, on the other hand, are much different. Earnings are not guaranteed and can be highly variable. But stocks represent ownership of real assets, such as machinery, property and patents – in other words, things that produce real goods and services which, in turn, generate profits. Over long periods of time, there is overwhelming evidence that company earnings will keep up with the rising prices of goods and services. Profits will rise with inflation. As a result, the return on stocks can be described as a good hedge against inflation – unlike bonds. Think of the inflation hedge as a benefit, offsetting the earnings' variability.

Currently, the projected S&P 500 earnings for 2022 are about $209, and the index is about 4204. This works out to an earnings yield of about 5%. Siegel has found that "the earnings yield is an excellent predictor of long-run real stock returns." If these earnings grow just at the rate of inflation, the expected long-term returns of the stock market should also be around 5%, *plus* inflation. If you figure inflation averages 2%, this would equate to a total return of 7%. This is significantly more than the 10-year U.S. bond rate of approximately 1.6%, with no increases for inflation.

Canadian stocks offer a higher earning yield, about 6% on the forecasted earnings next year. The forecasted earning yield of the Canadian and U.S. stocks in our Disciplined World strategy is about 6%.

In summary, earnings yield gives us an idea of what to expect for returns. It also gives us a simple comparison to bonds for valuation purposes. The bottom line is that, for long-term investors, stocks provide much greater opportunity than bonds. ■

Source: "Earnings, Inflation and Future Stock and Bond Returns," Proceedings of the American Philosophical Society, Vol 158, No. 3, September 2014.

Stan Clark is First Vice-President, Portfolio Manager and Senior Investment Advisor for the Stan Clark Financial Team at CIBC Wood Gundy. Stan has direct responsibility for the team and oversees all areas of financial planning, investment selection and investment management.

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 & Estate Planning

When should you start taking CPP?

By Sylvia Ellis, Senior Estate Planning Advisor

In our business, creating financial plans goes hand-in-hand with investing. Such plans guide us in helping determine your customized asset allocation, as well as answering certain questions. Of these, one of the most commonly asked is, "When should I start taking my Canada Pension Plan (CPP)?"

First, let's briefly refresh on the plan itself. CPP provides retirement, disability and survivor benefits for individuals who have contributed. It starts anywhere between ages 60 and 70, with 65 being the "normal" retirement age. Any earlier and you're subject to a reduced benefit (0.6% per month or 36% at age 60) and any later, an enhanced benefit (0.7% per month or 42% at age 70).

As of 2021, at age 65, CPP provides a maximum benefit of $1,203.75 per month.

So, how does CPP compare when taking it at different ages? The Canadian Institute of Actuaries (CIA) published a 38-page report in July 2020 titled *The CPP Take-Up Decision*. Specifically, the report compared taking CPP payments at age 70 and bridging the gap with RRSP/RRIF savings, versus taking CPP at age 65 and self-managing the income. In both scenarios, the same initial level of savings was used to target the same annual secure net income.

The analysis considered individuals retiring at age 65 who have sufficient registered savings to replace the CPP pension income that would be delayed to age 70. If those variables were changed – such as an individual having no RRSP/RRIF savings and having exclusively TFSA savings, for example – the conclusions might be different.

With this in mind, the analysis found that, for the majority of Canadians with sufficient registered savings to bridge the gap, the decision of whether to delay CPP payments depends on investment returns and life expectancy. The report concluded that, given today's low interest rates and increasing longevity, "delaying CPP payments is clearly a financially advantageous strategy" for those with sufficient savings. A major advantage of increasing payments via postponement is that it promises additional secure, lifetime income that increases each year alongside the price of consumer goods, thereby helping to

protect seniors against the financial risks associated with inflation, financial market returns and longevity.

One of the points the CIA report made was, again, to apply your registered assets to bridge the gap between 65 and 70. The report used this formula: 7.35 x CPP at 65 = RRSP bridge amount. So, if you expect the maximum benefit of $1,203.75 per month, this would equate to utilizing $106,170.75 of your registered funds.

Another important takeaway from the report is that delaying may actually provide a greater benefit than 42%. CPP is based on maximum pensionable earnings, which have historically increased faster than inflation. As such, the report concludes that the CPP increase from age 65 to 70 will actually be closer to 50%, not 42%.

In their Executive Summary, the CIA stated that "taking CPP payments later is a cheap and safe approach to receive greater secure income in retirement; nevertheless, more than 95% of Canadians have consistently taken CPP payments at normal retirement age (65) or earlier since CPP introduced flexible retirement in the 1980s. Why, you ask? It could be partly emotional. People feel that they want to ensure they get back some of the money they put in, just in case. It could also be, in part, education on the topic, which is what we hope to do with this article."

What are the exceptions? The following: if you don't have enough registered savings; or if your Guaranteed Income Supplement (GIS) or Old Age Security (OAS) could be affected. For most individuals, if you have an investment account sufficient to bridge you to age 70, then delaying makes sense if you desire having more guarantees later in life.

At the Stan Clark Financial Team, we use our proprietary financial planning software to look at various what-if scenarios, and to consider all variables in helping you determine when it may be best to take your CPP.

If you have any questions or would like to have a copy of the CIA report emailed to you, please let us know. ■

Sylvia Ellis is the Senior Estate Planning Advisor for the Stan Clark Financial Team at CIBC Wood Gundy. Sylvia provides support to the team in projecting and planning client financial affairs.

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. The *mere-exposure effect* is a psychological bias that leads us to:

   a) Distrust advertising

   b) Discount those who promote "celebrity stocks"

   c) Develop a preference for things we are familiar with

   d) Go off cornflakes cereal because we see too many commercials about it.

2. The difference between bond yields and stock earnings yields is that:

   a) Bond payments will not increase whether there is significant economic growth or massive inflation

   b) Stock earnings are not guaranteed and can be highly variable

   c) Stocks represent ownership of real assets, such as machinery, property and patents

   d) All of the above.

3. The Stan Clark Financial Team invests in many different stocks to achieve a strong, well-diversified portfolio:

   a) True b) False.

4. Many Canadians assume age 65 is when they should start taking their Canada Pension Plan. According to the Canadian Institute of Actuaries:

   a) Why not take CPP earlier, say at age 60?

   b) Delaying CPP payments past age 65 is a financially advantageous strategy for those with sufficient savings

   c) Age 65 is the traditional time to take CPP, and traditions are sensible

   d) To decide whether to start at age 65 or wait, just toss a coin.

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, 2021.

Trivia challenge runs June 1 - 29, 2021. 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 2021

CIBC Wood Gundy

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Where planning, investing and behavioral finance meet

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