CIBC Wood Gundy

My Investment Philosophy

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Minimizing Risk While Maximizing Return

Any investment philosophy must be founded on a set of beliefs. Some investors believe in value investing, others in growth investing… some investors believe in buy and hold, others position trade, swing trade, trend trade, day trade and/or some combination thereof. Being a bit of a math geek (Bachelor of Mathematics from the University of Waterloo) and one of approximately 206 dual holders, globally, of the Chartered Financial Analyst (CFA) and Chartered Market Technician (CMT) designations, I believe I get some say.

Like most aspiring investment analysts, I started from fundamentally-driven routes in pursuit of the CFA designation while working in the quantitative research department for an institutional investment manager. Since those early days, my process, interests and experience continues to develop. Around 2004, I decided to pursue an education in technical analysis, first through a variety of books, and then through the CMT designation. I believe (you may not believe this) that technical analysis is the more useful discipline in the pursuit of risk-adjusted returns. And I believe that technical analysis is still in its infancy within the global investment industry, relative to the institutionally dominated and more fundamentally driven world where it's billions of dollars instead of hundreds of thousands or millions.

Most global stock markets have shown little progress over the past 10+ years as periods of heightened volatility, uncertainty around past and present crises and fears loom large. The world appears to be increasingly concerned with debt risk and risks in general. Institutions move markets. Institutions invest billions of dollars, and it takes time for them to build and eventually divest of a security holding. These movements can be identified via technical analysis and through the study of price and volume.

How can investors be prepared for the markets of the coming decades? I have never really believed in buy and hold, but the last decade provides enough evidence that you should be exploring alternatives too, if you still think you can buy stocks and hold them for decades. I believe in helping to take stock off the hands of desperate sellers and then selling it back to optimistic buyers (often the same ones who were willing to sell it at lower levels).

Up… Down… Up… Down… Repeat

Markets rise and fall in cycles, and while many try to predict the exact nature of these cycles and when they start and end, things don't always work out exactly as they did before. That being said, markets move in trends and counter-trends, each of which can exist over the short-term, mid-term and long-term time frames.

My Beliefs

- Markets experience up waves of optimism, followed by down waves of pessimism.
- Owning stocks in uptrends makes far more sense than owning stocks in downtrends.
- An uptrend is defined by higher lows and higher highs.
- A downtrend is defined by lower highs and lower lows.
- Stocks can fall far more than you would ever think fathomable.
- Owning stocks during a bear market is akin to financial suicide.
- Small losses are preferred to big losses.
- Emotions + investing don't mix well.
- I like companies that make money, and preferably can boast large growth in earnings.

- I don’t like debt. I have none myself, and I prefer my investments to have modest debt/equity ratios.
- Liquidity can be a major issue in the markets. It’s important to ensure that the market is sufficiently liquid for your participation. I prefer to be able to liquidate positions in under 10 minutes.
- Investors should increase their risk when markets are in a clear uptrend.
- Investors should eliminate their risk when the markets are in a clear downtrend.
- Cash with no return should be preferred to falling equity prices.
- Total Return is far more important than dividends alone.
- Total Return = Dividends + Capital Gain/(Loss)
- Dividend-paying “blue-chip” stocks can experience significant losses and should not be considered “low risk”.
- A stop loss is an important part of any serious investment discipline.
- When the average investor is scared of the markets, investors should be looking for opportunities and consider buying stocks.
- When the average investor is complacent and BNN/CNBC are bullish, I get nervous.
- Buying stocks on pullbacks provide great risk to reward and is a generally less risky practice than buying breakouts.
- Most investors could be much more successful if they limited their losses on bad investments.

Constructing a portfolio of investments that offer above-average opportunity for return on a risk-adjusted basis should be the goal of most investors. In countless discussions with my clients, prospects, family and friends, one common wish is shared by all -- the desire for high returns with minimal chance for loss. Unfortunately, this proposition is contradictory and unrealistic. That being said, there are ways to smooth out the equity value of your account.

The Importance of Asset Allocation

Most investors are familiar with the most common asset classes; real estate, stocks, bonds and cash. They understand that holding a balanced mix of these investments should result in less overall risk. This remains true as bonds tend to operate differently than equities and investors crave bonds (and bid up their prices, pushing yields/interest rates lower) when they sell equities during declines and/or panics. The problem is the incredibly low yields that exist globally at this point in time (early 2012). I consider there to be tremendous risk with the proposition of loaning money to any government for 10-years, in many cases for less than 2% (the current scenario in January, 2012). With inflation, almost everywhere, running at higher rates than ~2%, we have negative real yields, which can be very damaging over the long-term to your financial health.

From an equity risk standpoint, the world has been operating differently in the past decade, and even more particularly in the past five years. I’ve found that correlations (the degree to which assets move in the same direction) have risen markedly over time, severely limiting the opportunity to diversify in the historic sense.

It used to be possible to own Asian equities, which you could expect to behave differently from Canadian equities (for example), thereby reducing the risk of holding one equity by itself, but not anymore. These days a selloff in Asia hits Europe and then hits the U.S. and vice versa. Fears of collapsing European countries, for example, can and do lead to stock market reactions around the globe. With the increasing amount of high frequency and algorithmic trading, and the ease with which we can all access information, we have a recipe for a different stock market than in the ‘80’s or ‘90’s.

Investors must realize that they are not compensated for taking unnecessary risk. And at any point that the risks exceed the reward potential (i.e., in a bear market) an investor should shun risk at all cost as preservation of capital is far more important than hugging to the story that it's the long-term that counts and you can ride it out. Many investors have been told by their advisors that dividend oriented "blue-chip" stocks will protect over the long haul, but tell that to investors in many of the largest (well they used to be anyway) banks in a wide swatch of countries whose stock prices are down more than 90% (still!!) several years after the '08/'09 bear market.

By understanding the risk tolerance of my clients, I can construct a portfolio of assets that typically adheres to a tolerable amount of risk. I can demonstrate this theory graphically and explain its implications mathematically.

The Pitfalls of Stock Investing

Investors are continually presented with ideas, thoughts, articles, commercials and reports that cloud their ability to make efficient decisions. Each day the media attempts to reconcile the previous day's market activity with some event that surely was responsible for the exact movements of the widely-followed indices.

I encourage my clients to step back from the day-to-day market activity. In fact, I can say from experience that 95% of the general public is incapable of looking at, analyzing and interpreting their investment portfolio values on a frequent basis. Most investors are emotional, and access to short-term account values often leads to irrational decision-making during market turmoil. It's crucial to keep a clear focus and mental state in the markets and to be prepared to change strategies immediately, when necessary. If you can't do that, hire someone who can (for the record, I can).

There is nothing wrong with being wrong -- we all make mistakes. We're all wrong at one point or another. Investors who purchase securities will inevitably have some that end up being losers. So what. The only problem is if you stay wrong. That is financial suicide. Holding onto your favourite stock is a bad idea, and I make no commitment to the stocks that I invest in for my clients. If a stock has upside prospects, great we'll own it, but if it's losing us money and not performing as expected, it's time to move on. No hard feelings. Unlike most novices, I also have no problem with selling a stock at a loss, and immediately buying it back (even at higher prices) again -- if I determine that I made a mistake in selling the stock, and it should be owned, am I going to let my pride overrule a smart investment decision? Perhaps you, but not me.

The key to investing is discipline – decisions based on probabilistic analysis and reasonable expectation, not emotion. Emotions are a dangerous obstacle that stand in the way of investing success. Panicked selling at market lows is common and results in below-average performance.

My Investment Process

I screen stocks based on a variety of fundamental and technical criteria. Fundamental screening can provide me with potential buy lists of securities that provide superior fundamentals like earnings and margins, but it's the technicals that tell me whether the stock can and should be owned and/or traded.

For longer-term, more conservative oriented equities, I prefer stocks of companies that have a market capitalization of more than $10 billion, which provide ample liquidity and tend to have smaller volatilities than small cap growth and/or resource type securities. Dividends are appreciated, but not sufficient to keep us committed to equities. When stocks fall below the 200-day moving average, and more importantly by the time the 200-day moving average is falling, it's time to cut losses and/or take gains irrespective of personal biases. Large losses kill investment portfolios.

For growth-oriented equities that I seek out for my Aggressive Growth Fund, I have several preferred criteria for any potential investment. I screen for stocks that have a market capitalization greater than $250M (although usually find myself at $500M+) and have average dollar volume of more than $15 million dollars traded on any given day. I am comfortable with being a maximum of 5% of the daily volume to either take or exit a position.

I follow all kinds of top down macro-oriented indicators and relationships, which give me a strong feel for the type of market environment that we are faced with. Conducting regular analyses of the relative strength between multiple asset classes, sectors and/or securities is crucial to having the pulse of the market. I have an extensive library of charts that I view regularly to stay on top of things. I regularly conduct intensive research into the various sectors, industries and companies within these segments in search of opportunities. I prefer companies that are market leaders in terms of relative price performance (performing more strongly than the market) and are leaders in their respective sector and/or industry groups.

I don't pay attention to the opinion of analysts, BNN or the crowd as I find much more value in following the markets themselves. The market reflects the collective opinion of all investors, globally, whether retail or institutional investors, informed or not informed, and it's fair to conclude that their opinion is more important (to me and my clients) than my own. The market is always right. Trying to force an opinion on the market and/or take a stance contrary to market conditions is foolish. If you're right, buy more. If you're wrong, admit it and move on. As is often quoted, markets can remain irrational for longer than you or I can remain solvent. Don't fight the trend.

A solid growth company does not equal a solid growth stock, and does not necessarily translate into above-average returns. Paying too much for a good company is not a sensible move and making a good decision requires patience in evaluating an appropriate purchase point.

Swing Trading

Swing trading is the technique of buying into short-term oversold pullbacks and riding the stocks higher for a period of typically 3-10 days, which is when the bulk of the gain tends to occur. After the stock experiences the initial bounce, I find that stocks then trade sideways, before often pulling back, possibly before trying to move higher again. By standing aside when the short-term rise is over and/or stalls out, you can protect your capital and save it for a more opportune stock that has just pulled back elsewhere.

Trend Trading

I primarily use moving averages in the determination of trend. The ADX is also a useful measure. When stocks are in an uptrend, the key is to stick with them until the trend ends. In that regard, I use volatility stops, which tend to only trigger when the trend is in the process of shifting and/or becoming more vulnerable.

Stop Losses

I use a wide variety of stop points in planning my exits from a security. These stops include: volatility stops, key support/resistance, recent pivot lows, 8% max loss, 20/50/200-day moving averages and profit stops. The last of which I designed to prevent having paper gains turn into losses, and I've found it quite useful in the past 15-months. If a position shows a gain of more than +10%, then I want to ensure that we exit with at least 50% of the gain. So if the stock subsequently falls and it is only +5% from purchase point, I sell it. Have you ever had a stock gain turn into a loss? I find it frustrating, and this rule is a non-emotional way to try to prevent it from happening too often (yes, gap downs can cause issues with this otherwise graceful exit).

Independent Research

I do all my own research, and my clients know that I wake up at 4am every (week) day irrespective of which time zone I'm in to run my daily research process. I enjoy having my morning coffee, while listening to some great music and running my screens and looking at charts while most of the rest of us (in my local time zone) sleep! My primary equity research tools are the High Growth Stock Investor (HGSI) and Metastock.

As a dual holder of both the Chartered Financial Analyst (CFA) and Chartered Market Technician (CMT) designations, I have a responsibility to use "independent, professional judgement", and I take my responsibility very seriously. This means that after any investing decision, I can tell you exactly which factors, circumstances and/or behaviour led to my decision to buy or sell a given security and/or rebalance a portfolio.

I do not favour companies that are not generating any earnings and largely avoid speculative exchanges like the TSX Venture Exchange.

Exchange-Traded Funds (ETFs)

Exchange-traded funds are extremely useful tools that are increasingly available to today's investor. They are liquid baskets of securities that can provide instant exposure to a given asset, geographic region or sector. They are bought and sold like a stock and based on passive characteristics within their focus. They also tend to have a very low Management Expense ratio (MER). Sometimes, top-down analysis will point towards the probable expected success of a given sector, but a specific investment is hard to find. In this case, an investor can use an exchange-traded fund to take advantage of the broad trend expected, while they further their research in search of a suitable individual candidate for purchase.

I use ETFs to manage risk in a more conservative-oriented account or to establish an immediate position in a timely market if a stock-specific idea is not available, but can definitely say that I prefer investing in individual securities. Individual securities vary widely in terms of performance, and buying a strong relative strength stock that is the clear leader in a given industry is my preference. I have seen, too many times, a rally in a sector like energy which produces 3-5% gains in a week, while many stocks can move 20-25% in the same time frame. I'd prefer to own the latter, when at all possible.

Research Tools

My core research and analytics tools include: HGSI, Metastock, StockCharts.com. stocktickr.com, finviz.com and Excel. I am also a member of Spiketrade.com, a global trading group run by Dr. Alexander Elder and InvestedCentral.com.

Personally, I have built and developed a variety of spreadsheet tools, and routines over the years that I use to help with my quantitative screening, valuation determination, performance attribution and portfolio construction.

Anyone who has been in my office knows that I have an extensive investment library and I share my library with my clients, who are free to borrow books that may interest and educate them.

Reading List

I am often asked what types of publications and periodicals that I read outside of books, and this list includes: Investors Business Daily (IBD), the Economist, Financial Times, Barron's, Wall Street Journal, Globe & Mail, Canadian Business, Moneysaver, Golf Digest, Harvard Business Review, Whisky Advocate and Robb Report. I also read the various publications of some investment managers and analysts that I hold a high degree of respect for including: Martin Pring, John Bollinger, Larry Berman and Don Vialoux. Not coincidentally, all technical analysts.

Based on my past experiences, I have a wide variety of contacts around the globe who are involved in institutional portfolio management, buy-side research, sell-side research, private equity, venture capital investing, trading, investment banking, hedge fund management and private client management. These connections can add considerable value in enabling me to provide independent and unbiased thought, while offering an avenue to seek alternative opinion.

Summary

Investment research is a time-consuming exercise and successful investing requires a carefully designed investment philosophy that is consistent, disciplined and allows an investor to set their emotions aside. My investment philosophy, decision-making techniques and process have been developing over the past 17 years and continue to evolve. It (my process) is capable of taking risks in the current volatile investment climate of the last several years and allows clients to comfortably reduce risk in the face of adverse market conditions. As a discretionary-licensed Portfolio Manager, I am comfortable assuming the responsibility of determining when to take risks, and when to focus on preserving capital. The ability to shift rapidly between these two polar opposites has proven valuable in the market climate presented by this century.

I always welcome your questions, comments and feedback.

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