CIBC PRIVATE WEALTH

THE STAN CLARK FINANCIAL TEAM'S

PERSPECTIVES

IN THIS ISSUE:

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Resisting a bad habit is just a matter of willpower. Or so we believe. As I discuss in this month's behavioral finance article, our natural restraint bias leads us to be overconfident about withstanding temptation. We're still vulnerable, whether it be to smoking, overeating, not exercising enough – or being influenced into making unwise financial decisions. Michael Chu takes an intriguing look at the factors that go into selecting the best stocks. Tom Cowans explores the Consumer Price Index as a way of gauging inflation. And don't miss Sylvia Ellis's insights on life insurance as a tool for safeguarding your estate.

Stan

Stan Clark is a Portfolio Manager and Senior Wealth 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.

Behavioral Finance

THE RESTRAINT BIAS: HOW MUCH CONTROL DO YOU REALLY HAVE?

By Stan Clark, Senior Wealth Advisor

In an episode of the classic TV show *Seinfeld*, Jerry follows George's hot stock tip and buys some shares. George tells Jerry to be patient. The ever-confident Jerry is sure he can.

But the stock is slow to develop. Jerry starts obsessively reading the daily stock market reports, wincing every time he sees the stock drop another point or two. (If it were today, he would be checking online every few minutes!) Finally, in a panic, Jerry sells – losing more than half his money. A day or two later, George reports that the stock is soaring.

In this article I'd like to discuss the *restraint bias*, that is, the bias that leads us to over-estimate our ability to withstand temptation. In looking at this bias, we'll consider just how much control we really have over our urges.

> The restraint bias is one of the key behaviours that makes it so hard for people to quit smoking, to stop over-drinking (or any other addiction), to lose weight – in short, to avoid any number of harmful habits.

Clearly, Jerry should have restrained his urge to sell. Perhaps that's not a perfect example of restraint bias, but it comes close. As you may recall from reading previous issues of *Perspectives*, we humans have a number of ingrained psychological biases. These biases all lead to patterns of poor judgment. They can profoundly affect the way we behave in the stock market and in other areas of our lives, too.

The restraint bias is one of the key behaviours that makes it so hard for people to quit smoking, to stop over-drinking (or any other addiction), to lose weight – in short, to avoid any number of harmful habits.

People trying to lose weight are sure they can restrain themselves. They continue buying favourite snack foods, such as ice cream, thinking, "I'll just have one spoonful every now and then." Smokers may keep a few cigarettes on hand just in case, so they rationalize, something stressful happens. Or, they continue to engage in behaviours closely associated with smoking, like going out for drinks with friends.

Then there's the person who needs to get out and exercise. They intend to, sure. But first they switch on the hockey game for a few minutes "just to check the score" – only to end up sitting in front of the TV for the rest of the day.

The tell-tale snacks

In one study, researchers asked students both arriving at and leaving a cafeteria to rate a number of snacks, from least desirable to most. They then asked the students to select one of the snacks but not to eat it. The researchers told the students that if they brought the snack back in two weeks, they would receive a desirable reward.

Hungry students entering the cafeteria tended to pick a less desirable snack to avoid the temptation to eat it right away. But students leaving the cafeteria after a meal felt they could easily resist any snack because they were no longer hungry. So, they tended to confidently choose one of their favourite snacks. Guess which group resisted

TEAM TALK

Jocelyn Johansson
Wealth Advisor

Through COVID, did you learn anything new?

I joined (along with a dozen other moms) a learn to play hockey group session. We all have kids who play hockey and wanted to be able to get out on the ice with them. I think of myself as a fairly decent athlete, but I certainly don't look like one on the ice! I have now skated more in eight weeks than previously combined throughout my entire life!

Now that worldwide travel restrictions are easing, any plans to travel?

Yes, we have a booked a big trip to Sweden and Greece! We're going to spend a few days in Stockholm visiting friends at their home and then head to Corfu for a week of family fun as a big group. Our older kids are the same age and are like cousins. We have never been to Greece, so we are all very excited for this adventure. We'll return to Stockholm for a week with our friends before returning to Canada.

Curtis, Callan, Mattias and I on a walk in Caulfield (spot our dog, Bruce)

temptation best and exchanged their snacks for the promised rewards? That's right: the ones facing the least temptation.

On a personal financial level, simply carrying your credit card increases the likelihood that you will be tempted to buy something instead of saving your money. Listening to hot tips can tempt you to make bad choices about buying or selling. And following the news too closely can tempt you to abandon a carefully thought-out, objective investment strategy in hopes of – like Jerry – achieving a quick gain, or avoiding a loss.

It's a rare person who can resist temptation. Studies show the very people who believe they have the most willpower or self-control are the ones most likely to behave impulsively. And that brings us to the *overconfidence bias*, one of the most dangerous of all. We will talk more about this bias next time!

Investing

QUALITY IS KEY

By Michael Chu, Senior Wealth Advisor

Warren Buffett, one of the world's greatest investors, once said, "It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."

Companies that are consistently profitable and growing, and have solid balance sheets, sound like wonderful companies to invest in. In 2013, Cliff Asness of AQR Capital Management put out a study called *Quality Minus Junk*, which demonstrated that stocks fitting the quality mold produced better-than-average returns in the U.S. and 24 other stock markets around the world. This study covered companies between 1958 through 2018, i.e., 60 years' worth of data.

The fathers of *factor investing*, Eugene Fama and Kenneth French, originally identified two factors that seemed to produce higher-than-average returns: value and size. In the early 1990s, other researchers, including Asness, documented a third factor: momentum. Then there's quality, a newer-generation factor that includes things like profitability, accounting quality, earnings stability and growth. In this article, we'll quickly review value and momentum and spend more time on quality.

Good value stocks are those with low prices compared to underlying company fundamentals, such as price-to-earnings or price-to-book value. *Good momentum* stocks are those that surprise investors by doing better than expected, with analysts raising earnings estimates, reported earnings higher than expected and positive price movement.

How to measure quality?

Quality stocks are those with strong profitability, growth and safety. Such stocks justify higher prices, but their positive qualities are often underappreciated by the market and therefore mispriced. Some examples of quality measures are:

1. High return on equity, high profit margins, strong cash flows
2. Growing earnings, margins and cash flows
3. Low price volatility, low earnings variability, low debt to equity.

Intuitively, one would think that higher-quality stocks are more expensive than low-quality stocks – after all, they deserve to be higher priced. But the reason they're attractive investments is that the price premium tends not to reflect the full benefit of their quality. In other words, they're not expensive enough! Despite seeming more "expensive" than average to begin with, investing in high-quality stocks yields better returns over the long term.

Why would such stocks exist? Perhaps it's that investors assume high-quality stocks are already efficiently priced, so they naively look elsewhere for opportunities.

Back to the Asness study mentioned above. As noted, the *Quality Minus Junk* authors looked at 40,000 stocks over 60 years in the U.S. and 24 other developed countries. Quality stocks delivered higher returns in the U.S. and in 23 out of the 24 other countries (only New Zealand fell ever-so-slightly short).

In addition to higher returns, quality stocks provided a safety net during crises. This is because historically, such stocks command a higher premium as a result of a flight to quality after a crisis. So, returns from quality are extra-high during downturns.

The *Quality Minus Junk* authors also noted that, for the market to rationally put a price on quality characteristics, the characteristics need to be persistent. The study found that profitable, growing and safe stocks tend to retain these characteristics over the next five to 10 years.

In summary, quality stocks tend to earn higher returns and yet appear safer as well. What does this mean for us? The stock strategies created by the Stan Clark Financial Team use all three types of factors: value, momentum and quality. As we've mentioned before, each factor works well on its own, but when combined with the other factors, the results are even better. Some strategies lean towards one type while others are a blend of factors.

The end result for our clients is a portfolio of stocks covering the full spectrum of factors that have provided above-average performance. We'll talk about this more in our next article on quality.

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.

Asset Allocation

THE CPI: HOW – AND HOW WELL – IT WORKS AS A MEASURE OF INFLATION

By Tom Cowans, Portfolio Manager, Wealth Advisor

After the 2008 global financial crisis, the main concern of central banks was *deflation* – prices falling to such an extent that would push economies into depression. However, due to effects of the COVID-19 pandemic and subsequent actions taken by governments and central banks, the pendulum swung the other way. There has recently been a resurgence of inflation to levels not seen in over 40 years.

Inflation is defined as the rate of increase of prices and the subsequent loss in a currency's purchasing power. The measures of inflation quoted most often in the Canadian press are the Consumer Price Index (CPI), and the CPI-trim, which strips out the extreme price movements of the top and bottom 20% of the CPI basket.

Statistics Canada (Statcan) calculates both the CPI and CPI-trim. How? Statcan collects information on over 700 goods and services that Canadians typically buy each month. Statcan then adds up the total cost of this basket of goods to track the month-by-month changes. They weight the basket based on the combinations of goods bought across different geographical areas. For that reason, the spending habits of Ontarians have the largest impact on the CPI figures. Statcan updates and weights the consumer baskets every two years.

Like any type of index, the CPI operates with various assumptions and rules. These, in turn, govern how each basket is put together. People often differ on how relevant or accurate a basket is for their own individual circumstances. For example, the health and personal care portion of the basket might be larger for seniors. The shelter cost might be larger for those people with a mortgage or renting.

Another example: Just as many investors own a different basket of stocks and bonds at any one time, each consumer in the economy has different spending habits. Therefore, each has different opinions as to how relevant the CPI figure is.

Note that the CPI figure is meant to be a sample of the spending habits of the *average* of the population. Many people vary from the average, and like any sampling process CPI's is subject to sampling error and biases.

Below is the CPI composition in Canada as of April 2022:

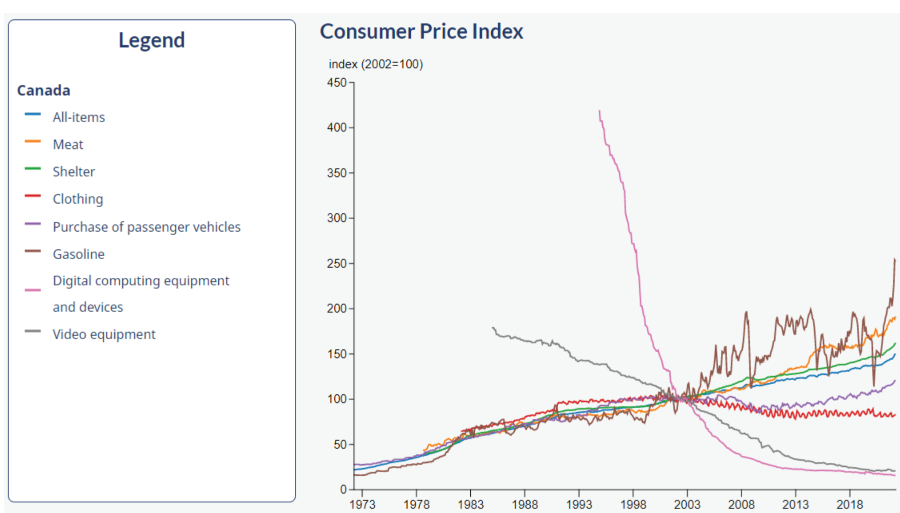
	Relative Importance %	Current Level (2002=100)	Annualized Growth %	Apr. '21 - Apr. '22 %
All ITEMS	100.00	149.8	2.04	6.8
Food	16.24	169.0	2.66	8.8
Shelter	30.03	161.9	2.44	7.4
Household operations, furnishing & equipment	14.89	129.8	1.31	4.1
Clothing & footwear	3.99	95.1	-0.25	0.2
Transportation	15.96	166.3	2.58	11.2
Gasoline	3.57	251.7	4.72	36.3
Health & personal care	4.68	137.0	1.59	3.4
Recreation, education & reading	9.40	121.6	0.98	4.1
Alcohol, tobacco & recreational cannabis	4.80	179.8	2.98	3.1

Gasoline prices have gone up the most in the past 20 years. In the past two years, gas prices soared from a very low base. (Remember when oil briefly went below $0 in April 2020?!) The cost of clothing and footwear has actually fallen in nominal terms. Both items still represent relatively small parts of the average consumer basket of goods. Shelter, household operations, furnishing and equipment, and food and transportation collectively represent just over 75% of the average consumer basket.

The main contributing factors to the recent surge in inflation have been increases in the larger components of CPI: food, shelter and transportation.

Some aspects of the sampling process have been shown to overestimate inflation, notably:

- **Lag time in adjusting the index:** Due to infrequent rebalancing, any new consumer goods or technologies that effectively lower prices for consumers

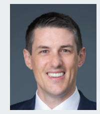


are not instantly reflected in the CPI.

- **Substitution bias:** Say the price of beef goes up. As a result, the consumer eats more chicken. The CPI still assumes the same amount of beef is being eaten. In reality, differing items have different elasticities of demand, with some items being more easily substituted than others.

The Bank of Canada's interest rate policy often focuses on the CPI-trim, which strips out extreme components not viewed to be sustainable changes. Why? The sometimes highly volatile price changes in food and energy have not shown to persist over time. Not surprisingly, the Bank's approach has come under criticism. Food and energy tend to make up a larger portion of some people's expenses as a proportion of their overall cost of living.

In our Personal Financial Plan process, we incorporate the CPI to reflect how your government and other pension benefits might grow. However, we also have the ability to separately define your own personal change in spending. This is important if you believe your spending changes might differ from the CPI now and into the future.



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

Financial & Estate Planning

SAFEGUARDING YOUR ESTATE: THE ROLE LIFE INSURANCE CAN PLAY

By Sylvia Ellis, Senior Estate Planning Advisor

Life insurance has several uses: estate preservation; income replacement; business planning; an investment alternative; and charity, among others. For this article, we'll focus on the first use.

Estate preservation deals with liabilities that result from death: capital gains tax, probate fees and other estate costs. You calculate the liabilities and determine the total funds that will be required to cover them. You then compare different funding methods, taking into account the time value of money.

Under normal circumstances, when one spouse dies, the deceased spouse's assets can be transferred tax-free to the other spouse. But when someone dies without a spouse, as would be the case with the surviving spouse, this triggers a tax liability.

Canadian residents without a spouse are deemed to have disposed of their property for fair market value immediately before death. Assets such as stocks, company shares or recreational property are subject to taxation on the increase in value above the initial cost base. Assets such as Registered Retirement Savings Plans (RRSPs) and Registered Retirement Income Funds (RRIFs) are collapsed and fully taxed as income.

The table to the right illustrates a basic scenario and anticipated taxes at death.

	Principal residence	Summer home	Investment portfolio	RRSP
Current value	$1,500,000	$750,000	$1,000,000	$500,000
Adjusted cost base	$ 750,000	$250,000	$ 750,000	Fully taxed as income
Capital Gain	$ 750,000	$500,000	$ 250,000	
Taxable capital gain (50%)	0	$250,000	$ 125,000	
Tax payable (50%)	<0>	<$125,000>	<$62,500>	<$250,000>

The total tax payable, not including probate fees, is $437,500. (The tax could actually be higher today, given the top bracket of 53.5% in BC, but for simplicity I have used 50%.) Consider your own situation. What are your options for paying these taxes, and which option would be the most cost-effective?

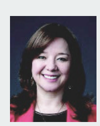
You or your estate could:

- **Establish an investment account** in which you set aside money over a number of years, with the goal of having enough to pay taxes due at death. The problem is that there is no way of knowing how long you have to save. Furthermore, income earned on these savings is taxable.
- **Your executor could sell assets.** For liquid assets, this is not an issue. For non-liquid assets, such as real estate or company shares, the problem is that they may potentially have to be sold below market value. In addition, it is important to remember that a liquidated asset can no longer generate income or appreciate in value.
- **Your executor could borrow the funds needed.** However, there are several disadvantages. Will a bank lend the money? What collateral will the bank require? And, will the revenue generated from the remaining assets be sufficient to repay the loan and the non-deductible interest?
- **Purchase life insurance.** Where health is not an issue, life insurance could be purchased to offset the potential tax liability. The incident that creates the tax liability (i.e., the death of the last spouse) can also be the incident that creates the cash to fund the tax liability.

When we do a comparative analysis, life insurance often comes out as the most cost-effective and tax-efficient option. Viewing life insurance as another asset class in your investment portfolio, you may see, as others have, that it can be a good way of funding the tax liability at a reasonable cost.

Life insurance premiums may also be guaranteed. And, most importantly, the death benefit is paid tax-free to your beneficiaries or estate.

Regardless of your intentions, when it comes to passing on assets to your heirs, proper planning is imperative. If you are concerned about preserving the value of your estate and want to ensure your heirs receive it in the most tax-efficient and timely manner, please do not hesitate to contact us. We'd be more than happy to do a review and provide you with options for consideration.



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. In making decisions, our *restraint bias* can:

   a) Cause us to be overly cautious

   b) Prevent us from indulging in the occasional expensive treat

   c) Lead us to over-estimate our ability to withstand temptation

   d) Ensure that we never take up bad habits

2. In judging the quality of a stock, we should take into account:

   a) High return on equity, high profit margins, strong cash flows

   b) Growing earnings, margins and cash flows

   c) Low price volatility, low earnings variability, low debt to equity

   d) All of the above

3. According to the Consumer Price Index, over 75% of Canadians' expenses go toward shelter, household operations, furnishing and equipment, and food and transportation:

   a) True b) False

4. As you plan for your estate, making life insurance another asset class in your investment portfolio can be:

   a) A confusing concept

   b) A good way of funding the tax liability at a reasonable cost

   c) A way of creating yet more paperwork

   d) Something to put off and think about another day

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, 2022.

Trivia challenge runs June 1 - 29, 2022. 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.