CIBC PRIVATE WEALTH

THE STAN CLARK FINANCIAL TEAM'S

PERSPECTIVES

IN THIS ISSUE:

Pg. 1 The planning fallacy: How optimism can lead to poor investment decisions
Pg. 2 Team Talk
Pg. 2 Quality is key (part 2)
Pg. 3 Maybe not a recession, despite negative growth
Pg. 4 OAS: To defer or not? And for seniors 75+, an increase
Pg. 5 SCFT Trivia

Volume 13 – Issue 6 **September 2022**

STAN CLARK
Senior Wealth Advisor

As I discuss in this month's behavioral finance article, we should beware of our innate optimism making us overconfident – and leading us into unwise decisions. Michael Chu finds that, despite slowing economic growth and rising interest rates, we may be avoiding a recession. And, continuing his look at quality stocks, Michael explains how we choose such stocks for your portfolio. Sylvia Ellis describes the advantages of deferring Old Age Security pension. Sylvia also details the government's recent increase to OAS – the first in 50 years.

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 PLANNING FALLACY: HOW OPTIMISM CAN LEAD TO POOR INVESTMENT DECISIONS

By Stan Clark, Senior Wealth Advisor

Late in 2009, Vancouver opened the Canada Line in time for the 2010 Winter Olympics. The Canada Line proved a huge success, daily carrying almost 200,000 passengers during the Olympics. And it's had strong ridership numbers ever since.

When the project began, planners optimistically estimated costs for the line at $1.3 billion. But the final cost was nearly double that: $2.5 billion.

I don't intend this to be a criticism of business practices or how governments spend public money. Rather, I'm giving an example of what Daniel Kahneman, author of *Thinking Fast and Slow*, calls the *planning fallacy*: a cognitive malfunction that arises, in part, from our innate human bias toward optimism in the planning process. In this article I'd like to discuss the planning fallacy – and how optimism can lead to overconfidence and poor investment decisions.

According to Nobel Laureate Kahneman, when we are personally engaged in a task, especially a complex one, we have an "inside view" of it. That inside view biases us to be more optimistic about our projections and chances of success than an informed outsider might be.

For instance, in one study, U.S. homeowners who optimistically projected the cost of remodelling their kitchens at $19,000 actually ended up paying closer to $39,000. Most people just seem to be innately optimistic. It's a bias that serves us well in some areas, like health and happiness. But it can also lead us into making plans and basing forecasts on unrealistic, best-case scenarios, ignoring a host of facts and statistics that may tell us otherwise.

For example, one measure of optimism in a CEO is how much of their company's stock they own. Kahneman reports that it is the most optimistic CEOs who overconfidently make the worst corporate decisions. These CEOs borrow money for growth, rather than raising equity capital. They pay too much for acquisitions. They merge with companies that diminish their focus, increase administration costs and saddle the merged entity with debt.

Optimism and overconfidence also lead inventors and entrepreneurs to soldier on, pouring money, often their own savings, into projects or enterprises that any objective outsider would declare hopeless. Optimism makes us feel more confident than we should. Meanwhile, the planning fallacy can cause us to underestimate how much time or money it will take to succeed.

And what about the world of investing?

Far too many traders, whether individual or institutional, have faith that their knowledge, skills, technology and reading of where the overall market is trending will enable them to *time the market*: to buy low and sell high, and thus profit. But there is no evidence that anyone has been successful doing this repeatedly.

It's clear that optimism suppresses doubt, begets overconfidence and leads to blindness to risk and uncertainty. Excessive optimism promotes faulty planning and poor decision-making. It is part of a combination of biases that influences investors to:

- buy and sell stocks too frequently and too quickly as they attempt to time the market
- hang on to overvalued or losing stocks too long because of short-term loss aversion

TEAM TALK

Michael Chu
Senior Wealth Advisor

What have you been up to?

Have been doing some local travelling. In August, I took the ferry to Sidney and rode my bike down and around Victoria. For the bike/walk enthusiasts, there are seemingly unlimited miles of scenic paved routes on Vancouver Island. I haven't been to Victoria in several years... there's lots of construction going on but it's nice to see they're able to preserve the old Victoria charm. Plus with all the hot weather we've been having, the sea breeze in Victoria makes it nice and cool.

Victoria's Chinatown looks exactly the same as it did years ago. Maybe a few new modern restaurants, but many of the original looking businesses are still there. Fun fact: Victoria's Chinatown is the oldest in Canada and second oldest in North America (San Francisco). It also has the narrowest street in Canada. The narrowest part of the street is only about four feet wide and is filled with brick and boutiques.

Riding through Victoria's Chinatown

- underestimate risks to their long-term investment goals
- confuse luck with skill – just because a stock has increased as they predicted doesn't mean they are the beneficiaries of anything other than luck, and
- ignore the long-term trends that are the real strength of the market.

As we've said before and will repeat often, investing for wealth and security is not a short-term activity. It means developing long-term strategies that benefit from the reliable, long-term growth in the value of businesses.

It's important to make decisions based on objective criteria and information that have not been biased by optimism or overconfident projections.

Investing

QUALITY IS KEY (PART 2)

By Michael Chu, Senior Wealth Advisor

In our previous article on Quality factors we discussed how selecting companies that fit the quality mold produced higher than average investment returns. Now let's look at some of those factors we use to select stocks for your portfolio.

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.

Most measures have been tested by researchers over several decades across various countries. This gives us confidence that the factors in each measure are sound and should continue to work in the future.

Further, the sophisticated back-testing system we use for our models can test the effectiveness of each variable, using realistic assumptions, going back to 1996 or longer. For example, a portfolio of stocks that we choose based just on return on equity (ROE) will have outperformed the market by 3.7% per year, on average. Of course, to properly evaluate a variable, we look at more than just one number. But that's a good starting point.

One consideration is how a portfolio does in different types of markets. For example, does its ROE do better in up markets or down markets? Ideally a portfolio will do well in both. However, it's also acceptable for a portfolio to be stronger in certain types of markets. In the above example, the portfolio's ROE does very well in down markets and okay in up markets. You can think of its ROE as being more the defensive type.

We also look at performance consistency over the years. In the 26 years since 1996, did the portfolio massively outperform over just a few sporadic years, or moderately over the majority of years? A more powerful variable will be one that performs more consistently. In this case, on a calendar-year basis, the ROE outperformed in 18 of 26 years, or 2/3 of the time, which is pretty good.

Let's look at another variable. The 5 Year Earnings Growth (5YEPS) is, as its name suggests, the growth in earnings over the previous five years. If we picked stocks just based on this variable, over the last 26 years the portfolio would have outperformed the market by 2.9% per year, on average. As before, it's important also to look at other results. 5YEPS outperforms 59% of the time in up markets and 52% of the time in down markets. On a calendar-year basis, this variable outperformed in 16 of the 26 years.

As we can see, the stocks did well when we used ROE; also when we used 5YEPS. But what happens if we pick stocks using both variables? Based on both, the portfolio returns 4.4% better than the market – higher than each variable on its own.

At first glance that may seem counterintuitive. But basically what's happening is that we're getting better results because the variables are un-correlated. For example, if one variable is not doing well for a certain period, it could be the case that the other variable compensates. So, overall, better results.

Some of the consistency metrics are better, too. Both variables combined outperform in 58% of up markets and 61% of down markets. On a calendar-year basis, the combined strategy outperformed in 20 of 26 years. Again, the variables work better together than each on its own.

Our Quality Strategy uses several more variables – each making the strategy better with more performance or better consistency metrics.

How do we use the Quality Strategy in our investment process? It's one of several strategies we use to help create our portfolios. Each strategy focuses on a distinctive combination of value, momentum and quality factors. And each strategy, on its own, has produced better-than-average results in the past.

Our unique approach to portfolio construction is that we combine top-ranked stocks from all the various strategies into each efficiently diversified portfolio. This design helps reduce risk – while maintaining our expectations of outperforming.

Asset Allocation

MAYBE NOT A RECESSION, DESPITE NEGATIVE GROWTH

By Michael Chu, Senior Wealth Advisor

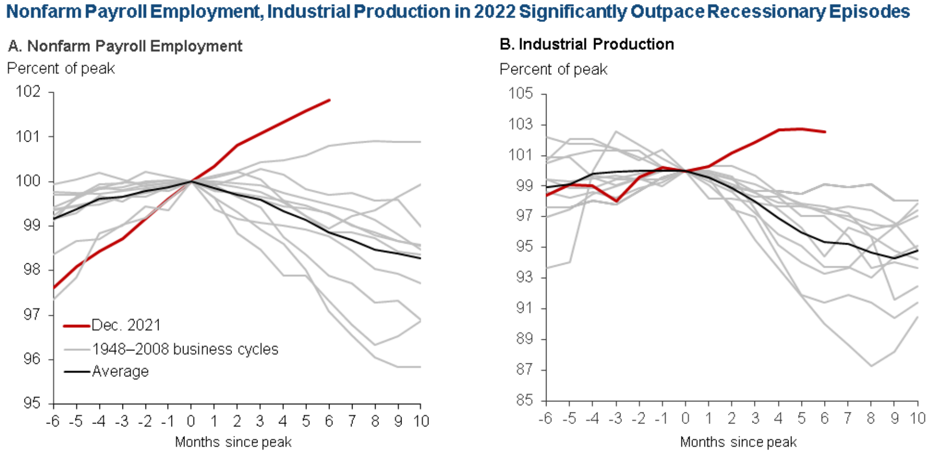
With slowing economic growth and rising interest rates, recession is a popular topic these days. Continuing the discussion from our recent *Mid-Year Review*, we thought it would be timely to delve a little deeper into this subject.

The layperson's definition of *recession* is two consecutive quarters of falling real economic growth. That's easy enough to measure and remember. However, sometimes the economy can drop for odd technical reasons that are not true indicators of economic weakness. The official determination of a recession is based on a broader look at the data – including the labour market, consumer and business spending, industrial production and incomes. For the U.S., the National Bureau of Economic Research (NBER) is the official scorekeeper, defining a recession as "a significant decline in economic activity that is spread across the economy and lasts more than a few months."

The tricky thing is that there are no fixed rules or thresholds that determine what, precisely, constitutes a decline. Also, there's a lag in the reporting of some economic data, so usually the NBER cannot say if we are in a recession until well after it starts.

In the U.S., the economy contracted 1.6% on an annualized basis in the first quarter of 2022 and was followed by a 0.9% decline in the second quarter. While this meets the simple definition mentioned earlier, there are arguments that the U.S. did not fall into recession. The Federal Reserve Bank of Dallas put out its argument for why this might be the case:

Nonfarm Payroll Employment, Industrial Production in 2022 Significantly Outpace Recessionary Episodes

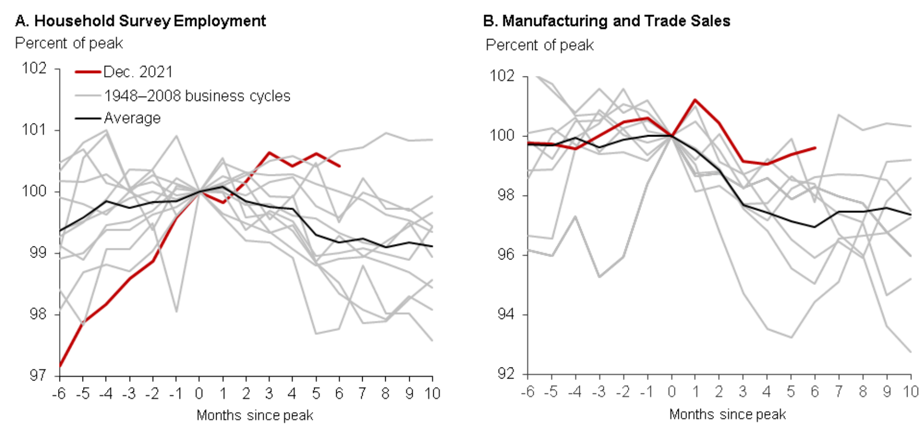


NOTE: Horizontal axis "0" denotes peak of business cycle, with preceding and succeeding months depicted.
SOURCES: Bureau of Labor Statistics; Federal Reserve Board of Governors; National Bureau of Economic Research; authors' calculations.
Federal Reserve Bank of Dallas

Employment and industrial production are two factors that NBER uses. The grey lines show the movements in previous business cycles. The black line is the average and the red line is what's happened in the past year. As you can see with the red lines, employment and industrial output have both been much stronger than in every previous recession at a similar point.

This strength, not typical for a supposed recession, held for other measures, too:

Alternate Measure of Employment, Goods Sales on Upper End of Recession Paths



NOTES: Horizontal axis "0" denotes peak of business cycle, with preceding and succeeding months depicted. Manufacturing and trade sales are measured in 2012 dollars.
SOURCES: Bureau of Labor Statistics; The Conference Board; National Bureau of Economic Research; authors' calculations.
Federal Reserve Bank of Dallas

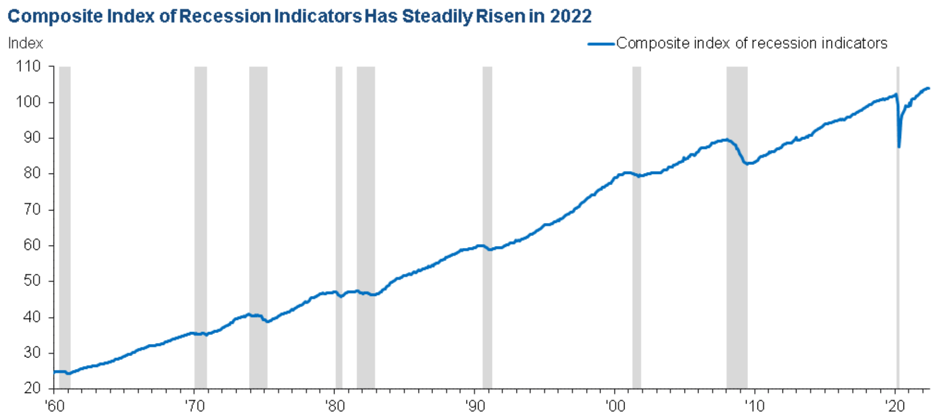
While not as prominent as in Chart 1, the red lines remained at the higher end of the distribution and are much higher than average recession paths. Similar charts exist for consumption and income.

We can also look at a composite of recession indicators. The chart on the following page shows that, from 1959 onwards, there was a decline from the peak point in every recession. But there has been no decline in recent months.

But how to explain the contraction in the economy, despite positive economic indicators such as employment and industrial production? The contraction could be due to a number of things: lower worker productivity, drop in inventories, ongoing supply chain issues and the war in Ukraine. These could cause the headline numbers to go negative while the economy is still reasonably strong.

Recession talk in and of itself can have an impact on changing people's economic behaviour. Too much talk could even cause or worsen a recession. That's perhaps why policymakers are reluctant to use the "R" word, especially so close to the U.S. mid-term elections. On the other hand, concern over recessions can also help to reduce excesses, lessening any subsequent need to correct those excesses.

So what does all this mean? According to the Dallas Fed, a recession is unlikely to have started in the first quarter of 2022. Of course, going forward, things may change (for either better or worse), but the Fed's comment also tells us that things are not always as simple as they seem. The economic slowdown we've seen so far this year may not be the game-changing "official" recession so widely feared. If a real recession does shows up, hopefully it will be mild. It's also possible that we avoid a recession and instead enter a period of slower and more sustainable growth that dampens inflation expectations. This



NOTES: Indicators include nonfarm payroll employment, industrial production, real consumption, real personal income minus transfers, employment from the household survey and manufacturing and trade sales. The growth rate is a weighted average, with the weights inversely proportional to the input series' growth rate standard deviation. Gray bars indicate recessionary periods.
SOURCES: Federal Reserve Board of Governors; Bureau of Economic Analysis; Bureau of Labor Statistics; National Bureau of Economic Research; authors' calculations.

Federal Reserve Bank of Dallas

is exactly what the Federal Reserve, Bank of Canada and other central banks are trying to achieve by increasing interest rates, reversing quantitative tightening, and their "threats" to keep doing so until inflation is tamed. It's very tricky, like maneuvering a supertanker through an obstacle course, and only time will tell how successful they will be.

In any event, conflicting opinions are another reason why having a financial plan that is resilient and stress-tested through a range of scenarios – and then sticking to that plan – is key to your long-term financial success.

Financial & Estate Planning

OAS: TO DEFER OR NOT? AND FOR SENIORS 75+, AN INCREASE

By Sylvia Ellis, Senior Estate Planning Advisor

Many of you are aware that the Old Age Security pension (OAS) is available to Canadian residents 65 years or older. And that, to collect OAS, they must have lived in Canada for at least 10 years since the age of 18.

Unlike the Canada Pension Plan (CPP), the government does not consider your employment history in determining your eligibility for OAS. Whether you've worked or not is irrelevant. What they do consider, however, is the extent of your residency. You will qualify for a full OAS pension if you have resided in Canada for at least 40 years after age 18. If not, the government calculates your benefit based on your number of years as a resident divided by 40.

All OAS benefits are indexed on a quarterly basis, ensuring they maintain their value over time. The increases are calculated using the Consumer Price Index (CPI), which measures changes in prices paid by Canadian consumers for goods and services.

OAS benefits do not decrease. They either increase or stay the same.

What's the current maximum you can receive? In July 2022, the maximum OAS benefit increased by 2.8% to $8,001.96 per year. Retiring Canadians can further maximize their benefit by delaying their OAS from age 65 to 70. Delaying by one year would increase your benefit by 7.2% for the rest of your life. Delaying until age 70 would increase your OAS benefits by 36%. As noted above, you cannot access your OAS earlier than age 65.

Let's not forget clawbacks. If your taxable income is over a specified threshold, your OAS amount will be reduced by 15% for every dollar over the threshold. The threshold for 2022 is $81,761. If your 2022 income is $95,000, then your repayment would be 15% of the difference between $95,000 and $81,761, for the July 2023 to June 2024 period. A full clawback would apply when net income reaches $134,253.

On July 1, 2022, a major change occurred. The Canadian government increased OAS for those age 75 and over by 10 per cent. It was a significant move: the first permanent raise to the pension (other than CPI increases) in nearly 50 years.

Take OAS now, or defer it?

One planning question to consider as you near age 65 is: "Should I start taking OAS now or should I defer it?"

Let's start by doing the math. Say you expect to live to normal life expectancy. Assuming there are no substantial changes to the clawback tests, it makes sense to defer uptake until age 70. The 10% increase introduced this year makes the case even stronger for doing so.

According to an analysis by Bonnie-Jeanne MacDonald at the National Institute of Aging, the average Canadian is giving up $13,000 in lifetime income – $9,000 for men and $17,000 for women, in today's dollars – by *not* delaying benefits. In her calculations, MacDonald took the extra payments you receive from age 70 onward (including the 10% boost), and subtracted the five years of payments you miss by not deferring.

Another advantage to deferring is that it will add to your residency requirement. Say by age 65 you have fewer than 40 years of residency. After age 18, you will receive a prorated partial payment. You can benefit from postponing OAS to extend your period of residency (but not beyond age 70).

Now for the drawbacks in deferring OAS. The percentage benefit of deferring it is less than for delaying CPP, which adds 42% (vs. 36%) at age 70. If you defer both CPP and OAS, you might need to draw down on your other assets to support your living needs. Then there's the emotional – and not unreasonable – perspective, i.e., "I want to ensure I get something from OAS, so I better take it as soon as possible."

And maybe the partial or full clawback based on your income level will increase over time. We just don't know what changes lie ahead. CPP is much less likely to be affected by future tax increases because pensioners have contributed to CPP and have a stronger entitlement to it. So, it makes much more sense to defer CPP than OAS. But for some people it might make sense to defer both.

As you can see, there's no concise answer to deciding whether to defer OAS. As always, we highly recommend discussing this topic with your financial advisor or accountant to determine what is best for you.

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. Nobel Prize winner Daniel Kahneman defines the planning fallacy as:

   a) A mistaken belief in the importance of planning

   b) A cognitive malfunction that arises, in part, from our innate human bias toward optimism in the planning process

   c) The tendency to be overly cautious when making plans

   d) Being too pessimistic to believe plans will ever result in success

2. The recent contraction in the economy, despite positive economic indicators such as employment and industrial production, could be due to lower worker productivity, drop in inventories, ongoing supply chain issues and the war in Ukraine:

   a) True

   b) False

3. In choosing quality stocks, i.e., with strong profitability, growth and safety, the Stan Clark team looks for stocks with:

   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

4. On August 1, 2022, the Canadian government announced the following about the Old Age Security (OAS) pension:

   a) From now on, only those residents born in Canada will receive OAS

   b) All residents aged 65+ will receive a very small increase to OAS

   c) OAS will increase for those age 75 and over by 10 percent

   d) Any increases to OAS are postponed until 2023

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 Spetember 30, 2022.

Trivia challenge runs Spetember 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.