CIBC PRIVATE WEALTH

THE STAN CLARK FINANCIAL TEAM'S

PERSPECTIVES

IN THIS ISSUE:

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STAN CLARK
Senior Wealth Advisor

Herding, or following the crowd, isn't always an emotional behaviour. As I discuss in this issue, some investment managers practise herding deliberately. By joining other investors to chase after popular stocks, they achieve impressive results – but in the short term only. In our *Quarterly Economic Update*, Michael Chu and I look at how, despite recession forecasts and rising interest rates, the economy remains resilient. And Tom Cowans explains why Tax-Free Savings Accounts (TFSAs) are a great way for Canadians to build their financial assets tax-free.

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

CAN PROFESSIONAL MANAGERS BE FOOLED BY 'HERD BEHAVIOUR'?

By Stan Clark, Senior Wealth Advisor

In previous articles, I have talked about the *herding* phenomenon: How it not only causes market bubbles and crashes, but also stocks to be over- and undervalued.

This month, let's examine why supposedly savvy fund managers are susceptible to herding behaviour, sometimes even adopting it as a deliberate strategy.

We'll start with the late, brilliant British economist John Maynard Keynes, perhaps best known for advocating government spending to break the downward spiral of an economic depression. What's less known is that Keynes wrote extensively on the psychology of investing – and on the errors both amateur and professional investors make. Keynes's theory on government spending remains controversial. However, no one disputes that he was an astute investor. His insights are well worth learning.

To illustrate investor behaviour, Keynes used the following example: Suppose newspaper readers must choose the six prettiest faces out of 100. To win the contest, you also have to rank the contestants in order of popularity. In other words, you aren't choosing based on your own preferences about beauty. You're guessing the average preferences of all other readers.

Keynes said that similarly, rather than choosing stocks based on the investments' actual worth, investors try to guess what other investors will do. They herd with the crowd to chase after popular stocks. The more focused investors are on short-term results, the more likely they are to use this herding behaviour.

Professional fund managers, whose main customers are institutions such as pension funds or foundations, are especially prone to herding. The institutions keep these fund managers under a constant microscope, comparing them to other money managers, and often with a short-term focus. This punishes anyone who acts differently from the crowd. Keynes warned, "Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally."

In *How Markets Fail*, John Cassidy refers to a recent study that confirms Keynes's view: "If an investment manager goes with the crowd and things turn out badly, he gets to share the blame with everybody else; if he follows a contrarian strategy, he bears sole responsibility for his mistakes."

The problem is often magnified because most pension funds are foundations run by board members who are not necessarily investment experts. Keynes wrote that those adopting an approach different from the crowd "will in practice come in for the most criticism whenever investment funds are managed by committees or boards."

The tendency to follow the crowd could be a major reason most mutual funds underperform the market averages. Leading fund managers such as Peter Lynch and Warren Buffett succeed by acting independently; by not investing like everyone else. Early in their careers both Lynch and Buffett experienced one of the major pitfalls of value investing. They bought in too soon, when prices had fallen enough to make an investment seem good value – only to have the market continue to fall because of herd behaviour. But they learned from this, persevered and in the end succeeded.

How to protect yourself from herding? First, be wary of money managers using subjective approaches that can be influenced by herding. Find out if they cater mostly to institutional investors. If they do, their investment philosophy could be too geared to short-term results. Ensure they use a process not to protect themselves from looking foolish – but one with objective criteria for picking stocks likely to outperform.

TEAM TALK

Elaine Loo
Wealth Advisor

Fun night at The Pumpkin After Dark event in Burnaby (Oct. 2023)

What is one of your favorite quotes?

Why put off to tomorrow what you can do today? I love using it on my kids on a daily basis!

What is your favorite time of the year?

Christmas - the snow, lights and food are the best! Everyone seems so happy and I love watching the family rip all the presents open!

If you could witness any event past, present or future, what would it be?

Definitely the night my parents brought me home from the hospital after I was born. It was cold and snowing and my dad forgot the house keys. I would love to have seen my mom's angry face and my dad's fearful expression while waiting in the car, with me bundled on her lap, waiting for the locksmith.

What got you into trouble growing up?

When I was 10 years old, I was singing very loudly in the back of the store while my dad was dealing with customers out front. I got into major trouble and I knew it was bad because he never yelled at me.

Quarterly Economic Update

DESPITE EARLIER PREDICTIONS, THE ECONOMY PROVES RESILIENT

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

In recent months one theme has characterized the economy: rising longer-term interest rates. Interestingly, the pressure for higher yields is mainly due to the economy's strength. U.S. Federal Reserve estimates are predicting as high as 5% growth.

After a strong first half of 2023, the third quarter was negative for stock markets around the world. At home, the TSX was down 2.2% for the quarter. The World Equity Index, a gauge of stocks around the world, was down 1% (in C$). So far though, despite the negative third quarter, the stock market has remained well into positive territory for the year.

	3rd Qtr. 2023	Year to Date 2023	Trailing P/E	Trailing Eanings Yield	Dividend Yield
Canada (S&P/TSX)	-2.2%	3.4%	14.9	6.7%	3.4%
U.S. (S&P 500)	-0.8%	13.3%	22.9	4.4%	1.6%
Europe	-2.5%	9.8%	13.9	7.2%	3.3%
Japan	-4.2%	9.4%	15.7	6.4%	2.3%
EAFE (Europe, Australia, Far East)	-1.7%	7.3%	14.4	6.9%	3.2%
Emerging Markets	-0.5%	2.0%	14.1	7.1%	3.1%
World	-1.0%	11.3%	19.5	5.1%	2.1%

Source: Bloomberg

Valuations

Top economist Ed Yardeni is expecting significant growth in earnings. Yardeni's forward estimate (next 12 months) for the U.S. S&P 500 is 243. That implies a forward price-to-earnings (P/E) ratio of 17.6 (vs. trailing 22.9) and a forward earnings yield of 5.7% (vs. trailing 4.4%). Forward earnings are based on the expected earnings over the next 12 months. Consensus analyst expectations are similar to these.

Yardeni also estimates full 2024 and 2025 earnings will grow, to 250 and 270 respectively. The average P/E ratio over the last 152 years is 16.0. So, if forecasted earnings are in the ballpark, today's valuation of U.S. stocks is only slightly above average. And if you remove the more expensive technology stocks, the P/E ratio falls a few points, so there are many other companies at better valuations. The key will be how much earnings grow – which can change valuations significantly.

According to Professor of Finance Jeremy Siegel, of the University of Pennsylvania's Wharton School, the *earnings yield* (the inverse of P/E) is a good predictor of long-run real stock market returns. Based on this, if next year's earnings estimates are not abnormally high, we can expect U.S. stocks to return 5.7% plus inflation, on average, per year over the next 10 years. Earnings yields in Canada and many other areas of the world are substantially better – a good reason for diversification.

Higher for longer

Siegel further points out that the economy's recent resiliency has driven up long-term interest rates. Despite fears of a weakening economy, activity remains strong, as shown by strong employment data. Yields jumped in reaction to recent employment reports, due to worry that the U.S. Federal Reserve will keep rates higher for longer. Fortunately, the unemployment rate stayed the same despite there being more jobs. This is because more people entered the labour force – which is what you want, because extra supply in the labour force will offset wage pressures.

Siegel doesn't think the Fed will hike rates come November. He says there are too many uncertainties: government shutdown, auto worker strikes, weakness in the housing market and now rising tensions in the Middle East. Plus, long-term interest rates rising on their own have done a lot of work for the Fed already.

Where's the recession?

Most economists were predicting a recession a year ago, yet we still don't have one. Has anything changed? Let's first look back to where we were a year ago. Central banks around the world were suddenly hiking interest rates. There were many aggressive headwinds: very high inflation; the war in Ukraine affecting trade and spiking oil prices; and

China, the second largest economy, engaged in rolling Covid lockdowns.

The economy proved resilient, but perhaps the bigger reason was that many of those headwinds faded quickly. High inflation become materially less high, the energy shock faded, supply chains continued to improve and China's lockdowns were eventually removed.

Official data is yet to be released for the third quarter, but the U.S. economy is expected to have real (net of inflation) growth between a decent 1.6% to a whopping 4.9% annualized gain, based on Federal Reserve models. Growth in Canada is expected to be much lower, around 0.1%.

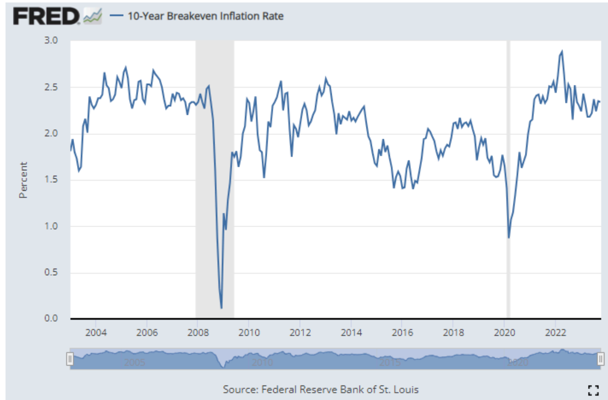
Today, interest rates seem to be the main focus. Central banks raised short-term interest rates, starting in April 2022 and continuing through 2023. Longer-term bond rates fell at the end of 2022 and into 2023. But recently longer-term yields have unexpectedly risen to new 15-year highs, while short-term interest rate hikes have slowed or paused. Most of this recent increase has come from an increase in real yields, not an increase in inflation expectations. Although the stronger-than-expected economy seems the main cause of rising real bond yields, large budget deficits and weak political leadership likely also factor in.

Inflation expectations are moderate, real bond yields up

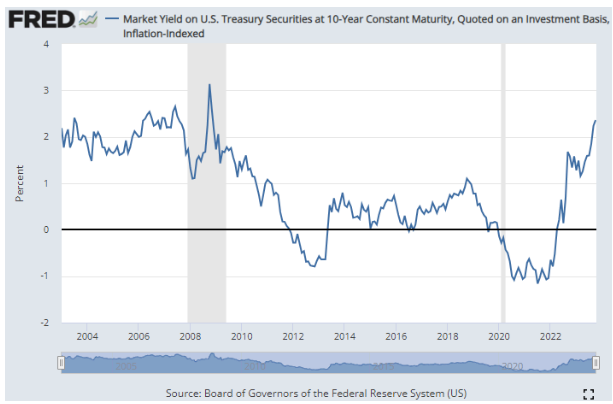
Inflation, while a lot lower than a year ago, has increased slightly according to the latest August data. In the U.S., inflation rose from 3.2% to 3.7% year over year. In Canada, inflation went from the low threes to 4% per year, mostly due to gas prices. Fortunately, shelter and food inflation are slowing, so it's reasonable to think inflation can continue to trend lower.

Despite the slight back-up in past inflation, expectations of future inflation have not been increasing. In the U.S. the 10-year break-even inflation rate (Treasury bond yields minus inflation-indexed bonds (TIPS) yields) is 2.3% and has been holding quite steady for the last year (see chart below). This means that the increase in bond yields reflects an increase in real, i.e., after inflation, expected yields. These have gone from close to zero (and even negative during the pandemic) back up to over 2%.

Inflation expectations remain in 2.0% to 2.5% range:



Real yields are up over 2%:

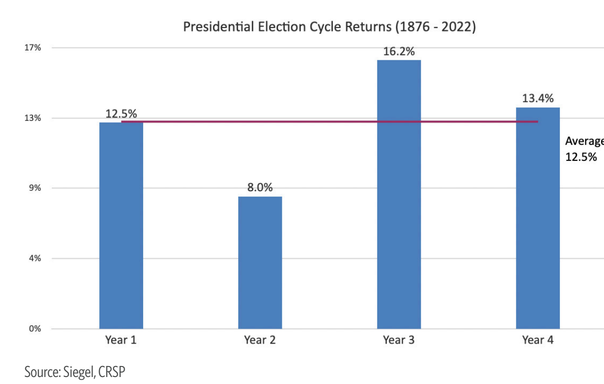


Central banks pausing

Central banks around the world, including in Canada and the U.S., are hawkishly pausing on rate hikes. Being heavily data-dependent, and given the extraordinary uncertainty around the path for the economy and whether inflation is truly vanquished, there are several possible scenarios. These range from further rounds of tightening to aggressive monetary easing. The more probable scenario is rates holding for now and then starting to decrease. Central banks don't want to raise rates further, but also don't want to give any concession towards rate cuts – as this would undermine all the work that's been done to cool inflation.

Presidential cycle

Since 1876, the third year of a president's term (as 2023 is) has seen U.S. stocks averaging 16.2%. Historically, year three has the highest returns, followed by years one and three which are about the same (about 13%), and then year two has the lowest returns (about 8%). Note these are average annual returns, not compound. With 146 years of data, we should be able to explain why it happens. In fact, there are several explanations. Perhaps U.S. presidents and Congress do all the dirty work in years one and two. Then they try to boost the economy in years three and four to help their re-election chances. As well, people may feel more optimistic when various presidential candidates start announcing their intentions to run and broadcasting their plans for change. That optimism may feed into the stock market.



Though still fairly distant, the U.S. 2024 election is coming into focus. So much could happen, but at present the 2024 election seems likely to be a reprise of 2020: a rematch between Biden and Trump, with the predictions of who wins seeming quite close. Still, it's not for certain who the final candidates even will be. At the beginning of his first term, President Biden was already the oldest person to claim the presidency. Biden is 80 while Trump is 77. It's not impossible that health (or legal) reasons could change who the final two candidates will be.

Stocks vs. bonds

U.S. 10-year bonds now yield about 4.7%, which is 2.4% above the expected 10-year inflation rate of 2.3%. This is high compared to what we've become used to this past decade, but really much more in line with the longer-term historical averages. Over the past 152 years, bonds averaged 5.2% return, 3.1% above the 2.1% average inflation. Today's bond yields are actually 0.7%, less generous vs. inflation than the long-term average.

U.S. stocks' forward earnings yield today is 5.7%, only about .6% below its long-term average of 6.25% (one divided by 16). As Jeremy Siegel has pointed out, earnings are claims on real assets, and this earnings yield is a reasonable estimate of future returns above inflation.

So, when you compare the 5.7% earnings yield on U.S. stocks to the 2.4% expected real return on bonds, the difference of 3.3% is close to the 152-year average. Based on this, the S&P might be expected to earn a premium of 3.3% vs. bonds going forward, not far off the difference over the past 152 years.

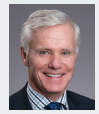
Because the difference in expected returns is now similar to the 152-year average, it also gives us even greater confidence in the targets generated by our proprietary financial plans, which are based on analysis of this full 152-year period.

In Canada, 10-year bonds yield about 0.7% less than U.S. bonds, while expected earnings on stocks are about 1.5% to 2% higher. Stocks look much more attractive vs. bonds in Canada than they do in the U.S.

Looking ahead

As we move forward, it seems likely that markets will continue to focus on central bank responses to economic data. With stock prices at above-average valuation, earnings growth will be more important.

Despite all the economic and geopolitical news dominating the headlines, we continue to stick with our investment process: picking companies with strong features and long track records of generating above-average returns. No matter what the outlook, we take comfort in our disciplined methods and asset mixes determined by your financial plan. We continue to rely heavily on the durability of our philosophy and processes in an effort to responsibly steward our clients' investments through uncertainty. Having the right asset mix is key: An equities target customized to your own personal and financial needs is important – and will help you stay resilient through these unusual times.



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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.

Financial & Estate Planning

DEATH AND TAXES? AN INTRODUCTION TO THE TFSA

By Tom Cowans, Wealth Advisor

Your home will likely form a large part of your overall wealth. But your home is also a form of consumption. It is therefore very important to set aside a portion of your income each year to build capital for your future self's needs in later life. The Tax Free Savings Account (TFSA) is one of the best ways for Canadians to build their financial assets tax-free.

Back in 1789, Benjamin Franklin wrote that "in this world nothing can be said to be certain, except death and taxes." As of today, the death part is still accurate. But since 2009 in Canada, there is an exception for the taxes part: TFSAs.

Usually, any income generated by your investments is taxable. If your taxable income is above around $15,000, you will pay tax on your investment income of 15% to 25%. The tax rate could get as high as 53.5%, depending on your province and total income level. This can become a big drag on the growth of your investments. TFSAs allow you to avoid that tax for a portion of your savings and investments. They are very flexible and should be a cornerstone of almost everyone's savings portfolio. The earlier you start, the better, because you'll have more time for the tax-free compounding to have its effect.

Let's start by reviewing some basics of what a TFSA is and how it works.

First, you are only allowed to contribute a certain amount each year into a TFSA. TFSAs were introduced in 2009 with a limit of $5,000 per year. This amount has changed from year to year; as of 2023, it is $6,500. To contribute, you need to be a Canadian resident and 18 years or older.

If you haven't yet opened an account, or you miss a year or two of contributions, no problem. It's retroactive. You don't lose the contribution room; it carries forward. If you've been able to contribute each year since 2009, your total contributions up to and including 2023 will total $88,000.

If you need to withdraw money from your TFSA, again, no problem. There is no tax owing on the amount withdrawn and you can re-contribute the amount as soon as the following calendar year. In a TFSA account you have many investment options, such as cash, guaranteed investment certificates (GICs), bonds and stocks.

TFSA growth assuming an 8% return, 40% marginal tax bracket and $6,500 in annual contributions, starting at age 18

Age	Contributions	Profit	TFSA	Regular Taxable Account	Benefit of TFSA
30	$ 78,000	$ 55,219	$ 133,219	$ 107,181	$ 26,038
40	$ 143,000	$ 246,306	$ 389,306	$ 256,174	$ 133,132
50	$208,000	$ 734,179	$ 942,179	$ 494,284	$ 447,895
60	**$273,000**	**$1,862,790**	**$ 2,135,790**	**$ 874,817**	**$1,260,973**
70	$338,000	$4,374,705	$ 4,712,705	$1,482,959	$3,229,746
80	$403,000	$9,873,073	$10,276,073	$2,454,850	$7,821,223

How much of an advantage are TFSAs? For illustrative purposes, say you start contributing at the eligible age of 18 and put in the maximum (we'll assume $6,500 per year going forward) until you are 60, with a compound annual return of 8%. Your savings would grow to over $2,000,000 tax-free. And they would be over $10,000,000 by age 80! In the chart below, you'll see how a TFSA grows over time. Notice that the longer your time horizon is, the more your savings can grow.

There are other things to note about TFSAs. If you over-contribute in a calendar year, you will be penalized 1% on that over-contributed amount until you withdraw it. But never fear: You can monitor your contributions online with Canada Revenue under My Account. If you designate your spouse as successor holder, on your death the TFSA account will transfer to them with all the tax benefits still intact.

Lastly, unlike Registered Retirement Savings Plans (RRSPs), which require you to stop contributing at age 71, there is no upper age limit for TFSA contributions.

Rather than making the full contribution on January 1 each year, if you save $270.83 twice a month, that will add up to $6,500 by the end of the year. Pay yourself first – your future self will thank 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. Some fund managers are susceptible to herding behaviour, that is, following other investors to chase after popular stocks.

   The problem with this is:

   a) Such managers may achieve impressive results – but only in the short term.

   b) As the late, brilliant British economist John Maynard Keynes noted, these managers are afraid of breaking from the crowd: "Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally."

   c) The managers buy in too soon, when prices have fallen enough to deceive them into thinking an investment is good value.

   d) All of the above.

2. A year ago, many economists predicted a recession. That hasn't happened because high inflation became materially less high, the energy shock faded, supply chains continued to improve and China's lockdowns were eventually removed.

   a) True b) False

3. Wharton Professor of Finance Jeremy Siegel doesn't think the U.S. Federal Reserve will hike rates in November because:

   a) Everyone is fed up with rate hikes.

   b) Long-term rates have already risen on their own. And now the U.S. faces the prospect of government shutdown, auto worker strikes, weakness in the housing market and rising tensions in the Middle East.

   c) Concerned about his popularity rating, President Biden has ordered the Fed not to.

   d) Higher rates scare people into not spending their money.

4. If you need to withdraw money from your Tax-Free Savings Account (TFSA), the following will happen:

   a) You'll face a financial penalty.

   b) You won't ever be able to re-contribute the amount.

   c) Nothing. There is no tax owing on the amount withdrawn and you can re-contribute the amount as soon as the following calendar year.

   d) You can't withdraw money from a TFSA, so don't even try.

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 November 30, 2023.

Trivia challenge runs November 1 - 29, 2023. 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 2023

CIBC WOOD GUNDY | The Stan Clark Financial Team
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