The Stan Clark Financial Team's

PERSPECTIVES

In this issue...

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Stan Clark
Senior Investment Advisor

Rationally, we know that forecasting events is a dubious practice. But emotionally, we crave future insights – and we trust forecasters more than we should. For investments, this *hindsight bias* can be dangerous, as I explore in this month's behavioral finance article. In Part 5 of Behind the Numbers, Michael Chu looks at *price momentum* and how to benefit from it. Michael also explains how our team's 100-year Stress Tests help ensure a solid financial plan going forward. And Sylvia Ellis reveals how donor advised funds are a strategic, tax-efficient way to give.

Stan

CIBC Wood Gundy

Behavioral finance

How hindsight can hurt our foresight

By Stan Clark - Senior Investment Advisor

At the start of every year we see reviews of the past 12 months, trying to explain what's happened and forecast what lies ahead. We just can't seem to get enough of these reviews and predictions! It's like we have an addiction to predictions. Our rational minds know most things cannot be forecast, yet our emotional minds crave divining the future.

In this issue, I'd like to discuss a common bias known as *hindsight bias* – and explain how hindsight can hurt our foresight.

Hindsight bias was most famously demonstrated in a study published by Baruch Fischhoff and Ruth Beyth in 1975 titled, *I knew it would happen*.[1] The Fischhoff and Beyth study focused on President Richard Nixon's 1972 trip to China, the first trip there by an American president since Mainland China became communist in 1949. There was intense speculation about what the outcome of the trip would be. Few expected what actually happened: that both countries would pledge to work towards normalizing relations.

Before the trip, Fischhoff and Beyth asked dozens of students to predict the probabilities of various outcomes. Then, at two intervals after the trip, they asked the students to recall their earlier predictions. Fischhoff and Beyth found that when an event occurred, most students believed they had assigned a higher probability to it beforehand than they actually had. But if an event did *not* occur, the opposite was true.

This is hindsight bias: the tendency to believe our forecasts were more accurate than they really were. It is also the belief that once events have occurred, these were more predictable than they really were. In retrospect, things do often appear to have been much more predictable than at the time of forecast.

Dozens of studies have documented hindsight bias. And indeed we've seen many examples of it over the past several years: the inevitability of the global financial crisis in 2008; the "sure thing" of growing dominance by large tech stocks; the rebound in company profits and prices after the pandemic panic in spring 2020; and the longer-term decline in interest rates. With the benefit of hindsight all these seem to have been inevitable.

Hindsight bias makes us believe we're better forecasters than we really are, and that the world's a more predictable place than it really is. Perhaps this bias is a way of making life seem more reassuring, as Nobel Laureate Daniel Kahneman suggests:

There are many causes of hindsight bias. Most are rooted deeply in our emotional mind, which makes the bias hard to avoid.

"Hindsight bias makes surprises vanish. People distort and misremember what they formerly believed. Our sense of how uncertain the world really is never fully develops, because after something happens, we greatly increase our judgements of how likely it was to happen."

There are many causes of hindsight bias. Most are rooted deeply in our emotional mind, which makes the bias hard to avoid. How does this hurt us? Well, one of the biggest problems is that we give too much credibility to forecasters who have been right in their recent predictions. Their correct predictions may very well have been pure luck. But, because of hindsight bias, we are much more likely to attribute their success to skill.

What can we do to fix this? As with many behavioural biases, the most important thing to know is that you can't. You just have to learn to live with it. Keeping a journal of your past predictions, or of others' predictions, can help. Stay aware of this tendency, and keep asking yourself, "Was this really as obvious as it now seems?" Remember, the world is complex, and most things are not as simple as they seem – even in hindsight. ■

[1] *Organizational Behavior and Human Performance, vol. 13, pp. 1-16.*

Team Talk:

Michael Chu

Investment Advisor

Riding along the beach in Delta (November 2020)

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

Fortunately, I was able to get a new bike in time to let me ride outdoors in the "off-season." I got a gravel bike which is a relatively new design. It's sort of like a heavy duty road bike that lets you tackle a wide range of surfaces between road and trails. I highly recommend it! I'm still a fair weather rider however. When the weather is not as good, I've been trying to read more. I usually try to alternate between fiction and non-fiction. But the "to-read" list is still quite long!

Happy to see the NHL season start. I wasn't too excited at the beginning with the new matchup format where they play the same teams over and over. I thought it might be a bit repetitive, but it's created some intense rivalries! Hopefully, the Canucks can improve, but perhaps they over-achieved last year.

I also signed up for some on-line learning on some new interests. There's a lot of courses out there from high end universities/professors… and they're free! Other than that, staying in touch with friends. Glad to see the weather improving and more day light lately. Hopefully, we can have some in-person visits soon. Take care!

Investing

Behind the Numbers Part 5: Price momentum

By Michael Chu, Investment Advisor

Sometimes in sports we hear about a team's momentum, referring to its winning (or losing!) streak – and how winning teams tend to keep winning. Stocks experience the same thing. *Price momentum* is a stock's price performance over a specific period. If a stock's price is up 10% in the last month, then the one-month price momentum is 10%.

Somewhat analogous to a sports team, the premise behind price momentum is that winning stocks continue to win – at least, for the short term. If a stock price is increasing strongly, it might be a good investment, as typically it will continue to do well in the short term. That's where sayings like "Don't fight the tape" or "The trend is your friend" come from.

But buying stocks based purely on price momentum seems a bit reckless – especially if that stock has already gone up a lot. So why would we want to trust price momentum? First, it gives us information about the future prospects of a stock. After all, it's not just people talking up a stock that makes it go up; it's people actually buying the stock. You might say they're putting their money where their mouth is! Second, people are slow to adapt to changes and new information. If a company has earnings better than expected, people tend to assume it's just a one-time thing and are reluctant to believe that it'll happen again. Of course, the prices of high momentum stocks have already gone up, because of the initial surprise. But the initial move often understates the importance of the surprise, which means there still might be room to improve.

In previous articles we've discussed that we should usually avoid high price-to-earnings (P/E) ratio stocks. By nature, high momentum stocks can often also be high P/E (expensive), but they're not necessarily super-high P/E (super expensive). Even if the P/E is fairly high, the benefits of strong price momentum can outweigh the negatives of a more expensive valuation.

In a long-term study of price momentum, researchers divided all Canadian stocks into five groups, sorted them by price momentum and calculated the returns of each group. Here's how the returns looked from 1985 to 2018 (33 years):

Variable	Top Group	Bottom Group
1 Month Price Momentum	12.0%	-2.5%
6 Month Price Momentum	15.2%	-6.4%
12 Month Price Momentum	16.2%	-6.4%
TSX benchmark return: 8.1%		

Source: CPMS

As you can see, the overall results from investing in high price momentum stocks (the top group) are very good and outperformed the market. Conversely, the returns from stocks with low price momentum (bottom group) are relatively poor.

Now, it's easy to conclude that momentum investing is easy: Buy high price momentum stocks and avoid low price momentum stocks. But this is only part of the story. In past articles we've discussed how investing using only earnings momentum is accompanied by high volatility and turnover. Well, with price momentum, it's even more extreme! So, while the returns from price momentum are very good, we need to keep volatility and turnover in check. That's why we don't use momentum in isolation. Instead we combine it with other variables to get the best of both worlds, allowing us to achieve the returns without as much volatility and turnover. We'll talk more about this next time. ■

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 Planning

Return Assumptions for Financial Plans Part 3: The 100-Year Stress Test

By Michael Chu, Investment Advisor

Previously we've discussed how return assumptions have a huge impact on financial plans. And, how performance returns in the future can't be accurately forecast. For that reason, we make conservative estimates based on long-term historical results, adjusted for current valuations. By "long term" we don't mean just for the last 10 or 20 years. Rather, we use data from the last 100 years to capture all the ups and downs. In this third part of our series on return assumptions for financial plans, we discuss our *100-Year Stress Test*.

A typical financial plan could be a 30-year plan. Even though the return assumptions are based on the last 100 years, there have been some very good 30-year periods and some very bad 30-year periods. The problem is, we don't know which version we're going to get in the future – and taking that into account will have a significant impact on how your plan looks. As discussed in Part 2, it matters a lot when the up and down years occur, relative to when you are adding and withdrawing money. So, how do we put it all together?

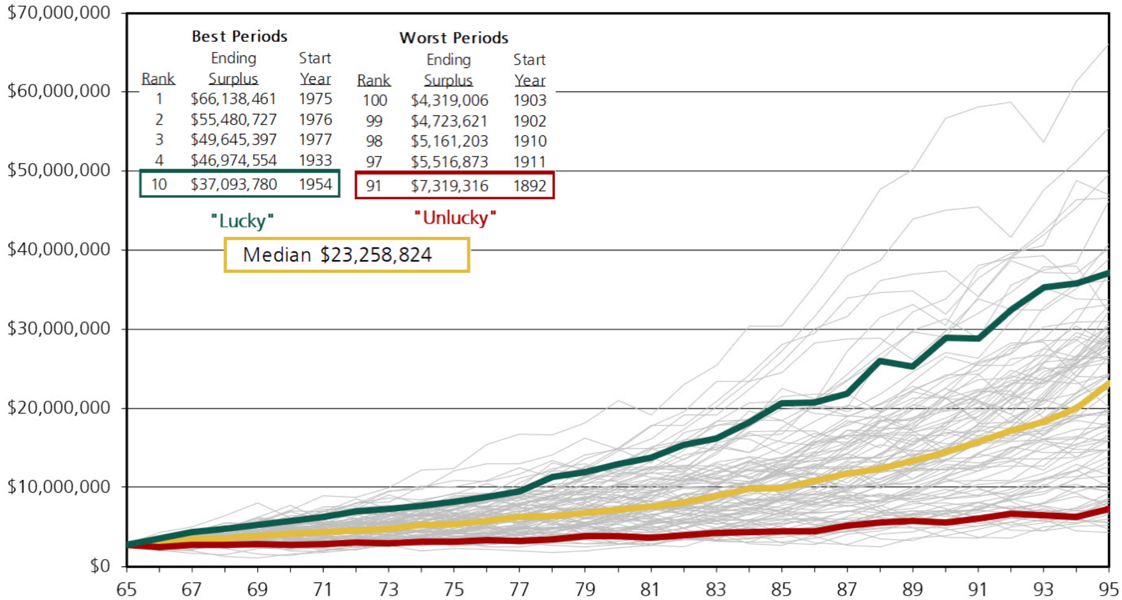
This is where we do something different from most financial plans. We run your plan through our 100-Year Stress Test. In this case, we test the plan through every 30-year period over the last 100 years. Let's say we start in the year 1920. We test the resiliency of your plan for the subsequent 30 years, using actual returns and inflation. Then we do it again, but starting in 1921, then 1922 and so on until all the data are exhausted.

As you can see in the chart below, each of the squiggly lines represents the value of your financial assets over a 30-year period, each with a different starting year. As expected, some lines do very well and some not so well. This gives you a picture of the range of outcomes that would have occurred in the past, and shows your best- and worst-case scenarios. We then evaluate each of the tests and see if any of them came up short, i.e., ran out of money. In this example, none of the scenarios came up short, which is good. If there were many scenarios that came up short, it would indicate to us that we might need to make some adjustments to the financial plan. These could include increasing savings, reducing future spending or perhaps downsizing a home. We also show the median outcome, to give us an idea of what a normal path would have been historically.

There have been many periods of market declines in history, and inevitably there will be many more. Although market fluctuations are a normal part of investing, they can still pose challenges to investors – especially those who are near or already in retirement. This is why our 100-Year Stress Test is important. No one knows if the market is going to be strong, weak or average going forward. We have to go through all the scenarios to find out how resilient your financial plan is. We're mostly worried about the bad periods. If the test can survive all the historical scenarios, then that gives us confidence in your financial plan and will also help you stick to it. ■

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.

This shows how your total financial assets would have fared in the past, using actual historical returns and inflation, with 100 different start dates.



100% of the simulations lasted past your age 95.

Financial Planning

Donor advised funds: a strategic, tax-efficient way to give

By Sylvia Ellis, Senior Estate Planning Advisor

For many Canadians, charitable giving is an important aspect of our lives. There are many different ways to give: donating through campaigns; volunteering your time; or giving directly to different charities. However, many individuals are looking for a more strategic and tax-efficient way to achieve their philanthropic goals. This is where donor advised fund (DAF) programs come in.

Easier and more cost-efficient than establishing a private foundation, DAFs are offered through a number of sponsor organizations, typically financial institutions or charitable foundations.

What makes a DAF attractive? Well, for the most part, it's the flexibility a DAF offers – and the ease in establishing one. You can receive immediate recognition for your donation for tax purposes, ensuring the tax credits are fully used to offset years of high income. Also, the assets grow tax-free within the DAF, so that designated charities will benefit even more in the future. And importantly, you don't need to decide on the ultimate charity at the time of the donation.

Minimum contributions vary depending on where you choose to establish the program. Typically, this might be $25,000, but can be as low as $5,000.

Some of the benefits of DAFs include:

- Simplified charitable giving.
- Tax credits can be used to offset high-income years while you are still living,

rather than perhaps being partly wasted if the donations occur only on your death.

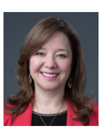
- Many of the advantages of a private foundation at a reduced cost.
- Provides the opportunity to teach children and grandchildren about philanthropy. Grants can be decided upon together, instilling shared values and decision-making skills.
- Grants can be made anonymously to protect personal or family privacy.
- Donors don't have to worry about any administrative details or record-keeping.

The process is simple:

- Personalize your legacy by naming your own fund.
- Receive immediate recognition for your donation. A tax receipt will be issued at the time of the donation for the full market value of your contribution.
- Donate a variety of assets, including cash, stocks, bonds, mutual funds and life insurance. For gifts of appreciated securities, you can donate in kind and realize the full value as a charitable donation – without paying tax on any capital gains.
- Select the charities you would like to support. Grants can be made to organizations recognized by the Canada Revenue Agency as a registered charity. To see if the organization you ultimately want to support is eligible, check the list of registered charities on the CRA website.
- Your DAF will be administered by the institution you select and your donation will be invested and professionally managed by your advisor. If you want, you can recommend how your assets are managed.
- You will be kept posted on the status of your DAF, with periodic reports outlining the granting activity and current value.

Whether you wish to support the arts or higher education, conserve natural resources, advance medical research or help the world's underprivileged children, giving through a donor advised fund program may be the right fit for you.

Does CIBC Wood Gundy offer a DAF? Yes, indeed! it's called the CIBC Giving Back Program. If you'd like to learn more, please let us know. We'll be happy to send you more information. ■



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 Fischhoff and Beyth study of predictions about President Richard Nixon's 1972 visit to China showed that:
   - a) If we read up about an event ahead of time, our predictions for it are likely to be accurate.
   - b) After an event, we are realistic about which of our predictions came true and which didn't.
   - c) After an event, we tend to believe our predictions about it were more accurate than they really were.
   - d) If Nixon had stayed in China he would have avoided the Watergate scandal.
2. With *price momentum*, or a stock's price performance over a specific period:
   - a) Winning stocks continue to win, at least for the short term.
   - b) If a stock price is increasing strongly, it might be a good investment, as typically it will continue to do well in the short term.
   - c) Price momentum gives us information about the future prospects of a stock.
   - d) All of the above.
3. In preparing your financial plan, the Stan Clark Financial Team uses a 100-Year Stress Test. This gives you a picture of:
   - a) How climate change has evolved over the past century.
   - b) The range of outcomes that would have occurred in the past – and shows your best- and worst-case scenarios going forward.
   - c) All the prime ministers of Canada for that period.
   - d) Society's changing tastes in music and art.
4. With charitable giving via a donor advised fund (DAF), you can receive immediate recognition for your donation for tax purposes, ensuring the tax credits are fully used to offset years of high income:
   - a) True   b) False.

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 March 31, 2021.

Trivia challenge runs March 1 - 30, 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

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The Stan Clark Financial Team
Where planning, investing and behavioral finance meet

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