ELAINE'S NEWS & VIEWS

July 2019

MARKET UPDATE

The bumpy ride continues. You will remember how much the market went down between Oct 4 and Dec 24 last year, almost 20% in the U.S. Our portfolios went down a fraction. Between Jan and Apr the market rebounded completely. Our portfolios didn't have to go up too much to be restored to what they were worth before the downturn. For other people whose accounts fell almost 20%, they would have needed 25% recovery to be made whole (100% - 20% =80%. 80% x 125% = 100%). So you may hear people talk about how much their portfolios made Year To Date. They may well have gone up more than ours, but they needed that to recover. You may wonder why we didn't move to other things to get so much upswing. Primarily it was not clear that the markets were not going to keep going down a while longer, or shortly after recovery, go down again. Then most people would not have been happy that we left low volatility steady funds to jump right into funds that fall hard. That being said, if we had gone into a bear market (a deeper drop in the markets) and stocks were down a good 25%, we may well have called you to suggest we switch out of funds that were modestly on sale to buy funds that were at a deep discount. Then we would have been position for a bigger recovery. However, your portfolio might have continued down another 10 or 15% before the recovery started. And, maybe a couple of years after the recovery, we would have called you to get into more conservative strategies again to be prepared for the next significant dip or more significant bear market. Indeed Jordan and I are planning on calling you when a bear market has been going on for a while to suggest selling your protective funds that protected you for the worst of the downmarket to get into hard hit but still quality funds to get their bigger rebound. It's a way we may be able to make a few extra per cent return. So don't be surprised when the call comes in the future and be prepared to be brave when others are panicking. You can of course stay the course with conservative holdings, but you may be missing a buying opportunity that only comes around less than a dozen times in one's life.

BASKETBALL PLAYERS, CARS AND EGOS

Kawhi Leonard has a $94 Million US contract. What kind of car do you think he drives? He drives a 20 yr old Chevy SUV. It's not the prestige, expensive car you were expecting me to say. Apparently when asked why he drives it, he said that it runs and it's paid for. Contrast that to some of his peers. According to the Maudlin Economics blogger on Jun 13, 2019, there are NBA players who "would buy a new suit for every day they were on the road. 41 road games, 41 suits. They would wear them once, and never wear them again. Given the size of the basketball players, these were bespoke suits and not off the rack." It's easy to tell who will have more of their earnings left when their careers are over, Kawhi or the new suit guys. And who do you respect more, the guys in the Ferrari's and Lamborghini's or Kawhi in his very modest car?

The article online at Maudlin Economics had a few well-phrased points on owning cars. "Unless you are driving a Ferrari, a car is not an investment. A car is basically a huge waste of money. Where else can you take $40,000 and set it on fire in 7 years? And pay a bunch of interest to the bank in the process? What a disaster. Funny thing about cars—people's egos are really tied up in the brand of the car. … The takeaway here is that your financial well-being, as I've said before, is not the product of a million small decisions, but two or three big decisions. A car can bankrupt you. Or you may get to watch helplessly as it gets towed out of your driveway. And don't get me started on leasing, the extended warranty of auto finance. I have had conversations with car salesmen. They all say the same thing: "I can get you in that car." They are pretty creative, financially speaking, and will find some way to make the sale, even if it puts you in a perilous financial position. That is not their concern. Their concern is selling cars. The ideal scenario: get a gently used Toyota, pay cash, drive it forever. You win the personal finance game." One thing I disagree on though is that your financial wellbeing over the long-term is also a product of those tiny daily decisions, like do I get a $2 cup of coffee every day or an $8 one, do I get the free cheques from the bank or the ones I pay extra for, do I pack a lunch or eat out every day etc.

FINANCIAL AND HOUSE CLEANING – GIFTS TO LEAVE YOUR HEIRS

It's all the rage today to de-clutter. There are lots of new books on the subject. Apparently it all started with a book by Margaret Magnusson called "The Gentle Art of Swedish Death Cleaning". It was based on a Swedish tradition of seniors sorting out what should be sold or given away and what should be kept in the family before they pass on so that their loved ones would not be burdened with a ton of possessions to sort through and dispose of when they have to wrap up the estate. Indeed this is a great gift that seniors can leave their heirs.

House de-cluttering isn't the only blessing for someone to leave their heirs. Financial organization is a precious gift too. Some of my clients discovered stock certificates and tax slips scattered all over their loved one's house and they had to hope they found everything and then they still didn't know if the stock certificates were worth anything. Some clients had to deal with closing bank accounts 9 different branches because their parents had money scattered geographically all over town. Doing a person's final tax return can be a nightmare when someone passes on with no records of the adjusted cost base of unregistered stock purchases or with no central file of all the current year's tax slips and previous year's notice of assessment. And taking care of wrapping up someone's estate is even more onerous and expensive for family members, if their loved one passed on with no will in place, or at least a will that could be found.

One last gift you can give to dependents is peace of mind. It is not uncommon for widows or widowers not to know if they can maintain their lifestyle, once their spouse has passed on. They often have no clue how large their savings are, because their spouse handled all the finances. And unfortunately I have met spouses after they have lost or as they are about to lose their partners, who come to me to find out how to try to survive financially, because they have found out they aren't going to get much survivor pension and don't have many savings. At that point all we can do is help the surviving spouse make the best of the little they have. It is so much better to meet with people earlier to help them get savings in place, to help them know how much they need to save to have enough to last their whole life, and to meet with both spouses at least occasionally, so the less involved spouse can have peace of mind that he or she can survive financially, if they are the last survivor.

We certainly can't help you declutter your house (I have my own basement to deal with). But we can help with projecting how much money a surviving spouse would have to live on and would love to meet with any spouses we rarely see or have never met. And we can help you with financial organization. On Sat Sept 14 from 10-noon at out office, Jordan and I will be hosting a small workshop on documenting all the information your heirs would want to know if you passed on. We invite you to register, and to bring your executor/heirs if you want to. Please call the office to register. We have over 50 items to go through that you might want to think about and communicate to your heirs and executors.

TAX RATES 2019

If you want to know your marginal tax rate, you can go to this Manulife website and see or download the 2019 tax rates for different levels of income and see RRSP contribution limits, TFSA contribution allowances etc.

https://repsourcepublic.manulife.com/wps/wcm/connect/25d80aa5-7dc8-473a-9eaf-2a2839bcb4a3/inv_trs_taxratecardmk2418.pdf?MOD=AJPERES&CACHEID=ROOTWORKSPACE-25d80aa5-7dc8-473a-9eaf-2a2839bcb4a3-mBdLIsV

RIDDING YOURSELF OF THE STRESS OF DEBT

According to a report cited in the June 14, 2019 Globe and Mail, the amount Canadian households are paying on debt hit an all-time high at 14.9% of disposable income. Considering there are lots of retirees with no debt at all, there must be lots of Canadians paying over a third of all their after-tax income paying down debt.

The 2017 Health Benefits Attitudes Survey by Wills Towers Watson showed that only about 19% of employees have neither health not financial problems and only 13% of them expect to work past 70 and they usually only have 1.8 days of absence per year. Contrast that to those who have both health and financial worries. 31% of those people expect to work past 70 and they average 4.4 days of absence a year, plus have about 12.5 days a year where they are at work, but not mentally there. They are 3 times more likely to be disengaged from their work. Over half live paycheque to paycheque and 2/3 have high stress levels. None of us would want to be in that group. We can make sure we aren't in their position by taking care of our financial health, and of course trying to take care of our physical health too.

Here are a few ideas from Manulife's Spring 2019 Solutions magazine on steps you can take to help yourself get out of debt:

- Create a budget and stick to it (this can help you eliminate impulse buying and find places to cut out non-essential spending)
- Start an emergency fund (so you don't have to add debt in an expensive way when you have surprise expenses like car repairs)
- Plan to pay off debt with the highest interest rate first
- Boost your income (can you make a case for a pay raise at work, can you run a small business in your spare time or take on a part-time job?)

None of these ideas will be an overnight cure, but actively managing and reducing your debt in small increments will get you there.

If you are part of a couple, both spouses need to get on board. A survey in July 2018 by Manulife Bank of Canada found 3 disturbing thing:

- 1 in 5 Canadians try to ignore their money situation
- 1 in 5 Canadians say their spouse doesn't know how much debt the family has
- 10% of Canadians have hidden from or lied to a spouse about a cost. 40% of the women had hidden or lied about clothing purchases. For men, 42% had purchased electronics.

VALUE INVESTING – THE LATEST RESEARCH ON THE MODERN WAY?

May the 4th (as in "may the force be with you…" with a lisp) wasn't just Star Wars Day this year. It was also the date of Berkshire Hathaway's annual meeting, featuring co-chairs Warren Buffett (aged 88) and Charlie Munger (95). I didn't go to Omaha for it this year, but I did watch the on-line streaming of the meeting for hours. The most successful investor in the world said his company, Berkshire Hathaway, was the largest shareholder in the world of Apple and his company has been buying Amazon shares. Neither of these companies look undervalued at current prices compared to their earnings. So how do they qualify as Growth At a Reasonable Price investments, which is the hallmark of Buffett's style?

Scott Barlow quoted a research report from a Credit Suisse strategist in the May 7, 2019 Globe & Mail that may explain why Berkshire Hathaway found Amazon an attractively valued stock to buy. He says that companies today need to invest less capital to keep operating than the companies of yesteryear (software is less capital intensive than machinery). So today's companies have a lot more free cash flow (earnings minus capital expenditures) and earn more compared to their invested capital (Return on Investment) than companies did in past years. Because of this, the old measure of Price to Earnings is not as important a predictor of future monies to be paid out to shareholders as is the Free Cash Flow generated by companies.

A switch to valuing companies based on Free Cash Flow would explain Berkshire Hathaway's recent purchases. Amazon and Apple were cheap for Buffett's company to buy on the basis of Free Cash Flow, even though they were expensive based on Price to Earnings ratios. The emphasis on Free Cash Flow would also explain why some of our longstanding value managers cannot find enough cheap stocks to buy, because they are basing it on Price to Earnings which is currently higher than historical norms. But some of our value managers say the market is still undervalued, because their focus is on Free Cash Flow. The market's Free Cash Flow ratio is currently about 20% to 40% cheaper than it has been historically.

So value investing in growing companies is probably still the safest and most profitable way to invest over the long term, but there may be a different way to measure what constitutes a cheap price compared to the past.

A SHORT-TERM CRYSTAL BALL?

A website called the Fat Pitch on Jun 17, 2019 reports that since 1950 markets have moved to a new all-time high within 3 months 81% of the time under certain conditions, namely 1) if the market is within 10% of the S&P 500 market high in the previous 52 weeks, 2) and there have been more stocks finishing up (called advancing, compared to the number of stocks declining for the day) than ever before. The average market gain was 4%. Apparently the market just hit those conditions. So, IF history repeats, there's a good chance the next 3 months could be good. Apparently this Advance-Decline percentage has no predictive value regarding market corrections. Other technical analysts are calling for another 20% decline and recovery before yearend. So what do these predictions mean ? Nothing important. It's all short-term noise.

If you are invested in the stock market, it should be the long-term that matters. If you care about the short–term, it's your near-cash or low volatility balanced funds that matter, and they shouldn't be terribly affected positively or negatively by markets. In the last downturn (Oct-Dec 2019), our favourite low volatility funds fell only 4-6% and our high interest savings funds grew slowly but steadily with no downturn at all.

The only thing important about a short-term market correction for long-term investments should be that it provides a good opportunity to put extra money into the market.

COMMON INVESTMENT BIASES

According to the science of behavioural economics, investment decisions can be affected by over 200 biases that override logic. I've written about the most common ones before, but our best defence against them is to be aware of them. Isn't that how Fitbit works? It doesn't build muscles or burn calories, but it makes one aware of how many steps one has done. And it seems to motivate people to work harder. So let's get more aware about flaws in the way human nature causes us to think. Here is a review of the 5 most common biases, courtesy of Russell Investments.

Loss Aversion

Apparently we feel the loss of money many times as much as we enjoy a gain. That's why we are fearful to lose money (even if the "loss" is only a temporary paper loss) and head for safety too early. It's also why looking at your account balances too often causes unhappiness even when the market is rising. If the market drops 1/3 of the time and you look at your account every day, you will see gains on 2 days and a loss on one day. That one day's drop can cause you more pain than the two up days brought you joy. Even though you made money over the 3 days. So, try not to look at your account too often and remind yourself that market dips are common and not to worry about.

Over-Confidence

Investors tend to believe they have better market prediction and stock picking expertise than they actually have. This can cause them to trade too often or just at the wrong time. And often they take on too much risk with sizable bets on what they perceive to be a hot stock. (And if they turn out to have chosen a winner, they won't take profits and mistakenly project that the stock will keep growing forever – Nortel, Bitcoin …)

Herding

People tend to follow the crowd and do what their peers are doing. Some people may remember when everyone was talking about Bre-X or Nortel or gold, or more recently Bitcoin and Marijuana. FOMO (fear of missing out) develops and people decide to copy their neighbours. One of the most famous examples was in 1929 when a shoeshine boy was giving stock market tips, to J. P. Morgan no less, an extremely successful American financier who co-founded GE, U.S. Steel and International Harvester. Everyday people, regardless of their lack of understanding of the stock market, felt they had to get in on the market because the market had increased 800% from late 1920 to late 1929. Then the stock market started to fall and people, especially those with no experience or understanding of the market got scared and all fled the market. In less than three years there was an 89% drop in the US market, the worst in history. All of this started because over-optimism took stocks to unrealistic valuations and then a stock fraud scandal in the UK made people re-assess the value of companies and sell even at bargain basement prices. And once the herd started for the exit, most people followed, dragging prices down more. Experienced, smart investors, like J. P. Morgan, whose name in still on a U.S. investment bank, didn't follow the herd. When the shoe shine boy gave him stock market advice, J. P. sold everything. He knew the herd had headed into the market. And the reality is that the herd had a huge track record of always doing the wrong thing. J. P. could later buy in at sale prices and make another fortune.

We see today that when markets are down and cheap, money is leaving mutual funds, and when markets are near their highs, people are pouring money into funds. It should be the other way around. And that's why we choose fund managers who unemotionally calculate the worth of companies whose stock they buy and will hold cash rather than over-pay for a business. And if the price dips, they buy more, rather than panic.

Remember how the excuse “well, all the other kids are doing it” didn’t fly with your parents when we wanted to do something they didn’t approve of? Now we need to recognize when we are feeling FOMO as adults and stop ourselves from making decisions based on our fears of missing out. Doing what everyone else is doing is not a good thing in investing.

Familiarity

Canadians are generally invested over 90% in Canadian stocks or funds, despite the fact that the Canadian market is only about 2.5% of world stock markets and we rarely beat the U.S. market. This concentration on investing in Canada is because people prefer what they know and are familiar with. We need to guard against this and try to evaluation opportunity on a rational basis.

Mental Accounting

Imagine you find $20 in a parking lot. There’s no way to identify the owner who lost it, so you have a windfall. You may think it’s a lucky day and you decide to buy flowers or a Raptors commemorative towel to treat yourself. A week later you pay for something in cash and get $20 change that you stuff in your pocket. The next day when you look for that cash to pay a parking attendant, you find you’ve lost it. Later you probably search your car and all the clothes you wore yesterday for it, multiple times (or is that just me). You may even feel that you won’t get popcorn at the movies this week to make up for the lost money. You feel worse about losing the money than you felt joy over the found money. That’s because people put money into mental buckets and value it differently depending on the source of the money (gift, earned income, winnings etc). And they spend it differently too. If you get a windfall, you think you can spend it frivolously. Some people treat their tax refunds this way, instead of saying, this is an easy opportunity to pay down my debt or add to my savings.

Putting money in different mental buckets can lead some people to borrow money rather than use the cash they have sitting around for years as just in case money. So if they earn money on that just in case money, they pay tax on it and might net .5-1% after tax. Meanwhile they might be paying 6% or even 22% on the loan or unpaid credit card debt. They could save 5 – 21% by using their cash reserve instead of the loan and then borrowing later if they have an actual emergency, but they think “no, that money is reserved for purpose X, so I can’t use that money for need Y”.

Mental accounting can cost you money and we should try to stop ourselves from thinking about our money that way. One last example is where people make a profit, let’s say $25,000, on some investment they made that was riskier than normal, but they won’t take the profit and put that money safely away someplace else. They say if they lose that profit, it was easy come, easy go. But if they lost $25,000 of any other of their money, they would be upset. That’s not logical.

RETIREMENT EXPECTATIONS VS ACTUAL EXPERIENCES

Fidelity surveyed about 1000 men and 1000 women to see what the pre-retirees plan to spend their additional time on in retirement and what the retirees actually spend their time on. The results were interesting. Retirees actually spend more time on-line, with friends and on their hobbies than expected, but less time on arts and entertainment, travelling or on sports and fitness. Women spend more time on volunteering, art and entertainment and hobbies. A third of current retirees have some work in retirement, half working for their pre-retirement employer, a quarter consulting or starting a new business. The rest are working full or part-time for a new employer. The top reasons for working in retirement, from most common reason to least common, are to keep mentally and/or physically active, to pass the time, for financial reasons, to get a sense of purpose, for social reasons, to stay current and to have a routine. Of pre-retirees, more high income earners plan to work in retirement than low income earners.

I appreciate these top reasons for working in retirement. I would miss the sense of purpose, seeing my clients and keeping up on all the latest in the financial world. My dogs now keep me in a routine, otherwise I’m sure I would miss work for that reason too. However, I don’t plan to retire and then come back to work. I just don’t plan to retire for a long-time. I might take art classes or play a little more golf during the week over time, and not work in the morning on the same day as I have evening appointments, as time goes on. I love my hobbies, but can’t see just doing them and giving up all I get from my work. I’m just not emotionally ready to retire.

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