Manulife Securities

ELAINE'S NEWS & VIEWS

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Lottery Ticket Fascination Explained

In the relatively new study of Behavioural Economics there is a cognitive bias referred to as the preference for lotteries. Craig Lazzara explained in Invesco's Aug 5, 2016 blog that, "This bias explains the irrational existence and popularity of lotteries in society. The expected value of buying a lottery ticket is negative. Therefore, no rational person would ever buy a lottery ticket. The logical conclusion then is that operating a lottery anywhere in the world would be futile. However, as we know, billions of dollars are spent on lottery tickets every year. Classical economics does not have an explanation for this phenomenon, and behavioural economists believe that some people are willing to risk a known amount in exchange for the possibility, even a slim possibility, of a huge financial windfall. If you take the insight and apply it to the financial markets, what is the equivalent of the lottery ticket? A relatively high-volatility stock that might not amount to much, but could potentially be the next Apple or Google? There are investors who want to buy volatility for its own sake – not based on valuation or the belief that a particular business is high-quality or poised for growth. Because there are investors focused on volatility this way, some stocks become overpriced relative to others that don't inspire the same demand. The structural argument behind low-volatility is that systematically avoiding the volatile stocks can produce better returns." So there is a new reason why I like low-volatility investing.

Are People's Memories Really that Short?

On Apr 20, 2017 Bloomberg reported online that a 6th bank in Canada was now offering packages of uninsured home loans (mortgages) to investors as Mortgage Backed Securities (MBS). Does anyone else remember when U.S. banks offered MBS to investors around the world because they wanted to off-load the risk of default on the mortgages they had issued? Then when people realized the mortgages were worth more than the homes that were the collateral for the MBS, the whole world went into a financial crisis the likes of which we hadn't been since 1929. This MBS crisis was only back in 2008, not that long ago that people should have forgotten it. So why aren't people scared that our banks now don't want to hold all the MBS debt themselves? If the banks think the mortgages they have written are too risky for the bank to hold, why should anyone else want them? And why are the banks worried about mortgages going into default unless they think Canadians won't be able to handle them as interest rates rise or unless they think the housing market bubble might burst leavings mortgages secured by houses that aren't worth as much as the mortgages on the homes? This is a big red flag to me. I won't be touching MBS, and I think prospective new home buyers and people with large mortgages should be nervous to be in the housing market right now.

Clients have been asking a lot of political questions these days. So let's see what answers learned people and history can give us.

What will Happen to Stocks if There is a Global War?

North Korea, Russia, the Middle East – conflicts could arise that in those parts of the world that escalate into global war. The risks seem greater than they have for many years. So many people are asking what would happen to stock markets in the event of a global war. All bets are off if there is nuclear war and then money is of comparatively little concern. Short of that, world markets may perform similarly to how they have in the past before and during WWII and the Korean, Vietnamese and Gulf Wars. In a study from 1926 to 2013 done by Mark Armbruster and quoted in David Fingold's Blog #202 (David is the fund manager of Dynamic Global Discovery and is one of the smartest people I have ever met), "stocks have outperformed their long-term averages during wars. On the other hand, bonds, usually a safe harbor during tumultuous times, have performed below their historic averages during periods of war." I vote for lower returns and no war. If war comes though, at least our portfolios may not be an added worry.

How Much Can Any President Affect the US Economy?

On Freakonomics.com there is a podcast called "How much does the President of the United States really matter?" In that podcast, Justin Wolfers, an associate professor of business and public policy at the Wharton School, says, "That's a really hard question to answer. We could just look in data and see where the economy went well under certain presidents and poorly under others. But we've actually had so few presidents it's going to be pretty uninformative. The truth is it could be reverse causation. People tend to vote Democrat when they're worried about unemployment and they tend to vote Republican when they're worried about the budget or when they're worried about inflation. Sorting this out is very difficult. … If I look at what a president does and how they spend their day and then I try and translate each of their actions into an effect on the economy, it's hard to see how they have much effect at all. Under this president [Obama] the fiscal stimulus was a useful thing. The unemployment rate might be a percentage point — or even a little bit more — lower as a result of what he did. But right now, I think a majority of economists — it's not unanimous — but a majority would say that more fiscal stimulus is a good thing. Even if you were to convince the president of that, there's no way on earth he could make it happen. Because the president has to work so closely with the legislative branch, that's an enormous discipline and also prevents them from really having a big effect on the economy." The effect Trump could have on the Canadian economy with lumber tariff's etc is another thing altogether. So it's another reason I want to underweight the Canadian economy and am not afraid to overweight the U.S. economy.
http://freakonomics.com/2010/11/04/how-much-does-the-president-really-matter-full-transcript/

Market Reaction to Politics and Investment Lessons to learn from the Super Bowl

As Warren Buffett put it recently, "mixing politics and investment strategies is a big mistake. And so is spending too much time watching news channels … Politics can be very divisive and generate emotional feelings … But **never let those feelings change a portfolio strategy**. Stocks follow earnings and earnings generally follow the economy. Economic growth is driven by changes in the labor force and productivity. The political party of the day can do very little to change the trajectory of those 2 forces,

generally speaking. The U.S. system, in particular, is built on checks and balances, limiting the power of any one person. "

"You can learn a lot from studying championship sports teams and there's probably no better place to start than with the New England Patriots, who have 7 Super Bowl appearances since 2000 with 5 wins. … So, what can we learn? One, **consistency matters**. The Patriots have had the same owner, coach and QB [quarterback] since 2000. … Too many teams trade players or fire the coach every time they feel the pressure. There's a lot to be said for **keeping an even keel in times of stress**. **Have a long-term vision, hire the right people and stick to it. When investing, let the great businesses and the magic of compounding do their thing, don't get in the way**.

> Jesse Livermore [sometimes called a legendary stock trader]: "The market does not beat them. They beat themselves, because though they have the brains they cannot sit tight."

Second, **defence wins championships**. The Patriots had the best defence in the NFL, with the fewest points allowed in the 2016 regular season. **Successful investing is all about defence and protecting capital**. …

And finally, **never give up**. Many people had probably switched channels at halftime, with the Falcons leading 21-3. There are many times when the markets are not co-operating and it feels like nothing will go right. Usually, it's right at this low point when so many people sell and seek the comfort of cash. [The Patriots came back to win the Super Bowl."

Views from the Equity Income Team of Dynamic Funds, Q1 Review Report

So this translates into investment advice for us as this. We stick to our long-term strategy through the next market downturn and every market downturn. We use strategies, like Growth At a Reasonable Price value investing (GARP), low volatility, dividend focused and deep value because they are defensive. Funds using those strategies typically go down less than the market, and as such are relatively defensive. Over the long-term our managers have tended to beat the market by being defensive, but we have to stick with them for the long-term for the rewards. If you think you may need cash out of your portfolio before a market has time to recover, we need to put enough investments to provide for those withdrawals into assets that are even more conservative BEFORE a market correction. What we don't have invested in those conservative investments should have the time to recover after any downturn before any withdrawals are needed from them. So **we stick with a constant strategy, play defence on our investments and even greater defence on the assets we may need to liquidate in the short-term, and we have patience with markets and don't give up when things look bleak**. These strategies worked for us through the tech crash and the Great Depression and we should never change our game plan just because things turn against us in the short-term, which will inevitably happen every few years.

In fact, since 1950, there have been 20 downturns greater than 10% in Canada, on average every 3-4 yrs. So you can see that we need to be patient with markets quite frequently. We must be emotionally prepared to take the next downturn in our stride. And even though positive years outnumber negative years, even in the middle of the positive years there are usually some trying dips. For the U.S. S&P 500 stock index, the average maximum drawdown is -16.5% across the years from 1928 to 2016 even though 2/3 of those years ended up positive. (From a Dynamic Funds presentation in Apr 2017)

This newsletter seems full of information from Dynamic Funds this time, even though I have read material from my usual broadly diversified sources and have gone to just as many presentations from other companies as ever. But Dynamic just seemed to resonate with my thoughts this quarter, especially how they summarize their approach: "Focus on Fundamentals, Think Probablistically, and Protect Downside". That sort of sums up my investment motto.

Below is a link to a Manulife Solutions article on protecting yourself from being a victim of fraud. There is so much identity theft going on, that this serves as a good reminder of ways to protect yourself.

http://manulifesolutions.ca/document.pdf?link=KqIgx24BNK65URqnMskpqjyxfEckVVVxPkd%2FP1AOc%2FlkOGcq4l7LwQ%3D%3D

Budgeting Help and the Payday Effect

Apparently in every income group, according to the Columbia Business School and Copenhagen Business School, people spend more money right after they have received a surge of money. It's called the payday effect. This is understandable for those who barely make ends meet and have bills to catch up on or essential things (like refilling the fridge) to get caught up on but what excuse do the rest of us have for spending more because we temporarily feel richer? If we control our impulse spending we may avoid the problem that the U.S. Federal Reserve found. 46% of American adults said that they could not cover a $400 emergency expense (think new brakes or a furnace repair) without borrowing or selling something (and keep in mind that Canadians are personally more in debt than Americans relative to our income). (Globe and Mail Dec 16/16)

It isn't just little spending that we need to control. I heard another advisor talk about this and was glad that I wasn't the only one noticing it. People make decisions to take out savings to renovate or travel even though they are not on track to retire. Around age 65 I hope they can say to themselves that they really enjoyed that new kitchen and don't mind working an extra few years before retiring because of getting it.

One Canadian Bank is trying to give assistance to people to live within their budget or just to curb the payday effect. TD has a new app called MySpend that lets customers know when their spending is higher than normal. Apparently the 30% of clients using the app at least twice a month reduced their spending 4-8% since using the app. (Globe and Mail Dec 16/16)

Canada Pension Plan (CPP) – Take it Early or Defer It?

Often clients talk to me after they have contacted CPP about starting to collect their CPP and then ask if that was the right thing to do. CPP monthly payments are increased the older you are before starting to collect it, nearly 50% greater if you wait till age 70. You can transfer some of your "longevity and investment risk back to the government" by collecting CPP later, rather than at 60 or even 65. Longevity risk is where you outlive the money you have saved to draw an income stream from. Many people don't take advantage of this because of one question: "What if I die early?" "First, I could say that the

probability of premature death is small. Between the ages of 65 and 80, there is only a 13 per-cent chance of dying if you are female and 20 per cent if you are male. …Second, I could point out the obvious: If you die early, you have bigger concerns than getting short-changed on your CPP." Many people start withdrawing from CPP early so they don't have to withdraw as much from their savings (RRIF, TFSA etc) to live on. This may seem to make sense but may actually be wrong. If you have a spouse who would collect survivor benefits from your CPP pension, their survivor pension will be lower for life if you started collecting a reduced CPP by opting to take it early. You may have left your spouse more RRIF money and other savings because you withdrew less in your early years of retirement because you collected CPP, but those savings normally deplete faster after you die than they would have had your spouse had a bigger CPP survivor benefit. Feel free to call to discuss what the best date is to start taking your CPP.

(Frank Vetesse, Chief Actuary of Morneau Shepell in the Globe and Mail Mar 6, 2017)

Why One Has to Take Bigger Risks As an Investor Today

Let's say your objective was to earn 7.5% return on you savings. Only 22 years ago you could get that return with 100% investment in bonds and only have 6% standard deviation, which is a measure of volatility or risk (depending on how you define risk). The Wall Street Journal published a chart from Callan Associates which shows that to get 7.5% returns in 2015, you would have to have invested 88% in mostly stocks, with some real estate and private equity (companies not traded on the stock exchange) to lower the volatility and still you would have a standard deviation of 17.2%, so almost triple that for 1995. Sometimes what worked in the past, doesn't keep working, and you have to adjust with the times.

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