Chapter 4

# The Business of Investing

The market is a business and, like any business you are not familiar with, there are terms and jargon, common practices, and tips and tricks to make things run smoothly. An overview of the market and its procedures and systems will give you a basis from which to begin your own investment plan or ask better questions of your advisor.

## The Efficient Market Theory

The efficient market theory (EMT) holds that analyzing stocks is futile because all public information about them is appropriately reflected in their prices and no group of investors or any investment strategy can do better than the market over time. In other words, the market always knows everything!

At its purest, EMT suggests that a portfolio selected by throwing darts at the stock tables would be as good as one chosen by the best expert. Useful techniques and unique investment opportunities exist, so even if stock prices move randomly, you shouldn't. Whether or not we agree with the theory, it deserves serious consideration.

The market is reasonably efficient much of the time, but not always. This is particularly true for small caps. Stocks that are followed rarely by analysts, in other words "thinly traded," would not fall within the EMT definition. Small caps is one such category.

The basic hypothesis of the EMT states that stock prices move based on a company's future dividends. If we have volatile stock prices, then the upcoming dividends will also be volatile. But when we look at big stock market movements, the subsequent dividends often don't mirror what the stocks were doing.

If you use EMT, then fluctuations in stock prices should be due to new information about the long-term outlook for real dividends. Yet, in the entire history of the U.S. stock market, stock prices and dividend payout fluctuations have never matched up in the way that EMT suggests they should.

> A blindfolded monkey throwing darts at the *Wall Street Journal* can select stocks with as much success as professional portfolio managers.
>
> — Wall Street Academia

Some experts don't think that EMT has any merit. The information that analysts access to make their investing decisions varies from newspaper to newspaper, from investment service to investment service, and from TV station to TV station. On top of the abundant and varying information, perceptions are as diverse as personalities. Since no two people interpret information in exactly the same fashion, individuals' backgrounds, diverse market perspectives, and investment motives will lead each to react differently, even if they have identical information on which to make their decisions. EMT claims that all new information is analyzed and almost immediately and accurately reflected in stock prices, but research shows that the market is actually slow to digest new information. It takes one to three years to respond to dividend cuts or increases; it takes months to respond to earnings surprises. Markets do not respond accurately to new information, instead move much higher or lower than is warranted by the actual data.

Those who discount EMT point out that it makes two unlikely assumptions.

1. Everyone has access to the same information at the same time and everyone has the same perspective on what this information will mean.
2. Human beings always act from logic instead of emotion.

Even if access to information was consistent (and the digital age is giving broader, quicker access), I think you will agree with me that most of our decisions are weighted by emotion instead of hard logic. Stock prices are driven equally by mass psychology and hard numbers. Consider the high-tech craze of the late 1990s. Investors collectively lost all sense of reason, driving stock prices ever higher on nothing more than enthusiasm and hope. There is no doubt that mass psychology can move markets in ways that are clearly inefficient. It can also do the same thing with individual stocks. Reasons for the movement of stocks may exist, but uncovering fundamental explanations is difficult. Inefficient markets result when there is a shift to more people with greed (bubbles) or to more people with fear (crashes). Generally, we believe amateurs are wrong and the professionals are always right. Wrong! Don't rely on "expertise" to predict the markets.

How we decide to invest and who we choose to manage those investments has a great deal to do with how we think about money. Individuals tend to view the markets differently. Stock investors may become irrationally optimistic or irrationally pessimistic. The market is not always perfectly rational. It will move in a rational way most of the time, and always in the long run, if it reflects the long-term earnings of companies. However, in the short term, markets can gyrate with price movements that are exaggerated by irrational ideas that alter the valuations investors put on future earnings. In the short run, the irrationality in stock returns is created by speculation.

The market's irrationality can be measured by the price/earnings (P/E) ratio. If investors have normally been willing to pay $14 for each $1 in earnings, the P/E is 14 to 1. If the P/E starts to rise, it could be due to favourable company announcements, higher projected earnings, or irrational investor behaviour.

The power of speculation dominates market returns in the shorter run. Speculation is ultimately temporary and fickle. The majority of players in the stock market are short-term oriented. This instant volatility is what creates opportunity for the long-term investor. Markets react only to differences between expectations and actual announcements. If a firm is expected to report bad earnings, the market has already priced the stock to reflect this gloomy outlook. If the earnings report is not as bad as anticipated, the price will rise on the announcement.

In the very long run the fundamental combination of dividend yields and earnings growth remains the predominant driver of returns. Significant increases in the prices of individual stocks occur when some catalyst, real or perceived, changes investor psychology about the prospects for a company. When Apple CEO Steve Jobs was diagnosed with pancreatic cancer, for example, Apple stocks went down. This wasn't based on the company's very healthy earnings; it was based on investors' somewhat irrational fears that the death of Steve Jobs would derail Apple. In fact, Apple is known for having a healthy management and development team that does not depend on one individual. But investors feared the loss of the iconic "face" of Apple, even though the CEO's death would have little to do with how their iPhone or iPad performed.

Investor emotion becomes the driving force behind a stock's price movements. The bull market for particular industries and their individual stocks then develop its own pattern based on changing economic fundamentals and the overall stock market environment.

As the price of a stock rises, it attracts a small following that in turn brings attention to its positive attributes. As the underlying economic fundamentals improve, analysts raise earnings estimates. The confidence of those who already own the stock is boosted, causing them to bolster their holdings. Potential investors treat this as positive confirmation of a promising investment and buy in. This pushes the price up. Momentum players, who jump on stocks with rising prices, accelerate the price increase. They are truly engaged in an exercise in mass psychology. Finally, steady rises in price over a period of time make the majority of investors buy the stock in a self-fulfilling belief that the stock can only rise. At its extreme, investors literally throw money at the market causing explosive upsurges. This is a very emotional time when irrational behaviour predominates and fundamental research becomes irrelevant.

This particular cycle had a lot to do with the destruction of Nortel, for instance. As investors fought to buy its stock the company became massively over-valued relative to the income it could earn. When an increasing number of analysts began to point to this fact, investors lost confidence and dumped the stock, putting it into a savage downward spiral. If the company's executives had managed to stay sane about the actual value of the company in terms of what it could reasonably produce, they might not have made the decisions that led to the disintegration of Nortel when investors re-evaluated the stock.

The best argument for the validity of EMT is the fact that only a tiny fraction of investors consistently do better than the market.

The efficient market hypothesis essentially says that investors cannot beat the market over time since stock prices are based on all available information. However, bias can play a significant role by affecting our decision making.

The three biases are:

1. tendency to become overconfident,
2. to go with familiar picks, and
3. to anchor (that is, seek like-minded opinion to confirm your own).

The conclusion? Avoid trying to outsmart the markets.

You rarely, if ever, know something the market does not. The market reflects the knowledge, the fear, and the greed of all investors everywhere. You can accept them and act on them.

## The Players

So, how does a broker fit into the financial picture?

A representative of a brokerage firm was trying to impress a wealthy and potential investor with the brokerage firm's success by showing him yachts owned by the firm. The investor asked, "But, where are the investors' yachts?" Enough said! Brokers do not help you make money; they make money from you.

The brokerage industry makes most of its money from underwriting and offering bonds and stocks to the public. The industry trades existing bonds and stocks, manages investment and mutual fund portfolios, and advises corporations on mergers and acquisitions. Brokers also trade in commodities and currencies. Unfortunately, there is a lot of wiggle room that benefits the broker rather than the investor. The Canadian federal government recently approved a $120-million budget to help fight white collar crime, with the objective of restoring investor confidence. This is indicative of the huge potential for criminal activity that exists in the brokerage industry.

An investment firm is a multi-limbed entity. Its corporate finance or investment banking division helps companies raise money in the markets. The bankers are the deal-makers and the ones making the big bucks. Traders do the actual buying and selling. Each firm also has an institutional sales division where brokers try to capture trading business from mutual funds and pension funds. Retail brokers do business with small investors. It is important to know that the role of each character on the investment industry stage and what they are permitted – and not permitted – to do. But always keep in mind that every step on the ladder is designed to make money for the firm.

### *Stock Analysts*

The job of the stock analyst is to provide unbiased opinion on companies that are publicly traded. Their analysis is used by institutional salespeople to attract large portfolio trading business. It is used by retail brokers to make more money for their clients. Research provided by the analyst helps corporate finance as well. If it's positive research, it helps to sell a financing proposition to a company that's seeking to raise funds and attract investors. Chartered Financial Analysts (CFA) have completed a very rigorous education to obtain that prestigious designation. They need to pass three six-hour exams over several years, requiring six months of study prior to each exam. Then they must complete 48 months of professional experience.

Theoretically, there should be a "Chinese wall" (a "wall" that, in theory, insulates departments of large companies from exchanging information so as to prevent insider profiteering) separating research and corporate finance. In reality, there is a necessary collaboration between the two. Corporate finance may consult with research when it looks into a potential underwriting deal. If research advises against the deal, the bankers are expected to back off. Once the deal is in the works, the analyst cannot make recommendations and must step aside.

Large sums of available money are the vehicle that leads to corruption all the way down the investment line from analysts to traders. Corporate finance is the revenue driver. Research has always been a necessary but costly function of the investment banker. The analyst's bonus, which can be double his salary, is set by the investment bankers. Analysts are pressured to publish optimistic reports on companies that are being solicited by the analyst's firm for lucrative investment banking business. Analysts affiliated with investment banks give significantly more favourable recommendations on firms their employer is underwriting than do unaffiliated analysts. Conflicts of interest arise when a corporate issuer pushes for positive coverage to go along with an underwriting deal. Corporations that pay huge fees to the investment firms to help raise capital won't settle for anything less! They will shop around for the positive write-up.

You should treat a company's earnings estimates with skepticism. It's uncanny how various analysts from different brokerage firms can arrive at similar earnings estimates. When these estimates turn out to be close to reported earnings, this negates analysts' credibility since they rely on companies to give them information. They also talk to each other. The result? Analysts don't differ substantially in earnings predictions, especially when they run the risk of being wrong. Where there is disagreement on forecasts, typically stocks perform badly, particularly stocks of small companies. Some analysts have considerable influence and when they are wrong, they can severely downgrade target prices. Stock prices are driven not only by business fundamentals, but by analysts' sentiment. Remember, accounting can be creative. With all that's at stake for companies and analysts, investors should view these estimates with a healthy sense of skepticism.

> Technical analysts do not help produce yachts for the customers, but they do help generate the trading that provides yachts for the brokers.
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> — Burton Malkiel

Veritas Investment Research Corp. has no underwriting department. They are one of a very few research-only firms in Canada. They have no need for analysts to toady to companies for investment banking reasons.

It's not just that it's impossible to consistently and accurately predict the future, financial analysts are saddled with conflicts of interest and psychological baggage that can warp their research. Analysts are human and plagued by the same biases as everyone else. For instance, the herd mentality is a powerful force. When all analysts are bullish on a stock, taking a contrarian view will draw attention. There is a tendency for analysts to be cheerleaders for stocks. This is reflected in the overwhelming number of buy recommendations that consistently outnumber sell recommendations. Bloomberg analyzed the performance of S&P500 stocks since the market bottomed out in March 2009. It turns out the stocks with the most buys dramatically underperformed stocks that analysts disliked the most. In 2012, the S&P500 stocks with the worst analyst ratings did better than the ones with the best ratings. In other words, it can pay to do the opposite of what analysts say. For all their faults, analysts can tap into information that regular investors could never get. There is value with analysts but it needs to be viewed with an awareness of their weaknesses and some skepticism.

In 2003–2004, brokerage firms were found guilty of having seemingly independent analysts give negative opinions of some companies while concealing their business relationship with competitors. Courts found conflict of interest between many brokerage firms' research and investment banking departments. Some firms paid out billions of dollars in settlements over allegations that they lured investment banking deals with favourable research reports.

Savvy investors recognize that investing is almost all psychology and very little substance, despite what the multi-billion-dollar research staff of every brokerage firm will tell you. A study by Mike Bradshaw, of Harvard Business School, and Lawrence Brown, of Georgia State University, found that price forecasts are overly optimistic and analysts demonstrate no abilities to persistently forecast prices. The "expert" stock analyst's predictions are often as valuable as those of a fortune teller at a fair!

### *Market-Makers*

Spread is the difference between the bid and the ask price. A stock or bond has two prices: the lower bid and the higher ask. In effect, the market-maker gives the offering price to the seller and charges the asking price to the buyer. You buy at the higher ask and sell at the lower bid.

To clarify, assume the latest trade on a stock was $10. The new bid price, the price someone is willing to pay, might be $9.80. The price asked by someone willing to sell could be $10.20. This difference is called the spread. The spread can be small for heavily traded stocks and large for thinly traded ones. On thinly traded stocks, this spread could be 2–5% of the purchase price. A frequent trader loses this spread every time he buys or sells.

The spread goes to the market-maker, the individual or company that maintains an inventory of stocks or bonds to allow for smooth trading. The market-maker takes the responsibility of buying and selling as necessary to create a ready market for the stock. Heavily traded stocks often have their own market-makers, also called specialists. These individuals work for brokerage firms, standing ready to buy and sell a stock. They buy shares from investors at the lower bid price, then turn around and sell these shares to other investors at the higher ask price. In doing so, they earn profits on their bid-ask spread.

By standing ready to buy and sell on the heavily traded stocks, the market-makers earn handsome profits on the bid-ask spread. They provide liquidity by overtrading. If the buying of a stock is slow, then the market-makers will lower the price until there's more interest. The same holds true for selling. This cycle repeats many times and is the basis of what is known as support and resistance. Spreads also create a great source of transaction fees, which can be greater than the brokerage's commissions.

### *Brokers*

A broker is an individual or a brokerage firm that arranges transactions between a buyer and a seller, and gets a commission when the deal is executed. A financial advisor is a person who offers advice about buying or selling investments. A do-it-yourself investor doesn't need advice on buying and selling investments and therefore would deal with a broker to execute his buying and selling, likely a discount brokerage firm. If he needed advice from an advisor, the advisor would execute the trades through his full-service brokerage firm.

It is in the broker's interest to trade as often as possible. Investment dealers, brokers, and advisors are often viewed as shrewd exploiters of the speculative enthusiasm of the uninformed and greedy public. Far too many Canadians are being duped for short-term gains because the investing community generally earns its income on commissions! By trading less often, you sidestep brokerage fees. A less obvious, but equally lucrative money-saver, you also sidestep the bid-ask spread. Successful and sophisticated investors scoff at the idea of trading stocks aggressively to make money. This is what the brokerage industry would like you to believe. People get focused on trading because most of the stuff coming out of the brokerage firms is oriented to short-term trading. Trading generates commissions!

Your broker is *not* your buddy. Brokers need trades to make money. Brokers are not trained to invest. They are trained by the brokerage houses to sell. Bonuses to brokers are not based on the growth of a client's assets, but on the increase in sales commissions. Brokers are not normally judged on how well their clients do in the market, but on the size of their annual sales commissions.

Most brokers want to make the market seem complicated to ensure investors come to them for help. This is understandable. Investment techniques shrouded in mystery clearly have value to the purveyor of investment advice. Brokerage firms and financial services firms are not in the business of truly educating the public, since a well-informed public would dramatically cut into their profits.

### *Financial Planners and Advisors*

Before you start investing, you need to take stock of yourself. Everyone is different. You will need to answer some questions and it's best you deal with a professional financial planner who specializes in preparing financial plans covering matters such as investments, tax planning, estate planning, insurance needs, retirement goals, income generation, tolerance for risk, etc. Generally speaking, financial planners will determine how individuals can meet their financial goals through proper management of their financial resources. They do not manage investments.

In Canada, with the exception of Quebec, anyone can call themselves a "Financial Advisor" and they don't need qualifications nor a license to do so. To add to the confusion, a financial planner can be referred to as a financial advisor. Financial planners are not subject to provincial registration or regulations.

For instance, a broker might also call himself a financial advisor. However, to recommend or sell securities, including mutual funds, a license is required. Thus, a broker can be a financial advisor, but a financial advisor is not necessarily a broker.

Anyone trading securities or in the business of advising clients on securities must be registered with the provincial securities regulator. Under securities law, there are two main categories of registration: dealers and advisors. The terms "dealer" and "advisor" are legal terms that describe a broad range of people who can deal in or give advice on securities. They may use a variety of titles, such as investment advisor, financial advisor, financial planner, investment consultant or investment specialist. These titles are not legally defined terms or official registration categories. In our discussions, I'm going to refer to the person you are dealing with at an investment house, as a financial advisor.

A person's registration is more important than their title because it tells you the type of products or services they can offer. For example, a person registered as a mutual fund dealer can sell and provide product advice on mutual funds, but they are not qualified to sell or provide advice on equities unless they hold further registrations.

## Do You Have A Complaint?

Small investors cannot afford the legal fees associated with filing a complaint with the courts. Their best course of action is to file complaints with the broker's compliance officer, and the ombudsman. The problem is that these entities are all paid by the very people you are filing a claim against.

Other routes you can take are the Securities Commission in your province and the Investment Industry Regulatory Organization of Canada (IIROC). The average investor is defenseless and the industry knows this. Most wronged investors will put the complaint behind them without a satisfactory conclusion.

When faced with a complaint, the brokerage firm will usually give the following response, "We suggest that investment advice is intended to provide a client with the guidance necessary to make an informed decision, but it's not intended to substitute for the client's own decision-making. He/she had an opportunity to complain about the proposals or the performance of his/her investments, and he/she did not. He/she is the author of his/her own misfortune." The distressed client may be bounced among several organizations created to protect his interest. Even a sufficiently motivated client is unlikely to ever see his claims presented in court. The public will never hear about the complaint or the result, for the agreement includes a non-disclosure condition. This demand for secrecy is never made by the investor. Confidentiality is stipulated by the investment industry, an effective method of concealing the extent of investor dissatisfaction and abuse.

Everyone in the industry with an interest in the facts, including lawyers, brokers, advisors, the IIROC, and other self-regulated organizations (SRO) can be privy to the details of a client's complaint, but the press or the public are totally barred from any knowledge of the financial company's misdeeds. From the perspective of an unscrupulous advisor, the individual investor's economic dilemma creates profitable opportunities. If the advisor knows that the vast majority of investors who sustain losses will not have the means or the economic incentive to sue to recover their losses, then withholding the truth becomes an attractive proposition.

Investment firms boast a compliance officer dedicated to ensuring that rules are followed. The main role of the compliance officer is to protect the firm, not clients! If you have a dispute, the firm will automatically try to convince the court your investment knowledge was better than "average." This means it would have to be "sophisticated." By this standard, what rating would they give a stock broker with 25 years of experience? The banks/brokerages ombudsmen are appointed to ensure clients are protected against any wrongdoing. But if the ombudsmen determine that a client has been wronged by a broker, do they investigate the accounts of the broker's other clients who are likely unaware but equally affected? Doubtful.

People in the investment industry are well protected and well prepared. They have the stamina (money) to defend their cases. They can afford the best lawyers. They know only a small percentage of defrauded investors will ever have the courage, time, or money to take them on. They have convinced the government that they can be a self-regulating industry and have been able to maintain that position despite the numerous cases of defrauded investors that have appeared in the news.

The number of investors who have launched complaints against brokerage firms has more than tripled in the past five years. If you want to check on disciplinary actions brought against your broker, visit the IIROC website (www.iiroc.ca). A survey done for the Canadian Securities Administrator found that almost one in twenty Canadians have been victims of investment fraud and 41% have been approach with a fraud at some point. The industry is a money-making machine on the backs of Canadians saving for their retirement. The industry consumes about 25% of the returns Canadians have invested in mutual funds. That there is no public outcry is astonishing! Canadians simply are unaware of how much money they lose by trusting their bank and investment broker to do the right thing.

> It's the financial industry's world, we just live in it.
> — Rob Carrick, *Globe & Mail*

Generally, the investment industry intends to adhere to the highest professional standards. The regulatory bodies (provincial securities commissions and the IIROC) are doing the best they can at reducing abuses given their limited resources. In this vast industry and in the real world, disappointments can be expected.

## Government Protection?

Why is the government not protecting investors? Why is government allowing the investment industry to be self-regulating? Government inspects workplaces, food processors, schools, roads, and hospitals, and many other businesses to ensure that Canadians are safe and protected. The government also ensures that established standards are maintained in many industries. However, there are no checks and balances in the investment industry and no attention paid to the protection of Canadians who have entrusted their life savings to these firms.

Recent scandals in the investment industry are strong evidence that self-policing doesn't work. It took a public outcry in the U.S. to initiate an investigation of a similar mutual fund scandal in Canada. This is the same industry our government has trusted with self-regulation. Firms were found guilty of defrauding their clients. Clients were compensated, but no apologies were offered and investment practices were hardly impacted.

To borrow a phrase from Stephen Jarislowski's book, *The Investment Zoo*, "Investors today are surrounded by predators, much like in a jungle." Existing laws completely fail to protect Canadian investors. Securities commissions are there merely to issue licenses to the industry. Everybody *but* the investors has had major input into formulating and changing securities laws. All too often, the laws, expensive lawyers, and deep pockets favour the investment industry rather than the investor. Once the investment industry has the investor's money, the investor becomes merely a nuisance. In a similar vein, David Dodge, former governor of the Bank of Canada, has described the Canadian capital markets as the "wild west of lax securities regulations." The Investor Beware alarm is sounding loudly and clearly these days!

No one is suggesting that the whole financial industry is tainted but, as in any other industry, there are shady firms and/or individuals who lack integrity. It is always wise to educate yourself about your financial affairs. After all, it is your money and no one is more careful of it than you. The more you know about the investment industry and how it operates, the more likely you will be able to successfully navigate its tricky shoals. This book intends to do just that.