GUIDE TO INVESTING

Advice from legendary money makers from Bay Street, Wall Street and Silicon Valley

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The only sure thing about investing is that there is no sure thing. Every bond or security has inherent risk—the potential rewards (and losses) are usually commensurate with the amount of risk tied to each. Ever since the financial bloodbath of 2008, when world stock markets plunged—the bellwether S&P 500 dropped 37%—most retail investors (that is, you and me) have shied away from re-entering the market. Which is a shame. The same markets that plunged have since recovered, and then some.

So, after an exuberant 2013, when the S&P gained almost 30% and the S&P/TSX rose a respectable 9.6%, where are the markets heading this year? Some analysts are calling for a 10% correction in the U.S., while others are suggesting an average 7% return. In other words, no one can say with any certainty.

To put your money on the line and still be able to sleep at night, you need to develop a personal investing philosophy. For this e-book, we’ve gathered together the most relevant stories published in Report on Business magazine—this year and in past issues—to help guide you along this path, from understanding what the new science of behavioural economics can teach you about trading stocks to whether time-worn investing maxims actually hold up to scrutiny. We talk to legends of investing—on Bay Street and Wall Street and in Silicon Valley—about the worst moves they ever made and the best advice they ever received. We also examine the art and science of value investing. Plus, we look back at an investor’s surprising conclusion in 2009 about Blackberry. If only we’d listened. /Gary Salewicz, The Globe and Mail
On his first day of Economics 101 in university, Barry Ritholtz realized that the discipline itself was missing something fundamental.

The Wall Street veteran says that when his professor began lecturing, “practically the first words out of his mouth were, ‘We’re going to deal with Homo economicus. Humans are rational, profit-maximizing creatures.’ Five minutes into my first economics class, I raise my hand and say, ‘But humans aren’t rational!’” The professor

**Contain yourself**

Your biggest handicap as an investor is that you are a human being. But take heart, primate—behavioural economics can help you overcome your unhelpful inborn biases

*By Dave Morris*
told Ritholtz he should imagine that they were. “Okay,” he thought, “imagine my grandmother had wheels. She’d be a bus.”

People, Ritholtz knew, tend to do stupid things, like smoking or not wearing seatbelts, despite overwhelming evidence that these behaviours can kill them. He couldn’t accept economics’ central assumption that people are by definition rational, and that they collectively express the order-making invisible hand of the market. Ritholtz went to the registrar the same day, and dropped the class.

Since the time when that contradiction vexed the young Ritholtz, a bridge between economic orthodoxy and human quirk has been erected in the form of behavioural economics, the study of how deeply embedded human traits affect financial decisions. Ritholtz is CIO of Ritholtz Wealth Management, a firm with $130 million (U.S.) in assets under management. He’s also a prolific writer and blogger—his website, The Big Picture (www.ritholtz.com), has logged more than 100 million page views, and became part of Bloomberg’s comment and analysis section, Bloomberg View, in late 2013.

Thanks to the bestselling books of academic popularizers such as Dan Ariely, Richard Thaler and Daniel Kahneman, the central lesson of behavioural economics—that the brain often misinterprets the information it receives—has been getting a good airing since the 2008 financial crisis. The mistakes include such well-known phenomena as the halo effect (believing that certain leaders can do no wrong) and the sunk-cost fallacy (our aversion to cutting our losses when a project or investment has obviously gone awry).

Behavioural economics’ roots extend to the 1970s, when the Efficient Market Hypothesis—which holds that market prices of traded assets reflect all publicly available information, and thus, because investors are rational, markets are efficient and self-regulating—was in vogue. The EMH became a wrecking ball in the hands of neo-conservatives, who used it to justify weakening regulations like the Glass-Steagall Act, a Depression-era law forbidding institutions from combining insurance, investment banking and commercial banking under the same roof. This went on until 2008, when economic carnage—blamed partly on the unregulated repackaging of home mortgage debt—led many people, such as former Fed chairman Paul Volcker, to call into question the omniscience of the market. No rational person with any knowledge of history would believe that house prices would go up ad infinitum, and yet the banks’ profit models depended on that very assumption. So much for Homo economicus.

One of the most fascinating areas of study within behavioural economics is the concept of framing effects. How a question or problem is framed—and, specifically, what future scenarios are presented—affects the kind of solution that our brains will produce. An example chosen by Thaler and Cass Sunstein in their 2008 book, Nudge: Improving Decisions about Health, Wealth and Happiness, is the question of how to encourage people to conserve energy. They write, “Consider the following information campaigns: (a) If you use energy conservation methods, you will save $350 per year; (b) If you do not
use energy conservation methods, you will lose $350 per year.”

It’s hardly a surprise that, as Thaler and Sunstein observed, option (b) is a “stronger nudge” and wins more converts to conservation. This behaviour is patently irrational—the outcome is the same, so why should framing the question in terms of a loss or a gain have an effect?—but because of the way our minds instinctively respond to certain scenarios, it works.

Some of our biases are harder to counter than simply changing the frame of the question. In Nobel Prize winner Daniel Kahneman’s *Thinking, Fast and Slow*, he describes how our brains suffer from **overconfidence**. This is not so much cockiness—though that’s part of it—as it is our tendency to believe past behaviour to be much more reliable as a predictive factor than we should, and to construct narratives to explain complex phenomena like the stock market even though there are far too many variables affecting a stock’s behaviour for us to really account for.

For example, conventional wisdom holds that the fate of a company is tied to the smarts of its CEO. A CEO’s specific contribution to a company’s overall success is hard to quantify. In order to examine the effect of hiring a rock-star leader to run an existing company, Kahneman compared various pairs of similar firms that had hired CEOs perceived as “strong,” which he defined as one whose strategy had been widely influential. The results suggested that such leaders have only a minuscule effect on a company. “A very generous estimate of the correlation between the success of the firm and the quality of its CEO might be as high as .30, indicating 30% overlap,” Kahneman wrote, noting that the respected CEO would be running the more successful firm in about 60% of the pairs—10 percentage points better than a coin toss.

So, how do you make decisions in light of the fact that, as Barry Ritholtz says, “Our wetware is so poorly wired for capital market investing?” He’s been studying behavioural economics for years, but, unlike many armchair observers, Ritholtz uses the lessons of the discipline to inform his investing practice. “What investors don’t seem to get is, this is not like being an accountant or a lawyer or a doctor,” Ritholtz says, echoing Kahneman’s observations that stock markets are too complex to predict accurately. Data amassed by the behaviouralists indicate that experience in stock picking has scant impact on results. “You know, if a lawyer lost half his cases, you’d think he was a terrible lawyer. But if you’re a .400 hitter as a stock picker, hey, you’re an all-star. The way to lose the ego is to say, ‘I am going to be wrong frequently, and occasionally spectacularly so.’”

Another common mistake investors make is to fall prey to what behavioural economists call the **recency effect**. When a particular investing strategy or market indicator has been successful recently, that is what will come to mind rather than the full panoply of strategies. Unfortunately, complex systems like the stock market produce results for a given action that, more often than not, revert to the statistical mean.

So if the market is largely unpredictable by definition, how do you predict it?

For starters, don’t put too much faith in the predictive power of any one type of analysis. “I use five major metrics: trends, macroeconomic [data], market internals, sentiment and valuation,” Ritholtz says. He then makes a decision
based on those factors, while bearing in mind the lessons of behavioural economics. “Here’s the thing I find fascinating: At any given time, three out of the five of those metrics are all but irrelevant.” Market sentiment, for example, is only useful, according to Ritholtz, at the very top or the very bottom of the market.

You also need to set rules for yourself, to combat the sunk-cost fallacy. Most investors know what it feels like to research a company, from its historical earnings down to the size of its factories, and be disappointed when the share price goes in the opposite direction than they had expected. Studies show that it’s hard for our brains to let go when we’ve invested time and/or money in a stock, no matter how much it tanks. If humans were rational, the pain of writing off a loss would be equivalent to the pleasure of an equal-sized gain. But as many investors have already learned, losses are disproportionately more painful to our brains than gains are pleasurable, and many investors sell far too late.

Ritholtz describes the fall of 2012, when he was CEO and director of equity research at a Wall Street firm, as a supreme test of his determination. After his former firm sold its volatile technology, emerging-market and small-cap stocks at the beginning of August, the S&P 500 dropped almost 15%. Beginning in October of that year, however, there was a five-day rally, and the firm decided to buy back into some of the small-cap names it had dumped. “It had a nice run,” Ritholtz says. “It ran up another 10, 11% from there, and up to 1,300 [in the S&P 500] or so. And then started heading back, and it came right back to the level where we bought, and it was heading through it, so we sold. We basically said, hey, this was a fake breakout, so if we can get out at a break-even and not suffer the drawdowns, we’ll be happy.”

Even though he says “the gut instinct is, ‘I gotta get me some of this; jump in!’” Ritholtz stands by the strategy he hatched in less emotional times. “I call that the prenup. When you’re first engaged, everybody’s happy and it’s unthinkable that it won’t work out, but at least you know everyone’s objective, you’re not throwing plates and there’s no emotion. You buy any asset class, any equity, you buy anything—you make a decision at that moment, while you’re still objective: ‘Hey, if it does this, this is where I get out.’”

Strategies to combat the emotional turmoil brought on by loss aversion, the natural cognitive disinclination toward any kind of loss, are even finding their way into the sell-side world. Insurance and wealth management titan Allianz has launched its own Center for Behavioural Finance, whose website features a white paper by UCLA professor Shlomo Benartzi that recommends advisers adopt what he calls the Ulysses Strategy, namely having investors and advisers draw up a “Commitment Memorandum” whereby they agree in advance what action would be taken in the event of market moves of, say, 25% in either direction. The agreement is legally non-binding, but it does encourage investors to resist being swayed by loss aversion, particularly in turbulent markets.

For all the doom and gloom about our mental shortcomings, behavioural economics does provide us with one reassuringly universal caveat: that no one is exempt from these irksome biases. You, me, Ben Bernanke and the rest of the human race: We’re all in it together.
To the Maxim

What's the difference between an investing maxim and an investing myth? The short answer is that the first makes you money and the second loses it. The trouble is, some advice sounds so pithy and convincing that you think it has to be true, especially if it's offered by someone who's made a killing in the market.

By John Daly

Step back to the heady days of 1999, the year the AIM Global Technology Fund topped Canada’s mutual fund rankings with a smokin’ 219% one-year return for its U.S.-dollar version (when converted back into Canadian dollars). If you’d invested $10,000 when the fund was launched in November, 1996, your investment would have been worth $52,100 at the end of 1999. No worries that stocks held in the fund were trading at a stratospheric average of more than 100 times their earnings per share. “Technology will always offer tremendous opportunities,” enthused the fund’s manager, Bill Keithler, at the time.

“If you refuse to pay the multiples, you miss huge moves up in the market. The market wants to own these things, and will pay almost any price.”

And you know what? Keithler was right. Well, he was right for two months. By the end of February, 2000, that $52,100 would have grown to $68,304. Then the great 1990s tech boom started to crack, and by the end of the year, you would have been down to $36,130.

Are there maxims that actually work? We examined 10 of them and weighed the evidence, pro and con. It appears that almost all of them do pay off—for some of the people, some of the time. And some maxims are better than others. Sometimes.

1. THE TREND IS YOUR FRIEND

PRO This buy-high-and-sell-higher approach is a counterintuitive favourite of so-called momentum traders, who try to buy during upswings for a particular stock or the market, and short-sell during downswings. As renowned early-20th-century speculator Jesse Livermore said: “Always sell what shows you a loss and keep what shows you a profit.” If a stock is climbing strongly, it’s probably doing so for good reasons, and other buyers will want in. Some modern statistical research backs that up.

CON Conservative, long-term value investors are wary of stocks that have surged in value. It’s not the trend itself that bothers them; it’s the

In a study published in The Journal of Finance in October, 2004, academics Thomas George and Chuan-Yang Hwang found that stocks that hit their 52-week high prices subsequently tended to outperform those that hit their 52-week lows. One big reason: Investors are at first skeptical of positive news like a new 52-week high, and it takes a while for a rally to pick up steam.
level of the share’s price relative to a company’s or industry’s earnings and to other fundamental indicators. They know they may miss out on some big short-term gains, as revered value investor Warren Buffett did in 1999 and early 2000, when shares in Berkshire Hathaway, his holding company, had plunged by almost half while the tech-heavy Nasdaq Composite Index more than doubled in value. But strong trends can also reverse sharply. The Nasdaq gave up its big gains by the end of 2000, while Berkshire Hathaway A shares almost doubled. “We have embraced the 21st century by entering such cutting-edge industries as brick, carpet, insulation and paint,” said Buffett. “Try to control your excitement.” As of early 2014, the Nasdaq was trading at about 4,200, still well below its all-time high of 5,049 in March 2000. Berkshire Hathaway A shares were worth about $173,000 (U.S.) apiece, up more than 400% since March, 2000.

**THE UPSHOT:** The trend can be your friend, but maybe not for long.

### 2. BUY WHEN THE BLOOD IS RUNNING IN THE STREETS

**PRO** If you’re aiming to buy low and sell high, it would make sense to try to pick the point of maximum pessimism when individual stocks, industries or entire asset classes have fallen out of favour. Take General Electric, which was trading near $40 (U.S.) when CEO Jack Welch retired in 2001. Successor Jeff Immelt has struggled for years, and if you’d bought GE when it sank below $7 (U.S.) in March 2009—at the bottom of the 2008-2009 financial crisis—your shares would have almost quadrupled in value to $27 by early 2014. Or how about McDonald’s, which hit a low near $12 (U.S.) in early 2003 as anti-fast-food activists ganged up on the company, but then climbed back steadily to $100 by early 2012. One successful method of picking low-priced stocks is the so-called Dogs of the Dow strategy: You buy the 10 highest-dividend-yielding stocks in the Dow Jones Industrial Average at the end of every year—usually, the yield is high because the share price has declined. You then hold the shares for a year and buy new dogs the next December. From 1928 to 2004, the average annual compounded return for the Dogs of the Dow was 13%. That was almost two percentage points higher than the Dow industrials, and 2.5 percentage points better than the Standard & Poor’s 500 Index.

**CON** Many bleeding patients don’t recover, and some of them die—you know that if you held on to your Bre-X stock certificate. Or shares in Nortel and Ballard Power Systems that you bought, say, back in 2000. The risk of buying a stock solely because the price has declined substantially is that you may be caught in a so-called value trap—the price is low, but still too high relative to the company’s earnings, prospects and other fundamentals.

**THE UPSHOT:** Do some triage.

### 3. DIVERSIFY DIVERSIFY DIVERSIFY

**PRO** The mantra belongs to William Sharpe, who shared the Nobel Prize for economics in 1990. Basically, he’s telling you not to put all your eggs in one basket. Buying just one stock or bond or property is risky. By spreading your money among a variety of asset classes (stocks, bonds and real estate, or funds that hold them), and among several industries, geographical regions and...
currencies within those asset classes, you cushion the impact of a downturn in any one. **CON** Maybe you could shorten that mantra by at least one “diversify.” The counterargument can also be found in the work of William Sharpe. In a 1972 article in the *Journal of Financial Analysts*, he looked at diversification and what’s called non-market risk. In the case of stocks, the market risk inherent in owning any one stock is that most of them fall when the market as a whole declines. Non-market risks affect one company or industry—suppose Lululemon introduces flimsier yoga pants and its share price continues to slide, or North American auto sales decline and the shares of all parts makers suffer. Sharpe’s article showed that non-market risk declines dramatically as you start adding stocks to your portfolio, but when you reach 25 or 30, the benefits of adding more become negligible.

**THE UPSHOT:** Portfolios are like your sock drawer—if it’s full, you don’t need more space; you need to throw out socks.

4. **FOLLOW THE U.S. PRESIDENTIAL CYCLE**

**PRO** U.S. presidents and their parties want to get re-elected, so they tend to introduce economic austerity measures during the first two years of their four-year term, then loosen the purse strings in years three and four. U.S. stock markets often follow suit. As measured by the bellwether Dow Jones Industrial Average, many bear markets since the late 1920s have begun or continued during the first year of presidential terms—1929, 1937, 1957, 1969, 1973, 1977, 1981, 2001 and 2009. By contrast, the Dow has climbed in most presiden-

tial election years. The cycle appears to have a big impact abroad as well. In a 1996 study, University of Western Ontario academics Stephen Foerster and John Schmitz looked at the period from 1957 to 1996, and found that the presidential-cycle pattern held true for 18 major stock markets, including those in Canada, Europe and Japan.

**CON** One of the most powerful influences on stock and bond markets is interest rates. Increases in interest rates put downward pressure on prices. If you glance at the historic interest rate statistics, dating back to 1954, on the U.S. Federal Reserve Board’s website, you’ll see that for each of the severe bear markets since then, the Fed increased interest rates that year or the year before. True, the central bankers look at the politicians’ fiscal policy as part of the many indicators they consider when setting rates, and presidents certainly try to influence the Fed. But it really is an independent agency, and that has been frustrating for many presidents. As an unnamed Johnson administration official said shortly after leaving office in 1969: “If you can trust the president of the U.S. with the atomic bomb, why can’t you trust him with money?”

**THE UPSHOT:** Markets usually pay more attention to the Federal Reserve chairman than the president, and you should, too.

5. **“BUY LAND. THEY AIN’T MAKING ANY MORE OF THE STUFF”**

**PRO** Humorist Will Rogers’s quip had logic to it, and for homeowners in just about every major city in Canada, it’s hard to argue with results. The average price of a house nationwide, as reported by the Canadian Real Estate Associa-
tion, climbed to $389,119 by December, 2013, more than double the level of $167,807 in January, 2000. Stocks, as measured by the S&P/TSX Composite Index, haven’t done as well, climbing only by about two-thirds. Buying a home and paying off a mortgage also seems to force a financial discipline on many families that they might otherwise lack. According to one 1999 study, the median net worth of renters in Canada was just $14,000, compared to $149,000 for homeowners with a mortgage, and $252,000 for those who had paid theirs off.

CON The dour, perennial worrywarts at The Economist magazine—who fret over an awful lot of statistics we don’t have room to list here—warned in December, 2005, that “the air is slowly leaking from the global housing bubble.” House prices in the United States and many European countries plunged in 2007 and 2008, a leading cause of the global financial crisis. So far, Canada has been spared, but for how long? Even leaving aside potential gains or losses in price, buying a house, a condo or a piece of land is an illiquid investment for most individuals—if you need cash immediately, it’s much easier to sell some stocks, bonds or mutual funds.

THE UPSHOT: Buying a home is a good thing, but try to make sure you won’t have to unload it to alleviate a temporary financial crisis.

6. DON’T SELL STOCKS ON FRIDAY

PRO Stock traders—who often are not the same thing as stock investors—love spotting patterns in markets, and many of them factor those patterns into their trading strategies. Often there appear to be sound fundamental reasons for the patterns. The 2008 edition of Yale and Jeffrey Hirsch’s Stock Trader’s Almanac, a respected industry bible, noted that from 1989 to May, 2007, the Dow Jones Industrial Average posted a whopping cumulative gain of 9,338 points on Mondays and Tuesdays, and a cumulative loss of 1,367 points on Thursdays and Fridays. The reason? Short-term traders apparently don’t like the uncertainty of keeping positions open over the weekend, so they tend to sell toward the end of the week, even if they take a small loss. The following Monday, they’re often reluctant to jump back in too quickly, which means stocks rally over the next day or two.

CON Like many patterns, this one does not hold every week. Nor is there any fundamental reason why it should. Think about it: Would companies only release good financial news on Mondays and Tuesdays? Would positive economic developments happen only on those days of the week? Those things tend to help push up share prices, regardless of traders’ emotions or their weekend plans. In fact, the Hirsches’ own statistical summary shows that from 1953 to 1989, Monday was the most cumulatively negative day of the week for the Dow.

THE UPSHOT: Your first question about any apparent market pattern should be: coincidence or what? And do you want to make investment decisions based on happenstance?

7. YOU CAN’T TIME THE MARKET

PRO There are reams of academic research showing that most investors—even professional money managers—don’t beat the market indexes over the long term. One classic study that explains why is Princeton pro-
Professor Burton Malkiel's book *A Random Walk Down Wall Street*, first published in 1973. Malkiel believes in the “efficient markets theory”: All information about individual stocks is reflected in their prices, and pretty well all traders and investors know what those prices are, so it’s unlikely anyone can consistently beat the market. Individual deviations from market averages are random.

**CON** This is a toughie, but let’s check in again with Berkshire Hathaway’s Warren Buffett. In January, 1990, you could have bought one Berkshire Hathaway A share for $8,200 (U.S.). By January, 2014, the price had climbed to about $173,000 (U.S.). If you’d invested $8,200 in the index—a Standard & Poor’s 500 ETF—your stake would have grown to $44,500. How do Buffett and other stellar money managers do it? Classic, disciplined value investing, which can’t be summed up in one or two simple rules. On the other hand, it may not be rocket science. In a lively 2003 book titled *Yes, You Can Time the Market!*, Ben Stein, a U.S. economist, lawyer, financial writer and game-show host, and Phil DeMuth, a psychologist and investment adviser, looked at stock market data going back to 1902 and determined that you could have beaten the market by using index funds and applying several classic value ratios, including the market’s aggregate price-to-earnings ratio and the average dividend yield. You buy when the ratios indicate that the markets are undervalued and sell when they appear to be overvalued.

**THE UPSHOT:** If you stick to a sound discipline, you may not beat the market, but you probably won’t do much worse.

**8. STOCKS ALWAYS GO UP IN THE LONG RUN**

**PRO** Promotional spooge from brokers often references Wharton professor Jeremy Siegel’s bestselling book, *Stocks for the Long Run*. No wonder. The charts, in particular, are dramatic. Like the line-graph showing that $1 invested in U.S. stocks in 1802 would have grown to $12.7 million by 2006, versus just $18,235 for bonds, $5,061 for government treasury bills, $32.84 for gold and just $16.84 if it had merely kept pace with the Consumer Price Index. Siegel says the lesson is clear: If you want to invest in the productive power of a growing economy, it’s best to do that directly by buying stakes in companies, rather than loaning money to them or the government, or putting it into volatile, poorly performing commodities markets.

**CON** For most investors, the long run is less than two centuries. A lot of people purchase their first home in their 20s or 30s, and only start saving and investing seriously for retirement in their 40s. Stock markets can suffer through some severe downturns over two decades. The Great Crash of 1929 looks like just a little blip on Siegel’s chart, but it took until 1954 for the Dow to return to its pre-Crash levels. The 1970s were another punishing decade. The Dow first closed above 1,000 in 1972 and didn’t stick there again until 1982. It also depends which stocks or stock markets you’re considering. Japan’s bellwether Nikkei 225 index peaked at 38,916 in 1989. By January, 2014, after two decades of bumpy decline, the Nikkei was trading around 15,000. The other thing to remember is that investors aren’t too bright. If you look at, say, the monthly statistics for mutual fund sales issued by the Investment Funds Institute of Canada, you’ll see that sales of equity funds often
rise when stock markets are high, and redemptions increase when they’re low.

**THE UPSHOT:** Start saving and investing for retirement in your 20s to lessen the impact of panic and stupidity—your own and that in the market.

**9. REMEMBER: PRICE CHASES PROFIT**

**PRO** Let’s take a shot at summing up a few hundred pages of hard-core textbook finance in a paragraph. In theory, people buy stocks for the dividends they pay each year and the expected capital gain—the rise in price. To calculate the price today, you add up all the dividends expected in future years, plus the expected price gain. You then discount that dividend stream and the expected gain using the guaranteed rate of return you could earn on a safe alternative investment like government bonds. The longer your time horizon, the less the expected capital gain contributes to your total return. Ideally, a company should pay dividends only from its earnings, or profits. So you should buy companies that have a record of strong earnings and are expected to maintain them. Simple, eh?

**CON** As mentioned before, investors aren’t too bright, and they often get caught up in euphoria. How else do you explain why they bid up Nortel Networks’ share price from less than $20 a share in 1998 (price reflects subsequent share splits) to a peak of more than $124 in 2000, even though the company reported losses for those years? On yet another hand, sometimes losses—and big sustained ones—aren’t such a bad thing if a CEO is growing a company by borrowing and spending like a maniac, er, visionary, such as the late Ted Rogers. Rogers Communications lost money for 15 out of 16 years from 1982 to 1998, yet its share price climbed from a low of $2 to about more than $5 over that time (price reflects share splits), and kept going even after Rogers died in 2008, to almost $50 in early 2014.

**THE UPSHOT:** Ted Rogers aside, it’s usually better to invest in companies that have made money consistently than those that have lost it.

**10. TRY THE SUPER BOWL INDICATOR**

**PRO** If a team from the American Football Conference wins, the Dow will decline for the year. If the game goes to a National Football Conference team or any of the three current AFC teams that were in the old NFL (the Colts, Steelers and Browns), the Dow will climb. Depending on how you interpret the indicator (in 2013, the winning Baltimore Ravens represented the AFC, but they were formerly the Browns), it has been about 75% accurate. Is your broker right 75% of the time? Another good thing about betting on the stock market—by buying an index fund or an ETF—rather than the actual game is the chances are virtually zero that you will lose all your money.

**CON** There is an Astrologers Fund, but no mutual fund that we know of that relies on the outcome of the Super Bowl. If this was even a half-reliable way of investing, don’t you think a canny pro would have launched one?

**THE UPSHOT:** If you have some spare cash, take a flyer on the market. However, if four-time Super Bowl losers the Buffalo Bills are in the final, double up and bet that they will lose the game—a 100% certainty.
Invest like a Legend
We talked to money-makers on Bay Street, Wall Street and beyond (all the way to Mumbai) about their best moves, their biggest screw-ups and their tips for the years ahead

Burton Malkiel*
Malkiel is a Princeton University economist and author of A Random Walk Down Wall Street (1.5 million copies sold and counting), a takedown of stock-picking. He’s also chief investment officer of Baochuan Capital, an investment firm that runs China-focused hedge funds using indexing principles.

What advice would you give investors?
All over the world, governments are holding interest rates down to extraordinary low levels. What that means is that short-term bonds are a sure loser. For what ordinarily would have been a bond portfolio, you can use what I call an equity substitution strategy. Also, look through the world for bonds that have reasonable rates of return. For a variety of reasons, I think emerging markets are less risky than they have been in the past. Governments are running surpluses, and debt-to-GDP ratios are low. If you want to worry about defaults today, worry about Greece and Spain.

Where do you see opportunities today?

*Appeared in the February, 2013, issue of Report on Business magazine
I am an indexer, so in the developed world, I would buy low-cost, broad-based indices [through mutual funds or exchange-traded funds]. But people are not diversified enough internationally, and in emerging markets in particular. Some frontier markets in Southeast Asia ought to be in a portfolio, if you can stand the risk.

**How would you invest a $100,000 windfall?**
I tend to be more aggressive. It would probably be 80% equities in indexed investments or funds. I might put 20% in bonds—tax-exempt bonds either through mutual funds or closed-end investment companies, and emerging markets bonds, which are available through reasonably priced ETFs.

**What was your best investment?**
My first investment was my best. I was a finance officer in the U.S. Army in my early 20s, and I was responsible for putting into effect a computerized pay-and-accounting system with IBM machines. When I got out of the army, I had something like $5,000. I had not developed my theory about indexing yet, so I put all of it into IBM common stock, and have held it ever since. It's worth over half a million dollars now.

**What was your worst investment?**
In the 1960s, I did some consulting for a company called Mathematica. It didn't actually pay in cash, but in stock. It was bought by Lockheed Martin, and my Mathematica stock was exchanged for its stock. I thought I ought to diversify and sold half of my Lockheed shares. The half I retained did tremendously well. I would have a lot more money today if I had not sold it.”

**What keeps you awake at night?**
I am really upset that our politicians do not seem to be able to deal with what I see as a looming, long-run fiscal disaster. So governments are going to keep interest rates well below the rate of inflation. They will deal with intractable government deficits by essentially taking it out on bondholders. That is financial repression. /Shirley Won

**John Bogle**
*John Bogle is a champion of indexing, and founder and retired chief executive of U.S.-based fund giant Vanguard Group*

**What advice would you give investors today?**
Ignore the volatility of the stock market. Stocks have been fluctuating since the beginning of stocks, and they will continue to do so, maybe even more violently in the years ahead, given the
mess that we have in our financial system. The value of stocks is not the prices in the stock market, but the amount of earnings and dividends of corporations around the world, particularly in America. The secret of making money is to own corporations that grow.

Where do you see the opportunities now?
I believe that stocks will do significantly better than bonds. U.S. stocks are now yielding about 2%. Earnings could go to around 5%. That would give you a 7% nominal return on stocks over the next decade. I happen to be very optimistic about Canada, because it has many of the characteristics of the U.S.—strong capital markets and solid governments that are not going to be overthrown tomorrow.

How would you invest a $100,000 windfall?
My family accounts are about 50-50 in stocks and bonds. My personal account is about 80% bonds and 20% stocks—I’m 84 years old, for heaven’s sake, so I want some money that is pretty safe. I happen to be totally in the U.S. market. Most intelligent people I know think I am crazy. But we earn money in dollars, we invest money in dollars, and we spend money in dollars. When you go outside the United States, you are taking a currency risk.

What was your worst investment?
When I came out into the world of investing, I naively went to a stockbroker and bought individual stocks. I finally decided that I did not like that game. I haven’t held individual stocks in any significant way since I was 40 years old. It’s time-consuming, tedious and unprofitable.

What keeps you awake at night?
Nothing. Just invest, and don’t peek. Don’t open your retirement plan contribution statements every quarter. Put in money regularly, and when you retire 40 or 50 years later, and open the statement for the first time, you run the high risk of heart failure—you’ll be stunned at how much money you have accumulated. 

Rakesh Jhunjhunwala*
In India, the billionaire founder of asset management firm Rare Enterprises is known as the Big Bull, and his every move is tracked obsessively by market watchers.

Who is your investing hero?
I don’t have any heroes. My thought is that we should not enslave our mind to any great man. But, personally, I like George Soros—for his human values, for his deep thought. I’ve met him. I had lunch with Warren Buffett, too. I’ve learned lots, but I don’t want to copy anybody. I think the first thing you need is an open mind.

What’s your investing style?
I’m 53. I’m too young to have a philosophy. Because a lot may change.

What sectors have you been investing in lately?
I made an investment in the liquor sector, a media company, a luggage manufacturer and a casino company. I’m very bullish on agriculture.

Why don’t you invest outside of India?
When the food at home is so good, why eat elsewhere? I have 102% of my wealth in Indian stocks, because I borrowed 2%.

If you were to invest in one other place, where would it be?
Africa. It’s the next frontier. The key to Africa is governance. Look at Botswana. Where there’s good governance, they’ve prospered.

Do you prefer passive or controlling stakes

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*Appeared in the February, 2013, issue of Report on Business magazine
when you invest?
Ninety-nine per cent of my investments are passive. I want to earn money by recognizing opportunity. I don’t want to earn money by squeezing opportunity. It’s better to understand your core competency. My core competency is balls of steel. I am a risk-taker.

What do you think of Canada?
I think Canada is in a great situation—all the natural resources, it’s thinly populated. The big problem is Quebec.

What are your best and worst investments?
My smartest investment was Titan Industries. It sells 6.5 million watches a year in India. Its turnover is about $2 billion. When I invested in 2001, the turnover was about $800 million. I invested about $10 million, so every rupee invested is now worth 60. My dumbest mistake is when I make an investment and fall in love with it. I become blind to reality, until it’s too late.

What do you tell foreign investors coming to India?
India is evolving. Have faith in India. Make money. God bless.

If you got a $1-million windfall, where would you invest it?
In India, very sure—in real estate and agriculture.

You said recently India was on the brink of a bull run.
I said the mother of all bull markets is ahead of us. Once politicians realize that the only way to retain power is to look good on development and
reforms, I think India will grow by 10% to 11% a year. Another thing people forget is that Indians in 2012 saved $650 billion to $700 billion. In 2020, that’s predicted to be $1.75 trillion to $2 trillion. If 10% comes to the markets, what will happen?

Anything keeping you up at night?

My health. At the moment it is very good, but I smoke 20 cigarettes a day. I have four whiskies a day. And I don’t exercise.

What do you think of your nickname—the Big Bull?

I think it’s the wrong one. I think I’m realistic. In 2007, I was one of the big bears. /Sean Silcoff

Donald Yacktman

Value investor Donald Yacktman, 72, has returned an annual average of close to 10% over the past 15 years in his two flagship funds—double the S&P 500 Index.

What is the biggest risk that investors face right now?

The stock market is not cheap.

Is that why you’ve been holding a lot of cash lately?

Yacktman Asset Management manages close to $30 billion. In 2007 and today, we’ve had a fair bit
of cash. We were at about 20% at the end of the third quarter of 2013. Usually, as the market goes up, our cash tends to build. Because we’re investing from the bottom up, not the top down, the cash is a residual. That’s telling you how hard it is to find stocks to buy.

**What about the argument that investors hire a manager to pick stocks, not to hold cash?**

Our primary goal is to protect our clients’ money, and there are two sides to that. One is protecting it against bad decisions—buying things that are overpriced. The other is to protect against inflation. You have a tough period now, because cash doesn’t earn anything. If it earned something, our cash position would probably be even higher.

**Your holdings aren’t little-known stocks. Are you just buying at the right price?**

Yeah, price is critical. But the second thing is time horizon. We view every stock as if it were a long-term bond. And we’re looking at risk-adjusted forward returns. The Cokes, Pepsis and P&Gs become our triple-A bonds.

**So how do you identify a bargain?**

Companies that tend to have consistently high returns usually have low fixed assets and low cyclicality. You will rarely see things like airlines, automobiles or steel companies or, for that matter, banks in our holdings.

**Your staff is very small, right?**

We have about a dozen full-time people. Five are what I would call analytical staff. We aren’t into body count. When I organized the company, I had the goal of trying to farm out everything except for the judgment part. Basically, the only thing we do is make purchases and make analytical decisions. There are a few critical variables, and most of them can be figured out on the back of an envelope.

**How do you decide when to buy?**

The easiest is when the market comes down. By the end of 2008, we had all our money invested. I’d said, “If you can’t find bargains in this environment, there’s a disconnect.” Then the market went down another 20%. In this business, you’re wrong almost all the time. It’s just a matter of degree, because nobody buys at the bottom or sells at the top.

**What are other good times to buy?**

Another one is an industry thing. For instance, you have a lot of health care issues in the United States. Everybody gets nervous, and they knock down the price of companies in that industry.

**Have you bought any health care stocks recently?**

Things in that area were disruptive in 2012. We now have big positions in C.R. Bard, Stryker and Johnson & Johnson. So three of our top 12 are in the medical device area.

**What about BlackBerry? You were a prominent investor recently.**

That’s an example of something company-specific. We’ve had back-and-forth positions in BlackBerry within the last year or two. When it got creamed, we bought it. We ran the share price up into the teens and we eliminated probably 90% of it. We should have got rid of all of it.

**And you made money on it?**

Mmmm hmhhmmm.

**So how do you get out of a dog like BlackBerry?**

I think the secret is to be incredibly objective and patient. First of all, don’t buy more. Also, stocks tend to fluctuate about 50%, from low to high, over 12 months. You’ll usually have opportunities to re-evaluate and exit. /John Daly
Peter Thiel

German-born Thiel left a New York securities law firm to move to Silicon Valley and start PayPal with his friend Elon Musk. Then he became Facebook’s first backer. He is also the chairman of Palantir, the data security firm that helps the CIA track the movements of miscreants (and the rest of us) on the Internet.

“We wanted flying cars—instead we got 140 characters.” Explain the motto of your investment company, Founders Fund.

We’ve lived through a period of relative technical stagnation. You can debate whether flying cars would be a great improvement, but if people wanted to make them work, it could be done. We are not trying as hard, not reaching as high.

As an investor, how do you choose which dreamers to back?

How many leaps are required for your solution to work? Having to invent one or two major things, that’s doable. More? Doubtful. Also, we look for founders who are good at co-ordinating large teams and convincing them that something that seems impossible is doable. It’s been a decade-long effort for Elon Musk to start SpaceX to reconstruct the American space program—which seemed impossible at the outset.

You’ve invested in three of the biggest successes in the Internet’s short history. How do you decide which start-ups have legs?

Each great company is geared to capitalize on a particular moment in history. PayPal and Facebook each began by providing a big benefit to a small market. There are only 10,000 people at Harvard, but Facebook had a 60% market share in 10 days. PayPal’s initial market was eBay’s “powersellers”—maybe 20,000 people. But within four months of launch, we had 25% of the market.

Is tech investing different from other sorts of investing?

It’s incredibly hard to get people to adopt new tech solutions, and you only get adoption of something if it’s 10 times as good as the next best thing. Amazon had 10 times as many books. PayPal was at least 10 times as fast as cashing a cheque.

What metric do you most rely on?

I’ve found a single question to be predictive of a start-up’s success: What is the CEO’s salary? If it’s less than $120,000, with equity a big component of the compensation, there’s alignment between the CEO and the investors. If it’s $150,000 or more, it almost never works.

How do your years of competitive chess-playing help you invest?

Chess champion José Raúl Capablanca said, “In order to improve your game, you must study the endgame before everything else.” Successful businesses have a very long arc. In 2001, we concluded that three-quarters of PayPal’s value would come from 2011 and beyond. The same thing applies to all the big tech companies currently—LinkedIn, Facebook, Twitter. Most of their value comes from the 2020s, 2030s and beyond. And so one of the critical questions is, what does the endgame look like, not how they will do in the next month.

What are your thoughts on the Canadian start-up scene?

We’ve been looking at Canada very carefully—a scene that is shockingly underfunded.

What’s your advice for investors?

We should never underestimate the degree to which investors act in herd-like ways. This leads to all these bubble-like phenomena. It’s difficult to time these things precisely, but understanding
extreme irrationality is a good starting point. You need to understand just how far we are from an efficient market. /Alec Scott

Peter Schiff
Schiff is CEO and chief global strategist at Connecticut-based Euro Pacific Capital. He has authored many books, including Crash Proof: How to Profit from the Coming Economic Collapse, and The Real Crash: America’s Coming Bankruptcy. His nickname is, not surprisingly, Dr. Doom.

Where do you see opportunities?
The U.S. economy is a bubble that will burst. In contrast to prior monetary excesses, this time the U.S. Federal Reserve has inflated simultaneous bubbles in stocks, bonds and real estate. As the Fed prints more and more dollars to keep those bubbles from popping, the dollar will lose value and eventually precipitate a financial crisis larger than the one we experienced in 2008. The U.S. dollar is being propped up by foreign central banks. But when our creditors finally understand the box we are in, they will not be willing to hold as many dollars. You don’t want to own U.S.-dollar-denominated assets, and you certainly don’t want to own U.S. treasuries or corporate bonds. You’re better off owning equities outside the U.S. I like resource stocks like Franco-Nevada, Goldcorp, Yamana Gold, Agnico-Eagle Mines and Endeavour Silver. Many people don’t understand how much inflation is being created, and how that benefits gold. Gold is going to be several thousand dollars an ounce before the bull market ends.

What would you do with a $100,000 windfall?
I am a 50-year-old guy with a family, but I would go with all equities, precious metals and little bonds. I’d buy more gold stocks and bullion because of how cheap they are. Also, buy dividend-paying foreign equities and get into emerging markets.

What are your best and worst investments?
Shorting subprime mortgages in 2006 was both my best and worst investment. There was a book written on it, called The Greatest Trade Ever. But it was also my worst trade, because I didn’t have it on big enough for me or my clients. At the time, I had a lot of money in gold stocks, which I didn’t want to sell because of a significant tax liability. I expected that the monetary policy that would

photograph by SEAN KERNAN
result from the bursting of the housing bubble would send gold prices much higher. As well, my brokerage account was already highly leveraged, as I had just borrowed against it to settle a divorce. Of course, those gold stocks imploded in 2008, and I could have sold them, paid the taxes, and then bought them back for much less with the profits I would have made shorting subprime. I was also under-invested because I thought the performance fees from my hedge fund [which returned just over 1,000% after fees over one year] would provide me with ample upside. As it turned out, very few clients actually invested in the fund, so my fees were much smaller than anticipated. Sure, I made a few million dollars, but it wasn’t a lot of money compared to what others made. I just didn’t put enough money where my mouth was.

What keeps you awake at night?
I worry it’s going to be a long time before the economic collapse happens. The longer it takes, the worse it is going to be. I want the world to stop financing the growth of the U.S. government—that is, to stop buying treasuries so that our economy can restructure in a healthy way.

What was the best investment advice you ever received?
I have been given lots of advice over the years—most of it bad. That is why I try to invest for the long term.

What advice would you give average investors now?
Be skeptical of mainstream Wall Street firms. Analysts who have buys on stocks are often trying to get investment banking deals from those companies, or to help favoured institutional clients sell their shares at higher prices. They will be reluctant to tell you to sell those stocks, even if they see problems. Also, be skeptical of government numbers. The U.S. government says there is no inflation, because the Consumer Price Index says that. But they have specifically redesigned the CPI to conceal inflation. The Fed is creating a lot of money. That is the definition of inflation.

Do you have a mentor?
Jim Rogers, Marc Faber and Jim Grant are people I used to listen to before I became one of those people. I gravitated to them because they were pretty much saying what I was thinking on my own. And now a lot of people listen to me. /Shirley Won

Jeremy Grantham
The chief investment strategist at global asset manager GMO has managed to dodge recent bubbles and scoop up opportunities on the cheap. But he’s getting increasingly worried about the environment, which bodes ill for Alberta. And don’t get him started on the Fed...

Some people would argue that there’s a lot to feel upbeat about right now: Washington is agreeing on budgets, the global economy is improving, Europe has avoided catastrophe. What’s your feeling about the state of the world?
In the short term, we’re jogging along okay. I agree that things look better than they did quite a bit of the time over the past five years.

In the longer term, I worry about the inability of many different countries to come to terms with environmental issues, which have already started to do damage to coastal cities and cause interruptions to farming. This is going to be a big problem as the population grows. And there is little sign that anyone gets the point that we can’t afford to go on burning coal unless we want to end up with
I belong to the camp that believes the long-term growth rate of the developed world is substantially lower than people seem to think. Basically, we’ll be lucky to have an economy that grows 1.5% after inflation—and Europe, probably less. Mainly because population is slipping, and as population slips, it is hard to keep productivity up.

Environmentalism crops up quite a bit in your thinking these days. To what extent are you arguing as an environmentalist versus arguing as an investor?

It’s very hard for me to separate them. It leads to some clear conclusions: Coal and tar sands will be stranded assets, in that they won’t get their money back. However much coal Third World countries burn, the industry is seen increasingly as dangerously polluting and contributing to global warming. The pollution in Chinese cities may be the single-biggest driving factor on that.

You've been critical of Canada’s oil sands in particular. Can you explain what you mean by stranded assets and how that will impact the industry in Alberta?

Scientists know that if we burn more than about 20% of the fossil fuels that we have proven in the ground, we will go way past the danger point. Research now suggests that the original global warming limit—a temperature increase of two degrees Celsius—is too dangerous and is already associated with self-reinforcing processes that may be out of control, such as melting tundra and the release of methane.

The tar sands is a particularly dirty and expensive form of fossil fuel. It doesn’t bubble out of the ground like it does in Saudi Arabia. If we burn an appreciable chunk of your tar sands, we’re toast. That’s it. We’re in this boat together, and the boat is leaking.

You’ve been warning of a potential stock market bubble ahead, followed by the third market bust since 2000. How do you play this sort of environment where there seems to be an opportunity for big gains and a risk of big losses?

There is no easy answer, and anyone who thinks there is an easy answer is either ignorant or a crook. If you get out too soon, you’ll be victimized as an old fuddy-duddy who doesn’t get the new world order. If you stay in too long, you’ll be just another superficial trend-follower.

But we know what the Federal Reserve does and we know what [incoming Fed chair] Janet Yellen thinks. She says that the market is not badly overpriced, which means that she’s not going to get disturbed if it were 20 or 30% higher. Consequently, I don’t think that is at all unlikely.

It’s nowhere near a bubble in quantitative terms, and I don’t think it’s close to a bubble in psychological terms. So I wouldn’t be surprised to see this market go 20 or 30% higher, and around there it would become an official quantitative bubble. This time, a lot of the stress would be on governments because a lot of debt has moved from the private and corporate sectors to the government sector. How that plays out, nobody knows.

It’s a very dangerous game. Why the Federal Reserve has embarked upon this series of experiments, I cannot imagine. And why the Fed has had political and public support, I also can’t imagine.

Should we be resigned to a series of bubbles and busts, or is this a cycle that can and should be avoided?

Of course it’s a cycle that can and should be
avoided. But by appointing Janet Yellen as Fed chair, you know there is no inclination on the part of officialdom to change the game. Bernanke and Yellen are guaranteed extensions of what I think of as the Greenspan experiment in stimulus and relatively lax regulation. It is a totally failed experiment, with enormous pain.

Bernanke is part of an era that encouraged asset bubbles in order to get the wealth effect to stimulate the economy. Two bubbles burst with ruinous effect, and yet once again the Fed brags about the stimulus that comes from rising stock markets and house prices. Will they never learn?

**You're a big-picture strategist. How important is stock-picking when you get the central ideas right?**

I would say that the big picture utterly overwhelms stock-picking if you get the big picture right. And if you only get it modestly right, it really would be a good idea to have some stock-picking skills up your sleeve.

**When you hear someone say that it is a “stock-picker's market,” what's your reaction?**

Every year that I can remember has been a stock-picker's market. It's what people say. And when the smoke clears, you can always identify a couple of themes that would have worked brilliantly.

**Why has timber persisted year-in and year-out as a good investment?**

When we first picked it up in the late 1990s, it was a totally mispriced asset. It was unacceptable to most institutional investors, except for a handful of mavericks, and it was notoriously illiquid. That resulted in a ludicrous mismatch with the rest of the market—and it provides wonderful diversification and it has a long horizon suitable for pension funds. It was an easy sell, and gradually that percolated around.

It's still a bit cheaper than other investments, but I do think it reflects a little bit of the Bernanke effect. His driving down interest rates has driven down yields on all assets. Timber is still cheaper than U.S. stocks but, like most assets, it is going to take a hit when we finally exit the Greenspan era.

**You're bullish on resources, particularly those tied to food production. With some commodity prices down, has your long-term view shifted?**

My long-term view has gained a lot of nuance over the past three years. The platform for resources is oil: When oil went from its low in 1999 to its high in 2008, it's not surprising that it tripled and quadrupled the price of everything else. Given the disappointment in global economic growth—we have underperformed for four consecutive years—this would normally have been a bloodbath for oil. But not this time; Brent crude trades at about $110 (U.S.) a barrel. This is exhibit one of a brave new world: This is not the old era when the price of everything came down with a lot of volatility. I believe this is the era in which everything goes up with a lot of volatility.

**So, what's your favourite resource for the long term?**

Forestry and farmland, if you can sidestep the Bernanke-Greenspan effect and find those properties that have the least overpricing from that influence. They would tend to be more exotic—overseas, in reasonably stable countries. That would be my preferred investment, unless I could get a share in the Moroccan government's phosphate enterprise, in which case I would do it with a quarter of my net worth and I would feed it to my grandchildren. /David Berman
Charles Brandes
Brandes has been spreading the gospel of disciplined investing in sound but undervalued companies since 1974. Like Warren Buffett, the San Diego billionaire counts Ben Graham as his mentor. The author of the widely read Value Investing Today, first published in 1989, regards investing as a long-term proposition. Anything else is just speculating.

What’s the best investment you’ve made?
The most recent example, believe it or not, is Microsoft. As deep-value guys, we generally don’t buy these high-flying technology companies when they’re trading at very high price-to-earnings and price-to-book ratios. But over the last three or four years, some of the premier technology companies had gotten to a value price. The feeling about Microsoft was that the PC era was over. But enterprise-wise, everybody around the world had Windows on their PCs, and we didn’t think that was going to go away immediately. Thinking long-term and of the basic fundamentals of the company, it was a very good bargain.

What’s the worst?
We bought stock in a brokerage firm in Japan called Yamaichi Securities, in 1997. It was the third-largest in Japan at the time. The stock price looked to be pretty cheap, compared to their earnings or cash flow, their dividend and that sort of thing. This was one of the rare cases of outright fraud. Yamaichi’s reporting was fraudulent. It went to zero. So that result was not satisfactory.

You say individual investors have a big advantage over institutions. How so?
The conventional wisdom is that the institutions always have an advantage over the little guy, and you can’t fight Wall Street. That is wrong. The
institutions have the same behavioural handicaps as individuals. However, they can’t overcome them, because there is so much pressure in the short term for institutions to perform.

**What are the biggest risks facing the average investor?**

I don’t know if your readers would believe this, but if you have a period of time for your investments shorter than three to five years, you’re not an investor. You’re a speculator.

**What risks should the long-term investor be paying attention to?**

Obviously, one of those would be technological change in the business that you’re invested in. And technological change has speeded up a whole lot. That is such a fundamental potential risk that you have to be aware of it. An example would be Kodak and its film business. Digital just wiped them out.

**Other risks to watch out for?**

Potentially, balance-sheet risk, credit risk. Of course, we saw that big-time in the credit crisis of 2008. But historically, you always have to be careful with a company that is getting too much debt on its balance sheet to survive properly in a recessionary environment.

**What keeps you up at night?**

Nothing, really. However, after 2008-'09, investors were scared about investing in equities—and it’s still going that way. The institutions used to have 60% in equities, 30% in bonds and 10% somewhere else. Now, they’re down to about 40% in equities. When you look at the long-term rates of return, equities are absolutely the superior place to be. If you’re a fundamental long-term investor, you just keep with equities because they always recover to new highs. /Brian Milner

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**Rob Arnott**

Rob Arnott has turned the practice of buying the market on its head. His fundamental indexing approach weights stocks on factors such as book value and cash flow, rather than stock prices. And, just as index investing beats most stock picking, fundamental indexing is beating them both.

**Fundamental indexing has been attracting a lot of attention for outperforming traditional indexes. Is it also attracting more criticism?**

Actually, I think it has been silencing the critics. The idea has been live for close to nine years, and it has worked. It has added 1.5% to 2% per year, compounded annually, across a whole array of markets. The simple fact is, fundamental indexing wins because of contra trading against the market’s most extreme bets. Whatever the market is chasing most aggressively as a fad, that’s what we’re trading against. Whatever the market is shunning, that’s what we’re buying.

**Is fundamental indexing supposed to replace traditional indexing?**

They are highly complementary. I can’t imagine ever investing in a cap-weighted strategy again, but there are times when growth is in favour and fundamental indexing will struggle. So for most investors, having a bit of both probably does make sense.

**As an indexer, what are your views of 2014?**

We think value in emerging markets, perhaps best illustrated by fundamental indexing, is really, really cheap. So to the extent that investors want equity investments, we think this is a wonderful time to fade their exposure in the U.S. and developed economies, and to rebalance into the deeply out-of-favour and unloved emerging mar-
kets. Emerging market debt has also fallen out of favour and is priced way out of proportion to the default risks. And we think that high-yield bonds still represent a modest opportunity.

Where do you stand on whether U.S. equities are heading into a bubble?
I think the word “bubble” is overused. I would characterize the U.S. stock market as expensive. Could it become a bubble? Yes, but buyers today are basically betting on two things. One, that it goes from expensive to bubble; and two, that they’ll recognize the difference and will sell after the bubble has matured. Those are two very aggressive assumptions. I’d much rather sell out of an expensive market and buy into attractively priced markets, rather than playing the game of picking up nickels in front of a steamroller.
/David Berman

James O’Shaughnessy
O’Shaughnessy, 53, is the author of the 1997 bestseller What Works on Wall Street and one of the most formidable crunchers of historical market data in the business. His Connecticut-based O’Shaughnessy Asset Management manages $6.4 billion (U.S.) and is a sub-adviser on seven Royal Bank of Canada O’Shaughnessy mutual funds.

Stocks have had a good run since 2009. Are they getting too expensive?
Stocks in the U.S. are about 150% higher than they were in 2009. At that time, we did a calculation based on 20-year averages: What would the market have to go through by 2019 to match the worst 20-year period ever? If memory serves me, it was 6% average annual gain after inflation. If we look back in 2019, I’m not saying that stocks will

photograph by SEAN KERNAN
be giving huge double-digit returns, but I do think they will end up being one of the best-performing asset classes.

**What are the biggest risks investors face right now?**
Extrapolating the bond market’s fantastic performance since 1981 into the future. We think long-term bonds will be going into a multidecade bear market, and we’re urging investors to invest only in short-term bonds. My entire adult life has been lived in a bull market for bonds. But bonds can be very risky, especially over long periods. If you’d started investing in 20-year bonds in 1940, by 1981, you would have had about a 63% real total loss on the portfolio. I’m not saying don’t buy bonds; I’m saying be careful which bonds you buy.

**What one piece of general advice would you give to investors right now?**
Establish an asset allocation and then rebalance it when it gets 15% out of whack. Really, if investors could just do that, they could substantially improve their overall performance.

**What about picking individual stocks? What numbers or ratios work best?**
Our value composite consists of five elements: price-to-sales, price-to-earnings, EBITDA-to-enterprise value, free cash flow-to-enterprise value and shareholder yield. For all 10-year periods, the value composite has outperformed any one of its constituents 85% of the time.

**What was your best investment?**
The data our firm uses to conduct our research on investment strategies. It is our second-largest expense after people. The data includes Standard & Poor’s Compustat, Thomson’s Worldscope, MSCI and the University of Chicago securities data and prices that go back to 1926. It allows us to answer questions like, how often does a strategy beat its benchmark and by what magnitude?

**What was your worst investment?**
OEX put options, based on the Standard & Poor’s 100 [which investors use as insurance against a market downturn], just before the crash in 1987. I was trading on my own account, and I was doing a lot of work with the Black-Scholes formula for options pricing. The puts tend to go up in price if the market goes down, and they were really acting up, so I thought the market knew something I didn’t. I slowly began acquiring puts. But then the market had a great day just a few days before the crash. I lost my nerve and I emotionally sold the puts at a loss. I don’t even want to tell you what I would have made if I had held on through the crash. Shoulda, woulda, coulda.

**Who is your investing hero?**
Definitely Ben Graham. I’m just lucky he didn’t have computers; otherwise, he would have written What Works on Wall Street. /John Daly

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**Gerry Schwartz**
The 72-year-old founder and chairman of Onex Corp. has long been one of Canada’s most successful investors. While building the country’s most influential buyout firm, the billionaire has stuck resolutely to the long-term view, ignoring quarterly numbers, market fluctuations and economic data to focus on the essential health and prospects of businesses he likes.

**What’s your assessment of the current state of North American markets?**
I have said many times that it’s a mistake to bet against the long-term health of the U.S. equity markets, because it’s a mistake to bet against the long-term health of the U.S. economy. It will have
ups and downs, some of them big downs, like 2008-’09. But if you look at it over a long period of time, it is a very strong economy.

**So do you ignore the economic news, quarterly earnings and day-to-day market gyrations?**
Totally. I have almost no interest in quarterly reports. Running a business or investing in a business based on quarterly earnings doesn’t make any sense at all to me. There are many, many things that can happen during the course of a year. Good decisions can have bad short-term outcomes but be great for the business long-term.

**What’s your worst investing decision?**
A lot of what I do is running businesses, rather than buying stocks. My worst decision is probably when I know I have the wrong chief executive running the business and I keep on waiting to make the difficult decision of replacing him. First of all, I’m probably friends with the person, so I don’t want to fire him. I made the decision to have him as chief executive, so I don’t want to admit that I was wrong. And above all, there’s the human dimension. It’s tough on the person. It’s tough on his family. It’s tough on the organization that he’s leaving. So I have too many times delayed, delayed, delayed. And lots of damage has been done by waiting too long.

**Is there anything about the economy or business conditions that keeps you up at night?**
The answer is no. But I believe that in running any business, you fundamentally need a very strong balance sheet. Fortunately, we’ve been able to create a fortress balance sheet at Onex. We have no debt whatsoever and a billion and a half in cash on hand. So I don’t lose any sleep at night.

**Were there times in the past when you did lose sleep?**
Sure, in 2008, when the markets all turned desperately bad. We had roughly a couple hundred million in cash on hand and worried that wasn’t enough, and made some decisions to sell some businesses to get a stronger balance sheet. In retrospect, I wish we hadn’t done that.

**Why is that?**
It was the right thing to strengthen the balance sheet. But I’m sorry that we sold some very good businesses.

**What would you do with a windfall?**
Buy Onex shares. /Brian Milner

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**Satish Rai**
Rai, 50, joined TD as a management trainee in 1986 and began applying more analytical discipline to the bank’s investment decisions. He is now in charge of investments at TD’s $217-billion asset management division and runs the bank’s own pension plan.

**What would you do with a $100,000 windfall?**
The same thing today as I did five or 10 years ago: Buy shares in great companies, Canadian or foreign, with strong balance sheets. Some people say those companies should pay dividends. I don’t necessarily agree, so long as they are allocating capital properly—the ones that are consistently growing their businesses. Think about two questions: “Will a company find this or discover that, and therefore make a lot of money?” and “Is this company going to grow at 5% or 10% a year?” There’s a big difference between the two.

**What was your best investment?**
My 25 years of investing in TD Bank shares.

**What was your worst investment?**
Early in my career, with my personal portfolio, I bought speculative stocks with a short-term time
horizon. I don’t have a name, but it was always a company that was rolling the dice on finding a product. I perceived those speculative stocks as a 50/50 bet that they would go up. In fact, it’s more like a 99% probability that they will go down.

What’s the biggest risk that investors face today? People haven’t figured out that they need to take on a different risk profile. They believe that, as you get closer to retirement, you should shift money from equities to fixed income. That’s all based on the 30-year bull market in bonds we’ve been through, not looking forward. In this environment—in which interest rates are low—fixed income is going to give you 0% capital appreciation.

What about corporate bonds? Isn’t the market strong for them? Spreads between the rates on government bonds and the traditionally higher rates on corporate bonds are thin, and they are going to stay thin. That’s why our team thinks that 2014 is going to be a strong year for mergers and acquisitions, because if you’re a good corporation, you can borrow large amounts at rates virtually flat to inflation. There will be a point in the cycle soon where people have confidence in economic activity. Once that happens, you will see an enormous amount of corporate development. The first stage will be for companies to acquire business using their easy access to capital.

So, should individuals invest in those bonds? No. They should be buying equities in strong companies.

Will interest rates go up any time soon? Our view is that it will be surprising how long rates stay low—short-term rates controlled by central banks, that is. The reason is not what people think: slow economic activity. It’s that governments can’t afford to pay higher interest costs on their debt. The U.S. has $12 trillion in debt. If rates go up 1%, that’s $120 billion a year in added interest.
Wont those low rates prolong the crisis in traditional defined-benefit pension plans? 
Pension plans can’t get higher returns without taking on more risk, and most are not willing or not allowed to do that. So the individual or the corporation, or other plan sponsor, has to make higher contributions—that’s it. But if you’re living paycheque to paycheque, what right do I have to tell you that you need to save 12%, 13%, 14% of your income? Society needs to find tools.

What can a boomer approaching retirement do? 
I have a simple piece of advice for boomers: Live off the dividend income, not capital gains from stocks or bonds. If you need the capital gains, you have to try to time the market when you buy and sell. But if you’re able to sustain your lifestyle with dividend income—plus OAS, CPP and your pension plan—you won’t have to worry about fluctuations in the value of your portfolio. You’ll have a very good retirement, because there’s enormous opportunity around this. /John Daly

Jeremy Siegel
Siegel teaches finance at the University of Pennsylvania’s Wharton School and is an investment strategy adviser with WisdomTree Investments. He’s also the author of Stocks for the Long Run.

What’s your outlook on the U.S. market, and where do you see opportunities? 
I am still very bullish. I think the Dow Jones will pass 17,000 points in 2014, a gain of 10% to 15%. In a low interest rate environment, stocks often trade at 18 to 20 times earnings. But they are now trading at about 15 to 16 times, and I think earnings are going to continue to rise in 2014. Internationally, I think emerging markets are the most undervalued and represent good opportunities.

What would you do with a $100,000 windfall? 
I don’t see another asset class that is going to beat stocks over three to five years. I would buy a broadly diversified global index fund with a higher weight toward emerging markets. While I think the U.S. market will do better than Europe in 2014, I think all stock markets will rise.

What keeps you up at night? 
I sleep pretty well. However, there is always a possibility of a terrorist attack. Such an event, involving nuclear materials or something of that nature, is very unlikely, but would have a devastating impact on the market. I don’t think that a financial crisis like the one we had in 2008 is going to happen for many, many years.

What’s the best investing advice you ever got? 
The late Paul Samuelson, who was my PhD thesis adviser at MIT, talked about low-cost indexed investments. That stuck with me, and I was one of the very first people in the Vanguard S&P 500 Index Fund. Low-cost investing is still the way to go, but I now prefer fundamental indexing, which weights stocks by earnings or dividends instead of by market capitalization. The bulk of my equity holdings are in funds that are fundamentally indexed, covering different regions of the world.

What advice would you give to investors now? 
I would advise investors to move toward fundamentally weighted index investments, and have a generous allocation to stocks. I think equities are going to do very well over the next three to five years. I know a lot of people are afraid of stocks because of memories of the 2008 market crash. But people who think they have missed the whole bull market, haven’t. There are more gains to be had. /Shirley Won
Bill Miller

Miller is chairman and chief investment officer of Legg Mason Capital Management and currently oversees the Legg Mason Opportunity Trust Fund. He formerly ran the Legg Mason Value Trust, which beat the S&P 500 Index for 15 consecutive years, from 1991 to 2005.

What’s your outlook for the U.S. market?
We expect the U.S. stock market to be up between 6% and 12% this year, so a very nice return. One of four areas of opportunity is housing. The U.S. housing market went through a five-year slump and has just come out of it. I expect housing stocks like PulteGroup and Lennar to do very well. Another area is financials, in part because many of them are related to housing through issuing mortgages. That would be everything from JPMorgan Chase to Genworth Financial. The airline industry has been dramatically restructured and significantly consolidated. I think the airlines have a long way to go, and our favourite is United Continental Holdings. Lastly, stocks in the technology sector, especially larger names, are very cheap by historic standards and have very high free cash-flow yields. We like Apple and Microsoft.
What would you do with a $100,000 windfall?
I would put it in a diversified portfolio of U.S. or global stocks. Part of the reason why the stock market has done so well is because it got too cheap after the 2008 financial crisis. The market has gone up, but it is still nowhere near where it is likely to go in the next several years.

What was your worst investment?
The worst among individual stocks is an investment we made in Eastman Kodak in 1999-2000. At the time, it was trading very cheaply, with a good dividend yield. Our mistake was staying with it year after year, despite the fact it continued to miss its own targets, and the business continued to deteriorate. For a broader category, we lost more total money in financials in 2008, mainly from misreading the credit crisis.

What keeps you awake at night?
A repeat of our mistake in 2008. We did not recognize soon enough the seriousness of a change in the macro environment.

What’s the best advice you ever received?
The late American stock trader Jesse Livermore once said that the big money is made in the big moves in prices. There were big moves in the stock market from March, 2009, to now, and from 1982 to 2000. It’s the same with bonds for the past 30 years. Most people are obsessed with the short term. Is the market going to correct? What is the stock going to do in the next quarter? All of that is pretty much irrelevant for most people.

What advice would you give investors now?
Think long-term, be patient and ignore the day-to-day news. In this kind of environment, people should have a maximum of 75% of their assets in stocks. People are too underinvested in equities because of the 2008 crisis, and that is because they are looking backward, not forward.

What is the most important investment metric?
We tend to first look at free cash-flow yield. A high cash-flow yield tells you that you’re getting a high current cash return on your investment. There is good evidence that that metric gets you into companies that are going to do well.

Do you have a favourite investment motto?
“Be fearful when others are greedy, and be greedy when others are fearful.” That comes from Warren Buffett. You are not going to make money doing what everybody else does at the same time.

/Shirley Won

Geraldine Weiss
Weiss, 88, began publishing “Investment Quality Trends” in 1966 (under the name G. Weiss, to hide her gender), and has won accolades from, among others, “Hulbert Financial Digest,” which has been tracking more than 160 newsletters since 1980.

You’ve been following dividends for decades.
How have things changed?
The Dow has changed a bit: In the 1970s and ‘80s, it used to travel between yield extremes, where 3% was overvalued and 6% was undervalued. Now, it seems to travel between yield extremes where 2% is overvalued and 4% is undervalued. I think it has changed because of the tech stocks that have entered the index.

What about the way investors approach dividend stocks?
I look at dividends not necessarily as an income factor, but as the only true measure of value in the stock market. Anything that doesn’t pay a dividend or some kind of return is a speculation—so dividends will always be a big factor in
the stock market.

Has there been any change in the way companies approach dividends?

Blue-chip stocks have always paid dividends, and they should—they should share their good fortune with their stockholders. And income is really the main reason why an investor would go into the stock market—to get a return on his investment dollar. We all hope for capital gains, but the only thing we can really count on is the dividend.

So what is the Dow Jones industrial average signalling in terms of its dividend yield?

When the Dow reaches a point where the yield is 2.1%, then it is considered overvalued. But I don’t advocate buying the Dow. There are many good-quality individual stocks that are not overvalued.

What do you think about Apple’s decision to pay a dividend?

A company that has been around as long as Apple and has been as innovative as Apple is a selfish company if it doesn’t want to share some of its good fortune with its stockholders.

You’re a competitive bridge player. There are many famous business and investing personalities who are also into bridge, including Warren Buffett…

I’ve played bridge with Warren Buffett. Once, when he called my office to arrange a game, my office manager announced, “There’s a character on the phone who says he’s Warren Buffett.” When I told her it really was him, she dropped the phone. /David Berman
Warren Buffett is a dangerous man. With his avuncular style and simple, witty turns of phrase, he can lull you into thinking that value investing—the hallmark of his $425-billion (U.S.) Berkshire Hathaway holding company—is easy. The truth is that value investing is damn hard. Or, as Buffett himself has said, “It’s simple, but not easy.” If it’s difficult for him, it’s going to be a gigantic struggle for the rest of us.

The classic yardsticks of value are ratios—primarily price to earnings (share price divided by earnings per share), price to book (share price divided by shareholders’ equity) and price to cash flow (share price divided by cash flow per share). The idea behind value investing is to buy shares (or any asset) for less than their intrinsic value, and these ratios are supposed to be the telltale signs. It’s true: They’re a good starting point. But read them incorrectly and they’ll lead you to the financial morgue.

More often than not, a low price-to-earnings ratio means a stock price is going down. The trick is to find out whether a stock is cheap or just looks the part. If it really is cheap, that’s likely because investors got spooked, or they don’t have the patience to wait for a turnaround, or they lack the skills to look confidently beyond the immediate noise. In short, they can’t tell the difference between a sneeze and a terminal illness. The market, however, usually corrects stock prices fairly quickly, so investors have to be pretty nimble.

What do you look for? First, a longish history of reasonably consistent earnings that have kept pace with inflation. Second, honest and capable management—you’re buying a business, not a stock, and if the business gets into a spot of trouble, you’ll be relying on management to navigate the

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**10 VALUE TESTS**

To help determine if a stock is indeed a bargain, value investing god Benjamin Graham (1894-1976) devised 10 numerical tests.

1. **GRAHAM SAYS:** Earnings yield (E/P ratio) is at least double the average yield on AAA-rated corporate bonds.

   **DECODER RING:** E/P is expressed as a percentage, and it’s the inverse of the price/earnings (P/E) ratio. It tells you how much profit the company is earning on each dollar’s worth of its shares’ current market price.

2. **GRAHAM SAYS:** Current P/E ratio is less than 40% of the stock’s highest P/E over the past five years.

   **DECODER RING:** How does the price now compare with historic highs?
danger. Third, make sure the economics are good, regardless of whether you're investing in a company that's in or out of favour. How does the business earn money? Does it wait around for the phone to ring with an offer to buy stuff at a price the customer determines? Or does it have a loyal clientele who need the company as much as the company needs them? The answer lies in how much money the business makes relative to how much it has to invest in order to generate it. That includes both the money investors ante in at the beginning and every cent of profit the company earned but didn’t give back to shareholders.

Invest only in companies whose value rises by at least a dollar for every additional buck it reinvests in the business. In other words, if a company earns $2 per share and pays out $1 in dividends, the value of your shares should rise over time by a minimum of $1.

Some of the best-known names on the TSX—Bombardier, Celestica, BlackBerry—are terrible investments. They have to invest your profits in new, expensive assets every year in order to keep the lights on. Compare that with a company like Leon’s Furniture. Furniture is a competitive business to be in. Anyone with a little money can build a store, acquire inventory and start selling couches. Yet Leon’s earns hefty profits on the money shareholders have put into its coffers, even after buying rival The Brick Ltd. in 2013 for $700 million, and borrowing most of the money to do that.

Why is Leon’s still so solid and profitable? It has a powerful brand name, otherwise known as economic goodwill. Throughout its history, Leon’s management has kept $433 million of company profits for reinvestment. The company’s market value is now about $1 billion, so it’s doing something right. The net accounting value of Leon’s assets is about $477 million. But you’d need a lot more than that to create Leon’s from scratch today. You’d have to spend heavily and work very hard to re-create the amount of goodwill that Leon’s enjoys.

The funny thing about economic goodwill is that it’s gen-

3 GRAHAM SAYS: Dividend yield is greater than two-thirds of the average yield on AAA-rated corporate bonds
DECODER RING: Is the annual dividend, which is less certain than bond interest payments, at least almost as large?

4 GRAHAM SAYS: Price is less than two-thirds of the tangible book value per share
DECODER RING: Tangible book value is the value of the company’s assets on its balance sheet, excluding intangible ones such as the value of patents, intellectual property, goodwill, etc

5 GRAHAM SAYS: Price is less than two-thirds of net current asset value
DECODER RING: Net current asset value is the value of cash and liquid assets (those the company could sell quickly) on the balance sheet minus the current liabilities

6 GRAHAM SAYS: Total debt less than the book value of the business—i.e. debt-to-equity (D/E) ratio—is less than 1
DECODER RING: Is the value of the shareholders’ equity on the company’s balance sheet greater than its short-term and long-term debts?
erally not shown on the balance sheet because it’s intangible—a company doesn’t “pay” for it directly. We’ll illustrate with an example: Consider two suction-cup makers, Allied Octopus and Consolidated Squid. Octopus has a net worth of $100,000, of which $40,000 is tangible and the rest is intangible (brand name, reputation, patents, and so on). Squid’s net worth is also $100,000, but all of it is tangible. Both companies earn $10,000 a year, or 10% on their equity.

Now suppose that both companies want to double their earnings. Squid will have to double its investment in such tangible assets as machinery, buildings and accounts receivable, at a cost of $100,000. It will finance this by either borrowing money, selling more shares or retaining earnings (that is, withholding them from its shareholders).

Octopus, on the other hand, will have to invest only $40,000 on tangible assets. It doesn’t have to create a new brand or reputation. After expanding, Octopus will earn $20,000 on equity of $140,000 (14%), while Squid will earn $20,000 on equity of $200,000 (still 10%). Octopus’s return has gone up and, rest assured, this will be reflected in its stock market value, which will be substantially higher than Squid’s despite the fact that both companies make the same amount of money. Which business would you rather own?

Investors often make the mistake of buying lousy businesses when they hit the skids, thinking the price has got to rise eventually. You now understand why that’s often a mistake (although not always—at a certain low price, any business is a good investment; you probably just won’t hold on to it forever).

Value investing is tough work. You have to look beyond the clichés and develop a thorough understanding of a company’s economics in order to do it right—though it’s well worth the effort. Ask Buffett.

Fabrice Taylor, CFA, publishes The President’s Club Investment Letter, which focuses on value and growth stocks. The letter and The Globe and Mail have a distribution agreement.
Value play vs. value play

In February, 2009, using value investing metrics, Fabrice Taylor compared RIM and Procter & Gamble, both of which looked like bargains.

If only we had listened to his recommendation.

P&G has almost 10 times the revenue of RIM, but RIM’s sales were up 66% from the same quarter a year earlier, compared with just 9% for P&G.

**ADVANTAGE RIM**

Both companies earn gross margins of about 50%. But RIM says its margin could narrow to 40% as it moves into the more competitive consumer market.

**ADVANTAGE P&G**

Selling soap, pet food and hundreds of other products costs a lot, and P&G spends about a quarter of its revenue doing it. RIM is leaner, but that could change as it pushes into the consumer market.

**ADVANTAGE RIM, FOR NOW**

RIM spends a higher proportion of revenue on R&D to keep up with changes in technology. But it has fallen behind the likes of Apple in creating buzz. P&G remains dominant in most of its product categories.

**ADVANTAGE P&G**

Technology companies rarely carry debt, so RIM has no interest expense. P&G is so stable it could borrow more, which can boost returns to shareholders through leverage. But its management is conservative.

**ADVANTAGE P&G**

Both companies have a net profit margin of about 15% on sales, but RIM has a higher return on shareholders’ equity. That may not last, however, because RIM retains and reinvests a lot of its profits, which bloats the equity held in the company.

**ADVANTAGE P&G**

RIM’s earnings per share have been growing much faster than P&G’s, although RIM’s growth might slow due to competition and a weak economy.

**ADVANTAGE RIM**

P&G pays a $1.60 annual dividend (for a 2.6% yield) and bought $4 billion worth of its own shares outstanding recently. RIM pays no dividend, and its share count is rising.

**ADVANTAGE P&G**

### The Bottom Line

P&G is huge, stable and makes a vast array of products. RIM is growing fast and is very profitable, but is untested in hyper-competitive new markets. What’s more, analysts have been cutting their earnings forecasts for RIM, and probably aren’t done. The share price has been dropping as analysts dim their expectations. Once shares of a market darling start to fall, they tend to keep going until the diehard believers have been beaten into submission.

Over all, give the final valuation round and the title to Procter & Gamble.
Introducing the New Globe Investor Tools

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