

Research can be set aside as irrelevant



INVESTMENT STRATEGY

By
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We are taught by the behavioral finance folks that humans are not wired to be rational about investing. There is no need to go into the details of their arguments, although they are certainly fascinating.

I've read plenty about the experiments, but last month I threw my entire file on this subject into the trash. That's because I came to the conclusion that all of the research could be set aside as irrelevant.

If investing could be reduced to a mechanical process that left no room for either ambiguity or emotion, then we would have a method for buying and selling stocks that would be completely objective.

I would not be saying this unless I believed that it was possible to execute the reduction in exactly the way I have described. I can assure you that I have thought this through in advance. Wouldn't it be great if we had a computer that could identify value stocks? If we had such a device, then investing would be a lot easier than many people apparently find it to be.

That's because there would then be an automatic way of deciding whether any given stock was a value stock or not. The procedure would be mechanical because the rules for constructing our device would be

completely explicit and complete. Such a procedure would halt after a finite number of steps because every formula in the system by definition contains a finite number of tests that are verified empirically as either true or false.

In categorical sentence logic, it is possible to test various formulas for validity by means of truth-tables. The rules of truth valuation are general enough to determine a unique truth value for any formula when the truth values of its constituent parameters are given.

In digital computers various formulas are expressed in similar fashion as rules or algorithms. A set of algorithms is a list of instructions, which is called a program. The problem to be solved must be described as a process or a method—a step-by-step procedure that, if executed, will lead to the correct answer.

Such a method is called a decision procedure, and a system is said to be decidable if there exists a decision procedure for it. You do not need to understand all of this in detail. You only need to understand this in principle.

Now, since we have all of that figured out, we may immediately see that my Value Stock Filtration System constitutes a decision procedure that may be used to select undervalued stocks.

In my system of value investing, stock selection is essentially a digital process of elimination. A total of 10 empirical tests are deployed. No fewer than seven criteria are financial ratios. Since the ratios are explicitly mathematical, these seven could be translated into equations. Then they could be reformulated into algorithms and, ultimately, a program.

In this exercise, all that would be

required would be to attach specific variables (or values) to each term in every ratio.

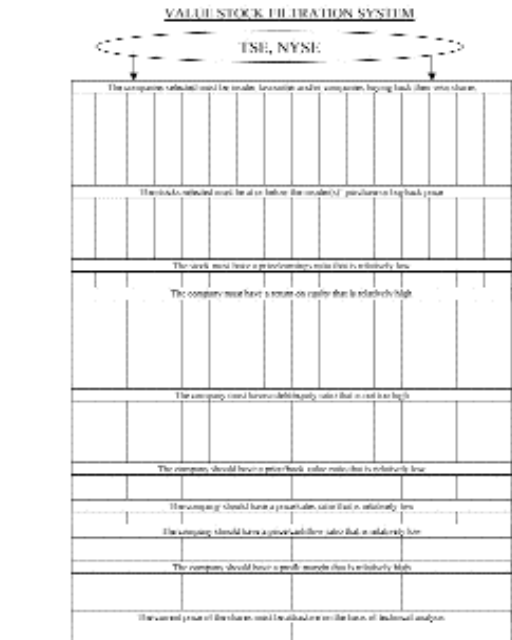
Then it would be necessary to add various definitions (or axioms) so that the truth conditions of a term such as 'undervalued' could be quantifiable. (In fact it can be seen that I have already advanced toward this objective in my January *Bottom Line* article. Among other things discussed is my conception of pentagon pricing).

Note that each one of the 10 characteristics is empirically verifiable and/or falsifiable. Seven criteria are quantifiable. Taken in conjunction, these 10 tests constitute an objective definition of an undervalued stock. Granted, that definition is my definition. However stipulative it may be, nevertheless it is entirely consistent with both the standard tools of security analysis and the canons of the value school of investing.

The unique effectiveness in rapidly eliminating potential research candidates may be attributed to the structural potency of the system. Each criterion is positioned in descending order of eliminative magnitude.

This structure increases the eliminative efficiency of the entire system, so that the survivals of the fittest, and hence most undervalued, candidates emerge with a descending number of empirical tests. Thus the economy of any research program based on my system is maximized.

The decision procedure for selling stocks is also uniquely effective when my Value Stock Filtration System is applied to any existing portfolio as opposed to a universe of 4,000 potential investments. Thus it constitutes an exit strategy because the eliminative digital decision pro-



DIRECTIONS FOR USE:
A quality, undervalued price-sensitive value investor must apply this system to all undervalued stocks. He considers only the 4,000 companies listed on the Toronto Stock Exchange and the New York Stock Exchange. Each vertical line represents a potential investment. The program checks to indicate that he may begin with 10 research candidates. There have entered the system by passing through the first five of the 10 criteria. Stocks are eliminated if they fail to pass. Being 5 in line, they are now company valuation system. The program's 10th test is applied to the system in the order of the diagram.

cedure applies equally to any current list of holdings.

I have no doubt that the invention of this system of selecting value stocks represents my best work as a professional investor. And I invite all of my readers to benefit from its usefulness.

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opinion, is based on various sources believed to be reliable, but its accuracy cannot be guaranteed.

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Retirement expenses understated

By **PETER MERRICK**

Our health rarely improves with age. After the age of 65, 41 per cent of Canadians are likely to use nursing homes or some type of home care.

Usually, the last five years of an individual's life will make up 50 per cent of their total health care cost spent during their entire lifetime, according to the Canadian Institute for Health Information.

Traditional financial planning as it has been sold to the public encourages Canadians to save enough personal capital to generate 65 per cent to 75 per cent of their pre-retirement income during their retirement.

This rule of thumb operates under the premise that when an individual retires their expenses will be less than when they were working. The principle behind this type of thinking is that by that point in time, those retiring are likely to have paid down their mortgage on their homes, they are no longer responsible for their children's

post-secondary education and they have enough money to spend on vacations and other luxury items.

However, this type of thinking has proven to be based more on myth than reality. People are living longer today than ever before and this will impact their ability to provide for themselves as they age.

The cost of long-term care can cause post-retirement living costs for many retirees to be greater than when they were working. This cost reality of old age can quickly eat away at one's retirement nest egg.

Many Canadians believe the government will look after them in their old age. If they become chronically disabled or mentally impaired, their provincial government plan may cover only a portion of their care of the assistance and supervision they may need. Each province subsidizes long-term care to a different degree. In many instances, long-term care is not necessarily medical care as outlined in the *Canadian Health Care Act*, but custodial care.



Merrick

Canadians will pay more long-term care costs out of their pockets, with ability to pay usually based solely on monthly income from pensions and investments. Thus, considering the already high costs of living and health care today, most Canadians may not be able to afford the full cost of their care in the future.

If a person is over 40 years old and has assets to protect, but is not wealthy enough to comfortably pay for long-term care out of savings, they should consider purchasing

long-term care insurance as part of their risk management strategy in their financial plan. This is especially important if there is a history of serious illness and longevity in their family.

Long-term care insurance is another coverage that is rapidly growing in popularity.

Long-term care insurance pays a daily or monthly benefit for medical or custodial care received in a nursing facility, in a hospital, or at home.

It is very important to apply for long-term insurance while you are still healthy. These policies are usually guaranteed renewable, meaning once you qualify, you'll remain eligible as long as the premiums are paid.

The premiums are based on a person's age at the time they purchase the insurance and rates are usually locked-in for the life of the policy. Since most premiums for this type of insurance are paid with after-tax dollars, the long-term care insurance benefits are tax-free.

When choosing a long-term care insurance policy, it is important to find a policy that allows customized coverage.

Some of the options one may purchase in their personal policies are:

- Location of care: in-home, in a nursing home, in an adult day centre, or an assisted living facility.
- Type of care: skilled nursing care, custodial care, home health aides.
- Options for size of daily benefit and length of coverage.
- Flexibility in applying benefits (sometimes called, "alternate plan of care").
- Choice of waiting periods before coverage begins.
- Coverage of organic mental illness, such as Alzheimer's.
- Benefit inflation indexing.

In essence, owning long-term care insurance can take away the financial insecurity that may accompany old age. By planning one's future today, it is indeed possible to have nothing to worry about financially during old age.