

## It's time to ride out the market storm



### INVESTMENT STRATEGY

By  
Jon  
Kanitz

When key market indicators point to rough water ahead—as they have recently—is it best to sell out and wait for a better market? No. At least it hasn't worked out that way for me and other private investors. That's because selling out and waiting for clearer weather means trying to call market turns.

Precious few professional market timers get it right either, for long. After a few years on a hot streak, their tea leaves fade, the old crystal ball glazes over and they end up sidelined with Richard Russell. Can you think of even a single seer with a long record of accuracy as a market timer? I can't find one. So why play a game that nobody has ever won?

How is it best to forecast? Carefully analyze what the market professionals are

saying. Then realize that won't happen. The broad consensus of professionals as a group is almost always wrong. Therefore, figure out what the consensus opinion is and then discard it.

Consider all other possibilities and use historical analysis, market theory and good data-crunching to eliminate as many others as you can. What happens? The market scenario that you cannot eliminate is the most likely one to occur.

Why? By the time forecasts are made public, the opinions and justifications behind them are already priced into the stock market.

That's why they can't work. The market is the great humiliator. This fact accounts for the old Wall Street adage that the stock market will always prove the majority wrong, or drive them up the wall, whichever comes first. This constitutes my first advanced investment concept.

Here's my second: Will Rogers had it right when he quipped that "Stocks are easy—you buy 'em and when they go up, sell 'em. If they don't go up, don't buy 'em." This is the Kanitz corollary to the Will Rogers maxim: Don't buy 'em unless they can go way up. Since there is always risk in the market of stocks, I want to own stocks only where the potential gain far exceeds the potential loss.

All the more reason for concentrating your investments in unpopular stocks of good companies. The thing that determines the big market moves is the difference between expectations and reality. Over time, the unpopular stock of a good quality company will gain popularity as investors realize it's not so bad after all.

According to value investors, it will subsequently rise in price in order to reflect reality. This is my third advanced investment concept.

And now, over to the subject of stock selection. The main skill is to buy companies of above-average quality through the now almost forgotten tools of security analysis measuring balance sheet strength.

The second skill is to combine this with looking for real world indicators of tangible fundamental business advantage. My fourth and fifth advanced investment concepts involve both of these skills.

In operation, the main skill is executed by avoiding junk. Ideally, I want to buy a company that is clearly recognizable as either the biggest or best at what it does—better yet, both. Other qualities include these: high relative market share, low-cost production, unique products, superior technology, top-notch marketing, and a brand-

name franchise. If a company has most of these characteristics, it is almost certain to be a winner in the stock market.

Then comes pricing. I don't time the market. Instead, I price the stocks. Shareholders' equity should be at least 50 per cent of total assets. The nominal price/earnings ratio should be below the nominal return on equity. In the U.S. stock market, darn few meet all of the above criteria right now. In the Canadian market, there are fewer still.

One of my favorite investment maxims is simply this: "Do your homework and get rich, or speculate and go broke." That maxim suggests that there are no shortcuts when it comes to picking winning stocks. However, there is an exception to the rule.

I call your attention to a well documented study entitled *Under reaction, Abnormal Returns and Supply Curve Elasticity: Evidence From Open Market Share Repurchases*, by William McNally, Brian Smith and Thomas Barnes (September 2002).

Among its many interesting findings are these important conclusions:

- When companies use their superior information to repurchase their own stock, they buy shares at an average discount of 6.8 per cent

to the price paid by other buyers of the stock during the year of the repurchase program.

- A portfolio that mimics the company repurchases would earn abnormal excess returns of between 4.3 per cent and 15 per cent over the course of the repurchase program.

These conclusions imply that, on average, share repurchases transfer wealth from selling to non-tendering shareholders. The corollary is that companies that are buying back their own shares are likely to experience superior returns. And this is an investment strategy that I have been advocating for years.

Finally, this is the fifth year of the decade. Historically, the fifth year is among the best, according to the 100-year decennial pattern in the stock market. Therefore, I expect a good year for the dedicated equity investor.

**Jon Kanitz, Ph.D.**, is first vice-president and Investment Advisor with CIBC Wood Gundy in Toronto. He and his clients own securities mentioned in this column. His views do not necessarily reflect those of CIBC World Markets Inc.

## Self-employment growth called an opportunity knocking

By PETER MERRICK

After explosive growth in the past decade, Canada now has 2.3 million self-employed workers and 1.1 million active incorporated businesses, three-quarters of which employ fewer than five people, according to Statistics Canada.

As our economy re-engineers itself, the nature of how we work as a society is in the process of change. Accounting and financial planning professionals servicing this newly self-employed workforce have a huge opportunity to guide an emerging segment of the Canadian economy.

My introduction to the self-employed/small business market happened purely by accident during the mid-1990s. In 1993, when I entered the financial planning industry, I got hold of a list of employees at the technology department of a new long-distance phone company.

Two years later, I was working with more than 50 IT professionals. Things seemed great, except for the fact that the phone company was losing \$1 million a day.

In January 1995, when most brokers and financial planners were in high gear for RRSP season, I was introduced to corporate layoffs and severance packages. The company had decided as a cost savings measure to cut most of its IT people.

What was surprising was that many afterwards said being fired was the best thing their previous employer could have done for their careers. Some felt they were stagnating at work and needed that push of being laid off to take control of their careers and make positive changes in their lives. Others shared with me that they were worried if they had not been let go, they might have received vastly different severance payouts from one round of layoffs to the next.

When all might have looked bleak for these IT professionals, two new words began entering into our cultural lexicon; Internet and Y2K.

Not being tied to a company turned into a career opportunity.

No one could have anticipated that both the Internet and Y2K would cause such high demand for these types of professionals. But they did.

Soon after, IT professionals were able to set their price. Companies that had cut staff found they needed to hire back many of the same people they had fired as independent consultants, at higher salaries. I know one IT staffer who was let go from a Fortune 500 company on a Friday. On the Tuesday its largest client demanded that it re-hire him. His story goes like this—he left full-time employment making \$90,000, to billing more than \$200,000 in his first year as a self-employed, indepen-



MERRICK

dent consultant.

After being laid off, some took their severance packages and entered the world of consulting. There were several reasons for this.

According to a KPMG study, 41 per cent of a company's gross annual payroll is associated with employee benefits. So companies can afford to pay consultants up to 41 per cent more than their full-timers without increasing the cost to their bottom line.

As an employee, the equation of earning goes as follows: you earn, you're taxed, and then you spend what is left over. When you're self-employed the government allows you to adopt a much more favourable equation: you earn, you spend, you income split, you defer bonuses and then you are taxed on what is left over.

If an individual decides they have had it with working for

someone else and chooses self-employment, it is important for them to hire teams of accounting and financial professionals and to create their own benefit packages. As an independent consultant, clients can afford to pay more because they don't have to take care of a consultant's taxes, EI, CPP, medical and dental benefits, long-term disability insurance, life insurance or pension plan.

Accountants will especially be needed to assist their self-employed clients to apply CRA's four tests to determine whether their relationships with their consulting clients are that of an employee or an independent consultant for tax purposes. CRA's four tests are:

**1) To what extent does the employer control how the work is done?**

This test looks at who has the ability to determine how, when and where the services are performed. The more flexibility the self-employed individual has in these matters, the more likely they will be considered an independent consultant.

**2) Who owns the tools?**

The basic tools of an independent consultant are generally theirs—their phone, computer, their technical ability, experience and education. Part of CRA's test is whether the self-employed person

has their own office outside their client's, this is most likely a home office.

**3) Does the independent consultant pass the integration test?**

This test is designed to determine if the independent consultant's services are ancillary to the core business of their client's. The greater the extent that the independent consultant's services are considered integral to or integrated into a practice's business, the more likely CRA will deem that there is an employer/employee relationship.

**4) What are the chances of profit and loss?**

The last criteria CRA uses to determine whether an independent consultant's status is that of self-employed or employee is the potential for profit and loss. An example would be liability concerns resulting from a consultant's negligence in providing their services. In an employee relationship, the employer would shoulder this type of liability for their employees.

Peter Merrick, BA, FMA, CFP, FCSI, is an instructor at George Brown College in Toronto. He is also president of Merrick Wealth Management, a boutique employee and executive benefit consulting firm. He can be contacted at: peter@merrickwealth.com, or at: (416) 854-1774.