"BEATING THE TSE"–

A CANADIAN GUIDE TO SUCCESSFUL INDIVIDUAL INVESTING

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FOREWORD

I was pleased to be asked by Dave Stanley to provide a foreword to this extended explanation of the "Beating the TSE" strategy. Prior to publishing Dave's findings on this Canadian stock selection system, we discussed similar studies for beating other offshore indexes. It seemed logical that research on the Toronto Stock Exchange would also uncover a workable investment strategy that was profitable and required a limited time commitment.

The simplicity of "Beating the TSE" meets the requirements of busy investors. Independent investors are attracted to a system that can be easily understood and implemented immediately with companies big enough, solid enough and resilient enough to withstand the daily ups and downs of the market. Large cap stocks keep most of their value even in turbulent times such as this dead bull market. When the downturns do occur, investors can pick up the bargain blue chips at discounts.

When over 90% of the money managers are struggling to beat the indexes, you should question the practice of paying significant fees to purchase their mutual funds. (If you do require a professional advisor, consider one who charges a fixed fee or percentage of assets for their service.)

So, a strategy employing blue-chip stocks permits you to arrange your own mutual fund. Because of their positive combination of risk and reward, these solid companies have a tendency to fall less than the market in general and rebound first in the uptrend. You do not need to be a market guru and predict the future market direction. This strategy accommodates the gyrations of the marketplace.

Here is a boring but low-risk strategy that makes money available to you when you want it. Unlike mutual funds, you can control future taxation since you determine when to buy or sell your quality companies.

Investors can easily access lots of information for these stocks. Today, the Internet has reams of free data available. Plus, brokers, the press and other financial sources constantly promote these stocks. They are always on the shopping list of brokers, money managers and portfolio advisers.

Salomon Smith Barney reported that only 5 stocks in the S&P 500 were responsible for 25% of the 1998's index return. In Canada a similar two-tiered system has developed with bank stocks, pipelines and telecommunications being the first tier. The second tier consists mainly of Canadian resource stocks. Thus, the first tier hid the real performance of the tier two stocks, which have been devastated.

The best money managers have one characteristic in common, ie. consistency. A structured decision-making process that can be easily defined led to the success of Peter Lynch of Magellan. An AT&T study reported that he also stuck with his strategy for a long time. James O'Shaughnessy in "What Works on Wall Street" states: 'It is the total reliability of application of the model that accounts for its superior performance.' Models beat human forecasts time after time because models don't display human traits such as ego, impulse, moodiness and other emotions.

'Investors who want to use yield as a sole determinant should stick to large, better-known companies, because they usually have the stronger balance sheets and longer operating histories that

make higher dividends possible. When other criteria are included such as strong cashflows, large sales, and large number of shares outstanding, large stocks with high-dividend yields offer the best risk-adjusted returns available' (P. 149, What Works on Wall Street).

O'Shaughnessy and others have found outstanding returns result from the highest-dividend yielding large cap stocks. Thus, there is wisdom in having at least a portion of one's portfolio in a related strategy employing their use.

David Stanley's "Beating the TSE" has been a successful strategy since the TSE 35's inception. It has a proven does not focus on individual stocks with their accompanying volatility but on a strategy with the highest risk-adjusted returns. The results speak for themselves.

PS - I wrote the forward above in the summer of 1998. The comments continue to be valid.
I would only add that today the markets continue to be driven by a few stocks—high-tech stocks—which push the TSE index and NASDAQ to record heights.

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INTRODUCTION TO THE REVISED EDITION

It has been almost a year and a half since I wrote the first edition of this publication and Dale Ennis and I both agree that it is time for me to buckle down and produce some revisions. Now, that is not a long span of time but much has happened during this short period:

- The TSE 35 index has increased over 9%, compared to less than 2% for the TSE 300.
- The Dow 30 and S&P 500 have both gained about 25%.
- The biggest winner among North American indices was the NASDAQ, up over 75%.

But, in my opinion, the most important event was the continued realization among independent individual investors that, collectively, they are correct as frequently, if not more so, than the high paid analysts (who get paid their bonuses whether they are right or wrong). Through such information sources as *Canadian MoneySaver* investors are being empowered to make their own decisions and to put together a portfolio of large-cap, blue chip stocks paying high dividends with the realization that by holding these shares they have an overwhelming advantage over index funds, mutual funds, GICs, bonds and other investment vehicles.

This has been my message throughout my association with *MoneySaver*, and Dale Ennis has been very supportive in helping me to make individual Canadian investors aware of this simple truth. In this edition I have updated my "Beating The TSE" strategy, added some information about US direct purchase plan stocks, provided a few of the handouts I have prepared for our ShareClub, and also the notes I use for my *MoneySaver's* investment conferences. As well, I have expanded the section on retirement planning. I hope they will be of some use to you in your investment activities.

INTRODUCTION

Believe me, I had no idea that I would ever be asked to write about investing. Since many of you will have no idea of who I am, perhaps I should introduce myself. My initial career was as a professor at a Canadian university. No, it's not what you're thinking—I wasn't involved in financial theory at the University of Toronto, or in investment strategy at McGill. From my basic training in chemistry and biology I went on to advanced degrees in nutrition and food science and wound up as a professor in the Department of Food Science at the University of Guelph, Canada's premiere agricultural college. Hardly the background one would expect for someone writing a treatise on investment ideas. My only solace is that Dr. John Kenneth Galbraith, the famed Harvard economist, also began his career at Guelph.

Of course, during my academic career I had contributed to my pension fund, purchased GICs, Canadian Savings Bonds, and even some mutual funds, but what brought me to thinking seriously about investing was a letter from the University's Office of Human Resources in 1994. It was no secret that our finances were in tough shape. A decade of government cutbacks in higher education was beginning to take their inevitable toll. The administration, along with the administrations of all the universities and colleges, were wrestling with an insurmountable problem: how to keep up the quality of their teaching and research programs in the face of dwindling resources. The fiscal belt simply could not be pulled much tighter. As a former Chairman of the University of Guelph Faculty Association, I knew all of this to be true and I shared with my colleagues the frustration of trying to

do more with less. The signs of decline were becoming apparent—reduced library acquisitions, cutbacks in support staff, hiring freezes for vacant positions, among others; feelings of disappointment were growing among the professorate.

But, I digress. About the letter I received—it was an early retirement proposal. One of the few tools left for the hard-pressed administration was to cut back on an operating budget, consisting mainly of salaries, through a program of early retirements. I was totally dazed—I had never thought of retiring, taking a job in industry, switching universities, pursuing a different career, or any of the other paths taken by quite a few of my colleagues. The pleasure and rewards I received through my teaching and research programs were unqualified. I had been fortunate enough to obtain a high level of research funding and ran a well-equipped, highly motivated laboratory that was making significant contributions to a basic understanding of food structure. So, it is not surprising that my first inclination was to toss the letter in the waste bin. But yet, I would soon be 55, scientific research is mainly a young person's game (from my own knowledge of other scientists and from reading, it is clear that the majority of "breakthrough" research comes fairly early in one's career), it was unlikely that the university would have enough funds to ever repeat this offer, there were some other things I would like to do. Hmmm. Well, maybe I will take a second look.

That second look took almost a year, a period of time marked by periods of indecision and near-anguish. It became apparent that I could continue in the department on a part-time appointment that would allow me to finish some on-going projects and take my current crop of graduate students to fruition. That, of course, had to be my very first consideration. But what about other things? Of these, the most important, I thought, was how I could put whatever small talents I have to good use. I had seen some of my colleagues retire, only to begin a precipitous downhill slide in both mental and physical facilities. I went to the library, I joined AARP and read their material, I spoke to friends and family and finally convinced myself that this would be a great opportunity, a chance to buy back some of my remaining years and put them to good use elsewhere. There were many things I had always wanted to do but just never seemed to have the time for. I wasn't going to retire, I was going to begin a second life—one unfettered by petty administrative quarrels, marking lab reports, or writing longwinded scientific diatribes!

And then reality set in—would I have enough money to support this new life style? Well, sure, I was going to get my pension wasn't I, even though it would be reduced, and there was a "leaving allowance", and my medical bills would still be paid, right? But I knew folks my age were living longer now and inflation is always a worry and what about government benefits? This is when I began to learn some hard lessons about money, investments and retirement. The first thing I realized was that I didn't have a clue about any of this. Nowhere in my long education had I ever been exposed to anything resembling the type of knowledge I would need now to answer my questions. I needed information and I needed it fast. No way would I consider early retirement if it meant spending my golden years eating cat food and wearing second-hand clothes!

The story of how I got from being an investment ignoramus to writing a column for Canada's premiere independent financial advice magazine revolves around Dale Ennis and his willingness to take a look at my initial ideas—he has been wholly supportive as I have attempted to educate myself. This present publication consists of some of my concerns about pending retirement and also some of the columns I have authored in *MoneySaver* presented in chronological order so that readers can follow how my thinking about this subject has developed. My trip was not a voluntary one—it was brought on by my basic ignorance about all matters dealing with money. I have now had the opportunity through *MoneySaver's* Investment Conferences and ShareClubs to speak to many, many

Canadians who have embarked on similar journeys of discovery. I have written this for them with the hope that it will help them reach their goals.

My aim is to get Canadians thinking about how they will finance the major acquisitions in their life, including retirement, and to provide some planning and investment tools that can help them achieve their goals. You will note that I have not used extensive footnotes, rather, general references are given at the end, including some internet resources. I want this to be short and easy to read. While having a computer and knowing how to use it will facilitate the transfer of knowledge, it is not mandatory.

The reader will note that I often resort to the journalistic plural, despite the fact that I'm the only person writing. Thus, if there any errors of either omission or commission they are mine alone. Finally, the wording that must accompany any publication of this kind: The author is the copyright holder of all the original material and the excerpts from *Canadian MoneySaver* included herein. "PowerBook" is a registered trademark of Apple Computer, Inc.; "Microsoft Excel" is a registered trademark of the Microsoft Corporation. The information contained herein was obtained from sources considered to be reliable, but it cannot be represented as accurate or complete. The views expressed herein are the author's alone and do not constitute a solicitation for the purchase or sale of any security. Consult a professional advisor before implementing any techniques or strategies herein.

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CHAPTER ONE

THE INVESTMENT IMPERATIVE—CANADA IN THE 21ST CENTURY

Welcome to a discussion of your personal wealth and how to make sure that it is adequate for your needs. In order to succeed in whatever field of endeavour we undertake we must have a certain set of skills and these skills must constantly be upgraded as we proceed in time. This is becoming even more imperative as we proceed towards the next century. The "Information Age", the "Computer Age", or whatever name it is given, demands that we stay abreast of new developments if we are to be successful. Certainly, this means a large dose of "technology", but it means other things too. Demographics tell us we are going to live longer, change jobs and move more often, travel more, etc. We had better be ready for these changes also.

Maybe the biggest change is how we are going to spend our retirement compared to the previous generation. It used to be quite simple: we worked at our job till we were 65, were involuntarily retired with a pension and some government benefits, and settled down to an easy, but short, period of rocking on the front porch with our grandkids. Things have now altered dramatically. Now we will work at our sequence of jobs until we decide to step down, but maybe not totally. It is unlikely we will have a full pension, the probability of government benefits is diminishing, and we can expect to live somewhere into our eighties. Well, most of that sounds pretty good until we think about how we are going to finance this long spell, maybe a third of our life. Kids? We are having fewer children and it seems they will be less inclined to be part of what we knew as the "nuclear family". Government help? Old age benefits are rapidly moving to a position where they will be available only to the truly destitute. Employer pension? The number of Canadian workers covered by a full pension is dwindling rapidly.

All of the above arguments lead to a single conclusion: if you are going to have an adequate financial future you are going to have to augment whatever funds you have through a successful investment program. This publication is designed to explain the options you have and which of these have provided the highest returns. Before we begin to consider which investments are best for you, we need to know three basic pieces of information:

- How much do you have?
- How much will you need?
- When will you need it?

Get these data if you don't already have them! We will do a few simple calculations in the next chapter, but remember that there are many publications in your local library that will help, as well as resources on the internet. Also, there are numerous qualified financial planners that specialize in examining your current and future needs.

Summary

The main point of this chapter is that the financial landscape is changing rapidly in Canada. An investment program is mandatory if you are to achieve financial independence.

CHAPTER TWO

DETERMINING WHERE YOU ARE FINANCIALLY

In this chapter we will go through a few simple exercises to determine your current total net worth, how much you will need to achieve your financial goals, and when those funds will be required. First, let me say a little about the calculations we will be doing during the course of this chapter. All of them can pretty well be done on the back of an envelope—no advanced mathematics is required. On the other hand, the examples I will provide will be in the form of a computer spreadsheet. If this is new territory for you, I would like to try to convince you that the single most important financial planning tool you can own is a computer with spreadsheet capabilities and a modem. Here's why—the relatively inexpensive Macintosh PowerBook computer that I am using to compose this text allows me to do the following things:

Table 2.1. Common uses of a modern computer.

Word processor	Compose text that may include tables and implanted graphics; form letters; mailing list databases, etc.
Spreadsheet	Prepare financial and other data with the capacity to forecast, analyze, sort, and organize.
Draw and graph	Prepare graphics that can be embedded in text.
Communications	A modem allows access to the internet, e-mail, and much more.
Accessories	Printers, storage devices, scanners, etc.

In order to take control of your financial planning and carry out a successful investment program, you will need access to a lot of information. You will need to organize, store and apply that information if it is to be useful to you. A computer is the best way to do these tasks. Some of you may have some anxiety in this area—don't; a computer is easy to learn to use and lots of help is available. As I have said before, one of the best sources may be your grandkids! It will change your life for the better and improve your ability to take charge of your own financial future.

Now, let's take a look at a simple total net worth calculation. Basically, we will add up what you have and subtract what you owe. What remains is your total net worth. I will be using the Microsoft Excel spreadsheet for these calculations. The calculation is, as promised, very simple. What might not be so simple, especially if you've never done this before, is coming up with the figures needed for the calculation. Basically, the idea is to arrive at a conservative estimate of what everything you have is worth today. A good place to start is to prepare an inventory of all household items and personal property. For every item you will provide a description, cost, when purchased, present condition, location and serial number. It is good to have this list anyway and you should probably give a copy to your insurance agent (along with a video tape of your house and possessions). There are several computer software packages available to help with preparing this list, some are available on the internet as freeware or shareware.

It is useful to divide our assets and liabilities into groups:

Table 2.2 Groups of assets and liabilities

Assets	
Cash and cash equivalents	Cash on hand, bank accounts
Investments	Stocks, bonds, mutual funds, GICs, RRSPs, insurance, pensions, etc.
Hard assets	House, vehicles, furniture, appliances, etc.
Liabilities	
Long term	Mortgages, car loans
Short term	Credit card debt, unpaid bills

Don't feel constrained by the categories I have chosen—feel free to make up your own. The important point is to get a realistic view of the current value of all your assets and liabilities. This may take some digging but it will be worth it in the long run. Use resources like your bank, a realtor, appraisers, insurance agents, used vehicle guides, etc., to come up with the best possible estimates since the rest of our planning will depend on these values.

How about an example? Here is a made-up total net worth calculation for our "average" Canadian family. This is what the spreadsheet looks like:

EXAMPLE OF NET WORTH CALCULATION

ASSETS		
Cash and cash equivalents	$250	Cash on hand
	1125	Chequing account
	9800	Savings account
	11175	Total
Investments	5645	108.55 shares of BCE @ $52
	16700	RRSP
	13095	Pension-current value
	35440	Total
Hard assets	120000	House-current value
	58500	Inventory
	178550	Total
	$225165	TOTAL
LIABILITIES		
Long term	$66890	Mortgage
	5110	Car loan
	72000	Total
Short term	4250	Credit card debt
	1330	Misc. unpaid bills
	5580	Total
	$77580	TOTAL
TOTAL NET WORTH	$147585	

This is a good time to point out a major advantage of spreadsheets. Suppose you have just finished all your calculations when the wife calls to say that she has received a small inheritance and has paid off all the credit card debt. Instead of tearing up all your work and beginning over, a simple re-entry is all that is required—the new calculations are made automatically.

Now that you know how to determine your net worth, I would like you to turn to another useful tool—the statement of income and expenses. When you know your income and expenses, you can determine how much you can set aside for savings and identify areas of excess expenses. The best way to obtain values for expenses is from your expense ledger, in which you keep records of bill payments, etc. Also, we are getting very close to preparing a budget. Although we won't go through that calculation, it is easy once you have your income and expense data. We will prepare this on an annualized basis. I have selected some categories at random but you use the ones that are appropriate to your situation. Here is what the spreadsheet looks like for an income and expense calculation:

EXAMPLE OF ANNUAL INCOME AND EXPENSE STATEMENT	
INCOME	
Salary (net)	$38000
Investment income	2200
Total	$40200
EXPENSES	
Mortgage payment	$8250
Food	6000
Child care and expenses	6000
Clothing	3000
Fuel and auto maintenance	2500
Travel	2000
Taxes	1350
Entertainment	1200
Utilities	1200
Misc. and emergencies	1200
RRSP contribution	1000
Home repairs and maintenance	900
Personal	600
Total	$35200
YEARLY BALANCE	$5000

With these two simple calculations we now have a pretty good idea of where this household stands financially. Now, we have to determine where we want to go and how we will get there. For the first part I have added an appendix that I hope will help you set up a retirement plan on your computer using spreadsheet software. Once you have established how much you need for retirement purposes it remains to set out a path that will reach these goals. The rest of this publication is devoted to presenting various strategies designed to attain your objective. Remember to always consult your library, the internet or a financial planner to make sure your data are reliable.

Summary - The main point of this chapter is that the first step to financial independence is determining your total net worth and your income and expenses.

CHAPTER THREE

INVESTMENT STRATEGIES THAT WORK FOR CANADIANS

I hope the previous chapters have convinced you that, unless you are extremely wealthy or extremely lucky, you will need an investment program if you are to achieve your financial goals. In this chapter we will discuss how to develop an investment strategy. Most financial planners agree that the best investment approach is to maintain a diversified investment portfolio consistent with your time horizon, risk aversion level, need for growth versus income, plus any other relevant criteria. A diversified investment approach would include investments in four main asset categories: cash, fixed income, stocks and hard assets (the latter would include real estate, precious metals, natural resources, collectibles, commodities, etc.).How much of each investment category to own at any given time will depend on many factors, as mentioned above.

The case is easily made for being maximally invested in a company pension plan, if one exists, and in an RRSP. The reason for doing this is obvious—your money will grow tax-deferred. A dollar that is not taxed will grow much more quickly than a dollar that is. But even with maximum contributions to these plans, it is unlikely to be enough to reach your goals.

By now you should have some idea of how much investments you will need by a particular time and how much you can invest on a yearly or monthly basis. What remains is to decide what to invest in. Let's take a look at the four main investment categories and see what their historical (5-year) returns have been. According to the July 12, 1998 *Toronto Star* these are:

- Cash, as reflected by 91-day Canadian T-bills 4.9%
- Fixed income, as reflected by Canadian bond index 8.1%
- Stocks, as reflected by TSE 300 total return index 15.6%
- Hard assets ?*

*This is such a heterogeneous group it is hard to generalize. But, over the past 5 years the London gold fix (US$) has lost 4.8% and the TSE 300 real estate index has dropped 3.0%.

These data don't really tell us the true story, however. Our investments will fall prey to both inflation and taxes. How do those influence returns? The Canadian CPI has averaged only 2.5% in the past 10 years, a period of low inflation. Taking that figure and assuming a tax rate of 42% (this will vary with the type of investment since interest income is taxed at a higher rate than capital gains income, which is taxed at a higher rate than dividend income), we can rearrange the previous table to show "net net" returns:

- Cash Total return - 4.9% Net Net return - 0.34%
- Fixed income Total return - 8.1% Net Net return - 2.20%
- Stocks Total return - 15.6% Net Net return - 6.55%

The above table, although the absolute numbers may vary from year to year, is really all you need to know about investing. As we shall see, this and the fact that dividend income is taxed at the lowest rate of all investment incomes, can serve as the basis for an investment strategy.

It is obvious that, for most people, it is necessary to concentrate a major part of their investment portfolio on stocks ("growth"), rather than fixed-income ("income") vehicles if they are to realize their goals. This means taking on extra risk. Why? Because even though stocks have significantly higher returns, those returns are not guaranteed, nor are the returns constant from year to year. How do we minimize the extra risk? Simple—develop a conservative, safe strategy and apply it for a long period of time. The first part of this chapter will serve as an introduction to the "Beating The TSE" strategy that I developed in order to enable individual Canadians to participate in large-cap Canadian equities. It seems to me that the best way to tell this story is to let in unfold the way it did in the pages of *MoneySaver*. Thus, what follows next are the columns, with some minor editing, that explain how this investment tool works and how it has fared. The second part of this chapter will focus on a strategy for investing in US stocks.

I. "BEATING THE TSE"

From *Canadian MoneySaver*, July/August, 1996 issue, pg. 19:

The Investment Maze

A friend recently complained that individual investors faced a confusing maze of conflicting information when trying to make decisions about where to place their money. Someone else in on the conversation was of the opinion that we individual investors would all be better off if we left such weighty matters to "professionals". I disagreed strongly, which, in a way, has led to this project.

My goal for these columns is to empower individual Canadian investors so they can then do the research necessary to make their own decisions. Together we will discuss investment strategies and share information. The first decision for investors is which vehicle to choose. The possibilities include stocks, bonds, mutual funds, money market accounts, GICs, and bank deposits, among others. A bewildering maze, indeed, for the beginning investor.

Why Stocks?

There can no longer be any doubt that, for the long haul, stocks will make the individual investor wealthier than any other asset. Some recent data show that, over the 20-year period of 1975 - 1995 Canadian 3-month T-Bills returns averaged 10.20% yearly, as compared to 11.67% for the Scotia McLeod bond index and 12.44% for the TSE 300 stock index. Not a very big difference you say? Stocks only outperform T-bills by 22%? Not worth the risk? This is probably a good time to start throwing out gross averages and dealing with the real world. Few of us get to enjoy our gross returns—even if the investment is in an RRSP that only delays taxation, it doesn't go away. And don't forget inflation. Let's make a few assumptions—our hypothetical investor has a long horizon, at least 20 years, is investing outside an RRSP, and is in the approximate 50% tax bracket. If we postulate that inflation averages 4% per year (I know, it is less than that now, but I'm using long-term data), the above figures will look a lot different. The net return on these three investments over the 20-year period (by the way, a 20-year period dominated by a sustained bull market) is 3-month T-bills - 3.10%, Scotia McLeod Bond Index - 3.84%, and TSE 300 Stocks - 4.22%. Now stocks do better than T-bills by 36%. And it's going to get better. Don't forget that there are some tax breaks for both capital gains and dividend income that will make stocks even a healthier deal. For example, top-bracket tax payers of Ontario need to earn $1.37 worth of interest income to equal $1 of dividends. You will get some of your tax back and I haven't mentioned the benefits of DRIP and SPP plans. I am convinced that the long-term, real gains from stocks are, in the end, necessary for investors to meet their goals.

You don't have to put all your money into stocks. Perhaps you think they are too risky for you or that you need to balance your portfolio with bonds, money market accounts, real estate, whatever. Go ahead, you'll get no argument from me. In concert with your financial advisor, decide how much you are going to allocate to stocks and go from there.

Notice I haven't mentioned mutual funds. They, also, can be an important part of an investor's portfolio. But select them wisely. A recent mutual fund survey tells us that the average annual compound rate of return for 82 Canadian equity funds over 10 years was 8.2% while the same figure for the TSE 300 total return index was 8.6%. Here's a pretty basic rule for stock investing—if you don't have the time or inclination to get at least a little involved in the process, stick with an index fund or TIPS shares. With the former you won't do as well as the index due to in-and-out costs and management fees, but all you have to do is plunk your money down.

On the other hand, if you have just a few minutes a year to devote to increasing your wealth and you want to beat the averages, keep reading.

Why Canadian Stocks?

OK-you do want a higher return and you can spend a little time to get it. Primary decision—where in the wide world of stock markets should you invest? There are a multitude of possibilities; the US , Europe, Emerging Markets, etc., but let me try to persuade you to consider our very own Canadian stock market. First, the bad news. For the same 20-year period, the US S&P 500 stock index has outperformed our TSE 300 stocks on an annualized basis by 16.32% to 12.44%, taking into account currency variations. The International Equity Index is also higher than the TSE 300. So why should your money be invested in

Canadian stocks? For the same reasons we talked about before—don't be fooled by gross averages. Dividends from foreign stocks are taxed at a higher level than the proceeds from Canadian stocks. We have to keep our eye on the real returns. Also, the benefits of DRIP and SPP plans must be considered. Finally, as Canadians, we should want our companies to succeed and prosper.

Why TSE 35 stocks?

The Toronto Stock Exchange (TSE) accounts for over 80% of all the equities traded in Canada, handling the largest and most heavily traded issues. The TSE maintains three major indices, the TSE 35 or Toronto 35, the TSE 100 and the TSE 300. Since the TSE 35 is a subset of the TSE 100, which is a subset of the TSE 300, it is not too surprising that the total returns (we will refer to returns based on only the stock price as stock price index values or SPIVs, and returns including dividends as total return index values or TRIVs) of these three indices are similar—over the past 10 years (1985-95) the annual compound SPIVs were 8.62% for the 35, 8.44% for the 100 and 8.29% for the 300. The TSE 35 Index (which just had its 9th birthday on May the 27th of this year, at the same time the Dow Jones Industrial Average or DJIA, the comparable US index, turned 100) is certainly not as well known as its American counterpart, although many of these stocks also trade on the NYSE and/or pay dividends in US funds, but the performance it has recorded has been impressive (Note - My data indicate that as of May 26, 1998, the total return of the TSE 35 index over its lifetime has averaged 10.38%). More information on these indices is readily available from the TSE.

We will use the TSE 35 since it represents Canada's industrial economy with a manageable number of the best known and most widely followed stocks in the country. These companies are known for their large capitalization, strong earnings and increasing dividends. They are our "Blue Chips". Now, this term has a negative meaning to some investors, who prefer to call them "Blue Gyps". I do not share that opinion; maybe all your investment capital should not be in this program but I think it beats the heck out of trying to market-time under-capitalized, volatile natural resource issues on the VSE.

Picking TSE 35 stocks

As mentioned above, the individual investor can choose to use an index fund or TIPS to follow TSE stocks, but let's look at a simple, quick method to pick stocks from the TSE 35 that will outperform the Index.

The approach we will use is similar to that developed by Michael O'Higgins in his 1991 book, *Beating The Dow*, and anyone who is serious about using this method would be well advised to read it, since I can only provide a brief summary here. Basically, Mr. O'Higgins, a professional money manager, has observed over the years that low-priced, high dividend DJIA stocks outperform the market. He has found that "dividends are the driving force in the blue chip segment of the market", and that lower priced stocks register higher percentage gains on average than higher priced stocks. Based on these principles a simple formula, requiring only a few minutes a year, was devised to select undervalued DJIA stocks that, over time, have outperformed the Dow 30 by about 100%. I have tested this method using TSE 35 data—it works, and it works well. Next time we will look at these results and see how the individual investor can apply them.

From *Canadian MoneySaver*, September, 1996 issue, pg. 24:

Picking TSE 35 Stocks

In my first column (July/August, 1996) I promised to explain a very simple, easy to use method that will allow the individual investor to beat the TSE 35 index. This approach is similar to that developed by Michael O'Higgins in his 1991 book, "Beating The Dow", and is based on his observation that, over the years, low-priced, high dividend stocks outperform the market. He is of the opinion that "dividends are the driving force in the blue chip segment of the market", and that lower priced stocks register higher percentage gains on average than higher priced stocks. Once you buy into these two premises (and even if you don't), the next part is the ultimate in simplicity:

- Identify the TSE 35 stocks. Easy enough—ask your broker, your financial planner, or contact the TSE.
- Get a newspaper that has the following two pieces of information about each stock on the list, the price and the dividend (what you want is the Indicated Annual Dividend or IAD. This is essentially the

company's best guess as to what their dividend will be for the next 12 months). Is any day better than another to begin? Not that I can see, but then I don't have a knack for market timing.

- The next part is very much easier if you have a spreadsheet on your computer, but you can use paper and pencil too. First, list all the stocks in alphabetical order, then beside each one write its last closing price and the IAD. Now, in the next column calculate the expected yield, obtained by expressing the IAD as a percentage of the price. Thus, if the stock price was $50 and the IAD was $2.00, the expected yield is 4.00%. Note that for some TSE 35 stocks the IAD is given in US dollars—simply convert it to Canadian dollars using that day's exchange rate.
- Next, rank the 35 stocks from highest to lowest with regard to expected yield (here is where your spreadsheet comes in handy). If two stocks are tied, rank the one with the lowest price highest. Now, pick off the top 10 highest-yielding stocks from your list. Then, rearrange these ten from lowest to highest with respect to price. So, you wind up finally with a list of the 10 stocks with the highest expected yield ranked according to price. That's all there is to it! No company research, predicting earnings, calculating P/E ratios, or market timing. It is simplicity personified and shouldn't take you over a few minutes to do. I'll give an example of how this is done later on.

Investing in the TSE 35 Stocks

Now what? We have our list and at this point several different strategies can be employed, depending mainly on the amount you wish to invest. Mr. O'Higgins details several approaches, the easiest being to purchase equal dollar amounts of the 10 stocks you've identified and hold them for one year. The process is then repeated. From practical considerations of commission levels, $1000 is about the least you can allot to each purchase. This adds up to $10,000 before commission. If that exceeds your comfort level you may wish to consider only the 5 lowest priced high yielders. This has the advantage of lowering the initial cost to $5000 before commissions but also limits diversification (Note: see later discussion of "Dozens" strategy).

Many, actually most, of the stocks that you have selected will have DRIP and SPP plans. Since it is likely that some of your first year picks will also be on the second year's list, keep these plans in mind. An advantage of the TSE 35 is that there are relatively few substitutions in the index. Since its inception only 51 stocks have been listed. This increases the probability of "repeaters", which lowers turnover costs. Mr. O'Higgins reports that on average between 3 and 4 stocks were replaced each year in his ten-stock portfolio.

A third method consists of ignoring the lowest price stock but buying double the amount of the second lowest price stock. The dollar weightings would then be 0-2-1-1-1 for the lowest price 5 stocks. The rationale for this is that historically the second cheapest stock of the group outperforms the lowest price stock because the latter may tend to be in financial trouble while the next is probably better off and its low price allows it to rebound. This variation is called the "Foolish Four" by the on-line investment group collectively known as the "Motley Fool" and is available on America Online or the www.fool.com

Finally, serious investors with research inclinations may wish to use the 10 selected stocks as a universe to which can be applied fundamental or technical analysis to come up with what, in their opinion, is a better but smaller list of issues to pursue. Or, you may elect to chose only those stocks having both DRIP and SPP plans. But be warned—after trying many different advanced methods to enhance returns Mr. O'Higgins concluded that none of these outperformed the basic procedure outlined here.

Performance

How have these methods performed? Data for the "Beating The Dow" approach given by Mr. O'Higgins for the years 1973-89 indicate that using the 10-stock method resulted in a 699.62% total return as compared to 1009.75% for the 5-stock method. This equates to an increase over the DJIA, which gained 499.35% during the same period, of 40.1% and 102.2%, respectively. Motley Fool data for their Foolish Four over the last 25 years show this approach has compounded at an annual rate of 22.23%, better than both the 16.85% of the 10-stock method and the 19.17% of the 5-stock method. During this time the DJIA averaged close to 11%.

What happens when Beating The Dow is applied to the TSE 35? Well, pretty close to the same results, taking into account the less rapid rise in our stock market. I have now back-tested these three methods against the TSE TRIV for the life of the index using data obtained from the Financial Post Data Group. The results are shown in Table 1 (Note: see updated table in a later column).

TABLE 1. Comparison of total returns to the TSE 35 TRIV Index.

YEAR	10-STOCKS	5-STOCKS	4-STOCKS	TSE 35 INDEX
1987[1]	-10.54	-7.67	-15.57	-12.45
1988	21.43	26.10	16.81	11.32
1989	23.36	19.77	24.16	21.89
1990	-11.65	-10.85	-17.69	-11.65
1991	29.41	31.92	41.56	11.01
1992	-1.49	-6.10	-5.58	-3.58
1993	22.76	16.05	28.32	24.34
1994	4.08	3.27	3.97	5.52
1995	16.70	12.93	16.37	14.72
1996[2]	10.40	7.46	9.94	9.94
SUM	104.46	92.88	102.29	71.06
AVG.	10.45	9.29	10.23	7.11
% INCREASE	47.00	30.71	43.95	

[1] Data for 5/27 onward

[2] Data from 1/1 to 5/27

Several important points emerge from this table. First, it is important to realize that only 9 years' worth of data are available, spread out over 10 calendar years. Thus, this limits the degree of certainty with which one can make conclusions. With the DJIA, a century of data exist, making those comparisons much more valid. Still, working with the numbers available, we can see that close to a 50% increase over the TSE 35 TRIV Index results from applying the 10-stock procedure. This looks to be the best method, but the small data set means that the differences among the 10, 5 and 4-stock methods are likely not significant. We can wait for the next 91 years to get more numbers or proceed with the, I think, reasonable conclusion that "Beating The Dow" can be applied profitable to selecting stocks from the TSE 35.

From *Canadian MoneySaver*, October, 1996 issue, pg. 6:

The Model Portfolio

In the first two articles in this series we examined the benefits of investing in Canadian large cap stocks and presented a simple method for selecting the ones that are due to outperform the index. Our next task is to set up a model portfolio. I have taken as our starting date May 27, 1996, the anniversary of the TSE 35. The initial list is shown in Table 1.

TABLE 1. TSE 35 worksheet.

NUMBER	STOCK	SYM	PRICE	IAD	EXP YIELD
1	Abitibi-Price	A	19.10	0.40	2.09
2	Alcan Aluminum	AL	45.10	0.82	1.83
3	Barrick Gold	ABX	42.50	0.19	0.45
4	BCE Inc.	BCE	54.95	2.72	4.95
5	Bank of Montreal	BMO	33.35	1.44	4.32
6	Bank of Nova Scotia	BNS	32.05	1.24	3.87
7	Bombardier Cl B	BBD.B	19.20	0.21	1.09
8	Canadian Oxy Petroleum	CXY	23.15	0.30	1.30
9	Canadian Tire Cl A	CTR.A	17.80	0.40	2.25
10	Canadian Imperial Bank	CM	46.25	1.60	3.46
11	Canadian Pacific Ltd.	CP	27.55	0.48	1.74
12	Dofasco Inc.	DFS	21.45	0.80	3.73
13	Imasco Ltd.	IMS	28.10	1.08	3.84
14	Imperial Oil	IMO	59.00	2.00	3.39
15	Inco Limited	N	44.80	0.55	1.23
16	Laidlaw Inc. Cl B	LDM.B	14.35	0.20	1.39
17	MacMillan Bloedel	MB	17.55	0.60	3.42
18	Magna Int'l. Cl A	MG.A	68.80	1.08	1.57
19	Moore Corp.	MCL	25.75	1.29	5.02
20	National Bank	NA	11.75	0.50	4.26
21	Noranda Inc.	NOR	29.85	1.00	3.35
22	Northern Telecom	NTL	74.20	0.71	0.96
23	Nova Corporation	NVA	13.10	0.36	2.75
24	Placer Dome	PDG	38.75	0.41	1.06
25	Renaissance Energy	RES	36.50	0.00	0.00
26	Rogers Commun. Cl B	RCI.B	13.95	0.00	0.00
27	Royal Bank	RY	33.00	1.36	4.12
28	Seagram Co.	VO	48.90	0.82	1.69
29	Talisman Energy	TLM	31.20	0.00	0.00
30	Toronto-Dominion Bank	TD	24.60	1.00	4.07
31	Teck Corp. Cl B	TEK.B	29.60	0.20	0.68
32	Thomson Corporation	TOC	22.30	0.76	3.39
33	TransAlta Corporation	TA	14.95	0.98	6.56
34	TransCanada Pipelines	TRP	19.95	1.08	5.41
35	TVX Gold	TVX	12.05	0.00	0.00

Note how much variation there is in the Expected Yield figures. Over the brief life span of the TSE 35 average Expected Yields have averaged 3.23%•0.48. but have been declining over the second half of the index's history. The dividend yield of the TSE 35 currently sits at 2.50 as of September 13, 1996. Now we rearrange our data to list the highest yielders at the top of the table, select the top 10 and rearrange them according to price. This results in Table 2.

TABLE 2. Identifying the lowest-price high yielders.					
NUMBER	STOCK	SYM	PRICE	IAD	EXP YIELD
20	National Bank	NA *	11.75	0.50	4.26
33	TransAlta Corporation	TA *	14.95	0.98	6.56
34	TransCanada Pipelines	TRP *	19.95	1.08	5.41
30	Toronto-Dominion Bank	TD	24.60	1.00	4.07
19	Moore Corp.	MCL *	25.75	1.29	5.02
13	Imasco Ltd.	IMS *	28.10	1.08	3.84
6	Bank of Nova Scotia	BNS *	32.05	1.24	3.87
27	Royal Bank	RY	33.00	1.36	4.12
5	Bank of Montreal	BMO *	33.35	1.44	4.32
4	BCE Inc.	BCE *	54.95	2.72	4.95

* These stocks have both DRIP and SPP plans.

The 10-stock plan would mean purchasing all 10 of these stocks. The 5-stock plan uses only the top 5, while the Foolish Four leads to a double dose of number 33 and then equal dollar amounts of numbers 34, 30 and 19. You will see the large number of utilities and banks in this list. That is because these stocks traditionally have higher dividends. The DJIA has few of these types of stocks, since there is a separate utility index, which may explain some of the differences between the two data sets. It would be interesting to remove the banks and utilities from the TSE 35 and rerun the data. Also, 8 of the top 10 stocks have both DRIP and SPP plans, a definite advantage for the individual investor.

Note, please, that the average expected yield of the top 10 is 4.64%. If we apply the 1.37 equivalent yield factor to get an equivalent interest yield this turns into 6.36%. In my most recent weekend paper, one year GICs are quoted from 2.75 to 4.55%, money market funds from 2.78 to 4.90%, and one year T-bills are yielding 4.54%. So we have a way to beat all these rates and also outperform the index with capital gains (my data show that when we compare SPIVs over the life of the TSE 35, the 10-stock method still beats the average by about 30%).

Results So Far

How has our portfolio performed thus far? Let's assume that we invested equal amounts in each of the 10 stocks listed in Table 2 on May 27, 1996, the anniversary of the TSE 35. As of September 13, the results look like this:

TABLE 3. Beating the TSE 35 model portfolio – results from 5/27/96 to 9/13/ 1996.			
STOCK-SYM	PRICE (5/27)	PRICE (9/13)	CHANGE (%)
National Bank-NA *	11.75	11.75	+0.00
TransAlta Corporation-TA *	14.95	15.70	+5.02
TransCanada Pipelines-TRP *	19.95	21.85	+9.52
Toronto-Dominion Bank-TD	24.60	27.45	+11.59
Moore Corp.-MCL *	25.75	24.05	-6.60
Imasco Ltd.-IMS *	28.10	27.75	-1.25
Bank of Nova Scotia-BNS *	32.05	36.30	+13.26
Royal Bank-RY	33.00	37.20	+12.73
Bank of Montreal-BMO *	33.35	34.60	+3.75
BCE Inc.-BCE *	54.95	55.00	+0.09
AVERAGE			4.81 (6.20)[1]
TSE 35 TRIV	446.45	453.62	1.61

* These stocks have both DRIP and SPP plans.

[1]Includes 4.81% capital gains plus 1.39% dividend (4.64% pro rated).

Not so very bad for a beginning. During a downturn in the market when the TSE 35 TRIV index gained only 1.6% and TIPS were up just 1.1%, you could have picked up a cool 6.20% on your investment, including a dividend that will give you a tax break and have 80% of your money in stocks offering DRIP and SPP plans. Note that with the two alternate strategies the returns would have been 3.90% and 4.91% capital gains for the top 5 and the Foolish Four, respectively.

There you have it—a simple and quick way for the individual investor to better the TSE 35 index. Make your picks and relax for the next 12 month period. No more concerns about day-to-day fluctuations in stock prices, what's happening to interest rates or what the media are screaming at us to do with our investments. No need to predict corporate earnings, to decide if inflation is increasing or decreasing, and, particularly, you don't have to try to forecast the direction the market is moving.

From *Canadian MoneySaver*, July/August, 1997 issue, pg. 3:

The New "Beating the TSE" Portfolio

Out with the old and in with the new, kind of. It is May 27, the anniversary date of the TSE 35 index, and our anniversary date for a new portfolio, but first let's take a look at how we did over the last year (Table 1).

TABLE 1. Beating the TSE 35 model portfolio – results from 5/27/96 to 5/26/97.

STOCK-SYM	PRICE (5/27)	PRICE (5/26)	CHANGE (%)
National Bank-NA *	11.75	16.80	+42.98
TransAlta Corporation-TA *	14.95	16.50	+10.37
TransCanada Pipelines-TRP *	19.95	27.55	+38.10
Toronto-Dominion Bank-TD	24.60	42.95	+74.59
Moore Corp.-MCL *	25.75	30.75	+19.42
Imasco Ltd.-IMS *	28.10	39.90	+41.99
Bank of Nova Scotia-BNS *	32.05	58.80	+83.46
Royal Bank-RY	33.00	61.70	+86.97
Bank of Montreal-BMO *	33.35	55.05	+65.07
BCE Inc.-BCE *	27.48**	38.25	+39.22
AVERAGE			+50.22 (54.86)[1]
TSE 35 TRIV[2]	446.45	588.76	+31.88
TIPS	27.20	35.10	+29.04

* These stocks have both DRIP and SPP plans.
**Adjusted for 2-for-1 split.
[1]The total return during this time period is 50.22% for capital gains and 4.64% for dividend yield or 54.86%. The dividend yield is prorated from the average expected dividend yield of 4.64%.
[2]Total Return Index Value for the TSE 35.

I think I am allowed to say WOW! Close to a 55% total return and we beat our benchmark index by over 70%! However, if we place these data in their historic perspective (Table 2) we can see that 1996 was indeed an exceptional year, way higher than any previous time period. So, don't expect these returns all the time, and remember that these data don't include commissions (but neither do they include the benefits of the DRIP and SPP plans). Still, it sure was a great year, the best in the history of the TSE 35, and now our strategy of selecting the 10 highest yielding, lowest cost stocks averages a 60% increase over the index itself. The 5- and 4-stock portfolios lagged this year, but still beat the index handily. I see from the May 11 *Toronto Star* Mutual Fund Survey that the average of the 229 Canadian equity funds increased by 14.8% over the past year and only 7.6% over the past 10 years. The obvious message? Spend a few minutes a year doing some research and buy your own stocks.

TABLE 2. Comparison of total "Beating the TSE" returns to the TSE 35 TRIV Index.

YEAR[1]	10-STOCKS	5-STOCKS	4-STOCKS	TSE 35 INDEX
1987	-10.54	-7.67	-15.57	-12.45
1988	21.43	26.10	16.81	11.32
1989	23.36	19.77	24.16	21.89
1990	-11.65	-10.85	-17.69	-11.65
1991	29.41	31.92	41.56	11.01
1992	-1.49	-6.10	-5.58	-3.58
1993	22.76	16.05	28.32	24.34
1994	4.08	3.27	3.97	5.52
1995	16.70	12.93	16.37	14.72
1996	54.86	42.31	36.25	31.88
SUM	148.92	127.73	128.60	93.00
AVG.	14.89	12.77	12.86	9.30
% INCREASE	60.13	37.34	38.28	

[1] Data for 5/27 to 5/26 of the following year.

That was then, this is now. Let's take a look at next year's selections (Table 3). I won't go through the process here again; if you would like to see how this is done please refer to the October, 1996 issue of *Canadian MoneySaver*. Come what may, we will hold these stocks for one calendar year, until May 27, 1998.

TABLE 3. Identifying the lowest-price high yielders for the 1997 portfolio.

STOCK	SYM	PRICE	IAD	EXP YIELD
Nova Corporation	NVA*	11.65	0.40	3.43
TransAlta Corporation	TA*	16.50	0.98	5.94
National Bank	NA*	16.80	0.60	3.57
Dofasco	DFS*	26.80	1.00	3.73
TransCanada Pipelines	TRP*	27.55	1.16	4.21
Moore Corporation	MCL *	30.75	1.29	4.20
Noranda Mines	NOR	32.70	1.00	3.06
BCE Inc.	BCE*	38.25	1.36	3.56
Imasco Ltd.	IMS*	39.90	1.20	3.01
Imperial Oil	IMO*	67.15	2.20	3.28

* These stocks have both DRIP and SPP plans.

Looking at these stocks tells us a little about the effect of last year's magnificent performance of the TSE 35 on stock valuations:

- Sixty percent of our portfolio stays the same. We only need to replace 4 stocks this year, saving a considerable amount on commissions.
- Ninety percent of our stocks offer both DRIP and SPP plans, a decided advantage to the investor. If you are not aware of these plans you should read Dale's column.
- The trend for this year has been to replace the banks with energy/steel/resource stocks. According to the 1996 *Globe and Mail* "Report on Business", 4 of our stocks are among the top 50 Canadian exporters; also, all are in the top 60 Canadian companies ranked according to after-tax profits.
- The combined cost of one share of each of our ten stocks is $308.05, up 22.7% from last year.

- The average expected yield of our portfolio is 3.80%, down from 4.64% last year. At the same time, the average expected yield for the whole TSE 35 has dropped from 2.55% to 2.06%. Still, 1-year Canadian T-bills only return 3.37%.

Yes, stocks are more expensive and yields have decreased. Does this mean we change our strategy? Nope, we do the same old boring thing every year, confident that, on average, we will continue to beat the TSE 35 index substantially.

From *Canadian MoneySaver*, July/August, 1998 issue, pg. 5:

Is This Party Over?

Ho-hum. Another year of our "Beating The TSE" strategy has gone by and again we have beaten our benchmark handsomely (Table 1).

TABLE 1. Beating the TSE 35 model portfolio – results from 5/27/97 to 5/26/98.

STOCK-SYM	PRICE (5/27)	PRICE (3/6)	CHANGE (%)
Nova Corporation-NVA *	11.65	17.40	49.36
TransAlta Corporation-TA *	16.50	24.00	45.45
National Bank-NA*	16.80	30.70	82.74
Dofasco-DFS*	26.80	24.30	-9.33
TransCanada Pipelines-TRP *	27.55	33.75	22.50
Moore Corporation-MCL *	30.75	21.75	-29.27
Noranda Mines-NOR	32.70	26.75	-18.20
BCE Inc.-BCE *	38.25	65.80	72.03
Imasco Ltd.-IMS *	19.95	27.75	39.10
Imperial Oil-IMO*	22.38	27.85	24.44
AVERAGE			+ 27.88 (32.64)[1]
TSE 35 TRIV[2]	588.76	713.77	+ 21.23
TIPS 35	35.10	41.75	+ 18.95

* These stocks have both DRIP and SPP plans.

[1]The total return during this time period is 27.88% for capital gains and 4.75% for dividend yield, or 32.64%. The dividend yield is prorated from the average expected dividend yield of 4.75%.

[2]Total Return Index Value for the TSE 35.

This year our results were not as spectacular as 1996/7, but we still managed a 53.7 % increase over the TSE 35 total return index value (Have you noticed that TIPS 35 always lags the index by a few percent? "Administrative" costs, I presume, but the point is that we actually do better than we think, since individual investors can only participate in the index via TIPS 35). Put into historical perspective (Table 2), the 10-stock portfolio outperformed the index a little less that usual while the 5- and 4-stock selections did better than usual. Ho-hum. Yet another year of outstanding performance, handily eclipsing our target index and more than 85% of domestic equity mutual funds with only a few minutes work a year while achieving tax benefits and participating in both DRIP and SPP plans. And we didn't have to shell out the 2+% expense ratio associated with mutual funds. Thus far, our simple approach to investing has recorded an increased return of close to 60% compared to the TSE 35 total return index.

TABLE 2. Comparison of total "Beating the TSE" returns to the TSE 35 TRIV Index.

YEAR[1]	10-STOCKS	5-STOCKS	4-STOCKS	TSE 35 INDEX
1987	-10.54	-7.67	-15.57	-12.45
1988	21.43	26.10	16.81	11.32
1989	23.36	19.77	24.16	21.89
1990	-11.65	-10.85	-17.69	-11.65
1991	29.41	31.92	41.56	11.01
1992	-1.49	-6.10	-5.58	-3.58
1993	22.76	16.05	28.32	24.34
1994	4.08	3.27	3.97	5.52
1995	16.70	12.93	16.37	14.72
1996	54.86	42.31	36.25	31.88
1997	32.64	42.32	42.04	21.23
SUM	181.56	169.47	169.60	114.23
AVG.	16.51	15.41	15.42	10.38
% INCREASE	58.94	48.36	48.47	

[1] Data for 5/27 to 5/26 of the following year.

Our editor is kind enough to allow me an occasional rant and here is my current pet peeve. The notion that the individual investor is too dimwitted to execute a winning investment strategy in stocks is dead, a result of the vastly improved information flow from publications such as *Canadian MoneySaver* and a much longer time horizon than the average quarter-to-quarter harried mutual fund operator. Nothing bothers me more that a supercilious money manager insisting that only professionals can take care of your money. Here is a quote from a recent investment house publication: Don't do part-time what the professionals do full-time...most investors are well-advised to let investment professionals make (their) decisions... Humbug! Sure, it is always good to have some professional input, but remember that the final resolution is yours and yours alone.

So, what can go wrong? From the title of this column you have probably gathered that I do have some concerns, but before I share them with you, let me hasten to say that they will have absolutely no influence on our strategy. Before long, I will show you next year's model portfolio which I expect to outperform the TSE 35 as it has done in 8 of the 11 years of its existence. This next table, however, indicates some potentially worrying trends (Table 3).

TABLE 3. Changes in the TSE 35 Index and fixed income yields.

Attribute	1996[1]	1997	1998	% Change[2]
TSE 35 Avg div yield	2.55	2.06	1.67	-34.5
BTT[3] Avg div yield	4.64	3.80	2.86	-38.3
1 yr T-bill	4.54	3.37	5.17	+13.9
10 yr Canada bonds	7.54	6.55	5.40	-28.9
TSE 35 P/E	15.3	19.3	34.4	+125
TSE 35 TRIV[4]	446.45	588.76	713.77	+59.9

[1]As of May 26.
[2]1998 data as a percent of 1996 data.
[3]"Beating The TSE" 10 stock portfolio.
[4]Total Return Index Value for the TSE 35.

These data and the cautionary signals they elicit are plain: stock prices are going up while dividend yields are decreasing; the price we have to pay for stock shares is increasing about twice as much as the underlying earnings the companies are generating; short-term fixed-income instruments, as represented by 1-year treasury bills, are presenting a more attractive alternative to the conservative investor while the yield curve flattens. These are real concerns for an investment strategy based on dividend yields, but as I said before, they will not dissuade us from our course. Why not? Several reasons, the first being that our average dividend yield for this year (2.86, as shown later) times the 1.35 tax factor (see pg. 19, May 1998 issue) equals 3.86, meaning our portfolio only has to show capital gains of about 1.3% to match 1-year treasury bills. Since over the past 11 years "Beating The TSE" has averaged over 11% capital gains yearly, I think it is a worthwhile investment. Next, simply looking at the yield in isolation is only part of the story. With interest rates and inflation also at historically low levels, many professionals tell us the yield is not inordinately low in comparison. Since companies think they can make a more tax-efficient use of excess earnings through share repurchases than in paying increased dividends they are tending to follow this strategy, but it is questionable that this will hurt the tradition of paying consistent and increasing dividends. For example, our previous year's portfolio has increased its average IAD by 3.6% during the year (this calculation excludes Moore Corp., which cut their dividend drastically). Until we see a real slippage in dividend increases and a sharp decline in our strategy's results I am not going to become overly anxious, particularly since high-yielding stocks fall less in down markets (see pg. 12, June 1998).

Also, our strategy is an invariable one with the goal of getting all the returns that would come from careful stock selection with a minimum input of time, year after year. This is a goal that has been achieved. From discussions I have had with *MoneySaver* readers I know that most of you are long-term investors with the admirable goal of planning for retirement. Thus, we are much more concerned with where the market will be in several decades, not several months. Yes, I do think we may be close to the point that only an extraordinary performance will insure that our portfolio does not lose capital, but no, I see no advantage to changing our strategy, especially if the available options are low-yield fixed income instruments, under-performing mutual funds, or trying to time the market in risky small-cap stocks.

Enough gloom—let's take a look at this year's portfolio (Table 4). I won't go through the process here again; if you would like to see how this is done please refer to the October 1996 issue of *Canadian MoneySaver*. Come what may, we will hold these stocks for one calendar year, until May 26, 1999.

TABLE 4. Identifying the lowest-price high yielders for the 1998 portfolio.

STOCK	SYM	PRICE	IAD[1]	EXP YIELD
Nova Corporation	NVA*	17.40	0.40	2.30
TransAlta Corporation	TA*	24.00	0.98	4.08
Dofasco	DFS*	24.30	1.00	4.12
Noranda Mines	NOR	26.75	1.00	3.74
Imasco Ltd.	IMS*	27.75	0.68	2.45
National Bank	NA*	30.70	0.68	2.21
TransCanada Pipelines	TRP*	33.75	1.24	3.67
Bank of Nova Scotia	BNS*	38.20	0.80	2.09
Thomson Corporation	TOC	41.90	0.90	2.15
Canadian Imperial Bank	CM*	49.55	1.20	2.42
Bank of Montreal	BMO*	80.25	1.76	2.19

* These stocks have both DRIP and SPP plans.

[1] Indicated Annual Dividends (CDN $).

Why 11 stocks rather than 10? It seems now a surety that Nova Corporation (NVA) and TransCanada Pipelines (TRP) will merge, leaving us with 9 rather than 10 stocks. When that is official, I shall promote Bank of Montreal (BMO) to the number 10 spot. The practical consequence of this is that if you are just beginning this strategy you would divide your funds into 10 equal amounts and purchase all 11 stocks with only 1/20th into both NVA and TRP.

Our portfolio is, I believe, outstanding. Note that 7 of these selections are repeaters and that 9 have active DRIP and SPP plans. The big loser of last year, Moore Corp., has cut its dividend so deeply that it is no longer on the list. If one was to set about to design a defensive portfolio with capital gains potential I doubt it could be any better than this. Does a 10-stock portfolio make too much of a dent in your pocketbook? Consider the 5- or 4-stock option, or the "Dozen" approach in which an investor purchases the top "Beating The TSE" stock each month that's not already in their portfolio (see pg. 10 of the April issue).

One final point. Dale Ennis tells me he has had some inquiries about when our new "Beating The TSE" portfolio was to appear, as have I. Of course, I am heartened that folks read this column and find it useful, but if your investment program doesn't go beyond parroting these picks you have misunderstood the whole purpose of my writing. You have the ability to perform these simple calculations whenever you want and the intelligence to adopt them to your overall strategy. Use these abilities!

(Added Note: If you are going to use this strategy, and I hope you are, be sure to obtain an updated list of the TSE 35 stocks before you begin—this index changes occasionally.)

From *Canadian MoneySaver*, July/August, 1999 issue, pg. 11:

Our New "Beating The TSE 35" Portfolio

In this column we will look at the results of last year's portfolio and unveil our new picks. Why? Didn't I say in a previous column that this would be the last year for this exercise? Yes, I did, but that was under the assumption that the TSE was going to do away with the 35 Index, but it seems now that perhaps they have come to their senses and it will continue. After all, what about all the folks that own TSE 35 TIPS? As long as this index is maintained I will attempt to report on it.

Some of you may remember the title of last year's new portfolio column—it was "Is This Party Over?" I will claim no prescience, but I did say: "Stock prices are going up while dividend yields are decreasing; the price we have to pay for stock shares is increasing about twice as much as the underlying earnings the companies are generating; short-term fixed-income instruments, as represented by 1-year treasury bills, are presenting a more attractive alternative to the conservative investor while the yield curve flattens." Now, let's see what has happened during the past year (Table 1).

TABLE 1. Changes in the TSE 35 Index and fixed income yields.

Attribute	1996[1]	1997	1998	1999
TSE 35 Avg div yield	2.55	2.06	1.67	1.90
1 yr T-bill	4.54	3.37	5.17	4.91
10 yr Canada bonds	7.54	6.55	5.40	5.44
TSE 35 P/E	15.3	19.3	34.4	26.1
TSE 35 TRIV[2]	446.45	588.76	713.77	675.13

[1]As of May 26.

[2]Total Return Index Value for the TSE 35.

These data show some improvement over last year: the dividend yield is increasing, fixed income instruments are holding steady, P/E values are dropping and so is the TRIV for the TSE 35—in short, valuations are a little more reasonable and better situated vs. bonds. So, my fearless prediction for the coming year is that it will be better than the last.

That shouldn't be too hard to accomplish considering our sorry performance last year (Table 2).

TABLE 2. Beating the TSE 35 model portfolio results from 5/26/98 to 5/25/99.

STOCK-SYM	PRICE (5/26)	PRICE (5/25)	CHANGE (%)
TransAlta Corporation-TA *	24.00	21.15	-11.88
Dofasco-DFS*	24.30	22.85	-5.97
Noranda Mines-NOR	26.75	17.90	-33.08
Imasco Ltd - IMS *	27.75	32.55	17.30
National Bank-NA*	30.70	21.70	-29.32
TransCanada Pipelines-TRP *	27.48	19.30	-29.77
Bank of Nova Scotia-BNS*	38.20	31.70	-17.02
Thomson Corp.-TOC	41.90	43.50	3.82
Canadian Imperial Bank-CM*	49.55	35.10	-29.16
Bank of Montreal-BMO*	80.25	56.10	-30.09
AVERAGE			-16.52 (-13.55)[1]
TSE 35 TRIV[2]	713.77	675.13	-5.41
TIPS 35	41.75	38.90	-6.83

* These stocks have both DRIP and SPP plans.

[1]The total return during this time period is -16.52% for capital gains and 2.95% for dividend yield, or -13.55%. The dividend yield is prorated from the average expected dividend yield of 2.95%.

[2]Total Return Index Value for the TSE 35.

Abysmal, certainly, but it didn't put much of a dent in our historical performance data (Table 3).

TABLE 3. Comparison of total "Beating the TSE" returns to the TSE 35 TRIV Index.

YEAR[1]	10-STOCKS	5-STOCKS	4-STOCKS	TSE 35 INDEX
1987	-10.54	-7.67	-15.57	-12.45
1988	21.43	26.10	16.81	11.32
1989	23.36	19.77	24.16	21.89
1990	-11.65	-10.85	-17.69	-11.65
1991	29.41	31.92	41.56	11.01
1992	-1.49	-6.10	-5.58	-3.58
1993	22.76	16.05	28.32	24.34
1994	4.08	3.27	3.97	5.52
1995	16.70	12.93	16.37	14.72
1996	54.86	42.31	36.25	31.88
1997	32.64	42.32	42.04	21.23
1998	-13.55	-9.26	-8.07	-5.41
SUM	168.01	160.21	161.53	108.82
AVG.	14.00	13.55	13.46	9.07
% INCREASE	54.39	47.22	48.44	

[1] Data for 5/27 to 5/26 of the following year.

Thus, we are still beating the index quite handily, by over 50% for our 10 stock portfolio. Now, what about next year? Our new portfolio is in Table 4 - I will not go over the calculations, if you are new at this please check previous issues.

TABLE 4. Identifying the lowest-price high yielders for the 1999 portfolio.

STOCK	SYM	PRICE	IAD[1]	EXP YIELD
Laidlaw	LDM	10.45	0.28	2.68
Noranda Mines	NOR	17.90	0.80	4.47
TransCanada Pipelines	TRP*	19.30	1.12	5.80
TransAlta Corporation	TA*	21.15	1.00	4.73
National Bank	NA*	21.70	0.68	3.13
Dofasco	DFS*	22.85	1.00	4.38
Bank of Nova Scotia	BNS*	31.70	0.84	2.65
Canadian Imperial Bank	CM*	35.10	1.20	3.42
Bank of Montreal	BMO*	56.10	1.88	3.35
Royal Bank	RY	67.60	1.92	2.84

* These stocks have both DRIP and SPP plans.
[1] Indicated Annual Dividends (CDN $).

Note that our expected yield has gone up to 3.74%. This, times a tax factor of 1.35 gives us 5.05%, higher than the 4.91% gain associated with one year T-bills. As always, we will hold these 10 stocks for one year, come what may. Does a 10-stock portfolio make too much of a dent in your pocketbook? Consider the 5- or 4-stock option, or the "Dozen" approach in which an investor purchases the top "Beating The TSE" stock each month that's not already in their portfolio. One final point, we have seen a great deal of volatility in the market over the past while and I expect it to continue. It only makes sense that the money you invest should be funds that you don't need for at least five years. The Motley Fool (http://www.fool.com/) quote data indicating returns for large company stocks have been positive in 62 out of the 69 possible five-year, rolling timeframes since 1926, a 90% success rate. Pretty good odds, don't you think?

II.INVESTING IN US EQUITIES

From *Canadian MoneySaver*, April, 1999 issue, pg. 5.

US DRIPs And SPPs That You Can Own

I am very excited about our title subject this month—I have spent a lot of time getting the information and figuring out how to avoid the potholes of investing in these US stocks, and more work will be needed. But, I wanted to share this concept with you so that you can begin your own research.

Most *Canadian MoneySaver* readers are familiar with the advantages of owning stock in Canadian companies that offer dividend reinvestment and share purchase plans (DRIPs and SPPs). Just to refresh our memories:

1. DRIPs automatically invest cash dividends into the shares of stock—In my opinion, a very efficient way to add to your holdings. It fosters regular purchases and a long-term mentality, both of which are essential for the successful individual investor.
2. SPPs allow investors to buy more shares directly from the company, thus providing a process by which small or large contributions can be made when convenient. Both these plans allow the investor to purchase shares while avoiding brokerage commissions. However, in both cases you need to own at least one share of the company in your own name before these plans are available.

We all know that US stocks have outperformed Canadian ones for the past few years. But, suppose you could get all the benefits of the Canadian DRIP and SPP plans in some US stocks and purchase the stock directly from the company for no, or only a small, fee. These direct purchase plans (DPPs) would allow you to make your initial stock purchase without a broker being needed. Then, you may invest small or large amounts into the plan when you can, and also elect to receive your dividends in the form of partial shares. Another plus is that most plans allow transfer of some or all of your shares to someone else. These programs are, however, not without their drawbacks; since the shares are purchased by the company, participants have no control over

the purchase price; also, there are various administrative and brokerage fees associated with each plan. However, I think these hindrances are of little consequence when weighed against the advantages I have mentioned.

This month I am going to outline how I went about setting up a diversified portfolio of US common stocks. First, my criteria were:

- The plans had to be open to Canadian investors;
- The companies had to be of the highest quality;
- The minimum buy-in had to be (US) $1000 or less;
- The initial purchase could be made directly, i.e., the company had to offer a DPP option.

I decided to build a diversified portfolio containing one stock from each of ten categories: conglomerates, consumer, entertainment, financial, gas and oil, health care, industrials, retailing, technology, and telecommunications. Initially, I had thought to also include utilities, but there were too many choices, none of which were known to me. It is important to remember that this exercise is to be done without the benefit of a broker.

Now, where to get the information on which companies offered these plans? I decided to go to the source. Charles Carlson has been guiding individual investors to successful DRIP plans with his books and articles for a while. After seeing his website (http://www.netstockdirect.com/resources/carlson/) I wrote Mr. Carlson telling him of my goals in setting up this portfolio. He was kind enough to respond with a great deal of useful information. From him I was able to find out which companies allowed direct initial purchases, what the minimum buy-in was, and how to contact them. Another source of direct stock purchase programs is First Chicago Trust Company who will send you a list of the over 50 programs they administer for a phone call to 800-910-8277 or you can visit their website at http://www.equiserve.com/. Also, at this site you can download a printable form W8, Certificate of Foreign Status, that you can send in with your application. Yes another source is http://www.stock1.com/. Mostly, the requests for a prospectus were made by telephone to 800 numbers where my mailing address was taken electronically. I did this in Florida and I can't say for certain either that these numbers work in Canada, or if you give a Canadian mailing address the program prospectus will be mailed. I directed inquiries to over 40 companies of the more than 200 firms offering DPPs, and of all the ones I contacted where a service representative was involved, only one refused to send the material when I mentioned I was Canadian; the responses from the rest varied from, "We welcome Canadian investors!", to "Let me check with my supervisor...I guess it's OK." Information for some companies may be ordered at http://www.enrolldirect.com/.

You will note, of course, that investors incur a tax liability when receiving dividends and capital gains from US companies. It has been my experience that the tax is most often withheld at source and winds up as a tax credit on your Canadian return. In terms of eligibility, most of the companies from whom I received a prospectus had a line that read something like, "Any person or legal entity residing in the United States, whether or not a Common Stock shareholder of record, is eligible to participate in the Plan. Citizens or residents of a country other than the United States, its territories or possessions are eligible to participate if such participation would not violate laws applicable to the Company or the Participant". I always indicated on the enrollment form that I was a Canadian citizen and enclosed a completed W8 Form.

So, now I had a group of stocks that met the criteria, but it remained for me to winnow down my list to just one per category. In some cases this was easy—there are a fair number of category-killing, world-class companies that can be purchased directly. I used a combination of different techniques and data to make my selections; about all I can say is that my portfolio reflects, I hope, my thought processes, in the same way that, if you chose to set up a similar set of stocks, yours should be tailored to your own needs. I found that a good place for data about US stocks is Quicken.com (http://www.quicken.com/investments). I do want to stress that embarking on an exercise of this type without the benefit of your friendly broker can be a bit daunting, and it does make you appreciate the research your broker does for you, but there is more and more information available to individual investors these days to make your task a little easier. The main point here is that purchasing a stock from a company that has DRIP, SPP and DPP plans is not worth the trouble if you wind up buying shares in an underperforming business.

Here is the portfolio that I have begun to purchase (Table 1) and some features of each company's plan (Table 2). Again, it is my portfolio, constructed to suit my specifications—I would expect yours to vary considerably. The bottom line is that I am able to purchase initial positions in some great US stocks for (US) $6500. I will own awe-inspiring companies such as IBM, General Electric, Wal-Mart, McDonald's, and Disney, and I think I have learned a lot along the way.

Table 1. US DRIP Direct Purchase Portfolio.

Sector	Stock/SYM	Business
Conglomerates	General Electric/GE	Diversified operations
Consumer	McDonald's/MCD	Operates and franchises fast-food restaurants
Entertainment	Disney/DIS	Produces family entertainment
Financial	American Express/AXP	Financial services, credit cards, travel agency
Gas/Oil	Chevron/CHV	Explores, refines and retails petroleum products
Health care	Pharmacia Upjohn/PNU	Develops and retails pharmaceuticals
Industrials	Ford (F)	Manufactures and sells cars, trucks and related parts
Retailing	Wal-Mart/WMT	Operates discount department stores
Technology	Intl. Bus. Machines/IBM	Data processing equipment, systems, and service
Telecom	Lucent Technology/LU	Telecom equipment manufacturer

Table 2. Characteristics Of The Stock Purchase Plans.

Stock	Fees	Buy in	Contact #
GE	$7.50-Registration	$250	800-786-2543
	$3.00-Purchase		203-373-2211
	No charge-Dividend reinvestment		
	$10.00+$0.15/share-Sell		
MCD	$5.00-Registration	$1000	800-774-4117
	$5.00+$0.10/share -Purchase		630-623-3000
	$3.00/yr-Dividend reinvestment		
	$10.00+$0.10/share-Sell		
DIS	$10.00-Registration	$1000	800-948-2222
	$5.00-Purchase		212-640-2000
	$0.04/share-Dividend reinvestment		
	$10.00+$0.04/share-Sell		
AXP	$6.00+$0.06/share -Registration	$1000	800-842-7629
	$5.00+$0.06/share-Purchase		412-234-5000
	$0.75+$0.06/share -Dividend reinvestment		
	$10.00+$0.12/share-Sell		
CHV	$8.00-Registration	$250	800-774-4117
	$3.00+$0.08/share-Purchase		415-894-7700
	$2.50 -Dividend reinvestment		
	$10.00+$0.08/share-Sell		
PNU	No charge-Registration	$250	800-774-4117
	$3.00+$0.08/share-Purchase		908-306-4400

	No charge -Dividend reinvestment		
	$10.00+$0.08/share-Sell		
F	$10.00+$0.03/share-Registration	$1000	800-955-4791
	$5.00+$0.03/share-Purchase		313-322-3000
	$5.00+$0.03/share -Dividend reinvestment		
	$15.00+$0.12/share -Sell		
WMT	$20.00+$0.10/share-Registration	$250	800-438-6278
	$5.00+$0.10/share-Purchase		501-273-4000
	No charge -Dividend reinvestment		
	$20.00+$0.10/share -Sell		
IBM	$15.00-Registration	$500	888-421-8860
	$5.00 -Purchase		914-765-1900
	2% -Dividend reinvestment		
	$15.00+$0.10/share -Sell		
LU	$7.50-Registration	$1000	800-774-4117
	$2.00+$0.10/share -Purchase		908-582-8500
	$2.00+$0.10/share-Dividend reinvestment		
	$15.00+$0.10/share -Sell		

Note that all values are given in US dollars. Also, I have provided the telephone number for each company as well as the 800/888 number—one of these should work for you. We shall, perhaps, revisit this US DRIP portfolio in the future. Remember, the stock selection process was mine, but I hope you might gain some insight in how to go about setting up such a portfolio for yourself based on my experience. As of this writing I have obtained confirmation that some of these purchases have gone through; it seems to take a long time, but I can report that you too can own US DRIPs and SPPs without going through a broker.

From *Canadian MoneySaver*, May, 1999 issue, pg. 27.

More US DRIPs And SPPs

This month we shall get back to our "Beating The TSE" portfolios, which I have neglected for too long. But first, just a short update on the US DRIPs and SPPs column of last month. As of now, our portfolio looks like this (Table 1).

Table 1. US DRIPs & SPPs Portfolio (all values in US dollars, as of 4/9/99).

Stock	Cost	In Price	Fees	Shares	Price now	Value
AXP	$1000	127.9975	$6.00	7.7658	128.1250	$994.99
CHV	$250	83.6254	$8.23	2.8939	94.0000	$272.03
DIS	$1000	35.1550	$15.00	28.0188	34.5000	$966.65
F	$1000	57.9680	$10.00	17.0780	60.5625	$1034.29
GE	$258	98.8438	$7.50	2.5292	112.1875	$283.74
IBM	$515	178.3750	$15.00	2.8031	186.3125	$522.25
LU	$1000	50.7519	$9.50	19.5166	63.6250	$1241.74
MCD	$1000	43.2500	$12.30	22.8370	45.8125	$1046.22
PNU	$250	53.8750	$3.37	4.5850	62.5000	$286.56
WMT	$250	86.1000	$20.00	2.6710	102.7500	$274.45
TOTAL	$6523					$6,922.92

A note is in order. All the above data reflect real purchases except IBM because I already owned that company and had a DRIP plan in place before I constituted this portfolio. I included it because I thought, and still think, it is the best technology stock offering both a DRIP and SPP plan and a direct purchase plan. I did attempt to purchase one other stock in this manner, Home Depot; for me, the choice of Wal-Mart as our retailer was obvious, but I also like HD and decided to acquire it, but not for this portfolio. On April 3 my initial deposit of $250, dated February 22, was returned by Bank Boston with a curt statement informing me that all cheques must: 1) be imprinted as US Dollars, 2) must be drawn on a US bank or "be payable at a US bank office of your overseas branch". Flummery! (As Nero Wolfe would say). The cheque I sent was from one of our chartered banks, imprinted as "US Funds", and since when did our big banks not have US branches? Also, all the other US banks involved readily cashed similar cheques. In any case, that $250 I will gleefully direct to one of the stocks in our portfolio.

You will see that at present we are slightly above water with this portfolio to the tune of $400.42 (6.14%). Why isn't it more, when most of the stocks have in fact risen a good deal from our purchase price? Fees. Yes, we would be further in the black without those pesky fees. But, I wonder how many of us remember to subtract transaction costs (mainly brokerage fees) in our portfolios? At the current rate charged by brokerages I am of the opinion that we are better off going this route if we know what we want to purchase and if that stock has a direct purchase plan available. Do you think you could have set up this portfolio for a little over $100 in brokerage fees? Charles Carlson, the guru of US drip stocks, calls direct purchase plan stocks "no-load" stocks. I wouldn't go that far, since some fees are attached to these purchases, but I think that they are worth considering for the individual investor.

I am pleased to see that this little experiment has already raised some questions among our readers. Here is a note I received: "DRIPs are supposed to be for non-commission investing and you appeared to have selected companies which all charge fees. In my mind, this is not much different from what you'd pay a broker to buy the stock. Now, there are a number of US companies which offer no-fee DRIPs. Why did you not choose any of these? Some of the no-fee companies are certainly great companies to own, like Intel, Pfizer, Heinz, Johnson & Johnson, Medtronic, Coca Cola, etc." I replied: "Yes, I own some of the companies you mentioned, but I had to purchase the initial shares through a broker. With the stocks in the *MoneySaver* article, the initial shares can be purchased through the company. Yes, there are some fees attached, but overall this is less expensive than going through a broker. Also, there are some very good stocks that have this type of plan. I am assuming, of course, that one continues to purchases shares when one can through the company since this dilutes the cost."

Summary—This chapter describes an investment strategy that has been proven to outperform the TSE 35 index and a way to invest in US stocks.

CHAPTER FOUR
SOME THOUGHTS ON EVALUATING STOCKS AND OTHER INVESTMENTS

Thus far, I have covered some basic techniques for investing in both Canadian and US stocks. In this chapter we will attempt to extend that into other investment categories and also look at stocks in more detail.

Based on the results thus far, I am of the opinion that strategies like "Beating The TSE" and US DPPs have a significant place in the financial planning of most Canadians. Should it be the entire portfolio? No, remembering that diversity is a critical cornerstone of any individual's blueprint.

In order to pick the proper path for your unique situation you should do a lot of reading and researching. I have always thought that getting some professional advice is also worthwhile, bearing in mind that selecting an honest and knowledgeable advisor is sometimes a difficult and lengthy process. While it is true that there are varied approaches to successful individual investing, what is most important, I think, is the disciple to follow whatever investment pathway is chosen.

I.EVALUATING BONDS

From *Canadian MoneySaver*, June, 1997 issue, pg. 15.

Strip Bonds—Buy, Sell, or Hold?

I finally got around to taking the advice of Angelo Vicere in the May, 1996 issue of *Canadian MoneySaver*. The current worth and future yields of strip bonds was a great revelation to me, so I thought we might revisit this topic and do some calculations.

As Angelo and others have said in these pages, the performance of a strip bond is influenced by two factors: how long the bond is held (under the control of the investor), and interest rates (not under the control of the investor). If you purchased strip bonds for your RRSP a few years ago, the subsequent falling interest rates have been in your favor and you may be surprised at their current value. The recent uptick in rates could make you rethink your plan of holding these bonds till they mature.

Let's take a look at some examples. I have prepared a portfolio of typical provincial strip bonds, assuming a purchase date of February 1, 1995, and a sell date of April 1, 1997. Table 1 shows these data.

Table 1. What is the current value of our strip bond portfolio?

STRIP	PAR	COST	CURRENT	GAIN
BC 12/21/97	$ 12000	$ 9411.60	$11677.32	$2,265.72
BC 8/16/00	$ 13000	$ 8156.20	$10769.20	$2,613.00
ON 7/13/01	$ 18000	$10112.40	$13872.78	$3,760.38
ON 7/13/03	$ 22000	$10245.40	$14553.66	$4,308.26
BC 6/21/04	$ 23000	$10030.30	$14224.81	$4,194.51
BC 6/9/06	$ 33000	$11959.20	$17325.99	$5,366.79
TOTAL	$121000	$59,915.10	$82423.76	$22,509

This portfolio has performed well, yielding an average rate of gain of 16.52%. Great, but what about the future? We can evaluate these bonds using the formula:

- where fv is the future value, pv is the present value, and n is the term. Applying this equation, Table 2 has less welcome results.

Table 2. What will be our rate of return if we hold this portfolio to maturity?

STRIP	PAR	CURRENT	YRS TO MATURITY	RATE (%)
BC 12/21/97	$12000	$11677.32	0.65	4.31
BC 8/16/00	$13000	$10769.20	3.30	5.87
ON 7/13/01	$18000	$13872.78	4.21	6.38
ON 7/13/03	$22000	$14553.66	6.21	6.88
BC 6/21/04	$23000	$14224.81	7.15	6.95
BC 6/9/06	$33000	$17325.99	9.12	7.32

Thus, if held to maturity, our strip bond portfolio will yield only an average of 6.29%, or less than half of what they have achieved to this point. This is because declining interest rates have caused our bonds to appreciate at a more rapid rate; if we sell these bonds now we will realize a capital gain, but this won't be a tax problem for us since the bonds are held in our RRSP. In order to wind up at their par value, these bonds will have to gain value at a lower rate until they reach maturity. A nice graph of this effect is shown in Angelo's article.

Well, so maybe it is time to consider realizing our profits. But, of course, this raises another question, I strive to be a prudent, informed, conservative investor. I know I should have my interest-bearing investments in my RRSP because of the tax break I get. So, what do I do with my money now?" I will leave it to other *Canadian MoneySaver* writers to tackle this one, but it might be worthwhile to go back to the April, 1977 issue and re-read David Swingler's article on "Real Return" strip bonds. Also, there are several new types of income units that could be worth a look. This investment vehicle has progressed beyond just REITs and conventional oil and gas units.

II.EVALUATING INCOME TRUST UNITS

From A Report to the Guelph ShareClub, 1999.

A Guide to Income Trust Units

At our last meeting I agreed to provide a brief overview of income trust units. We'll take a look at some of the basics of these investments and at our next meeting an invited speaker will fill in this outline.

1. What are income trusts?

Income trust is a generic term applied to publicly traded businesses that offer investors direct or indirect ownership in cash generating assets. This market was originally conceived to meet investor demand for higher yields than were available from GICs and other fixed income instruments. There are currently over 70 publicly listed trusts; they are widely diverse with respect to potential capital gains, yield, and risk. The risk/reward tradeoff associated with trusts may be illustrated as below:

Risk/Reward Tradeoffs In Income Units

Business	Yields (%)	Risk Factors	Risk
Utilities	8-10	Low risk	Low
Pipelines	9-12	Volume risk Competition risk	
REITs	10-18	Real estate risk Economic risk	-to-
Mining	12-17	Price risk Volume risk	
Oil & Gas	14-22	Price risk Volume risk	High

Thus, as with most investments, this class spans the spectrum of safety from rock solid to considerably less reliable, and the rewards are directly proportional to the risks involved. How do the yields of income trust units compare to the more familiar high dividend and preferred shares? Let's take a look:

Yield Comparison Of Income Trusts To High Dividend Equities*

Instrument	Pre-tax Yield	After-tax Yield
Banks	2.3	2.0
Energy Utilities	4.7	4.1
Resource Companies	4.1	3.6
Industrials	4.4	3.9
AVERAGE	3.9	3.4
Preferreds	5.3	3.9
Utilities Trusts	9.1	8.7
Pipeline Trusts	10.2	7.3
REITs	12.2	10.2
Mining Trusts	15.2	9.5
Oil & Gas Trusts	14.0	12.2
AVERAGE	12.1	9.6

* Assuming a tax rate of 50%

It would seem reasonable to compare low risk income trusts such as utility trusts to utility common stocks on the basis of yield; however, those trusts having a higher risk such as oil and gas trusts contain a significant equity risk and should not be evaluated solely on the basis of yield. The conventional measures of equity valuation such as earnings, cash flow, P/E, etc. need to be employed in such cases to determine value.

2. What types of income trusts are available?

- Utility Trusts—These are the income trusts that are closest to a fixed income investment since they have contractually committed cash flows for the next 15-20 years. Some examples include:

Examples Of Utility Trusts

Name	Business	Yield	%Tax def*	% Div	% Inc
KMS Power	Owns & operates 3 electrical power plants	10.4	69	0	13
Northland Power	Leases one electrical power plant	9.5	95	0	5
TransAlta Power	Owns & operates 3 electrical power plants	8.2	100	0	0
TransCanada Power	Owns & operates 4 electrical power plants	8.0	85	0	15

* % Tax deferred. When you receive tax sheltered income, Revenue Canada considers the amounts to be a "return of capital". So, for tax purposes these amounts will reduce the "adjusted cost base" of your investment. When, in the future, you sell the units and pay the tax on the sheltered income it will likely be at the 25% lower capital gains rate rather than at the maximum personal rates. Other portions of the returns may be classed as either dividends (Div) or income (Inc).

- Pipeline Trusts—Some pipeline trusts should be considered as indirect energy investments since their throughput levels have declined in response to lower energy prices, but some others, because of their contractual agreements, are immune to price fluctuations. Some examples include:

Examples Of Pipeline Trusts					
Name	Business	Yield	%Tax def	% Div	% Inc
AEC Pipelines	Transport of oil via 3 pipelines	8.8	15	10	75
Koch Pipelines	Owns and operates oil pipelines	11.0	40	0	60

- REITs - While the concept of income trust units is relatively new, REITs are the most mature segment of this market; the first of these trusts became publicly listed in 1993/1994. REITs are composed of a range of real estate assets. Thus, apartments are the most defensive while hotels have the greatest economic leverage and retail and office assets are more balanced between risk and return. The apartment trusts trade at the lowest yields (9-10%) and highest valuation (9-10X cash flow), commercial REITs have yields of 10-12% and cash flow multiples of 6-8X, and hotel units trade at 14-18% yields and lower valuations (5-6X cash flows).
- Since REITs are the "original" income trust units we should spend a little more time discussing them. These instruments were originally created to allow investors to take advantage of reliable revenue streams from income-producing real estate properties. But why might an investor consider purchasing these units now?

  A – Property prices (and REIT prices) have declined from their highs but may be starting back up, thus allowing the possibility for capital gains.

  B – High yielding real returns. An average after tax return of over 10% isn't bad in the current low interest rate environment. Tax implications are favourable, but if the REIT is held in an RRSP/RRIF these implications are irrelevant.

  C – By purchasing a REIT one obtains more geographic and class diversification than is possible from owning real estate directly.

  But, these investments are not without risks. Keep in mind the following: General real estate risks (Will it remain well-leased? Will the tenants stay current with their rents? Can the property be maintained at a reasonable cost? What happens if a building collapses and a class action lawsuit is launched? etc.); Interest rate risks (effect on mortgages, tendency to pull investors back to low risk fixed income products); Tax risks (possibility that tax rules will be changed, recapture of capital cost allowance, need to acquire new properties to replenish capital cost and offset diminishing capital cost allowances); and Stock market risks, since these units are traded on the exchanges they could get swept up in a prevailing bearish trend.

  Perhaps the biggest risk with REITs (and this applies generally to all income trust units) is that uneducated investors view them as a high yielding form of fixed income product. Actually these investments are more like a cross between a stock and a bond. They have the downside risk of stocks but not as much of the upside and, while they may provide a cash flow similar to a bond there is no maturity date and, thus, no guarantee that you will get your initial capital back. Still, for many investors REITs have a place in their portfolio as long as the selection is made with due diligence. What are the most important variables to consider when selecting a REIT?

Some Factors To Consider When Evaluating A REIT	
Location of the properties	Sustainability of revenue stream
Value and type of properties	Liquidity/market capitalization
Rental and vacancy rates	Limits on debt
Mortgage rates and maturities	Insurance coverage
Management quality	Future acquisitions
Management fees	Stable, rising cash flows
Net book value vs. market price	Lease expirations

Some examples of REITs include:

Examples Of REITs					
Name	Business	Yield	%Tax def	% Div	% Inc
RioCan REIT	Owns 84 retail properties	11.3	61	0	39
Summit REIT	Owns 82 mixed sites	12.3	60	0	40

- Mining Trusts – This small group of trusts is involved with either mining operations or servicing these operations. Some examples include:

Examples Of Mining Trusts					
Name	Business	Yield	%Tax def	% Div	% Inc
Luscar Coal	Operates 11 coal mines	17.5	11	25	64
Labrador Iron Ore	Receives royalty on sales of iron ore	11.6	0	20	80

- Oil & Gas Trusts – The decline in the price of crude oil has had a significant impact on the oil and gas royalty trusts including deteriorating operating performance, declining distributions and unit values. This trend has reversed recently as the recent increase in the price of crude oil has pushed these units back up. Some examples include:

Examples Of Oil & Gas Trusts					
Name	Business	Yield	%Tax def	% Div	% Inc
ARC Energy	Owns a mix of oil and gas producing sites	14.9	85	0	15
Morrison Facilities	Owns a mix of gas and oil producing sites	12.5	100	0	0
Superior Propane	Distribution and retail sale of propane	8.4	20	0	80

3. Directions and conclusions

This discussion has necessarily been abbreviated. Our speaker will be able to add specific examples and recommendations. By way of a summary you may wish to take a look at the most recent *Canadian MoneySaver* article dealing with this issue, "Income/Royalty Fund Sector" by Michael Smedley (pg. 20, July/August, 1999). TSE-listed Canadian income trusts now have a market capitalization of more than $15 billion. Their growth has been a reaction to the need of investors for higher yielding instruments. As shown in

Table 1 (pg. 21), income trust funds were in a downward trend approaching the September/October 1998 date for the payment of final installments. Since then, many of these issues have stabilized and turned upward. Also, merger and acquisition activity has taken place and these funds are being more widely covered by analysts as maturity and stabilization occurs. Income trust units are taking their place on the Canadian investment scene but the question remains if these vehicles are right for your portfolio. As always, individual investors will be best served by a diligent study of specific trusts in which they are interested. Many units have websites and downloadable annual reports, the weekend *Globe & Mail* carries some useful information, and your investment advisor should be of help.

III.EVALUATING STOCKS IN MORE DETAIL

From *Canadian MoneySaver*, October, 1999 issue, pg. 19.

Large Cap vs. Small Cap Stocks

I see that in the past little while there has been a "resurgence" of small cap stocks. Not only have the small cap indices begun to show some life after a very long hibernation, the "talking head" herd has climbed aboard as well. In this column we will discuss some of the pros and cons of the size of the companies in which you invest. First, let's define what we mean by "market cap"—the market capitalization of a company is obtained by multiplying the number of outstanding shares of a company by the current price of its stock. Notice that this definition does not take into account the true "size" of a company, perhaps best reflected by revenues. Rather, it is based on stock price; we need only look at some US internet companies to see examples of businesses with high market caps but low revenues.

It is only fair to declare my bias upfront. As regular readers are aware, the TSE35 index is composed of BIG companies—the biggest in fact. To my mind, investing in large cap stocks is both much safer and also much more financially rewarding than speculating in the small cap arena. Let's look at some data.

Table 1. Annual Returns for the TSE35 vs. TSE 300

Year	TSE35 (%)	TSE300 (%)
1999-YTD*	14.2	8.0
1998	-2.3	-3.4
1997	14.4	13.2
1996	23.7	22.8
AVG	12.5	10.2

* As of September 4.

That's right—for the past three and two third years the TSE 35 has outperformed the TSE 300 by 23%. Yes, I agree, it is only a relatively short span and you can't really term the TSE300 a small cap index, however the difference is striking and,. when compounded over the life of your investments, is even more so. For comparison, contrast Table 1 with returns for the VSE. During the same time period this exchange, replete with small cap stocks, has lost over half its value.

Here are my top ten reasons why I prefer large cap to small cap stocks:

10. It is so much more difficult to pick winners in the small cap arena. Not only are there fewer winners as a percentage of a much larger universe of stocks, reliable information is difficult to come by since few legitimate analysts follow these issues, making evaluation much harder.

9. Thus, smaller stocks are much more prone to trade on unsubstantiated rumors and not on fundamentals.

8. With small cap stocks one must always be watchful for illegal and deceitful practices employed by unscrupulous promoters. One of the most common is the "pump and dump" scam in which a syndicate will purchase a large number of shares in a floundering small cap company, pushing the share price higher of course, and then sell their shares at a profit to other unsuspecting individuals who have been coerced through cold calls and broiler room tactics.

7. Larger companies generally have much more financial flexibility and can fund expansions internally instead of issuing new shares or borrowing. Almost all small companies have cash flow problems and have large "burn

rates". One easy way to raise money is through dilution of the stock, either through selling more shares or warrants. This leaves you with shares that are worth less (or maybe worthless).
6. Because so-called "penny stocks" are inexpensive, individuals reason that they have no way to go but up. Wrong.
5. If you are shown data that purports to illustrate that small caps actually outperform large caps over a long period make sure to inquire if those companies that sank into bankruptcy were removed from the database. Thus, when a company becomes bankrupt its effective return becomes -100%. It is common to ignore these figures, but as can be appreciated it skews the data and any conclusions drawn from them.
4. Hardly any small companies come into existence without some kind of competition, usually from larger, better-established firms. The R&D and advertising budgets that can be afforded by large cappers ensure continued domination. The odds are against small cap success, especially now. We are, like it or not, living in an era of large cap domination.
3. Liquidity, the ease with which a given investment can be converted to cash, is often lacking with small cap stocks since investment firms, pension funds and mutual funds, shun them. Also, the "spread", the difference between the bid and asked price is usually higher. And, small cap stocks rarely pay dividends which, as well as putting some money (or shares) back in your pocket, tend to cushion stocks prices.
2. Obviously, a portfolio dominated by small cap stocks will require a larger number of companies to be properly diversified than a portfolio of large cap stocks. You will have to do a lot more work on small caps than large caps. Your brokerage costs will be higher since more issues are involved. Instead, why not consider the "Beating The TSE" strategy which has consistently beaten the index by a wide margin and requires only a few minutes per year thought on your part?
1. The number one reason I prefer large cap to small cap stocks is that on average small-company stocks are riskier and do not outperform large-company stocks. Too much risk but not enough reward. My suggestion is that rather than putting your "play" money into small cap stocks you should consider donating it to charity. Who would you rather have it—whoever sells you the shares or the needy?

From *Canadian MoneySaver*, September, 1999 issue, pg. 8.

The One Stock To Own?

This month's column arises out of a little experiment I tried with our ShareClub. I asked them all to write down the symbol of the one Canadian stock they would own if they could own only one. The result? Overwhelmingly, the answer was "BCE". Not too surprising you say? Why? The group had literally hundreds of stocks from which to chose. This month we will explore BCE to see if we can arrive at why it is so widely admired. Before we begin, let me remind you that I am not in the business of "recommending" stocks and the information in this article is presented only to stimulate your thought processes. And, yes, I own shares in this company.

First, we need to separate the emotional from the factual. Just because a stock is admired doesn't mean it will be a rewarding investment. At one time, I suppose, Bre-X was quite widely admired; on the other hand, a well-performing stock such as Seagram or Imasco may not be popular with some folks because of the businesses they are in. Is the business that BCE engages in particularly lovable? Well, no, I don't think so—I hear almost as many generic complaints about phone companies as I do about banks. So, we must look elsewhere for the source of BCE's wide-spread acceptance. How about the fact that in this year's *Globe and Mail* "Report On Business", BCE ranked first in profits, beating out second place Thompson Corporation by a factor of over 2? Now, as a stockowner that gives me a warm and fuzzy feeling, as does the news that Nortel Networks, a BCE-held company, ranks number one (just ahead of its parent) in building shareholder value, but what I really want to do in this column is to discuss some factors that can be used to identify outperforming stocks.

In evaluating stocks there are two major parameters that need to be considered—the quality of the stock and its relative price. Certainly, low quality stocks are can never be too inexpensive, but high quality stocks can be overpriced. Table 1 gives some of the common quantitative attributes that can be used to characterize stock quality and price.

Table 1. Measures of stock quality and price.

Quality	Price
Earnings and earnings growth	Market capitalization
Profit and profit growth	Price/earnings
Margins and margin growth	Price/sales
Return on equity	Price/cash flow
Return on capital	Price/book value
Market share	Dividend yield
Debt	

Most of you will have seen tables like this previously—measurements that can be expressed mathematically aimed at aiding the serious stock picker. I don't intend to go through the exercise of generating these data here; suffice it to say that I have done the calculations (as should you) and they are impressive. I would, however, point out one discrepancy that might be overlooked by a cursory examination of these numbers. How can we use earnings to help evaluate companies? The most common value calculated when we are attempting to use earnings to evaluate companies is the price/earnings ratio. While not a forward looking number, it is widely used in the valuation process. The P/E ratio (or the multiple, as it is often called) is one of the key indicators used in fundamental analysis and is easily obtained. The P/E ratio is defined as the current stock price divided by the company's annual earnings per share. Thus, the higher the ratio the more you have to pay for a dollar of earnings. This figure is given in the many newspapers for stocks on the major exchanges.

The current P/E reported for BCE is around 9.1. Amazingly low for such a company don't you think? It certainly would be if this was a true value. Unfortunately, this is a good example of when it is important to go a little deeper into the data. If one examines BCE's annual report and looks at the quarterly financial data, net earnings per share is given as follows: 1st quarter – $0.27; 2nd quarter – $0.46; 3rd quarter – $5.83; 4th quarter – $0.50. Are any bells ringing? Sure, one quarter (the third) is way out of whack. A diligent search of the fine print reveals the following statement: "BCE's 1998 net earnings before extraordinary items increased by $3,184 million compared with 1997. Included in BCE's 1998 net earnings are special net gains of $2,913 million resulting primarily from the $3,613 million non-cash gain on the reduction of ownership in Nortel Networks partially offset by BCE's Nortel Networks' amortization of intangibles related to the Bay Networks acquisition and the amortization of purchased in-progress research and development related to other acquisitions." I don't pretend to know the full importance of what "amortization of intangibles" means, but I do know that Nortel is only going to purchase Bay once. Thus, it would seem much more prudent to use the average of the other three quarters to calculate our P/E (I could have backed out the Bay contribution or used regression analysis, but I am just looking for an estimate here). This calculation [(0.27+0.46+0.50) X 1.33=$1.64] gives us earnings we can divide into the price ($70.00) to get an adjusted P/E of 42.68, over four times higher than the apparent figure. I'm not saying this company doesn't, perhaps, deserve this higher multiple, but it does emphasize that things are not always what they seem.

How did I come across this tidbit? Tea leaves? A crystal ball? Nope, I was speaking to my broker about something entirely different when I happened to mention the results of our ShareClub experiment. It was he who pointed out to me the importance of looking past the published numbers. Conclusion – if you are getting all your financial advice from a newspaper and purchasing your investments from a bank teller you may be saving some short-term money but are getting long-term value?

Back to BCE. I would like to focus on three measurements of quality that are difficult if not impossible to quantitative, but which I think are the real reasons our ShareClubers selected BCE: proprietary knowledge, brand strength, and quality of management. Let's take management first.

How does an individual investor go about assessing management? Some argue to just focus on the numbers and nothing else. Management's ability will eventually become apparent in the profit and loss statements generated quarterly. Lagging profits, shrinking margins and poor stock appreciation speak for themselves. If you want to get beyond this to evaluate management's competence, look at press releases, public filings and the "Letter to Shareholders" in the annual report. It is in these statements that management sets it goals for the future and reports on how well previous plans have been executed. Be especially watchful for potentially weak excuses such as weather conditions, foreign exchange rates and uncalled for restructuring charges. Also, take note of how management allocates available capital. Disastrous diversification, acquisitions that take the company away from their core business, and rising debt loads are danger signs. Is the company buying back stock, increasing dividends, or building up inventories? How well are they dealing with the inevitable problems that always arise in running a company? Perhaps the most important attribute of good management is that we, the stockholders, can believe that we are being told the truth—trust is irreplaceable.

Considering BCE in this light, I, as a stockholder, feel confident in the corporate management. This is a company with an impressive history of growth. From the annual report, "The compound annual return on BCE common shares during the five-year period ending December 31, 1998, assuming reinvestment of all dividends, was 25.6 per cent compared to a 10.7 per cent return on the TSE 300." "Beating The TSE" indeed! I would add that the compound annual return for Canadian mutual funds during this period was a dismal 7.6% (see *Canadian MoneySaver*, Jan., 1999). The stated goal of this management team is to prepare the company for competition in the deregulated telecom world.

Two major reasons for BCE's success are proprietary knowledge and brand strength. I have no hard data on this, but it is my guess that BCE holds more Canadian patents than any other TSE company, remembering that Nortel is in the fold. As far as brand strength goes, many pundits were predicting the downfall of Ma Bell as a result of the influx of a multitude of other long distance carriers. On the contrary, it would seem that BCE has done quite well in the ensuing "telephone wars". One reason is their strategic investment in other companies. That stable now contains: Bell Canada (100%), Northern Telecom (41%), BCE Mobile (65%), Bell Canada International (74%), Teleglobe (16%), the eastern Canadian telephone companies (35-55%), Expressvu and Telesat (100%), as well as some others. Can you get through a day without seeing some evidence of BCE's presence?

Let me end our discussion of BCE by reemphasizing that this is not a prospectus to purchase shares. Use your own research and judgment. But if you were told you could only own one Canadian stock, what would it be?

<u>From A Report to the Guelph ShareClub, 1997.</u>

A Guide to Evaluating Companies and their Stock

At our last meeting I very foolishly agreed to tackle the subject of how to evaluate companies and their stock. In keeping with my overall theme that less is more, the material given here is only a small selection of the voluminous information available. An important point is that no one measure of the type described here is worth very much by itself; the best analysis comes from using multiple comparisons over a wide range of time periods. Now let's get started.

1. Three Basic Questions And An Admission of Bias Before We Begin

Before we start the evaluation process we need some understanding of what the company we are interested in is about:

- What business is this company in?
- What needs do they satisfy?
- How do they make money?

Obviously, the way we answer those questions will define the approach we take to evaluating the company and its stock. For example, we would not use the same methods for a startup high technology company as we would for a large blue chip industrial company.

I would be less that honest with you if I didn't admit here at the beginning that my bias is toward fundamental analysis and away from technical analysis. Which is to say that I am more prone to base my decisions on the actual business dynamics represented by the company behind the symbol than on charts of past price movement. While it is true that stock analysis can be divided into these two approaches, I am of the belief that no chart pattern has any predictive value above and beyond what is possible through pure chance in the short term. Even technical analysts will admit that their "science" is really more art than system, saying that "experience" is required in the reading of charts. To me that is like saying that even a blind hog will root up an acorn now and then. For those of you inclined to this approach, be warned of my proclivity at the outset.

2. Evaluating Companies From Their Balance Sheet/Annual Report

The first step is to know where to get the information you need. Most companies will gladly send you their most recent annual report. Of course, by the time you ask for it the financial data may be out of date. Try getting updated information from other sources: publishers (the Globe and Mail will send you free annual reports and, if available, quarterly reports for many Canadian companies; they also sell the Report on Business – Canada Company Handbook; the Financial Post has a large selection of company-related publications); your broker; the Internet, etc.

Let us now assume you have a recent balance sheet of the company you are interested in. If it is contained within an annual report, remember the advice of Peter Lynch—flip past all the expensive colour photography to the back and focus on the Consolidate Balance Sheet. I have always liked his simplified approach to investing so let's take a look at what he calls his "three-minute balance sheet drill". There are a myriad ratios and calculations that can be made from the data in a balance sheet, but in my opinion Peter's approach covers most of the important things you need to know about a company:

- A balance sheet is composed of two major sets of data; a company's liabilities or how much money it owes, and the assets or what it owns.
- The difference between these two is what belongs to us, the shareholders. It is called, appropriately, shareholders' equity.
- On the asset side of the ledger we usually have entries for: cash or equivalents, short and long term investments, accounts receivable, inventories, prepaid expenses, and goodwill. Goodwill represents the amount that has been paid for an acquisition above and beyond the book value of the actual assets. For example, brand name and other intangibles mean that a company's shares can trade at a premium to its growth rate. Although intangibles are difficult to quantify, they can have a tremendous influence over a company's share price. For our purposes it is important simply to determine whether the goodwill figure is too large a percentage of the total assets.
- On the liability side we usually have entries for: accounts payable, accrued expenses, income tax payable, short-term debt, and long-term debt.

Now that we have the important figures how do we interpret them? Firstly, most reports have a section with some historical data so some comparisons can be made. Is the company's cash position improving relative to debt? One way to determine that is by calculating the debt-to-equity ratio. This is obtained by comparing the shareholders' equity to the long-term debt. Mr. Lynch suggests ignoring the short-term debt in these calculations, assuming instead that other assets such as inventories could cover this if needed; he also says. "Pay special attention to debt...more than anything else, it's debt that determines which companies will survive and which will go bankrupt in a crisis".

Are the number of outstanding shares growing so much as to be dilutive, or is the company buying back its own shares? If it is buying shares do they go out the backdoor in compensation packages for executives, or are they held?

If we add the cash and cash assets and divide by the number of shares we come up with the net cash that you get with every share you buy. Perhaps more important than this is what the company plans to do with its cash. Will the company blow that cash on ill-advised acquisitions, will it spend it on more R&D to achieve or maintain a technological edge, or will it go to dividends?

I have spoken often about the value of dividends and readers of the *MoneySaver* will know that dividends are the driving force behind "Beating The TSE". Stocks that pay dividends are usually favored over those that don't and not only because of the income stream they provide. As we have seen in the recent market downturn, dividends can serve as a cushion under stock prices so that price drop is smaller than the market as a whole. Use the long-term financial summary in the annual report to determine if the company has a good history of paying increasing dividends, i.e., dividend growth; use the balance sheet to make sure the company has enough cash to continue this trend.

The most common way that investors see shareholders' equity displayed is as a per share value called book value. This is the amount of shareholders' equity per share and is calculated by taking a company's shareholders' equity and dividing it by the current number of shares outstanding. When you have book value, you can then take the stock's current price and divide by the current book value in order to arrive at a price-to-book ratio. Theory says that the closer to book value you can buy something at, the better it is. The problem lies in arriving at a reasonable assessment of asset value. However, with financial companies such as banks the book value is extremely relevant since in the banking industry takeovers are often priced based on book value.

Another use of shareholders' equity is to determine return on equity, or ROE. Return on equity is a measure of how much in earnings a company generates in four quarters compared to its shareholders' equity. It is measured as a percentage. For instance, if a company made a million dollars in the past year and has a shareholders' equity of ten million, then the ROE is 10%. Thus, return on equity is calculated by taking a year's worth of earnings and dividing them by the average shareholders' equity for that year. Companies with larger ROEs generate more profits with smaller capital investment. A company with little capital spending does not require constant cash outflows to upgrade equipment. One of the quickest ways to gauge whether a company is an asset creator or a cash consumer is to look at the return on equity that it generates. By relating the earnings generated to the shareholders' equity, an investor can quickly see how much cash is created from the existing assets. If the return on equity is 20%, for instance, then twenty cents of assets are created for each dollar that was originally invested.

Cash-flow is the amount of money a company takes in as a result of doing business. Free cash-flow is what's left over after capital spending. Cash-flow is probably the most common approach for valuing public and private companies used by investment bankers. It is literally the cash that flows through a company during the course of a quarter or the year after taking out all fixed expenses. Cash-flow is normally defined as earnings before interest, taxes, depreciation and amortization (EBITDA) and looks at the money that goes through a company's coffers after all fixed costs are paid for. It is designed to focus in purely on the operating business and not secondary costs or profits. Cash-flow is most commonly applied to industries that involve tremendous up-front capital expenditures or companies that have large amortization burdens.

You may have heard the term "the bottom line"; what this refers to is the final number at the end of the income statement—profit after taxes or retained earnings. Earnings over sales is profit margin—what is left of sales after all costs have been deducted. Typically, net profit margins are reflected as a percentage. This number can be revealing when comparing companies within a sector since the company with the highest profit margin is the lowest-cost operator.

All the sales volume in the world is meaningless to shareholders if the company cannot manage to turn a profit, so pricing a product to be as profitable as possible and generate stable sales growth is the Holy Grail of sales and marketing groups across the business world. The profit margin is one of the easiest ways to assess whether or not this group is meeting the test of the profitability side of the equation. Profit margin is simply earnings (or profits) divided by sales, both measured over the same time period. Profit margins are the money left over after paying all of the costs of running the business. Management that increase profit margins are controlling costs either by squeezing efficiencies out of the business or cutting out unprofitable ventures. For

the purposes of analyzing the return on equity generated by a business, a higher profit margin means a higher return on equity.

Profit margins are also an expression of the amount of competition inherent in the business. Competitive industries like grocery stores or discount chains tend to have very low profit margins. This is because it does not take all that much to get into those businesses. High profit margins tend to indicate that a company either has a high proprietary good or service, possibly "branded" and therefore able to carry a price premium, or the company is in a business where it has a monopoly or is part of an oligopoly over a particular type of goods or services.

My final comment about financial reports is to be careful—remember that the same set of facts about a company's transactions and operations can lead to quite different values for earnings, assets, and liabilities. Financial statements involve a variety of assumptions, estimates and choices about how values are reported. Uncritical acceptance of financial statements may lead to conjectures that are not warranted. An advantage is that time is on our side since, in the end, all the news will come out, good or bad. Footnotes are vital in financial statements. They are an integral part of the financial statement, allowing you to find out about the firm's accounting practices, any changes in accounting policies, pending litigation, etc.

3. Evaluating Companies Using Other Sources

There is much more you need to know about a company than you can get from the annual report. Note that all the information we have achieved so far is historical in nature, but when we buy a stock we should do so with some idea of how it might perform in the future. Needless to say, this knowledge will be imperfect, and it is also more difficult to get than historical data.

The most important figures investors seem to want is an estimate of forward earnings. My thought about this is that it seems to easier to predict dividends growth than earnings growth (if a company has increased its dividend by a certain amount over a relatively long time period, and sufficient cash-flow is available, it would seem to be a good bet that next year's dividend will increase also), and that since, in the long run, the value of the type of stocks that pay high dividends (typically large-cap blue chips) is determined largely by dividends, this might be a better investment approach. However, the average investor studying the average stock is sure that its future price will be earnings driven, so we had better learn how to calculate on this basis.

Where can we get earnings estimates? As far as obtaining these data, it is relatively easy to obtain estimates of future earnings growth for the bigger US stocks but it is more difficult for smaller companies and Canadian shares. Your broker may be able to help you with this or you can visit various on-line sources. The *Globe and Mail's* "Report on Business - Canada Company Handbook" contains forward-looking earnings estimates (and also sales/share data). As you might expect, companies themselves are averse to making public estimates of future earnings, but may sometimes guide an analyst's projections.

How can we use earnings to help evaluate companies? The most common value calculated is the price/earnings ratio. While not a forward looking number, it is widely used in the valuation process. The P/E ratio (or the multiple, as it is often called) is one of the key indicators used in fundamental analysis and is easily obtained. The P/E ratio is defined as the current stock price divided by the company's annual earnings per share. Thus, the higher the ratio the more you have to pay for a dollar of earnings. This figure is given in the Saturday *Globe & Mail* for all stocks on the major exchanges. So, is the answer to stock picking just selecting shares with low multiples? Well, no, not really. Many stocks with low P/E ratios certainly deserve them as a consequence of questionable future prospects. It is much more telling to put the ratio in context, to compare it with similar stocks and to see how it has performed over the past few years. More importantly, comparing the ratio to future earnings estimates helps in this process.

Peter Lynch suggests viewing multiples in the light of growth by adding the dividend yield (Y) to the long term (5 year) growth rate (G) and dividing by the P/E ratio, i.e., (Y + G)/(P/E). I call this the Lynch ratio and it must be examined in context, but as a rule of thumb, if the P/E ratio and the growth rate are about equal the stock is considered to be fairly priced.

This last calculation is similar to the P/E and growth ratio (PEG), which is expressed as the P/E ratio divided by the expected growth rate, i.e., PEG = (P/E)/(G). As before, A PEG of 1.0 suggests that a company

is fairly valued, which is to say that if the P/E ratio is greater than the growth rate the stock may be overvalued. Over the past few years, however, P/E ratios have tended higher and I suppose the argument could be made that some stocks deserve them due to their very strong brand name (Coca-Cola, General Electric, and McDonald's come to mind) or because of their outstanding growth rates (Intel and Microsoft are examples).

Note that with both these ratios an estimate is needed of future growth in an attempt to look forward. Obviously, this makes more sense than working only with the current, termed "trailing", P/E ratios. But don't forget that we have all seen many earning "surprises", both high and low. Michael O'Higgins in "Beating The Dow" reports an average historical margin of error of 47.5% for analysts' estimates of earning for the 30 Dow stocks. Still, I think the near term is much more difficult to predict than the long term. Which is to say that, for my money, there are many more meaningful ways to live than trading stocks day in and out.

Finally, we come to the price to sales ratio (PSR). This relationship has received growing interest recently since several US gurus have advocated it. It is a way to determine how much we are paying for every dollar of sales and is calculated by taking the current market capitalization and dividing it by the last year's revenues. Market capitalization is the current market value of a company, obtained by multiplying the current share price times the shares outstanding, and is the stock market's estimate of total value of the company. If a company's annual sales are $100 million and it has four million shares outstanding at a price of $25, then the PSR = (4 million shares X $25/share)/ $100 million sales which equals 1. Mr. O'Higgins thinks that one reason the PSR is a good indicator of stock value is that sales provide a more consistent view of performance than earnings, which are prone to one time charges and other variables. Research has shown that stocks with a PSR of 3 tend to perform poorly while stocks with PSRs of 1 usually outperformed the market. Again, however, this is only a guideline.

So, we have detailed three different methods to value stocks outside the information provided in an annual report. Keep in mind that they are synergistic, meaning they are much more powerful together than separately.

Lastly, we will explore is relative strength, our only example of a technical analysis evaluation tool and one that does not depend on chart reading. Relative strength is the measure of a stock's price performance relative to all of the other stocks in the investment universe. In other words, by examining relative strengths, you can see which companies have performed better than all of the other stocks out there during a given time period. Why is this valuable? The theory goes that you should purchase those stocks that are doing the best and the market is then likened to a horse race. Basically, if you could see which horse was winning the race, you'd want to bet on that horse. Relative strength is a way for you to see which stocks are winning, i.e., which have current momentum.

How does relative strength work? If a company's shares have risen 100% over the past year while the market has only climbed 5%, it is said to have a high relative strength. However, if the market has risen 99%, then the company's "relative" strength is not as great—even though it has climbed the same 100% in both examples. Relative strength even works when the market goes down. If the market is down 10% and a particular stock is down 20%, then it is said to exhibit much worse relative strength than a stock that is only down 5%. These data are available in the weekend *Globe and Mail*; the stock tables gives a comparison of performance to that of the TSE 300 over the past 13 weeks. My personal feeling is that chasing high momentum stocks is a quick way to lose money, however this may be a useful tool when combined with other forms of evaluation.

4. Examples - Information of the type given above is much more useful if the reader can put it into practice. We will now take a look at several stocks, selected for their diversity. Although they are large-cap companies they are from very different sectors. Does this mean that they are all "value" stocks as opposed to "growth" stocks? Not at all—these companies averaged a 12.8% compounded growth rate of profits over the past five years, indicating that big doesn't necessarily mean slow. Data for this exercise were taken from annual reports, the 1997 "Report On Business - Canada Company Handbook", the Nov. 14 *Globe and Mail*, and First Call on America Online.

First, we must know a little bit about the companies:

SYM	COMPANY	BUSINESS	PROFIT RANK[1]
BCE	BCE Inc.	Telecommunications	4
BCG	BC Gas Inc.	Gas utility operations	78
CDL.A	Corby Ltd.	Distillery operations	183
CM	CIBC	Chartered bank	2
DFS	Dofasco Inc.	Steel producer	39
IPL	IPL Energy Inc.	Petroleum pipeline	53
MG.A	Magna Intl.	Auto parts maker	22
NTL	Nortel Ltd.	Telecommunications equipment	7
T	Telus Corp.	Telecommunications	33
TA	TransAlta Corp.	Electric utility operations	49

[1]From profit ranking of top 1000 Canadian public companies

Now, lets take a look at the data in the next table:

COMPANY	BCE	BCG	CDL.A	CM	DFS	IPL	MG.A	NTL	T	TA
Debt to equity	1.14	2.25	0.01	0.45	0.46	2.49	0.33	0.37	0.88	1.37
Dividend gro (%)	4.21	0	15.9	28.8	466.7	1.5	107.3	47.1	3.4	0
Book value	16.55	13.75	18.2	18.62	19.16	20.69	33.49	17.35	14.07	9.92
Price	42	26.15	60	43.15	23.05	56.05	88.75	130.75	31	20.1
Price to book	2.538	1.902	3.297	2.317	1.203	2.709	2.65	7.536	2.203	2.026
Return on eq (%)	10.47	17.59	22.35	16.73	11.39	14.47	15.75	14.9	12.54	11.58
Cash flow	7.49	3.64	2.77	2.74	4.71	7.48	8.39	3.26	5.08	3.1
Profit margin (%)	3.82	15.76	37.33	10.3	6.17	7.96	5.28	4.82	14.03	10.11
P/E	19.7	15.4	15.2	12.9	10.2	17.6	10.7	32.5	19.3	15.1
PEG	0.774	0.995	0.601	0.975	2.347	0.562	1.528	0.5738	0.428	0.76
P/S	0.944	1.629	5.941	1.471	0.671	1.538	0.943	2.6255	2.558	1.782
RS	104	102	106	114	77	110	101	91	115	115
Yield	3.24	3.82	2.33	2.78	4.34	3.89	1.35	0.65	2.97	4.88
5 Year growth	12	11.5	6.8	9.8	19.6	6	15	18	5.3	6.6
Sales/share	44.51	16.05	10.1	29.33	34.36	36.45	94.15	49.8	12.12	11.28
Price/(book+cash)	1.747	1.504	2.861	2.02	0.966	1.99	2.119	6.344	1.619	1.544
Price/cash flow	5.607	7.184	21.66	15.75	4.894	7.493	10.58	40.107	6.102	6.484

Explanatory notes:

- Debt to equity ratio – long term debt/common shareholders' equity
- Dividend growth – %age increase over the past 5 years
- Book value – shareholders' equity/share
- Price – As of Nov. 14, 1997
- Price to book ratio – price/book value
- Return on equity – earnings before extraordinary items as a %age of shareholders' equity. Shows the rate of return on investment for the company's common shareholders, the only providers of capital who do not have a fixed return
- Cash-flow – cash-flow from operations/common shares outstanding
- Profit – earnings per share/sales per share, expressed at a %age
- P/E – current stock price/earnings per share from continuing operations for the latest 12 months

- PEG – I prefer the Lynch ratio, calculated by adding the dividend yield (Y) to the long term (5 year) growth rate (G), and dividing by the P/E ratio, i.e., (Y + G)/(P/E).
- Price to sales ratio – current price/sales per share
- Relative strength – gives a comparison of performance to that of the TSE 300 over the past 13 weeks
- Yield – expressed as a %age; calculated by dividing the dividend by the current market price
- 5-year growth – best estimate of the yearly % growth for the next 5 year period
- Sales/share – net sales/outstanding common shares

Given what we've discussed so far you should be able to make some informed conclusions from these data. What differences do you see among sectors? What limits the usefulness of these calculations? The businesses chosen were all big-cap, blue-chip companies – would these methods be as useful for small-cap, start-up operations? How can these factors be combined to produce a stronger tool? How would a trader and an investor differ in their approach to stock evaluation?

5. Conclusions - We have taken a look at some of the ways investors can evaluate companies to determine if they should put up some of their hard-earned money to buy the shares. Was this a comprehensive exploration of all possible methods? No, for example we haven't covered any major concepts involved in technical analysis and while I personally don't use it much, it might be a good idea to at least take a look at a chart of the stock price before you invest. Nor have we examined insider buying/selling, institutional ownership, or many other possibilities. Some other logical questions to ask include:

- Who are the major customers and how many are there?
- Is the company a cyclical, and, if so, what part of the cycle is it in now?
- How many key products does it have?
- What percentage of sales are to foreign countries and what risk does this entail?
- What is the competition picture?
- What is the supplier picture?
- Are there upcoming changes in government regulations that will impact the company?

But I think the basic concept to remember is that a prudent individual investor, as Peter Lynch says, spends at least as much time and effort in choosing a new stock as in choosing a new refrigerator. The less you know the more time it takes, but through experience you will discover which combination of these methods best suits your style of investing.

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Summary - This chapter explores some approaches to evaluating investments in stocks, bonds and income trusts.

FINAL COMMENTS

I hope the material I have provided in this short publication will be useful to you and that it was presented in a manner that you have found easy to understand and apply. In conclusion I would urge you to continue to read *Canadian MoneySaver* since it provides a wealth of vital information at a very reasonable price. I do believe that Dale Ennis has done more to empower individual Canadian investors than anyone else I know. Remember that the you are the person responsible for your own investment decisions and that, if properly taken, they will allow you to buy back some of your time, time that can be used to do the things you have always wanted to do. The creation of wealth through investing allows for freedom—the same freedom that pensioners and retirees now enjoy, as many re-enter the community full-time to participate in a variety of good works, ranging from spending time with grandkids to volunteering for charitable functions. Good luck to you all!

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WEBSITES

- *Canadian MoneySaver* Online – http://www.canadianmoneysaver.ca/

- Fifty-Plus.net – Canadian Association of Retired Persons – http://www.fifty-plus.net/

- Money: Personal Finance – http://www.canoe.ca/Money/home.html

- The Motley Fool Web Site – http://www.fool.com/

- TSE – The Toronto Stock Exchange – http://www.tse.com/