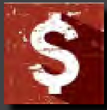

DSR PREMIUM NEWSLETTER

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    - Valuation focus

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MAY 30TH, 2024

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DIVIDEND STOCKS ROCK

INVEST WITH CONVICTION, ENJOY YOUR RETIREMENT

INVESTMENT BIASES & MISTAKES – A SURVIVAL GUIDE

Since I was eight years old, I have always been passionate about numbers. I first wanted to become an accountant, but I quickly got bored by the infinite numbers and columns with which I had to deal with routinely. I then pursued a bachelor's degree in marketing which was infinitely more fun. Halfway through my collegiate years, I secured a job in the back office of an investing firm (it was at National Bank). I was clearing options and futures transactions. When I discovered this crazy world (where you can trade pork bellies!), I knew exactly what I wanted to do in life and that was to work around the financial markets. I've always been captivated by how markets evolve in various directions for various reasons. Therefore, I completed a bachelor's degree with a double major in both marketing and finance.

When I did my financial classes, everything seemed so well organized and rational. Financial theories are so straightforward and comparatively easy to understand. It's almost impossible to mess up the applications in the real world, or is it? Investors are supposedly rational individuals making sound decisions based on facts and intricate calculations. Well, that is the theory behind what has been written in many financial books.

Unfortunately, the truth is significantly more complex. Emotions taint our judgment and have us do things that don't really make sense. Since it is very hard to control our emotions, I thought it would be interesting to read about certain investment biases and mistakes so it might ring a bell with my readers when such a situation occurs. At least, you may have or develop the intuition to take a pause and take a second look at a specific situation before pulling the trigger.

This newsletter will start with investment biases, and we will then explore classic investment mistakes that I've observed over time.

Not all biases are based on emotions. Our brain must deal with millions of data points each day. Therefore, it has learned to cut corners to make its analysis process faster. Our brain will create patterns and direct information towards conclusions that are based on data that was previously stored. This may lead to terrible investing decisions as your brain does not take all the data into consideration when it's time to buy or sell a position.

We all know about common investor biases, but we tend to forget about them at times when things are going too well, or at other times when things are going downhill. This newsletter is about the most important investors' biases and how you can avoid making mistakes caused by those biases which we all possess.

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01 CONFIRMATION BIAS

When we believe in something, we tend to give it more credibility and more weight as we accumulate data, research, and opinions confirming that belief. On the other hand, we may tend to ignore or diminish the value of research and opinions that go against our beliefs. This is because we like to find people that think like us and disregard people who challenge our thoughts and beliefs.

For example, if I determine that Apple (AAPL) is an amazing company, I will likely assign more value to an investing firm telling the world this stock should be traded over $200 per share instead of another firm explaining why AAPL is at risk and there will be an end to the iPhone sales cycle.

This is a behavioral bias that applies in all spheres of our lives. **The confirmation bias is the tendency to look for information or people confirming what you already believe.**

"Confirmation bias, also called confirmatory bias or myside bias, is the tendency to search for, interpret, favor, and recall information in a way that confirms one's pre-existing beliefs or hypotheses." – Wikipedia

This totally makes sense. You would not hang out with people who always tell you that you are wrong. Hanging out with people having the same mentality and beliefs will reinforce yours and make you feel better. I rarely see a vegetarian hanging out with intense steak lovers.

The same bias happens all the time in the investing world. If an investor is convinced the market is going to crash, the only news he will read or give credence to is the stories supporting his conviction. The financial market is a widely discussed topic across the internet and the media. For example, if you think Target (TGT) is going to beat Amazon (AMZN), you will most likely find bloggers and analysts telling you that TGT is a strong dividend king, and you may choose to ignore articles telling you the opposite.

Looking for information confirming your belief will reinforce your conviction in your decision. On one side, this is good as we all need a bit more confidence. On the other hand, the more you confirm your belief, the more you blind yourself to other investing theories and beliefs. Once you are confident about an investment, you should stop reading similar thoughts on the same topic.

How to beat the confirmation bias

Here's an easy trick that I use. Once I'm done writing my investment thesis with a focus on all the great things a company does, I take a break for a day or two to let that sink in and let the hype go down. The stock won't be gone if I buy it next week anyway. Then, I complete the investment thesis with a potential risk section. I know for a fact that this section of the DSR stock card is often skipped (or minimized), but it's usually the most important part. Knowing what could go wrong is a lot more important than reading about how great a company is. To complete my potential risk section, I search for bearish cases on the internet. My research round starts with Morningstar and Seeking Alpha, but I also look on Youtube, and podcasts and I now use Chat GPT to help me narrow down all the risks.

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02 CONSENSUS BIAS

If most investors in your environment agree that Johnson & Johnson (JNJ) is a great dividend stock and should be an integral part of any dividend portfolio, it may be hard to go against the crowd. The truth is, JNJ might not be such an amazing stock, but it "becomes one" since everybody is going in the same direction. Strangely enough, we see that bias even with professionals!

We have previously discussed how noise can influence investors in a bad way. Whenever a market news item (about a company or a market event) gets traction, it creates a global consensus in the media. In early 2021, many stood up to discuss the possibility of a deep bull market in the oil industry. As the economy recovered, the oil demand started to ramp up. Then, we came to realize the lack of investment in exploration/production over the past few quarters. This narrative has become the consensus of many that we will need more oil for a longer period. It pushed many "experts" to claim that the oil per barrel price would hit $100 and go beyond. Fast forward to 2024, the price per barrel of crude oil is still stuck bouncing up and down between $70 and $90 but we are far from trading above $100.

Did we start to produce that much oil in such a short period? Or was it just the consensus bias driving a bullish narrative around oil? I remember reading the same narrative (and the same consensus toward oil) after the market crash of 2008-2009…

How to beat the consensus bias

Shutting down the noise is a challenging exercise, especially when everybody is singing the same song. I often say it's easy to pick someone's idea, but you can't pick his conviction. For this reason, I tend to stay away from "trends" in the market by default. My trick to avoid confirmation bias is to avoid confirmation altogether. Warning: this action could lead to an "anti-confirmation" bias.

When everyone invests in one direction, I keep my asset and sector allocation intact. It happens that my portfolio is aligned with "what people think", but it's not by design. By maintaining the same strategy and the same allocation, I avoid getting a high exposure to a single event.

My sector allocation has been determined by:

a) My investment goal is to find dividend growers that are potentially low yield but high dividend growth stocks.

b) My level of knowledge as I select sectors that I understand best to be the largest sectors in my portfolio.

Now, if everybody thinks we should invest in tech stocks and I have some in my portfolio, this portion of my holdings will likely perform well for a while (as demand drives prices), but I won't increase my exposure to this sector to "follow the consensus".

Again, *know what you own and why you own it!*

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03 REGRET / LOSS AVERSION BIAS

This one is well known as we all know that it hurts more to lose $10,000 than it feels good to make $10,000. Go figure as we are just that kind of animal!

I think this may be the most powerful bias an investor faces: the pain of losing money is greater than the joy derived from making money. As the market recovered from the March 2020 crash, investors who had cash on the sidelines likely waited "for the next dip" as the apparent outcome of entering the market at peak levels could generate severe losses.

"In economics and decision theory, loss aversion refers to people's tendency to prefer avoiding losses to acquiring equivalent gains: it's better to not lose $5 than to find $5." – Wikipedia

As the market recovers, investors become more concerned about losing their money over the coming months. They expect the market to fall any day and would rather wait on the sidelines. Because, if you are about to invest $100,000, you may prefer to earn $100 in the next month than risk losing $10,000. Fast forward to today and the market is trading at an all-time high, and many think it's better to wait as a crash is imminent. Keep in mind many also thought the same thing in 2017.

SPDR® S&P 500 ETF Trust Total Return
iShares S&P/TSX 60 ETF Total Return
THE MARKET IS CLEARLY DUE FOR A CORRECTION,
RIGHT?... RIGHT????
192.5%
160.0%
106.9%
80.00%
0.00%
-80.00%
2010
2012
2014
2016
DIVIDEND STOCKS ROCK
INVEST WITH CONVICTION, ENJOY YOUR RETIREMENT
Jul 15 2021, 12:40PM EDT. Powered by YCHARTS

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While the market traded at an all-time high in 2017, someone sitting on the sideline lost a lot more by waiting than by investing in the past 7 years. Your portfolio could have doubled during that period.

	VAL
iShares S&P/TSX 60 ETF (XIU.TO) Total Return	84.65%
SPDR® S&P 500 ETF Trust (SPY) Total Return	166.2%

May 24, 2024, 10:26 AM EDT Powered by YCHARTS

And here we are today, once again trading at an all-time high.

Unfortunately, nobody knows what will happen in the future. Therefore, this kind of thinking is completely non-productive. The loss aversion is often combined with choice paralysis. Choice paralysis comes when there is an overload of information that hinders the actual decision process.

Finally, regret aversion is also responsible for some investors keeping their losing stocks forever. Once the paper loss is digested, investors are wiling to wait until they recover that loss. They would rather wait than sell their losers now and subsequently see them go back up the next year.

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How to beat the regret / loss aversion bias

To fight this bias, I'd argue that there is nothing like some additional knowledge combined with a long-term horizon. When I write *long-term horizon*, I mean more than ten years. If you will not deplete your portfolio entirely in the next ten years, you can keep reading.

Here's the result of a study done by J.P. Morgan showing what happens to your portfolio if you invest at all-time highs vs. any other day. After 1 year, 3 years and 5 years, investing at the all-time high is the best solution (between 1988 and 2020).

You can indeed suffer over a few months if you invest "now", but in 5 years? You'll be golden most of the time! As I always say… *stay invested!*

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04 HINDSIGHT BIAS

The hindsight bias is what we refer to as "playing Monday morning quarterback". When you look at what happened in the past, and you find obvious reasons to explain how the market evolved. Have you ever noticed how everything is so obvious when you look in the rear-view mirror?

Everybody should have known the market would crumble back in January of 2020 as the virus was spreading everywhere!

Everybody should have seen the financial crisis coming.

Everybody should have purchased Amazon 10 years ago because the future of retail is online!

Everybody should have ignored the Blackberry devices as it was obvious Apple would crush them!

The funny part is that we can convince ourselves that those trades or movements were obvious back then. This is mostly due to our deep desire to correctly predict the future. By looking at what happened, you select only the factors that contributed to the results ignoring all the uncertainties at that time. Strangely enough, when you look at the present and you try to predict the next 3 months, we can see that nothing is clear now.

Keep in mind that whatever happened in the past may not replicate itself in the future. Each situation happened in a different context. For example, the credit bubble burst of 2008 would have not been that violent in the 80's since mortgage-backed securities, hedge funds, and leverage strategies (including short selling) weren't common then. When we look at the 2008 bubble, we all think "yeah, that was obvious; the market had to implode". Back then, most people didn't know what subprime mortgage-backed securities were (and that was the problem!).

How to beat the hindsight bias

I pay very little attention to how I would have (or, should have) seen what is coming. I accept that I will sometimes be right and sometimes I'll be wrong. For example, I've been expecting a recession since the end of 2022. To this day it hasn't happened (yet).

The most important part is that I don't trade on my hindsight, I trade based on my investment rules. It would be easy for me to claim that I "knew" the tech sector would crash in 2022 and that's why I sold shares of Apple and Microsoft in December of 2021. But the reality is that I simply followed my investment rule to not be over-exposed (I established my maximum weight for one stock at 10%). Therefore, at the end of each year, I trim my best performing investments if they have appreciated to exceed 10% of my portfolio.

Following clear investment rules is a lot easier than trading on hindsight.

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05 ANCHORING AND RECENCY BIAS

When you build a theory in your mind, your brain will tend to rely heavily on a handful of facts or data that support your belief. Like holding shares of Algonquin (AQN) relying on the fact it was once worth $22 a share. Thinking the stock market is going to collapse and never come back by citing Japan or calling for stagflation as you remember the 70's are also great examples. Ironically, we had legions of "experts" calling a stagflation period a few years ago. They are pretty quiet now.

If you look at your portfolio and you constantly think of the 70's, you may sell a good portion of your stocks and buy gold as you may be convinced the yellow metal will make another 900% run. You will ignore the reasons for what happened in the 70's due to a particular context (which is far from the one we have now) and you will focus on the "high probability" of seeing gold prices continue their upward trajectory. Since gold is on its way to doubling its value in 5 years, why not imagine a run where it finishes around $7,000 in 5 more years?

Like anchoring bias, there is the recency bias. Looking at the past 10 or 20 years to draw conclusions may also lead you in the wrong direction. The recency bias tends to give more weight to recent events compared to what happened a long-time ago. Since there is a limit to the amount of information our brain can properly process,

Keeping in mind the last important events is often enough to shape an opinion.

As the economy is in constant evolution (nobody used the expression cloud services back in 1999!), it's important to consider recent history. However, ignoring how similar crises were handled in the past could also cost you a lot. When you look at the big picture, history does in fact tend to repeat itself almost indefinitely.

Dangerous things happen when you combine the hindsight bias with anchoring. You would then focus on an event and think you see the same factors happening again. The hindsight bias will make it obvious and will push you to take action accordingly. The anchoring bias will make any situation seem like the one you fear the most (tech bubble, credit crunch, stagflation, you name it!).

How to beat the anchoring & recency bias

When someone asks about stock ABC during a webinar, I often explain to not give a value (e.g. a good or a bad investment) to a company based on its recent stock performance. When a stock is up, it's not necessarily a good investment for your portfolio and vice-versa. What matters is the reason why a stock is doing well (or not) on the market. Those reasons are not found in the media, but rather in your process to conciliate your investment thesis with financial metrics (my favorites are combined in the dividend triangle).

Will AQN ever trade back to $22? Ask yourself what the narrative was back then. AQN had an aggressive growth-by-acquisition strategy using cheap debt to buy utility assets. It then converted those utility assets into renewable energy providers and kept on growing. Today, AQN is selling its renewable assets and has stopped growing by acquisitions. It wants to strengthen its balance sheet and pay off its "expensive" debt. We are far from the 2021 narrative. To get back to $22, AQN will have to write a new growth narrative starting from scratch.

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05 OVERCONFIDENCE AND SELF-ATTRIBUTION BIAS

Overconfidence is probably a bias we are all guilty of having from time to time if we choose to manage our own portfolios. As an individual investor, we believe we have an edge on others. We believe we have a unique ability to understand the market a little better than everybody else. We don't have to think we are geniuses; we just must believe that we are better than the average bear.

I plead guilty to being overconfident from time to time! After all, investing with conviction could lead to overconfidence!

When I buy shares of Alimentation Couche-Tard (ATD.TO), I believe it is the best convenience store operator on the planet. I think their assets are better than gold and that their stock price will be going up. The fact that ATD.TO is now in my portfolio makes me think it's getting better every day. After all, I picked that stock for a reason, right?

The self-attribution bias is slightly different. This is where all success is attributed to our magnificent ability to read the market while all failures are caused by external (and impossible to predict) causes. This protects our ego (so we can feel confident again) while denying any flaws. This could be highly counterproductive if you can't own your decisions.

For example, I could say that I went through the 2020 market crash (followed by a strong recovery) with great success. That my strategy is rock solid and my ability to select the right stocks is the only reason to explain my portfolio performances. This statement is partially right as following a rock-solid investing strategy helps, but I would be dishonest to ignore the fact that about 25% of my portfolio was concentrated in tech stocks. This sector thrived during the lockdown and helped my portfolio recover a lot faster than the market. Did I plan to have a quarter of my portfolio invested in tech stocks because it would be beneficial in case of a global lockdown? Absolutely not. One must remain humble when looking at his/her portfolio returns.

How to beat the overconfidence and self-attribution bias

When my portfolios increase in value, I usually stay humble and thank the quality of my investing process. In other words, I *"trust the process".* When my portfolio goes down, I acknowledge my potential losses and try to define where I went wrong. Once I have reviewed my investment thesis for each holding and make sure it is backed by a robust dividend triangle, I go back to my golden rule… *"trust the process".*

By making everything about the process and not about me, I reduce the overconfidence and self-attribution bias. My goal is to maintain a high level of conviction since it helps me to avoid panic selling whenever the market goes down.

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INVISIBLE INVESTING MISTAKES

Warning: this part will not be easy to read for most of you. I'm not reciting classic investing mistakes with some generic solutions. I'm attacking the top investing mistakes I've seen across the DSR community over the past 11 years.

In the following pages, I will not only identify what most investors do wrong, but why they do it and how it hurts their retirement plan. The worst mistakes are often the ones we don't see. You'll see that some of them are also linked to investment biases described in the first pages of this newsletter. You don't even realize it's a mistake since it's not making you lose money right away. The impact is only visible over a long period of time. It's like my eternal battle with weight loss.

I've been trying to lose weight for several years. It's a classic resolution most of us make and then forget along the way. The thing is that I don't forget about it. I even have a plan to make sure I achieve my goal! Over the past 10 years, I've made sure to "stay in shape" as I was going through my 30's. I had been going to the gym regularly until I eventually built one in my basement. I've been running 3-4 times a week and even completed a half-marathon. I'm now running consistently 1,200 km per year. Not bad for a guy who lives in a country where winter lasts 4 months a year!

Do you know how many pounds I lost? None. For all those years, all I have been able to do is to maintain the same weight. I always had a solid training plan and followed it. Nevertheless, my story is like Groundhog Day. Do you know why?

I make the same "invisible mistake" each year.

Sometimes it is called "the weekend", and sometimes it is "a good glass of wine by the terrace". But each year, the mistake I make is not about training intensity, the quality of my plan or my diligence. The mistake I make is about eating too much.

You may feel your portfolio is in good shape. In fact, if it is not, it would be quite surprising considering how great the stock market has been to all investors over the past decade. This is the market covering up for your mistakes. Lucky for you, there is still time to solve these issues and get your portfolio on the right track.

I know very well the following investing missteps as I've experienced most of them during my investing journey. We usually say that the ultimate result of a mistake is to allow us to learn something. Let's explore together those errors and learn how you can fix your portfolio using DSR tools.

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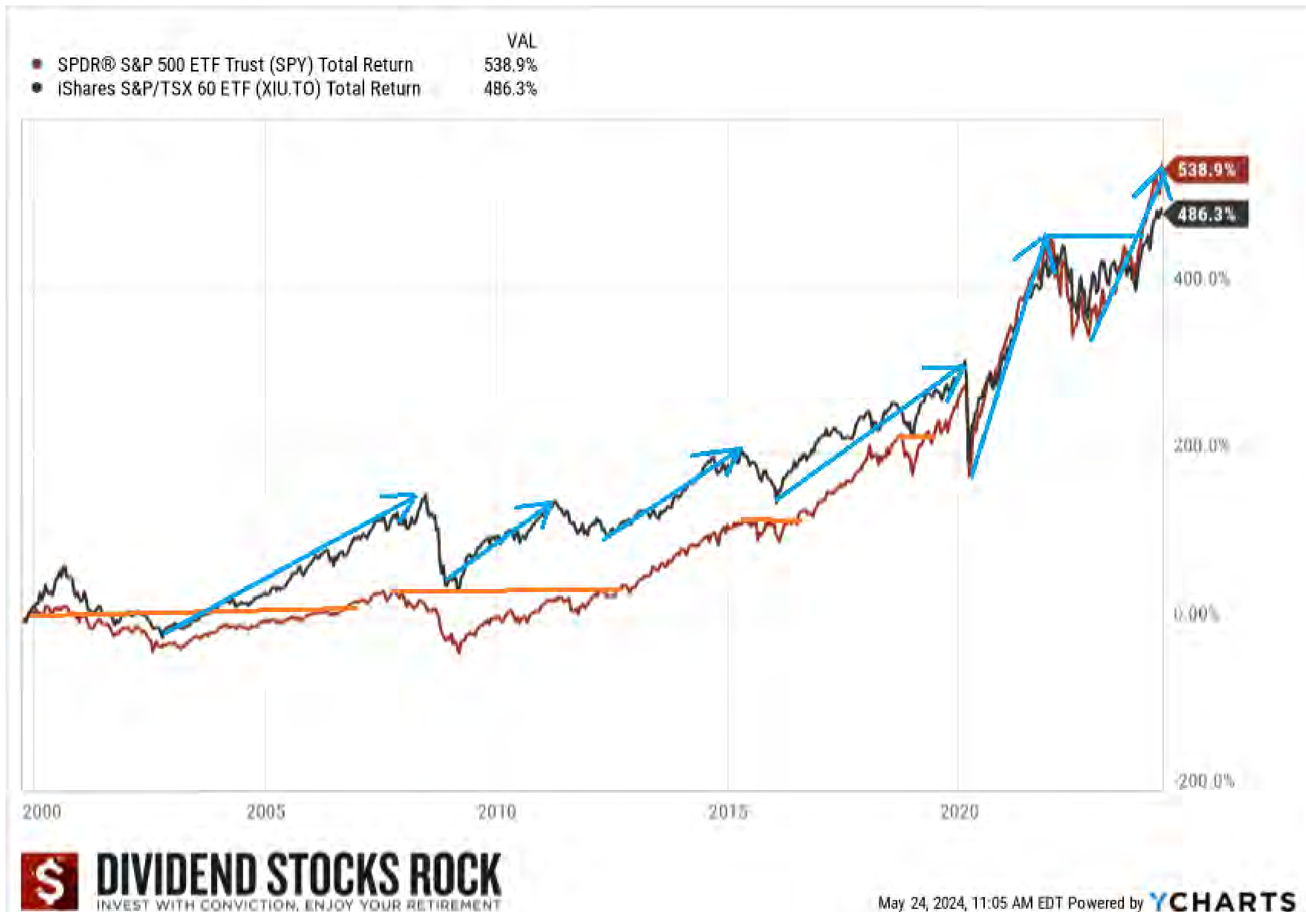
01 WAITING FOR A PULLBACK

"*Buy low, sell high*". That is the most basic and sound investing advice we can give to anybody starting their investing journey. Now, what do you do when the stock market keeps going higher and higher? You are not going to buy high (and sell low), are you? This is why you end-up waiting for a pullback. Now that we are currently trading close to an all-time high, it's even more tempting to wait for the next crash.

Why are you doing this?

History is filled with investing horror stories. During the past 25 years alone, we had the "chance" of running into the tech bubble, the Twin Tower terrorist attack, the 2008 financial crisis, the oil bust in 2015, the 2018 quick bear market, the 2020 pandemic crash, and another quick bear market in 2022. Keeping cash aside for the next crash tells a seducing story: you will buy shares at an incredibly low price, and they will eventually go back up and generate strong returns. After all, why would you buy now, if you can buy later at a cheaper price? Plus, keeping 30% of your money in cash doesn't make you lose money. It looks like a win-win situation as you get paid (e.g., mediocre interest rate) on your cash and you will eventually get bargains in the stock market.



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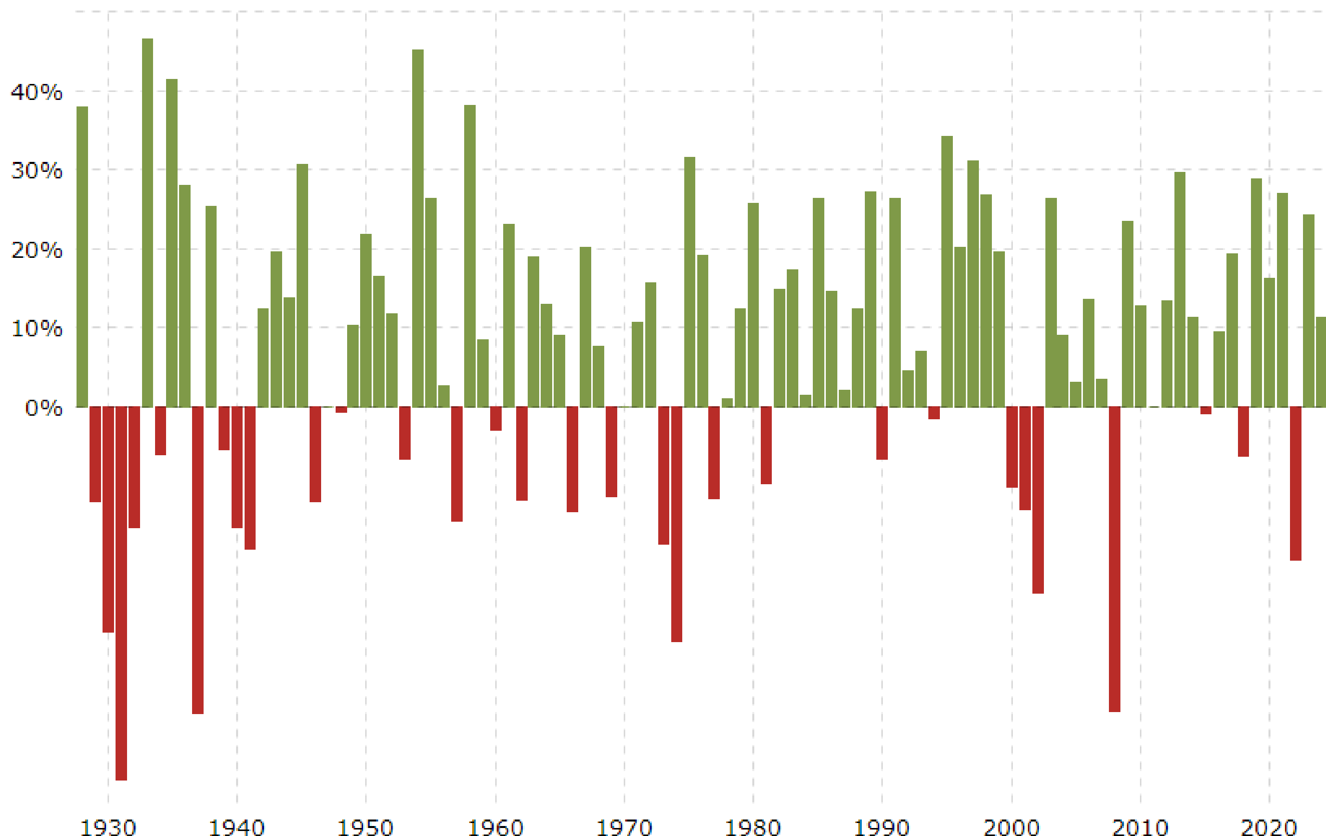
For an inexplicable reason, most investors keep referring to what happened in 2008-2009 as the norm for a market crash. They expect the next bear market to be fast and furious (pun intended). Therefore, all you need to do is to wait for a few months until the bleeding stops. Then, you put all your money in, and you feel like a king.

The Canadian market almost tripled in value while the U.S. market soared by almost 700% between 2009 and 2024. This is enough for any investor to be "set for life" if they played their cards correctly back in 2009. When you think about it, *waiting for a pullback* makes total sense. Unfortunately, you are wrong.

How it hurts your portfolio

If a year like 2009 happened every 5 or even every 10 years, waiting for a major pullback would be a defendable strategy. After all, any investor who put his money to work in 2009 shows impressive results today. I remember that the famous Canadian Banks were offering yields of between 7% and 9% at their bottom. Just the thought of buying Royal Bank (RY.TO) with a 7+% yield makes me smile… but it is unlikely to happen. In fact, **this happened only once in the past 25 years** (with a special mention to 2020 where you could have caught RY with a 5% yield). Waiting for such a pullback to get "market deals" is more like waiting to see the Montreal Canadiens win the Stanley Cup (this also happened once in the past 25 years). The problem is that we rarely have the chance to invest after a major stock market correction (Source: Macrotrends)



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Since 1970, there have only been 3 interesting pullbacks that would have been worth the wait (1973-74, 2000-01-02 and 2008-09). Imagine if the market correction of 2018 happened similarly to the one in 1990. This would mean that you would be waiting **another 9 years before a market crash.** Can you afford to wait another decade before investing? Do you think the next market crash will bring prices back to the 90's? **Here's my blunt answer; it won't.**

But waiting has a more important impact on your portfolio: it inserts doubt into your investing plan. You want an example? How many of you (or your friends) invested all available money on December 26th, 2018? Or on November of 2022? After both markets showed a strong double-digit decrease from their peak levels. Wasn't that the pullbacks you were waiting for? Like most of us, you didn't know that the end of 2018 and the end of 2022 would mark the start of another bullish segment. You probably didn't invest more money in December 2018 and 2022 because you started thinking about the possibility of another 2008. Even worse, what if the market moved into another bear segment like the one in 2000-2002? The same question could easily apply to the crazy year of 2020. If you tell me that you are waiting for a pull-back now, where were you in March of 2020? As mentioned earlier, it's very easy to play Monday morning quarterback as hindsight is truly 20-20!

Waiting for a pullback will do one thing: make you wait to invest. Nobody will come around raising a flag and tell you it's now the time to pull the trigger. Therefore, why are you waiting?

How can you fix it?

The answer was explained in "How to beat the regret aversion/loss aversion bias" where I showed that investing at an all-time high is statistically better than investing on any other day.

That's just more proof that the good old "*time in the market, not timing the market*" is a cliché that works! To experience "time in the market" without suffering too much, you must invest with conviction.

That comes with a clear investment process with simple investment rules.

By being invested at all times, you will go into bad times, but you will catch 100% of the bull market too.

After all, even Wayne Gretzky understood that:

"You miss 100% of the shots you don't take."

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02 THINKING IT WILL BOUNCE BACK

While some investors wait desperately for a market pullback to invest, others are fully invested in the wrong companies. Making poor investment decisions happens to all investors from time to time. I've highlighted many of my mistakes in my portfolio updates throughout the years. However, as opposed to investors holding unto their shares until it recovers (which is like holding their shares "forever" in some cases), I'm quick to own my mistake and let go of my losers.

Why are you doing this?

The rationale used here is like the wait for a pullback: you don't want to buy high and sell low. The first 10-20% loss can be justified by a temporary setback. "The market doesn't get it", or "investors will realize this is a good company" are often the rationales employed. You may also try to justify your purchase by any means. It is hard for anybody to admit their mistakes. We could also suffer from the price anchoring bias. Selling a loser hurts our ego, and our brain seems to do everything in its power to protect that ego. For that reason, we often patiently wait for our losers to come back on track and prove us right. After all, AbbVie dropped by 40% before fully recovering between 2018 and 2022.

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We also comfort ourselves by telling ourselves that selling at a bad time is acting on fear. We don't want to let our emotions take the wheel and drive our portfolio transactions. While this is a good reflex to have, further analysis must be done before making the final decision on whether to keep a given stock in our portfolio.

How it hurts your portfolio

Many investors will tend to let their losers run as they will consider the money lost. Once you have made a bad investment and you are losing 40% of your capital, what could go wrong from there? How could you possibly lose more money than what you have already lost? If that is the case, you are likely to keep your shares and think that one day it will bounce back, and you could recover your money. In this case, what you are leaving on the table is the opportunity cost of keeping your money invested in a bad place. What if you cut your losses and bought shares of a strong dividend grower instead? Do you really think you will do worse if you sell your loser(s) now and buy something else with better prospects?

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Even after the oil run of 2021, Vermillion and Peyto look like bad investments. For the record, the TSX 60 reported a total return of 134.8% vs -26.67% for Vermillion and -3.58% for Peyto…

Once again, allow me to share a personal story. A few years ago, I held shares of a company that failed me: Black Diamond Group (BDI.TO). The company saw challenging times coming after the oil bust of 2014-2016 and management decided to cut their dividend. Following my investing principles, I took my loss and sold all my shares right away. I wasn't happy to lose money and I felt a bit dumb for having Black Diamond in my portfolio in the first place. After all, I was wrong with my investment thesis, and I wasn't fast enough to see the dividend cut coming.

Instead of whining about my bad investment, I sold my shares and moved on. With the proceeds of my transaction, I bought shares of Canadian National Railway (CNR.TO / CNI). The rest is history:

	VAL
Black Diamond Group Ltd (BDI.TO) Total Return	24.30%
Canadian National Railway Co (CNR.TO) Total Return	160.2%

200.0%
160.2%
100.0%
24.30%
0.00%
-100.0%
2016 2018 2020 2022 2024

May 24, 2024, 11:28 AM EDT Powered by YCHARTS

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If I had waited for better days with Black Diamond, I would have suffered a second dividend cut and eventually would get my money back (after a once-in-a-100-year worldwide pandemic that created a unique situation around the oil & gas industry). Meanwhile, CNR kept increasing the dividend and my shares have appreciated substantially.

How can you fix it?

As you know, I give little weight to my decision regarding the recent stock performance (trying to avoid anchor and recency biases). So how can we make sure stocks we own that drop by 25%+ are the right ones?

How did I decide to keep Microsoft and Apple in 2022 (total return of -28.02% and -26.40%, respectively), but quickly sell Algonquin (with a ~50% loss) after it cut its dividend in 2023?

I use two clear investment rules:

#1 I conciliate my investment thesis with the dividend triangle. Combining the narrative (the story behind why I like a stock) and its financial metrics (positive revenue, EPS and dividend growth) will validate if I should hold or sell an underperforming stock. Numbers tell us a story. That story must be aligned with my investment thesis.

For example, MSFT continued to have several growth vectors in 2022 such as the cloud business, investment in artificial intelligence, acquisition of ActivisionBlizzard and the organic growth from software subscriptions (thesis). When I looked at the dividend triangle in 2022, the narrative checked out as the company reported growth for most of its business segment.

On the other hand, I explained how AQN's business model, balance sheet and overall situation has completely changed from when it was a darling in 2021 and when I sold in 2023.

#2 I sell on a dividend cut. If a company fails me as a shareholder, I simply sell and move on. In the past 14 years, I've made only two exceptions to this rule (CAE and DIS) and they are related to the covid. Before the pandemic, both companies were steady dividend growers with low payout ratios.

When Algonquin announced a dividend cut, I quickly sold my shares without any remorse. I didn't ask myself "*but what if AQN shares bounce back in 6 months?*" as I preferred to stick to my strategy which is investing in dividend growers. In the end, even if AQN had bounced back, I would still feel better with a dividend grower in my portfolio.

Having a high level of conviction in your strategy is your best ally when in doubt.

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03 PUTTING INCOME ABOVE ALL

For many DSR members, the #1 reason they choose a dividend investing methodology is to create an income stream from their portfolio. I am sure you dream of living off your dividends while your capital is comfortably secured in your brokerage account. You can then live a happy retirement and make sure you leave something behind. If you hold your shares, you get your paycheck. It is like a pension plan, but you get to manage it! Through the choice of high-yielding companies, you see the opportunity to increase your pension check "without taking additional risks". While I appreciate the desire for additional dividend income, I respectfully suggest you look at the bigger picture.

Why are you doing this?

If you consider the past 10 years history in the market, you probably don't understand why I make such as fuss about high yielders. After all, high-yielding assets have performed as well as the entire market. Why would you change a winning strategy, especially when it helps you live more comfortably in retirement? The search for high yielding stocks makes plenty of sense when you look at the graph below.

	VAL
Vanguard High Dividend Yield ETF (VYM) Total Return	151.5%
SPDR® S&P 500 ETF Trust (SPY) Total Return	230.9%
Vanguard FTSE Canadian High Div Yld ETF (VDY.TO) Total Return	109.5%
iShares S&P/TSX 60 ETF (XIU.TO) Total Return	112.8%

230.9%
200.0%
151.5%
112.8%
109.5%
0.00%
-100.0%
2016
2018
2020
2022
2024
DIVIDEND STOCKS ROCK
INVEST WITH CONVICTION, ENJOY YOUR RETIREMENT
May 24, 2024, 1:32 PM EDT Powered by YCHARTS

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For similar returns, you might as well enjoy a high yield (sometimes this is a synonym for “guaranteed” income for investors”). However, it’s not that simple…

How it may hurt your portfolio

In light of what has happened to the market over the past decade, I can confirm that not all high yielding stocks are bad investments. However, you must take some precaution when it comes to selecting high yield stocks.

First, considering inflation. A high-income solution is only interesting if the dividend increases by at least 2% per year. If you cannot reasonably expect that from the companies in your portfolio, then you are running into potential trouble. Unless you are 80 today (you can skip this part if you are), you will have to generate income for 10, 20 or possibly 30 years. With the likelihood of living up to 90 or 95 years old, no dividend increases should be a concern.

Second, an absence of dividend growth is the first step toward a dividend cut. While the stock market went up and down a few times over the past decade, we haven’t recorded a single recession. If some of your holdings have not increased their dividend payouts in the past 5 years while interest rates were low and the economy was doing well, what is going to happen when we go through difficult times? You are right, a dividend cut is likely to happen.

In most cases, a dividend cut will have a terrible impact on your portfolio. On top of reducing your income stream, your capital will likely take a hit at the same time. Here’s an example of what could wait around the corner if you hold companies that are likely to cut their dividend in the future.

You will notice the weak dividend increases for a few years just before the company stopped its dividend growth policy. The stock price started to go down before the first dividend cut. Therefore, it is important to follow your holdings quarterly. The market saw it coming, they sold the stock leaving you with an important loss at the first dividend cut and the bleeding just kept going.

This unfortunate situation hasn’t happened much in the past 5 years. It is likely to happen a lot more during the next recession. The positive for you is you can “clean” your portfolio before this happens.

How can you fix it?

Going after high-yielding stocks is not the problem here. In fact, we have been able to build two complete retirement portfolio models (Canadian and U.S.) averaging between 4% and 5% yield. While I personally tend to discard most stocks offering a yield over 6%, you can still pick a few good companies in that range too. The key is to track their payout ratios carefully (always discussed on our stock cards) and consider their dividend safety score.

A high yield combined with a weak dividend triangle and a high payout ratio is a recipe for disaster. There is no room for wishful thinking (*I hope the dividend is safe*) in your portfolio.

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04 HOLDING TOO MANY STOCKS

Once you start investing, it's like opening a bag of Doritos (at least for me) as you can never get enough! (I like the spicy ones). Many do-it-yourself investors will start with a decent number of holdings in their portfolio. At DSR, we would consider that any number between 20 and 40 holdings is good for a portfolio over $100,000 (more on that later). As years pass, some investors may be tempted to add more positions.

Why are you doing this?

On one hand, you like your existing positions, and you follow the proven "buy and hold" methodology that opens the door to some magical dividend growth and total return numbers. After all, I keep telling you to hold your winners and ride them as long as they fit your investment thesis.

On the other hand, there are new opportunities that arise each year as you develop strong buy lists to potentially replace some of your underperforming stocks. Some retail REITs or energy stocks were ready to get picked in mid 2020 after a major crash in those sectors. It makes sense to add a couple of stocks in those industries as the timing was perfect. The problem is that you keep doing this year after year and you wake-up suddenly with 70 stocks in your portfolio.

How it hurts your portfolio

I see four issues in crossing the 40+ holdings mark and start turning into the "dark side". The first one is a matter of time. How can you effectively track 75 stocks quarterly and not miss important news? Every quarter, I review each of my holdings' quarterly reports. I review their financial metrics (starting with the dividend triangle) and make sure the company has increased its dividend in the past 12 months. While this task requires some of my time to cover my ~35 different positions, it would become a daunting chore if I had to do the same routine for 75+ stocks. The risk of missing crucial information that would put my portfolio at risk increases exponentially.

The second issue is one of diversification. Have you heard the expression "diworsification"? This is the action of adding more holdings to your portfolio without improving its diversification. Adding a 5th Canadian bank to your portfolio is a classic. Would you add table salt, kosher salt, sea salt, Himalayan pink salt and a pinch of *Fleur de sel* to your favorite dish? I like to pick the best stocks for each industry instead of doubling or tripling my exposure to the same industry with similar picks.

The third is having 75 stocks in my portfolio would start to look a lot like having an ETF. Therefore, why would I spend time and energy managing my portfolio that will be exactly like any dividend growth ETF I could purchase within minutes?

Finally, the third issue I see is one of portfolio weighting. When I research a stock and decide I want to add this position to my portfolio, I want my decision to matter. If I add a new stock to my portfolio that weights 0.5% of my portfolio, how can I benefit from my stock research? Even if that stock doubles in price, it would add 0.50% total returns in my portfolio. This is not moving the needle.

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How can you fix it?

You can use a good old minimalist rule: One in, one out! When you want to buy something for your house (furniture for example), something else must go out. First, establish the number of holdings you are comfortable following quarterly. Then once you want to add a new position you should review your portfolio and determine if you are still holding only the "best of breed" for each industry. If that is not the case, simply sell one position and add the new stock. You can use our PRO ratings and dividend safety score to make sure you hold strong companies. You can also review your portfolio sector by sector and identify duplicate positions. Since I have National Bank (NA.TO) and Royal Bank (RY.TO), it makes little sense to add TD Bank (TD.TO) to my holdings. I might as well increase my position on one or both current positions.

05 FOCUSING ON THE WORD "VALUATION"

I decided to add this one as I read a lot of articles about the market being overvalued these days. I'm preparing a complete newsletter about valuation (that will come in September), but I wanted to share a few words about this invisible mistake. If you focus too much on valuation, you will likely skip buying amazing companies for the sake of "not buy the stock at the right price". This is particularly true for growth stocks.

When you look at classic dividend payers with steady growth, it is true that you can use stock valuation methods to determine an entry point. However, I have never understood investors who sit on the sidelines until a stock has reached a specific dollar amount.

Why are you doing this?

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The rationale is quite simple as you would be ill-advised to invest in January 2008 when you can buy in March of 2009. There are stocks trading at such high valuations that you wonder how they will ever match the market's expectations. If you buy a stock at its peak value, you may have to wait for several years before making a penny.

The examples of Microsoft (MSFT) and Walmart (WMT) (graph on the previous page) are shocking. Their PE ratios were so high during the tech bubble that it took more than a decade for investors to get their money back. Would it make sense to buy a well-established company at 60+ times their earnings? You are quite right as it never does.

How it hurts your portfolio

So how is waiting for the "right price" a bad strategy? As I mentioned earlier, I'll cover the valuation topic in a full-length newsletter as this is a tricky topic. However, if you always wait for the right moment to invest, you will likely miss several trains in the process and never get to your destination. Let's take Alimentation Couche-Tard for example.

If you look at the stock price chart today, you will tell *me "Mike, the right time to invest in ATD was 10 years ago. Now it's too late".*

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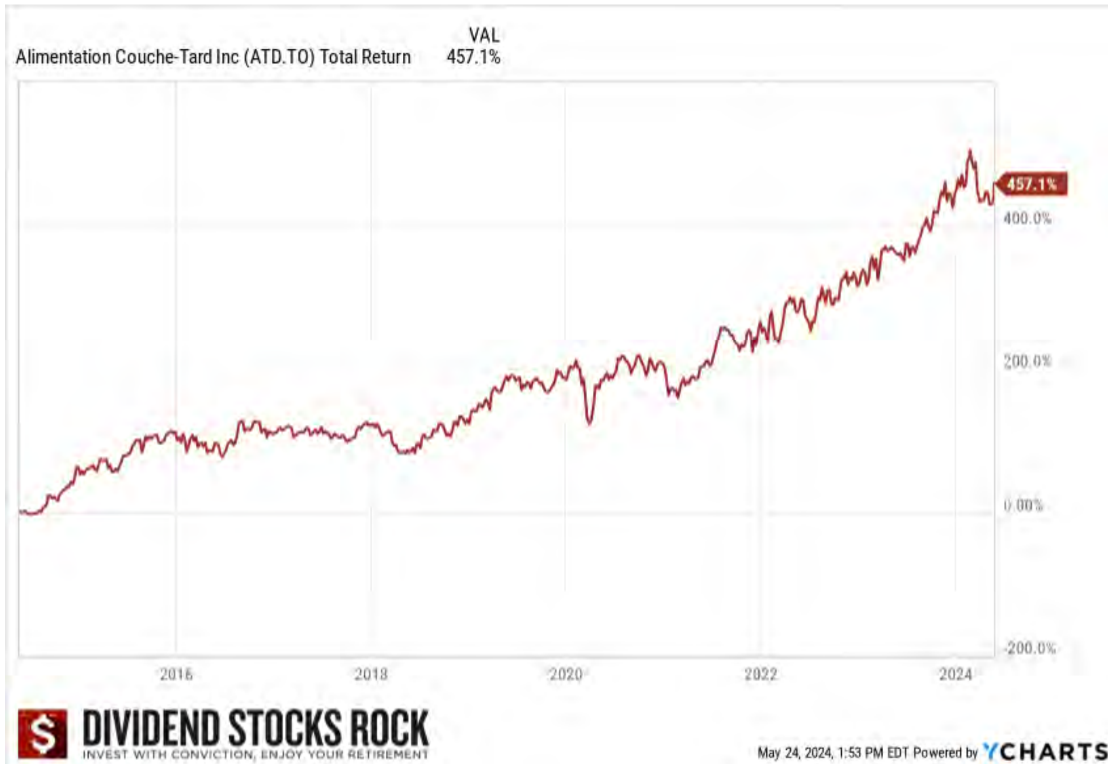
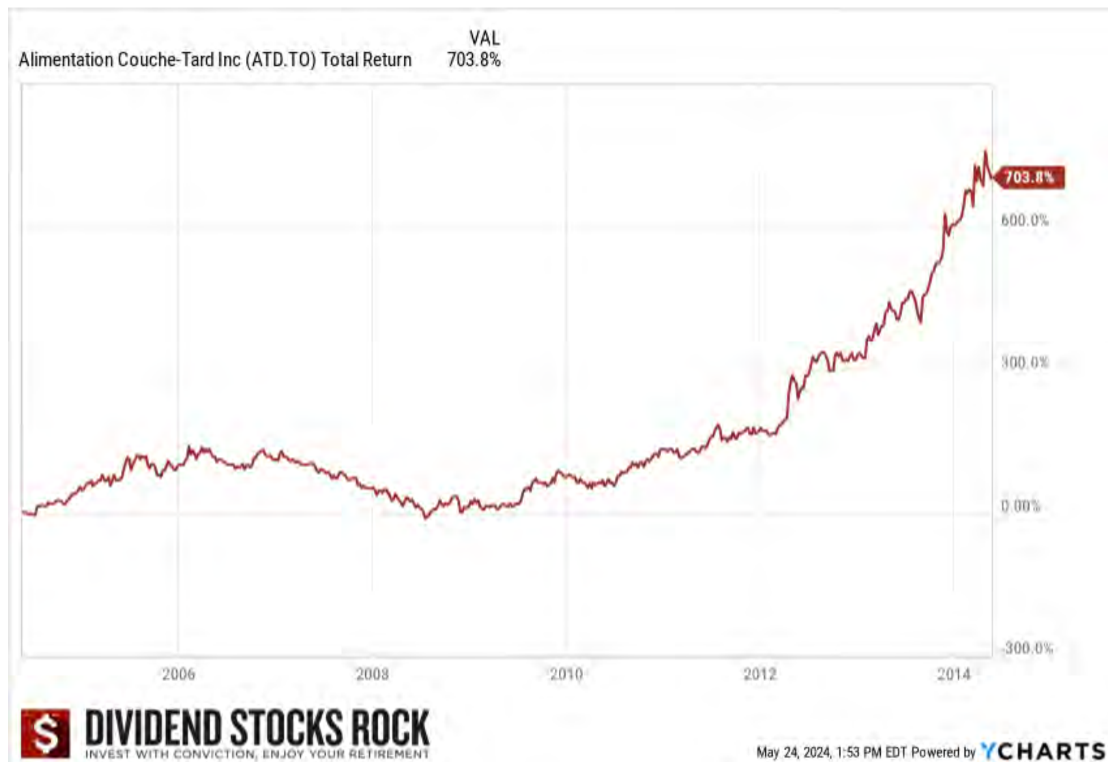


And I'll answer: *"That's also what investors said 10 years ago"*



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Please remember the research about buying at an all-time high earlier in this newsletter. Paying a “high price” is not always bad, but it doesn’t mean you should completely ignore valuation, though.

How can you fix it?

First, valuation is relative to a context and to a company. Therefore, you can first determine if you are paying a ridiculous price by comparing the company’s PE ratio with its 5-year average and do the same thing with its dividend yield.

In general, a company will trade to a consistent multiple of its business and the earnings should make the price fluctuate (while keeping a similar multiple). The same phenomenon is observed with a company’s dividend yield (which tends to fluctuate in a small bracket overtime).

Fortunately for you, those metrics are available in the Stock screener, the Stock card, and the Stock comparison tool. There is no reason to not use this shortcut, right?

Then, the key to taking the focus away from valuation is to add more metrics and factors in your investment process. More details are included in the DSR buying process, which will be reviewed in the upcoming weeks.

When you focus on the company’s growth potential, you are less likely to wait for the “perfect price” which may or may not ever happen. I obviously wish I had bought Visa in 2009, but the second-best time to buy it was when I had money to do so in 2017.

FINAL THOUGHTS

I like to make use of the hiking analogy to describe our investing journey. We know where we start, we know a great deal about the road ahead, and we are certainly aware of our destination. However, we must face various challenges throughout our journey. We sometimes make bad decisions, and we must learn from them. As your hiking buddy, I hope this newsletter finds you well and helps you in the management of the potential pitfalls in your portfolio.

As the market continues to evolve with growth (i.e., breaking records pretty much each month!), you still have time to review your portfolio and make sure you are not making any of these invisible missteps. If you think of any other investing mistakes I should add in the future, let me know. As always, you are a great source of inspiration!

Take care,

Mike.

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