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Thinking about recency bias in today's market

The four most dangerous words in the investing world may be "It's different this time" – closely followed by "We are in a paradigm shift." Behind these catchphrases is a psychological phenomenon known as "recency bias." That's the human tendency to give greater importance to more recent events when trying to predict what may lie ahead. And it's something you need to know about as an investor.

Recently, things have been pretty good in the markets. Since the depths of the COVID-19 bear market, the S&P 500 Index has advanced some 300 days without as much as a 5% price correction. There are sound economic reasons for such robust markets and it is not an historical anomaly by any means. However, it's important to remind ourselves that recent events do not necessarily foretell what may lie ahead. In this article we discuss the recency bias in today's market, and how portfolio diversification and rebalancing can reduce its impact on portfolio performance. While today's market and economic indicators do not suggest anything of concern, we need to always be prepared for the next inevitable correction.

Take a moment to think back to how you felt during the depths of the COVID-19 market sell off in February-March 2020. You may have believed, quite naturally, that the market correction may persist for some time, and perhaps even decline

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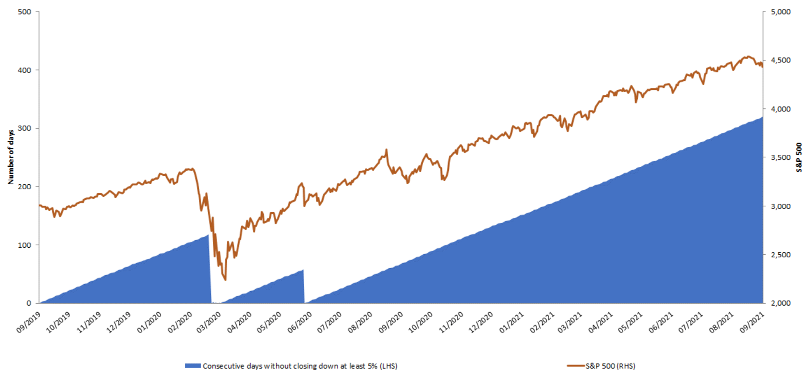
beyond the -35% recorded in the S&P 500 Index. That is a good example of recency bias, and it's why the sharp recovery in stocks and bonds that started in March took so many investors by surprise. With minimal disruption to the recovery since then (see Chart 1), it's important to be aware that recency bias could be creeping back into the narrative today.

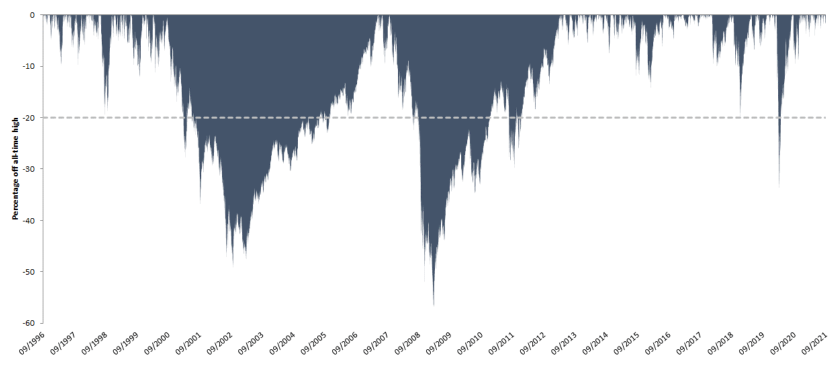
This chart looks at the S&P 500 Index and consecutive number of trading days between 5% corrections in the index from September 2019 until Sept. 15, 2021. The S&P 500 Index has now gone more than 300 consecutive trading days without a 5% correction, and 367 days without a 10% correction. While traditionally a market correction is considered a decline of 10% or more from the previous market close, 5% corrections are more common, and they can still cause some investor angst, especially when they have been less frequent. Have no doubt, the market can move higher and can persist even longer without 5% or 10% corrections. For instance, between Aug. 8, 2011 and Mar. 6, 2020, the S&P 500 Index went 2,158 trading days without a 5% correction. So today's approximately 300 trading days and counting does not seem like an anomaly by any stretch. Nevertheless, over a longer period of time, stock market corrections of 5% or more have been quite common and some have led to extended drawdown periods as well (see Charts 2 and 3 for both U.S. and Canadian stock markets).

Chart 1: Number of consecutive sessions for the S&P 500 without a +5% decline



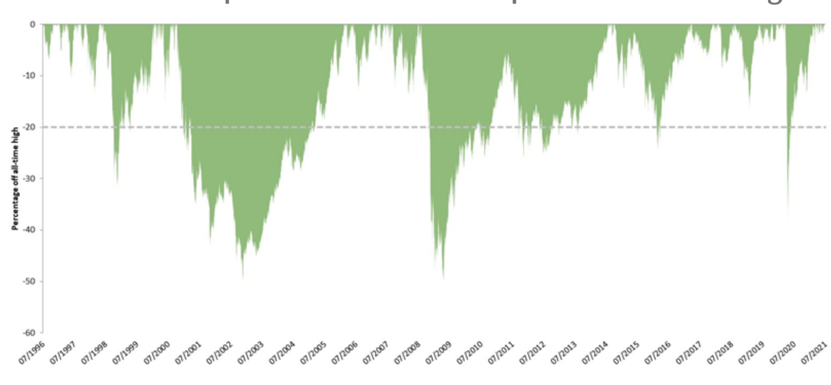
Note: As of 09/17/2021. Source: FactSet, RBC PH&N IC.

Chart 2: S&P 500 price drawdown from previous all-time high



Note: As of 09/17/2021. Dashed line represents bear market (drawdown of at least 20%). S&P 500 prices have been at least 20% off all-time highs 28.2% of the time since 09/17/1996. Source: FactSet, RBC PH&N IC.

Chart 3: S&P TSX price drawdown from previous all-time high



Note: As of 09/17/2021. Dashed line represents bear market (drawdown of at least 20%). S&P TSX prices have been at least 20% off all-time highs 27.5% of the time since 09/17/1996. Source: FactSet, RBC PH&N IC.

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None of this is meant to predict an oncoming correction or suggest that investors should try to time the market versus sticking with their long-term strategy. It's merely a reminder that markets can change direction at any time, and that corrections are quite common despite the more recent lower volatility period following the 2008 financial crisis. Investors need to be psychologically ready with a diversified portfolio that can withstand any market environment.

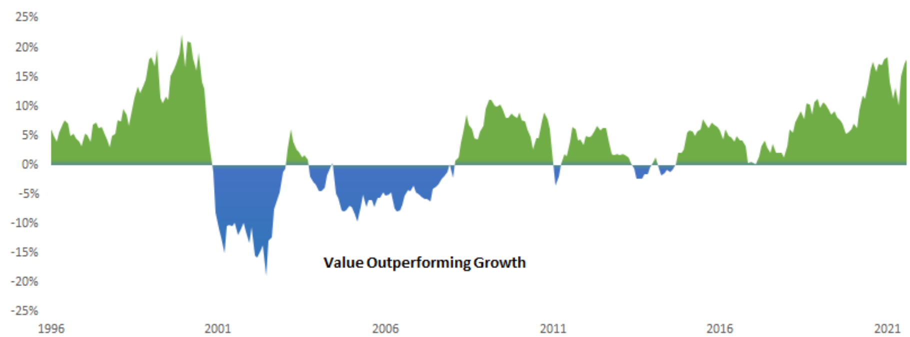
The case for continued strong equity market performance remains intact today. For instance, indicators related to employment, financial conditions, inflation, credit and consumer balance sheets all show positive trends. And they appear to be supported by growth expectations as vaccination rates across the world continue to climb. Relative to fixed-income markets, equity markets remain attractively positioned from an expected return perspective today considering the strong recovery from the pandemic lows of 2020, supported by lower real (after inflation) interest rates. In addition, strong corporate profits in Canada and the U.S. suggest support for continued employment and capital expenditures well into 2022 – even if corporate taxes and labour market inflation are headwinds to the outlook.

Despite these positives, there are four examples of recency bias worth highlighting.

1) Growth vs. value bias

Growth and value investing are two common, but very different, investment styles. Value investors are interested in stocks that appear to be undervalued, while growth investors tend to look for companies that offer strong earnings growth. Equity market indexes can be divided amongst growth and value stocks, as shown in Chart 4.

Chart 4: Relative Performance S&P 500 Growth vs. Value - 2Y Rolling Return



Sources: RBC PH&N Investment Counsel, Bloomberg. Please see disclosures for a detailed description of the indexes used in this chart. All data is time-weighted, in US dollars, before costs and taxes. Data series reflects monthly price data from Jan 1996 to Sept 2021. You cannot invest directly in an index and past performance is no indication of future performance.

Growth versus value as an investment strategy, justifications for either during different periods of market cycles, and the long-term merits of both strategies could be the subject of an entire series of articles. So we won't debate growth versus value in this article. Instead, we include the chart here which compares the two-year holding period returns for the S&P 500 Growth Index, relative to the two-year holding period returns for the S&P Value Index. What stands out most from this chart is that over the last 25 years approximately, growth and value have seen fits and starts of relative performance. Going back further in time would likely show more of a value dominance versus growth, for many reasons of which the inflation/ interest rate environment is one. The value rotation had been the main manifestation of the inflation trade in the equity space over the last year which isn't visible in the chart given we are looking at two-year return periods.

Recency bias may lead us down the road to assume that since growth investing has been outperforming value investing for some time now, at least based on the chart here, that we should continue to ignore any value approach in portfolio construction. Without any definitive means to accurately predict the timing of when one style like growth or value will do better than the other, proper portfolio construction techniques suggest exposure to each style according to your individual risk tolerance.

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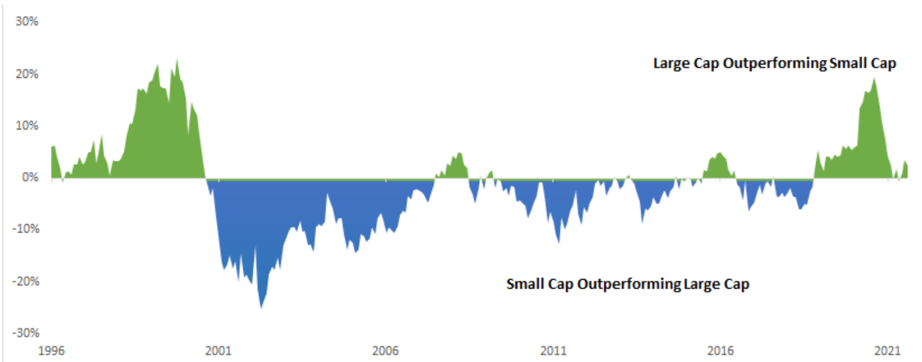
Chart 5: Relative Performance S&P 500 vs. Small Cap 600 Index - 2Y Rolling Return



Sources: RBC PH&N Investment Counsel, Bloomberg. Please see disclosures for a detailed description of the indexes used in this chart. All data is time-weighted, in US dollars, before costs and taxes. Data series reflects monthly price data from Jan 1996 to Sept 2021. You cannot invest directly in an index and past performance is no indication of future performance.

2) Large-cap vs. small-cap bias

A second example of recency bias some investors may have is towards larger cap exposure relative to smaller cap exposure. The term “cap” refers to market capitalization and is calculated by multiplying the price of a stock by its number of shares outstanding. It is considered a measure of relative size of a company. Large-cap stocks are generally those with a total market capitalization of at least $10 billion, while small-cap stocks are generally those companies with less than $2 billion.

Large-cap stocks are generally considered less risky as they tend to be companies that are very stable and dominate their industry. Small-cap stocks are generally considered to be riskier but can be more profitable. Many small caps are young companies with significant growth potential but also a higher risk of failure, relatively speaking. In the U.S. equity market, small-cap stocks can offer investors additional exposure to the recovery in services spending post-COVID, and are considered relative beneficiaries of an infrastructure spending trend as well. Relative company valuations between large-cap and small-cap investments is an additional consideration for investors, which today would favour small caps.

Similar to the previous growth versus value discussion, a properly diversified portfolio with exposure to both large-cap and small-cap companies is appropriate given nobody can consistency predict the timing and magnitude of any one of these doing better than the other. While Chart 5 suggests the degree of more recent large-cap outperformance has narrowed, we cannot accurately predict whether that trend continues, or changes direction. Individual investor preferences and risk tolerance need to be considered when deciding on the allocation to each style.

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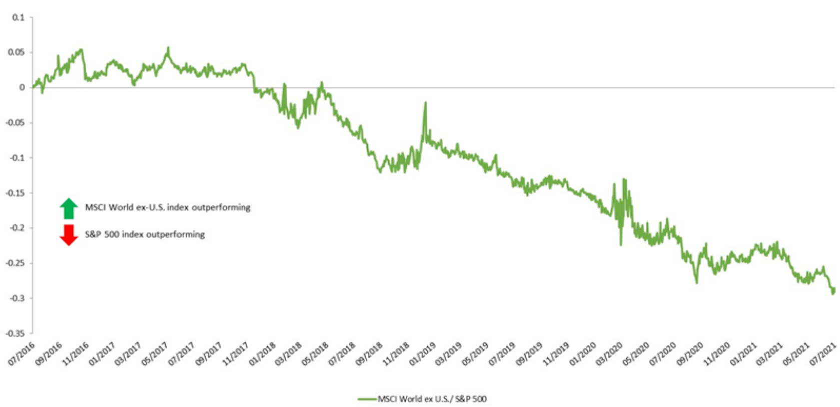
3) U.S. vs. the rest of the world bias

Stock performance in the U.S. market has outpaced the rest of world for the last five years as shown in Chart 6. A relatively higher weight in the strong performing technology, communication and consumer sectors in the S&P 500 Index versus the MSCI World ex-US Index is one reason why.

Chart 6: MSCI World ex-U.S. relative performance to the S&P 500 index

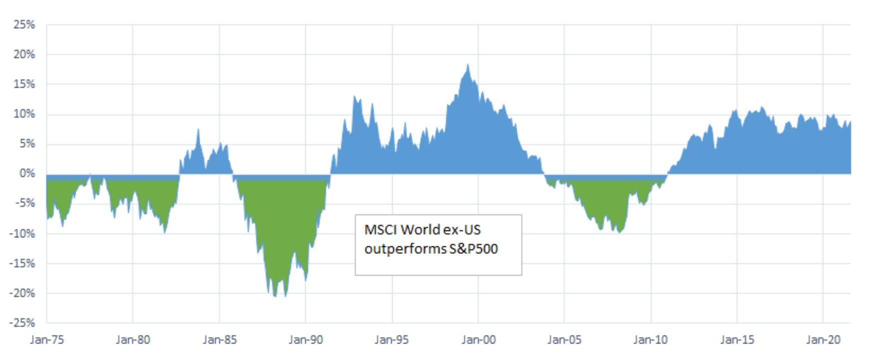


Sources: RBC PH&N Investment Counsel, Bloomberg. Please see disclosures for a detailed description of the indexes used in this chart. All data is time-weighted, in U.S. dollars, before costs and taxes. Data series reflects monthly price data from July 2016 to August 2021. You cannot invest directly in an index and past performance is no indication of future performance.

It's important to note that this period of relative performance may change direction at some point as shown in Chart 7 which looks at relative five-year returns between the U.S. equity market and the rest of world from January 1975 to September 2021.

It's difficult to say for certain what may change the direction of U.S. equities versus the rest of the world in the future. But that's exactly the reason for diversification, isn't it? We build diversified portfolios because nobody can persistently predict the future over time.

Chart 7: Relative 5-year annualized return, % S&P 500 Index vs. MSCI World ex-U.S.



Sources: RBC PH&N Investment Counsel. Bloomberg. Data is price returns, time-weighted, in US dollars, before transaction costs and taxes. Data series is Jan 1975 to September 2021. Past performance does not indicate future performance, and you cannot invest in an index. Please see disclosures for a full description of indexes referenced.

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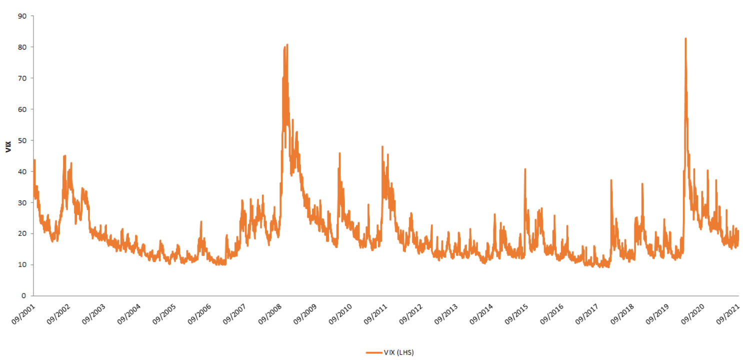
4) Low volatility bias

Following heightened price volatility during the brief depths of the COVID crisis of 2020 (see Chart 8), volatility has for the most part been somewhat subdued. The Cboe Volatility Index (VIX) shown in the chart is a real-time index that represents the market's expectations for the relative strength of near-term price changes of the S&P 500 index. Because it is derived from the prices of SPX index options with near-term expiration dates, it generates a 30-day forward projection of volatility. Volatility, or how fast prices change, is often seen as a way to gauge market sentiment, and in particular the degree of fear among market participants. The higher the VIX (%) the higher the implied forward volatility, and vice versa.

Chart 8: VIX: CBOE Volatility Index



Source: RBC PH&N Investment Counsel, Bloomberg, Factset. Please see disclosures details on the VIX index. Data series is from September 2001 to September 2021.

Looking at the historical VIX index, we can see two distinct periods of heightened volatility (2008 and 2020), along with several other periods (2010, 2011, 2015, 2017, 2018) which were not as damaging to equity returns in the given period, but they all negatively impacted investor sentiment. There are many reasons for the dampened or low volatility over time: stable geopolitical environments, low real interest rates, investors underexposed to stocks with too much cash forcing them to buy market pullbacks at any time, central bank monetary policy/communication of policy, demographics, etc. It's important to note that a low VIX index measure may not necessarily mean investors are completely complacent either.

Nobody can accurately and persistently predict the next stage of volatility to come, which is another case for diversification to avoid recency bias and complacency in your portfolio.

The recovery from the COVID-19 bear market has been remarkable, and for good reason. However, we caution investors that as expectations change, so too could the direction of the stock and bond markets over time. It's never really "different this time" despite what some of the pundits might tell you. So instead of exposing your portfolio to the downside risks of recency bias outlined in this article, ensure your portfolio reflects an optimal level of diversification that is tailored to your unique circumstances and risk tolerance. Also, ensuring you are following a disciplined portfolio rebalancing process is critical to reducing recency bias in your portfolio.

If you have any questions about this article, please reach out to your Investment Counsellor at any time.

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Required Disclosures:

S&P 500 Index: The S&P 500 Index includes 500 companies across many sectors of the U.S. economy. The index is weighted by market capitalization so bigger companies make up a larger proportion of the index than smaller companies. The index is designed to measure performance of the broad US economy through changes in the aggregate market value of the largest US companies.

S&P 500 Growth Index: The S&P 500 Growth Index is a stock index administered by Standard & Poor's-Dow Jones Indices. As its name suggests, the purpose of the index is to serve as a proxy for growth companies included in the S&P 500. The index identifies growth stocks using three factors: sales growth, the ratio of earnings change to price, and momentum.

S&P500 Value Index: The S&P 500 Growth Index is a stock index administered by Standard & Poor's-Dow Jones Indices. They measure value stocks using three factors: the ratios of book value, earnings, and sales to price. S&P Style Indices divide the complete market capitalization of each parent index into growth and value segments. Constituents are drawn from the S&P 500.

S&P Small Cap Index: The S&P 600 is an index of small-cap stocks managed by Standard and Poor's.

It tracks a broad range of small-sized companies that meet specific liquidity and stability requirements. This is determined by specific metrics such as public float, market capitalization, and financial viability among a few other factors.

Canada S&P/TSX Composite: Comprises the majority of market capitalization for Canadian-based, Toronto Stock Exchange listed companies. It is a benchmark used to measure the price performance of the broad, Canadian, senior equity market. It was formerly known as the TSE 300 Composite Index.

MSCI World ex-US index: The MSCI World ex USA Index captures large and mid-cap representation across 22 of 23 Developed Markets (DM) countries excluding the United States. With 934 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

Cboe Volatility Index (VIX Index): The VIX Index is a calculation designed to produce a measure of constant, 30-day expected volatility of the U.S. stock market, derived from real-time, mid-quote prices of S&P 500 Index call and put options. On a global basis, it is one of the most recognized measures of volatility -- widely reported by financial media and closely followed by a variety of market participants as a daily market indicator.

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