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Stu's View

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Hindsight is 20-20 – lessons to be learned

Each year in early January we find ourselves drowning in a sea of predictions and forecasts about what is to come over the next 12 months for the markets and economy. Human nature pushes us to listen to such predictions and make our own predictions. This is often driven by our own psychological need to reduce stress and uncertainty. As it happens, investing is all about risk and uncertainty, so seeking out predictions about the market seems reasonable. But is it a useful exercise?

I'll be upfront and tell you that you will not find any short-term predictions here. While I do not wholeheartedly discount the process of looking out over the next year and trying to guesstimate what could, or could not, happen, for most investors this exercise will yield few prizes, in my view. I would go so far as to say that such short-term predictions can be downright dangerous for investors to play out in their portfolios from one year to the next.

The success rate of short-term (i.e. one year) forecasts for equity markets is certainly up for debate. As shown in the chart below, there is a considerable discrepancy between the expected returns provided by Wall Street strategists for the S&P 500 Index at the beginning of any given year, and the actual returns of the index in that year.

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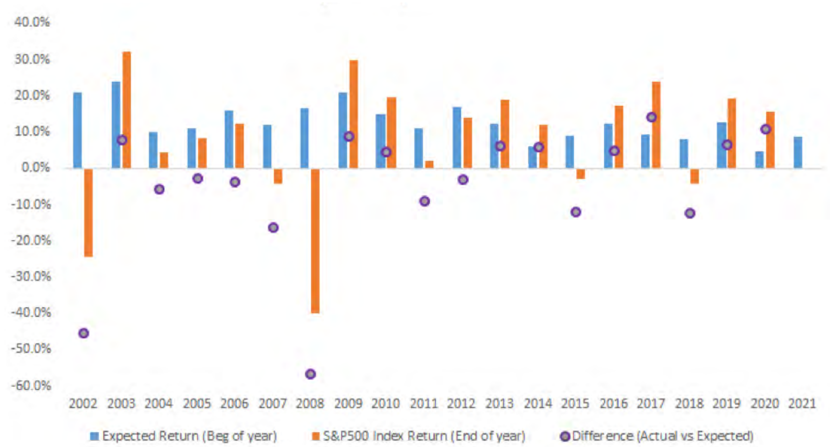
Clearly taking the advice of the experts has its flaws, especially if you are adjusting your portfolio from one year to the next on these forecasts. While the chart only captures the Wall Street forecasts at the beginning of each year, note these estimates for what the index will do over the calendar year are usually not static. They change over the course of the year, and can change dramatically based on the trend in the market narrative. Despite the flaws in the approach and the track record as shown in Chart 1, investors still look to the experts for their opinions. We do this because we are forever looking to diminish risk and uncertainty in any form in our lives. Investing, as we all know, is about risk and uncertainty. So it isn't a surprise that investors search out expert opinions even if the exercise does not yield positive results.

Forecasts for the coming year are, in large part, formed based on what the market did in the last year, either with respect to earnings growth, or changes in valuation expectations. But empirical data tells us another story. From one year to the next, the previous year's returns have no bearing whatsoever on the outcome of the coming year. As detailed in Chart 2, the correlation between the previous calendar year returns and the coming calendar year returns is 0.01. From our Statistics 101 course we know this implies that there is pretty much no relationship between the two variables.

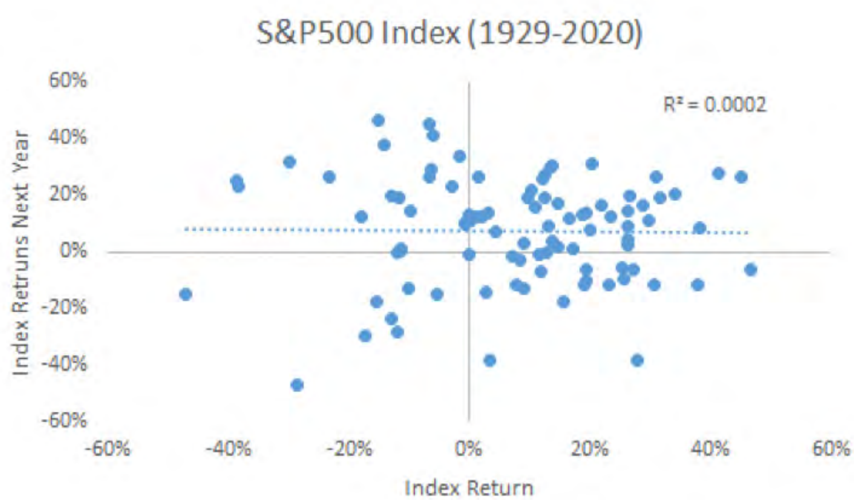
Despite the statistical evidence presented in Chart 2, I believe there are still valuable take-aways from 2020 for investors. Keeping track of how we and the market (i.e. other investors) reacted to certain events, and what risks still lie ahead in the mid/long-term as a result of the pandemic, are worth considering.

Chart 1: One-year projections for S&P 500 Index returns versus reality



Source: FactSet, RBC PH&N Investment Counsel. You cannot invest in an index. For a complete description of the S&P 500 please see the appendix. All prices are in local currencies, returns are time weighted and gross of fees, and dividends reinvested. Expected Return (beg of year) consists of the aggregate forecast expectations submitted by brokerage firms at the beginning of each calendar year. S&P 500 Index Return is the index returns measured over the first trading day of the calendar year to the last trading day of the calendar year.

Chart 2: S&P500 previous calendar year return (x-axis) and subsequent calendar year returns (y-axis)



Source: FactSet, RBC PH&N Investment Counsel. You cannot invest in an index. For a complete description of the S&P 500 please see the appendix. All prices are in local currencies. Returns are annual, time weighted and gross of fees, and dividends reinvested.

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Lessons learned from 2020

So much happened in 2020 – some of which we may not want to remember, and some providing lessons worth their weight in gold. To quickly review, we saw the worst global health pandemic since 1918, the largest drawdown in markets since the crash of 1929, the largest "peacetime" stimulus package unleashed on a global scale, historically low real interest rates, negative future oil prices for a brief period of time, and a rebound back to all-time highs for some markets in the final months of the year. All of this drove record price volatility.

I am a big proponent of process, especially when it comes to investing. There simply isn't any other way to do this. One part of a well-tuned investment process is the post-mortem, which is essentially retrospection for continuous improvement. As part of the post-mortem process that should be done at regular intervals (ideally annually, if not bi-annually), you ask yourself what went wrong, what went right, what could have been avoided in order to improve outcomes the next time. The following are some of my lessons learned in 2020.

1. **Sometimes even the "known" unknown risks are difficult to forecast.** COVID-19 surprised the markets in early 2020 when it became clear the global economy was about to enter a very swift and deliberate recession. While some subject matter experts warned of a global health pandemic, the timing and magnitude were very uncertain. Maintaining discipline, following a systematic approach to portfolio rebalancing and adhering to one's goals and objectives were lessons learned.

2. **Embrace central bank policies/ outlook rather than resisting them.** This is also referred to within the investment industry as "Don't fight the Fed." It means that positioning for rising interest rates and tightening monetary policy is in contradiction to the current outlook for the U.S. Federal Reserve, and hasn't resulted in excess returns for investors. Central bank policy will change at some point in the future, but timing of the change remain uncertain. Similar to lessons learned in 2008, we saw in 2020 that swift action by global central banks to provide liquidity, combined with trillions of dollars of fiscal stimulus, served to ensure the economy didn't fall off the rails.

3. **Maintain a certain level of portfolio liquidity at all times.** This ensures we don't have to sell at inopportune times, and could provide the ability to buy investments "on sale." The catchphrase of "going all-in" never makes sense when it comes to your portfolio. Allocations to cash and other liquid investments, as well as bonds are an essential part of a properly diversified portfolio. 2020 performance should have made this abundantly clear to most investors.

4. **Markets are complex, adaptive systems that are forward looking.** At the depths of the negative headlines in March, the equity and bond markets were starting to bottom, aided by central bank liquidity and fiscal stimulus provided by government bodies around the world. These were lessons learned from the Great Financial Crisis of 2008, and allowed the market to look through the "valley" of earnings declining to the other side of the eventual recovery. Last year we wrote about how sometimes there is a disconnect between how we see the economy (where indicators can lag) and the performance of financial markets, which tend to be more forward looking. This disconnect was very apparent in 2020, and serves as a good reminder of how market sentiment can function even during bear market corrections.

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5. **Timing the market doesn't work.** Dollar cost averaging (DCA) is the only market-timing tool you need to be concerned with. DCA essentially is an autopilot discipline of regular investing which remains underappreciated by most investors. As a market-timing strategy, it ensures investors benefit from market volatility like we saw in 2020, to become more aggressive buyers when the market is "on sale" and more disciplined buyers when the market prices recover and reach new highs. DCA ensures that you don't need to know what happens next in the market. Also, 2020 made it clear that trying to cherry-pick out-of-favour asset classes and investment styles is not an easy game either. Value, small cap and foreign equities all staged rallies at points during the year, but the volatility was not for everyone. Portfolio diversification and patience were lessons learned.

6. **Be a short-term pessimist, but a long-term optimist.** Full disclosure: I am a reformed pessimist. I work hard at always keeping an eye on the long-term trend, while being mindful of what may lie right in front of me both in terms of risks and opportunities. Pessimism is counterintuitive when you really break it down. It rests on the notion there is no solution to the crisis, for which there is no historical precedent and tends to extrapolate the problem in a straight line, while holding the potential solution (human ingenuity/will) constant. On the other hand, optimism is the only view of the future that squares with the past. To be a pessimist means you have to believe not just in the possibility but in the probability of something that has never occurred. While the pace of inoculations isn't as fast as we would all prefer, the speed of development of multiple vaccines and the distribution of them when compared to the past is quite remarkable. Lesson learned would be don't discount human ingenuity and innovation despite the enormity of the situation at hand. We will get through this.

7. **Be humble.** I think we all took away a slice of humble pie when it comes to investing after going through 2020. The speed and magnitude of the market correction after March took many by surprise, and potentially left a number of investors on the sidelines who voluntarily or otherwise moved money out of "risk" assets (e.g. stocks) into cash, potentially as a result of having a portfolio that was not aligned with their risk tolerance. The market volatility seen in 2020 could easily repeat itself, so if there was real discomfort with that level of volatility, perhaps revisiting the mix of equities, fixed income, alternatives and cash is a good idea.

Market headwinds worth noting

While we remain steadfast with respect to the long-term outlook for equity investments, we are not oblivious to the near- or mid-term headwinds potentially facing investors. Time horizon is specific to each investment and investor, so these noted risks may or may not be that relevant to you. They may or may not be resolved during 2021, but I suspect I could be writing about most of them again in next year's note.

To be certain, these are known risks, meaning that they have formed part of the market narrative at some point. So they are not unknown risks, which pose a higher risk to portfolios. As such, they may or may not currently be priced into assets at the moment.

- **Rising inflation:** I expect to continue to report back to you the changes to the outlook for inflation as we look out into the coming years. At this point I am more certain that it's a matter of when and not if inflation poses a risk to investors. The data is mixed with respect to the potential drivers of inflation. One thing is clear as far

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as I am concerned, the consensus expectation for inflation to remain stagnant for years to come bears watching closely as aggregate asset mix decisions have yet to reflect above-average inflation making an appearance.

- **Pockets of speculation and excess:** This is always a difficult game to weigh in on, and traditionally it's been easier to point out there are areas of excess in the market. It's exponentially more difficult to try and pin down the timing of these excesses being resolved. As of the time of writing, Special Purpose Acquisition Companies (aka SPACs) and Bitcoin seem to be two such examples of potential excess investment or speculation. SPACs are essentially "blank cheque" companies – shell companies that use the cash raised in their initial public offerings (IPOs) to buy a privately held company and take it public. They dominated the IPO scene in 2020, having raised $82 billion in 2020, a more than six-fold increase from the year before and a figure greater than all of the money previously raised, according to the Wall Street Journal. Reasons for the sudden "boom" in SPACs include ultra-low interest rates, which force investors up the risk curve looking for incremental expected returns, and they are a potential shortcut for private companies looking to go public. SPACs provide private companies a lower-cost and faster path to public markets that endures less scrutiny than a traditional IPO, since they are going public via an acquisition or merger instead of an independent IPO. Bitcoin and cryptocurrencies experienced extraordinary gains over the last year, and they are a subject worthy of a separate note all together. As such, I'll only foreword my future comments with this: there is reason to be cautious with these assets while respecting the potential they hold for long-term investors at some point in the future.

- **Paying the bill for the crises.** We all dislike the moment when the waiter presents the table with the bill for the meal consumed. We all know that it is coming but it seems to nevertheless leave us with an awful taste in our mouths. Governments around the world have provided much-needed fiscal stimulus over the last year with respect to filling in the gap between the recession and the eventual recovery. But we all know that at some point somebody (i.e. the taxpayers) will have to pay the tab. I expect this isn't happening any time in the coming years, but higher taxes and/or reduced spending in the future seems likely to me.

- **Commercial real estate – what does the future hold?** COVID-19 is affecting commercial real estate markets globally, and the recession will have impacted demand to a degree with retail likely being the hardest hit sector while logistics and the outlook for warehousing remain relatively robust. Easing financial conditions which have been supported by global central banks will provide a cushion to commercial real estate values. A short-term recovery (particularly for retail, restaurants, travel and a return to the office) will be driven by the speed and effectiveness of the vaccine. Over the mid to long term, once COVID is behind us, the key secular trends of livable urbanization, population growth and technology-centered job growth will again become key drivers reinforcing the long-term value of real estate. Canada is particularly well positioned on each of these factors. On commercial real estate in Canada – quality matters. Exposure to urban markets of Toronto, Ottawa, Montreal and Vancouver are essential, as they are contain large numbers of skilled workers, and are well positioned to benefit from the eventual economic recovery and growth. The long-term outlook for real assets, including real estate, remains attractive on a risk-adjusted basis. We remain confident in the long-term resilience of neighbourhoods and Canada's major cities, as well-located real estate will always be needed, even if the specific use of individual assets may shift over time.

Past articles counseled that following a disciplined investment process means adhering to diversification principles, systematic portfolio rebalancing, and dollar-cost averaging. This process tilts the odds in your favour of reaching your goals and objectives by keeping you invested and allowing your portfolio to do what it is supposed to do, which is grow over time through the magic of compound returns, unabated to the best of your ability and life's uncertainties. In hindsight it seems obvious, or perhaps even boring. Yet it has worked in any market environment over time.

I hope that you and your family remain in good health and wish you all the best for 2021. Please reach out to your Investment Counsellor if you have any questions or concerns.

Be well,
Stu

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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.

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