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2020 Review

Not the Worst Year Ever

State of Alarm

A big part of my job, maybe the most important part, is helping clients maintain the underlying confidence integral to successful investing over the long term. If you do not believe that the world is a much better place than it was even 20 years ago, and that civilization's progress is likely to continue for some time yet, then investing makes little sense.

However, human nature being what it is, progress is never smooth; no block of time is a duplication of a past one. The anomalies that pop up and disturb our view of things make the real world different from what we think it should be. The unfolding future occasionally requires force of character to maintain course – or change course, as the situation requires. The world is a scary place, and courage is required. And so investing is an endlessly fascinating undertaking.

In 2020 the equity markets saw a spectacular 34% decline in only 30 days, and since then we have been personally derailed and completely dominated by the public policy response to the pandemic. News has been hyperbolically negative, compounding the already significant stress of lockdowns. At least one writer asked if 2020 was the worst year since the concentration camps and atom bombs of 1945.

One of the interesting features of financial markets and economic development is that the good news accrues gradually, over decades. New inventions are refined and put to use as their utilities are discerned by experience. New ways of doing things are discovered and implemented as our perceptions and social norms adapt.

Most importantly, the Enlightenment emphasis on the individual person as the locus for rights – and responsibilities - underpins the free-enterprise society that has delivered so much: life expectancy has increased from around 40 in 1850 to almost 80 today, while delivering material goods and services to average citizens undreamed of by kings and queens of only 100 years ago.

A child's cellphone puts more computing power than an Apollo moon mission and almost all the information in the world at her fingertips – things not only undreamed of 40 years ago, they were inconceivable.

This progress in health and wealth is reflected in the growth of the markets longer term: $1,000 invested in the US market in 1945 would be worth $230,000 in real purchasing power terms (after inflation)[1]; before inflation it would be worth a staggering $3.3 million, according to officialdata.org. On a shorter time horizon, since 1980 $1,000 invested in the US market would have almost tripled to over $2,900 in real purchasing power terms; in today's dollars it would have become over $94,000.

This gradual accumulation of wealth and economic progress is punctuated nevertheless by dramatic setbacks: a dozen times since WWII bear markets have driven financial markets down on average by 30% and by as much as 57% peak to trough in 2009. These bear market declines are often like multi-car pileups on an expressway: triggered by a surprise or anomaly such as a trebling of interest rates or oil prices, regional war, or just a cyclical correction of overpriced assets, a relatively minor economic event cascades through people minds, producing an emotion-driven overreaction, causing prices to fall sharply before recovering and continuing on their trajectory upward and to the right.

Economic and other crises also punctuate the development of countries, but the cycle is usually longer than the average bear market. Some countries, unlike equity markets, are badly derailed by their crises and can take much longer to recover. Greece borrowed its way to the edge of oblivion in 2012. Venezuela, with the world's largest oil reserves, has been economically destroyed by socialist folly.[2] Japan's equity market has not recovered from its real estate bust 30 years ago.[3]

Bad news is a series of loud bangs, while progress accrues slowly and silently. The result of negative shocks is a biased narrative of negativity in the daily news. We are hardwired to hear 'Wolf in the forest!' We are deaf to 'No wolf in the forest today'. Our instinct is to feel fear when others do, yet investing with the herd begs a 'Big Mistake'.

Younger people's investment errors are frequently the opposite, but just as fatal. Inexperienced investor psychology is usually dominated by, 'I don't see a wolf', or 'I'm smarter than a wolf'. The result is still a 'Big Mistake'.

If you are interested in how this psychology of a Big Mistake – which seems so trite or obvious – can lead to calamitous investment errors, you might re-read 'The Science of News' in Resources at www.chrishoran.ca.

Herewith, a number of observations and fearless forecasts[4] to sparkle up your forward-looking view of 2021.

First, the virus. The spectacular ramp-up in vaccine production will stop Covid-related mortality in its tracks. It may seem bold to say at this point, in the middle of the Second Wave, but the vaccines will do their job. Already (late January) the US has applied more than 25 million doses, at least one dose to over 7% of the population, according to Our World in Data. This is the equivalent of half the population over age 65.

Data clearly shows that over 90% of Covid-related mortality is people over age 60; about 75% has been in nursing homes, and a large percentage of all deaths having co-morbidities notably obesity and cardio-pulmonary issues. The point is that the cohort with the highest risk is a very small percentage of the total population; when nursing home staff, hospital, and other front-line workers are vaccinated, the Covid-related mortality will stop.[5] There will continue to be cases, lots of them, particularly among younger people, but mortality will plummet.

You won't see it in your newsfeed. Cases, mutations, and heart wrenching stories about the tiny fraction of ongoing Covid-related mortality will continue to dominate news media until well after the pandemic is over. This is the curse of our addiction to news.

The pandemic has brought to light certain aspects or issues that will deserve thoughtful discussion and honest leadership. Spending half a trillion dollars in Canada alone to support lockdowns while accomplishing zero improvement in LTC protection, ICU or acute care capacity, is one. The refusal of many 'remote northern communities' to be vaccinated, resulting in the shocking wastage of vaccines, at great expense and effort to help these so-called 'at risk' communities, is another.

Second, the markets had a pretty good year. If you left the planet last January and returned today, you'd think the last 12 months had been pretty good.

The chart below shows the US market was up 19%, driven as previously discussed by the technology giants, with Canada lagging again at 4.4% because we don't have a technology industry of any significance, and our heavy exposure to banks, energy and other resources. Small caps in Canada and the US also had good years, with those indexes up 16% and 17% respectively.

Bonds also did well across the board, driven by sharply declining interest rates as central banks again forced rates lower (bond prices move in the opposite direction to interest rates).

These results show once again the folly of trying to avoid downside volatility by trading in the midst of a storm – the market decline burst from a clear blue sky, and the rebound was equally surprising. Anyone who sold into the Covid panic has been painfully wounded.

Third, global progress. According to the Brookings Institute, a think tank, we have passed a tipping point where 3.8 billion people – half the world's population – have reached the middle class or higher. For the first time ever, more than half the population of the world are no longer poor or in extreme poverty. Credit goes mostly to China, where more than 1 billion people have lifted themselves out of poverty as that country adopts more individual initiative and a market-driven economy. It's a monumental accomplishment.

China seems to have recovered from the Coronavirus shutdowns, and economic growth has resumed in the 6%+ range. This growth rate would double the size of the Chinese economy in only 12 years. Since China's economy is now larger than the US economy in purchasing power terms, doubling would add the equivalent of an entire US economy to the world.[6] Aside from the humanitarian achievement, the potential for mutual benefit in trade could lift the world to new heights of prosperity.

Investment Markets in 2020

The chart below shows the returns from the major fixed-income and equity indexes for the last 20 years. As usual, the numbers contain some very interesting stories. They also tempt some inferences that might seem fairly obvious but would be very wrong.

Annualized Total Returns in CAD to December 2020

	1 Year	5 Year	10 Year	20 Year
S&P 500	16.1%	13.3%	16.7%	6.7%
US Small Cap	17.6%	11.4%	13.9%	9.3%
S&P/TSX	5.6%	9.3%	5.8%	5.9%
S&P/TSX Small Cap	12.9%	8.8%	1.3%	7.7%
MSCI World	14.5%	10.9%	13.3%	5.8%
MSCI EAFE International (EAFE)	6.4%	6.1%	8.7%	4.1%
MSCI EM (Emerging Markets)	16.6%	11.3%	6.6%	9.0%
Canada Bond Universe	8.7%	4.2%	4.5%	5.4%
US High Yield Bond	5.1%	7.2%	6.5%	7.0%

Source: 1, 5 and 10 year data from RBC GAM and 20 year data from Tacita Capital as of December 31st, 2020.

The equity index 20-year numbers contain 3 full bear/bull market cycles. The tech crash that began in March of 2000 and the financial crisis of 08-09 took the US market down 50% and 57% respectively, while the Covid bear market of 2020 was a more middling 34% decline. The three cycles work out to a compounded 20-year return for the US market of 6.7%/yr, and Canada at 5.9%.

While Canada and the US returns aren't terribly different over 20-years, you can see over the last 10 years the US has been quite strong at 17%/yr while Canada is only 5.8%/yr. This tells us that the opposite must have occurred in the first 10 years: Canadian markets had a decent run from 2003 to the financial crisis in 2008 as China's rapid modernization drove strong resource prices. Since the financial crisis, however, Canada has struggled, and as of January 2021 is only 18% above its 2008 high while the US market is almost 170% above its pre-crisis 2008 high.

Bonds, Again

You might be tempted to see the 20 year bond market returns at 5% - 7% as very similar to equity market returns in virtually the same range, and you'd be correct, in a limited way. You might also conclude that bonds are a good investment and deserve a large allocation in your portfolio, since the volatility of bonds is much lower than stocks.

But it would be a dangerous conclusion. Bonds have been good – very good. But in the investing world, the same song never plays twice.

Bonds have been in a bull market since 1982. A massive, once in a lifetime, never-to-be-repeated[7] bull market, driven by interest rates declining from 19% in 1982 to almost zero today. Bonds go up when rates go down. So the bond data captures 20 of the best 40 years for bond investing in the last 1000 years[8].

Equities, by contrast, have seen at least 6 declines of 20% or more since 1982. Equity prices are driven by the emotions of the daily news cycle projecting the panic du jour into the infinite future. The 20-year data above includes some of the worst returns ever for stocks: it begins with two successive epic bear markets that took equity prices down 50% and 57% respectively from 2000 -2013, making that period one of only three times in the last 100 years where stocks went nowhere for 12+ years[9].

All this is through the rear-view mirror. Skill-testing question: what is the probability that bonds will see a return anything like 5 – 7%/yr annualized over the next 5, 10 or 20 years? Hint: interest rates would have to go back to 19% first…

My advice: Investors should hold the minimum allocation of bonds required to mitigate volatility and provide liquidity for withdrawals; longer time horizons and stronger stomachs for volatility can have no bonds.

Your advisor is one of the few in Canada to have the returns from a client account tracked by an independent 3rd party consulting firm for almost 20 years. This $3 million pension fund account has followed a balanced mix of stocks and bonds, based on my advice exclusively, and using the same portfolio managers as you (and me personally). Many of you will have similar portfolios and will have experienced similar returns. The annualized returns are compared below to peers in the equity- and income-oriented balanced fund categories.

	1 Year	3 Year	5 Year	10 Year	Inception
Pension Fund	10.0%	6.4%	7.2%	7.3%	6.6%
Balanced Equity	8.1%	5.8%	6.3%	6.7%	n/a
Balanced Income	6.7%	4.5%	4.3%	4.7%	n/a

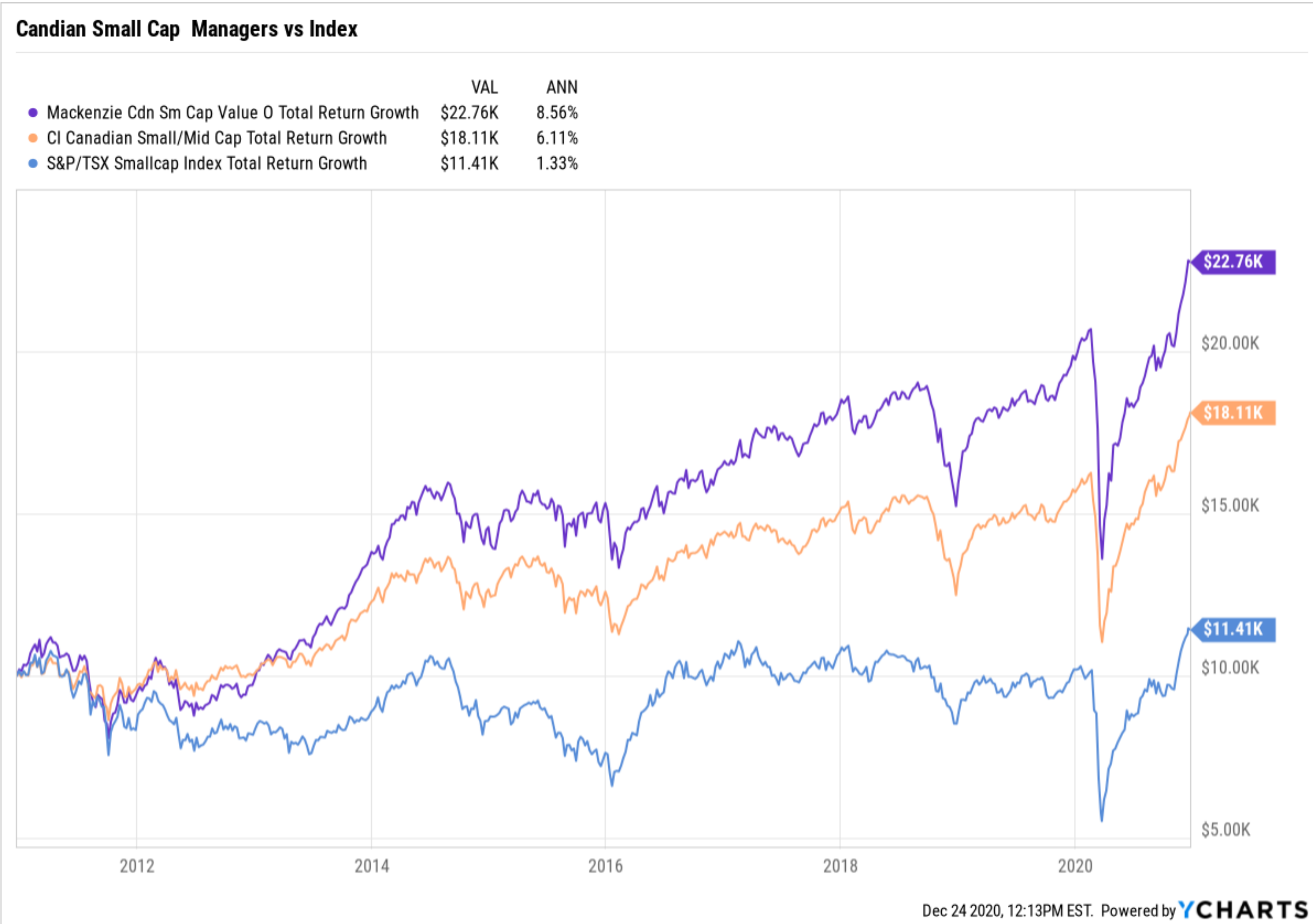
Returns annualized to December 31st, 2020; Peer group data from Morningstar; returns net of fees; inception = March 1998.

Managers vs Index

You might hear a lot these days about equity managers not beating the index.

The chart below shows two Canadian Small Cap managers vs the index over the last 10 years. You likely have one of these managers in your portfolio. The Mackenzie manager, Scott Carscallen, posted a return of 8.6%/yr, and Picton Mahoney/QV Investors at CI was 6.1%/yr, while the index languished at 1.3%/yr for 10 years.

Note that the managers' returns are after fees, while the index is a theoretical return with no fees subtracted (fees would apply to invest in the index) which makes the managers even better.



10 Years, 2010 - 2020

The reason the managers were able to do so well against the index is their asset mix was different from the index, notably by avoiding mining and energy stocks, which dragged the index lower especially in 2015.

The opposite happens from time to time as well. In 2020 the US market was dominated by the FAANGs[10], which went to the moon and left many investment managers spluttering in the dust.

But indexes aren't so simple – nothing in investing is. Most indexes are constructed in such a way that the largest companies by market value are given the greatest representation in the index. This means as a company's share price goes up, it gains more weight in the index, and index followers are required to buy more, thereby driving an upward spiral. As long as things keep going up, the index looks smart.

The problem happens when the music stops. It may only happen once in your investing life, but the magnitude and duration of the damage can be greater than your investing life can withstand. For instance, from its last epic peak in March 2000, the NASDAQ index lost a staggering 80% of its value over three years to 2003, and from that peak has only caught up to the broader S&P500 index in 2020 – 20 years later. You pay a high price for a cheery consensus. (YCharts data, S&P500 vs NASDAQ, 3/2000 – 12/2020, dividends reinvested)

If it were simple, everyone would be rich.

Notable Extremes

Airbnb Some people are betting on a big time recovery in the travel market. Airbnb's initial stock offering more than doubled on its first trading day in December from US$68 to US$144. This gives it a total market value (called market capitalization) of just over US$100 billion, in the same league as General Electric, Caterpillar Tractor, Goldman Sachs and TD Bank.

The Financial Post reported that Airbnb's Q3 results were 'the most profitable ever', which sounds good. They didn't publish the Q3 numbers, but it must have been really good because the 9-months including Q3 was a loss of almost $700 million on revenues of $2.5 billion. (Same period last year was a loss of $325 million on revenue of $3.7 billion.)

I may have missed some math somewhere but I'm not sure how you get the 'most profitable 3 months ever' and still have 9 months of losses.

Pot Stocks The smoking-hot cannabis fad of a couple of years ago has burned itself out (sorry). Of the 20 largest pot stocks by market cap in 2018, all but 5 had serious declines in share price by October 2020 as reported in the Globe. Serious declines: eight of the largest 10 companies suffered share price declines; averaging -51%; three fell by 89% or more. The largest company, Tilray, saw its stock price decline by 96% over the 2 years. Something may be high, but it isn't the stock prices!

Bitcoin After a spectacular implosion 3 years ago, Bitcoin is back on the speculative crowd's radar, having gone from about $7,000 in March 2020 to $45,000 in January 2021, and is being bandied about as a potential successor currency to the USD or Euro.

Forget about it. While the Blockchain technology behind Bitcoin may someday be very useful for ensuring privacy and security of certain things, it fails to satisfy one of the most important criteria for any currency, which is a store of value. There is not a chance that Bitcoin in its present form will be used for anything other than immediate transactions under a cloak of secrecy.

If that's not bad enough, Bitcoin exists only on various computers. Maybe this will be a benefit one day, but for now it isn't: one of the early Bitcoin host computers, known as Mt Gox, disappeared in 2014, taking 740,000 Bitcoin with it. Unlike the mighty US dollar, which is backed by the US Government's powers of taxation, 147 million ounces of gold in Ft Knox, a formidable military, and 250 years of history, Bitcoin sits on a bunch of hard drives.

Final Note From the Crystal Ball

These extremes, by the way, are notable only for their entertainment value. Their eventual implosion will be yet another example of why we invest the way we do: globally diversified, professionally managed portfolios of great companies serving customers around the world.

Forget the fads. The real physical economy is getting going again, driven in the short term by a rebound from the Covid shutdowns. Longer term growth will continue to be driven by continued strong growth in Asia, and the demographic vitality of the United States.

One of the bellwethers of the real economy is the price of copper, because Dr Copper knows what is actually going on in the world of physical industrial production. The price of copper has rebounded, almost doubling from US$4,371 March 30, 2020 to US$7,900 at January 2021.

Equity markets will be underpinned by strong earnings growth as the global economy gets under way again.

Endnotes

1 Dividends reinvested, with zero costs

2 'Destroyed' is hardly an overstatement. GDP is 40% of its pre-collapse (2013) level, grocery stores are famously empty, the currency has been inflated a thousandfold, and millions have fled the country.

3 In 1989 the Emperor's Palace in Tokyo was famously reputed to be worth more than all the real estate in California; plus Japan's economic vitality is crippled by its zero-immigration policy, two very important differences from Western countries.

4 Clients know that I do not pretend to see the future in any way, much less to base investment decisions on.

5 Almost 9000 of Canada's 17,000 total Covid-related deaths are in Quebec, leaving 8000 in the rest of Canada. At least 75% of those ie 6,000 are in nursing/LTC homes; 90% ie 7,200 are over age 60. This leaves 2,000 deaths not in LTC across the 30+ million Canadians not in Quebec. Quebec has 20% of the population and over half the deaths, which means Quebec's mortality rate is 2 ½ times the rest of Canada. Very clearly this is a nursing home and Quebec issue that is highly age and co-morbidity-dependent.

6 In purchasing power equivalent terms China's GDP is $25 trillion vs the US at $20 trillion; at current exchange rates China is $14Trn vs the US at $20Trn; Economist.

7 My legal department probably won't let me say "never-to-be-repeated" so I'll add the disclaimer that nobody alive today under the age of 20 will live to see another bond market like this one, and even if they did it wouldn't do them any good because by the time rates went back to 19%, which rates would have to do, they'll never believe rates could fall that far back down. I didn't believe it and neither did anybody else.

8 Slight exaggeration here, since bonds have only been around since 1693.

9 The others being 1929-1942 and 1969-1982.

10 Facebook Apple, Amazon. Netflix and Google, as discussed here before.