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Chris provides financial planning, investment planning and full implementation services to about 100 families.

We are pleased to welcome new clients. New clients should have $1 million or more of investable assets.

Routinely Under Water

Your March statements reflected the nice little – ok, very nice - run up in equity markets to all-time highs as I write in early June.

Once again we have seen the movie, albeit in a mercifully condensed time frame. The actors and the setting are always different, but the screenplay is the same: a bear market, in this case bursting out of clear blue skies, the attendant fear prompting people to rush from equities into cash or bonds in volumes not seen since the financial crisis of 09 - and timed almost to the day with the bottom of the decline.

The rush out of equities is, in a quick shift of plot, followed by an equally strong rebound in markets, confounding those who fled, and finally, in the closing scenes, markets recover their relentless upward march as the villain – in this case the latest SARS Covid virus – is wrestled to the ground (almost, at time of writing). As the credits roll, we are amazed once again at the power of human ingenuity and perseverance to drive through obstacles.

Covid Bear Market

At the depths of the Covid Bear Market in March of 2020 the US market as measured by the S&P500 had lost more than one third of its value, having fallen from about 3380 on February 19 to below 2240 on March 23, 2020. The magnitude of the decline – 34% - was not terribly unusual, since the average bear market post-WWII is about 30% according to industry commentator Nick Murray. The riveting part of this decline was that it happened in a record 32 days.

This version of the screenplay went with the central banks promising unlimited funding to financial institutions (see liquidity crisis below) and the realization that the disease was much less potent than first feared.

The markets tore back up, recovering the pre-Covid peak by August, and inflicting irreparable damage on those hapless people (I'm reluctant to call them investors) who sold out their portfolios of great companies into the decline, hoping to avoid the stress of falling prices and wait 'Till things got better'. Markets then see-sawed back and forth in a series of 6% swings between Labour Day and Hallowe'en, each downswing accompanied by endless and truly hysterical media concentration on the end of the world as we know it.

Then, as markets so often do, confounding all the negativity and rewarding the courage of those investors who held their ground, (which is all clients of mine) starting on Hallowe'en the markets went on another wonderful leg up, rising by another 900 points - more than 27% at time of writing. The US market now sits just below 4200, a head-turning 86% higher than the bear market lows of March 2020, and 23% above the pre-Covid levels.

The 900 point 27% run since Hallowe'en is one of those glorious little runs that occur in investing. It is important to recall now, before that brief phase passes from our memory into the past, how easy it was to have felt fearful last March 2020. A third of our equities' prices lost in a month! The uncertainty about a continuing recovery. How easy it would have been, to 'sell and wait till things settle down'. Recall those thoughts and conversations honestly now, and remember them for next time.

Because next time is surely coming. It will look and feel different, because the new movie is always different. But it isn't. To think one bear market is different from another begs a Huge Mistake. The part that is exactly the same is that you never know when they start, and you don't know when they're over, so all you can do is be prepared and hang on. Trying to jump in and out is devilishly tempting, but impossible to do consistently. As John Templeton famously said, 'The four most dangerous words in investing are, "It's different this time".

Remember the gain today from the pre-Covid peak is almost 25% above pre-covid levels. I'm going to beat this one into the ground like the proverbial tomato stake: the crystal ball-gazer who sold out before the pandemic (how could you do that, anyway?) has missed a 25% gain. The dodger who sold out near the bottom has locked in a 30% loss and missed the 86% recovery. As we will see below, some of these gains will be permanent. One of the most important values a good advisor provides is the courage to avoid these Big Mistakes.

Liquidity Crisis

It seems that the sharpness of the decline of March 2020 was not entirely related to fears of the new virus from China. My trader sources say that a component of the record ferocity of the decline was a liquidity crisis in corporate bonds, which means that parties wanting to sell, such as hedge funds and other leveraged players, couldn't.

Restrictions placed on banks and investment dealers after the financial crisis severely curtailed their ability to hold inventories and trade securities for their own accounts. Previously, this institutional trading allowed professional traders to provide buying power in a decline, an important source of liquidity to the market (and profits to the traders – the 'buy low' thing again).

As a result, bond markets were severely curtailed in the 2 weeks prior to the intervention of the Federal Reserve – which marked the bottom of the decline. According to the Journal of Financial Economics (May 2021), trading volumes shifted to the most liquid securities, including stocks, transaction costs soared, and even dealers shifted to selling from buying. The Fed intervention, as discussed in the movie review above, ended the equity market decline.

So it seems the Covid bear market was significantly accentuated by this liquidity crunch. It is interesting to speculate how much of the Covid hysteria might have been a result of the record sharp fall in markets. If the decline had been a less serious 10% or 15% instead of 34%, would we have accepted full Chinese Communist-style total population lockdowns? Maybe we would have adopted the Swedish-style approach, which is no lockdown at all. Maybe we would have developed a different, all-Canadian approach, say something intelligent like much better protection of nursing homes and people over 70 (where over 80% and 90% of mortality respectively has occurred), while keeping schools open.

Routinely Under Water

We have all been pleasantly surprised by our March statements. Most clients will have seen three-year returns in the 7-10% per year range (depending obviously on your equity weighting), which works out to a 20-30% increase in portfolio value over the last 3 years. A 20-30% increase in portfolio dollar value in 3 years - including a 34% bear market – is a great reminder of how quickly the volatility can come and go, and leave us with decent results.

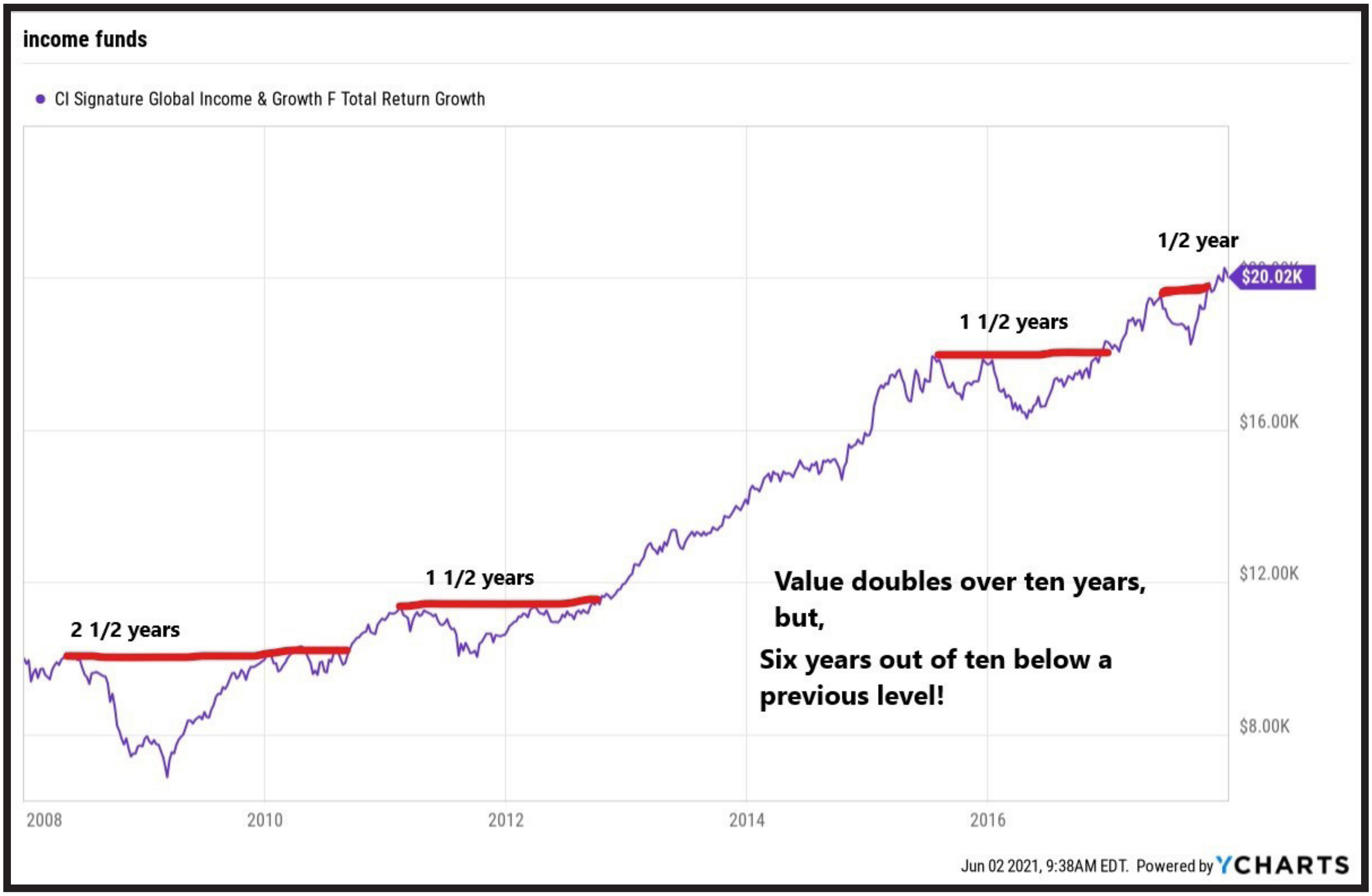
(The real eye opener is the one-year return. Because the March statements measure the recovery from very close to the bottom, many of you will see 12-month returns of an eye-popping 30-50%! Editor's note: this is in brackets because we're pretending the one-year return isn't important.)

Now, if you are like me, you probably know roughly what your total portfolio dollar value was as of March. You may even know last Friday's dollar value. A significant increase in your portfolio value, especially following the stress of the bear market, undoubtedly registers in your mind.

And because of the psychological heuristic called 'anchoring' we will tend to remember the high points of our portfolio values. The number sticks in our heads like a great holiday or dinner party. We will tend to think of our portfolio as its highest dollar value, particularly if the markets turn downwards. ***And here the danger lies***.

The chart below shows the return of $10,000 invested in a balanced portfolio over the 10 years ending in 2018. (I've chosen the time period to include the financial crisis, which helps make my point.) The chart will be very similar to many of your own portfolios, because it is conceptually similar – more than half in equities, most of which are in the US, and as little in bonds as we are comfortable with. The point of the chart is that a portfolio like this has roughly doubled in value over the 10 year period.

The red horizontal bars mark the periods where the value of the portfolio was below an earlier level. Only the longer periods 'under water' are marked; the shorter periods are ignored. The key message here is that a typical balanced equity portfolio has about doubled over ten years, ***despite having spent 6 years out of the 10 below a previous level!***



Most people are very surprised to see this chart. How can a portfolio double in 10 years if it is below a previous high over 60% of the time?!

We all know that portfolios fluctuate. After all, we talk about volatility all the time. But it is difficult to exaggerate how important it is to recognize that the ups and downs of market volatility means that you spend a lot of time below where you were at some point in the past.

Being below where you were before doesn't feel very good. You aren't making progress. If some reporter calls you up and asks if you are happy with your investment results, if you are receiving value for your fees, would you be able to say 'Yes'?

Or even more dangerous, if some financial salesperson presents you with a 'Second Opinion' idea that seems to have done better than yours, like maybe it hasn't gone down at all in the last block of time, would you be able to see through the ruse and say, 'No thanks'?

It's a ruse of course, because any dimwit can pick from a list of things that have gone up in the last block of time. Anything after the fact looks obvious (another perception error). The question is to ask, 'What were you recommending 5 and 10 years ago and how has that done?'

Being under water is not unique to the last 10 years. In a November 2009 article my former colleague Michael Nairne pointed out that the US market spent more than 70% of the time from 1926 to 2009 below a previous month-end level. That's right: using month-end data, investors would see their portfolios going down 33% of the time, recovering 38% of the time, and reaching new highs only 29% of the time.

Why is this so surprising? The classic chart of long-term market returns shows a squiggly line going from the lower left corner to the upper right corner (Morningstar/Ibbotson, US Large Cap stocks, 1926 – present). The total return is fantastic: $1 in 1926 grows to $7,000 today. How can you spend 70% of the time under water and still grow $1 into $7,000?!

The answer of course is volatility. Crucially, we tend to underestimate the effects of volatility on the day-to-day journey. The average of the monthly declines in Nairne's essay is almost 7%. The bear market of 2009 was 57% peak to trough. Human psychology as it is, we tend to look at the $1 to $7,000, or more practically the $10,000 to $20,000 and forget the scary ride.

Monthly volatility of 7% in a trendline of 10% is extreme. The trend is lost in the noise. When you have a long term average return of 10%, a 7% decline takes you back 9 months. Recoveries often take a little longer than declines, so you might be a year coming back, making the round trip to get back to your previous high more than a year and a half. A year and a half for zero!

Individual stocks are often much more volatile. Morgan Housel, a venture capitalist turned blogger, reported that while Netflix went up 350-fold between 2002 and 2018, and Monster Beverage went up by 3500x from 1995 through 2018, each stock spent more than 94% of that time trading below a previous all-time high (WSJ, 8/9/2020). The volatility implied by a hundred or thousand-fold return while spending 94% of the time 'under water' is staggering.

Very few people would have the courage or patience or both to hang on to those tigers' tails.

At a seminar I gave back in the tech bubble of 1999 I said that Dell, the computer company, was the only stock to have gone up three-fold in 12 months twice(!). But, I claimed, most investors would lose money on Dell. A guy put his hand up and said, 'I've lost money on Dell'. I couldn't believe my good fortune that my claim would be corroborated so immediately.

In one of the most exquisite summaries of the investor's problem, he explained, 'Dell has tripled twice, but it didn't go straight up. It would go up 30%, I'd get my courage up and buy some. Then it would go down 20%, I'd get scared and sell, just in time for it to go back up. After a few months it would have gone up 20 or 30% again, I'd be afraid of missing out (FOMO, these days) and I'd buy in again. All told, I've lost money on Dell'. He wisely became a client.

Trade Out Now?

The question that naturally may occur today is, 'With markets at all-time highs, should I lock in some gains by selling equities and sitting in cash or bonds?' Most clients will have been through this at least once with me, and so they'll know the answer, but for the newer ones on the plane, and because one can never be inoculated too often against market timing, just re-read the previous paragraph.

The first problem very simply is that you never know how long the present run will continue before the next downturn begins. Nobody knows what tomorrow brings. And once a downturn begins, you don't know how long it will go before it turns around and goes back up. Look again at the chart. You can't tell the difference between one of the dozens of tiny downturns of maybe a week or so and the air-pockets that take a year and a half to recover.

It is very difficult to internalize the fact that there are always as many reasons to sell as there are to buy. Once you try and base your investment policy on avoiding declines, you are focused on short term fluctuations, you are trading on news, and you are lost.

If you were looking for reasons to sell to miss a decline, last October was a good example: markets had recovered based on endless central bank money, yet nothing substantial had happened with Covid, and the dreaded 'Second Wave' threatened with the coming flu season. Another 6% decline in about two weeks looked like, and was called by many pundits, as the continuation of the Covid Bear Market. Yet here we are today 25% higher.

The second problem is the other side of downward volatility - since it's a two-way street – is upward volatility. The way markets work, bouts of downward volatility are frequently followed by upward volatility (and vice versa). Upward volatility is a problem ***if you miss it***. It should be intuitively obvious that if you are going to double your money in 10 years, your frequent sharp declines must be offset by some fairly sharp upward runs in markets as well. You can see from the chart that in the 3½ year run from the intra-year low in 2011 to the peak in 2015 the portfolio gained about 80%. That's 80% of the full decade return captured in one glorious 3½ year run.

Add to that the fact that downturns happen literally all the time – the average peak to trough downturn in any year is 14% according to JP Morgan – trying to trade in and out is the Biggest Mistake you can make.

The lesson once again so clearly illustrated by the last 18 months is that we have no idea what the future holds. We had no idea that the SARS Covid 19 missile would fly in the window, and we had no idea, when the plummeting markets beckoned us to the sidelines, that the recovery would be as sharp as the decline and then run on another 27%.

Conclusion: It is perfectly normal to have your portfolio value below where it was at some point in the past. In fact, you normally spend a great deal of time 'under water'. If it's normal, it's not a problem, and if it isn't broken you don't try and fix it. It may feel nice while it's happening, but a smooth and constantly rising portfolio value is not a goal. Today is a good time, as we have erased the last bear market and are sitting on gains, to remind ourselves that volatility will one day reassert itself. That too, is a part of investing. Much less pleasant than record highs, but normal nevertheless. And trying to miss the declines is a fool's errand.

View from Here

Looking forward, I maintain my view that the markets – equity markets anyway, are not overvalued.

There are certainly pockets of foolishness. These will follow their course as they do, and take their fools with them. Newsmedia will wonder how it could happen, while the pros and experienced investors will shrug. Earlier this year Tesla's market value was greater than the next nine biggest car companies combined (CNBC report). The stock has fallen back this year, but it is still one of the 10 highest market value companies on the planet. Do Tesla shareholders think that Toyota will be unable to build very high-quality electric cars, or the Germans will not build high-performance luxury EVs?

My back of the envelope math is this: consensus earnings courtesy of Yardeni Research calls for the S&P500 to be around $200 this year. Not difficult to see with the strong rebound in economic activity earnings could easily be another 10% next year to about $220. At the current Price Earnings (P/E) multiple of 21x that works out to S&P500 at 4620 or 10% higher than today. All the pieces are in place for a sustained economic run. The emergence of China continues – their improvement in standard of living surely one of the greatest accomplishments in human history. If we can keep our manufactured animosity to the level of rhetoric only, and continue to engage and trade with them, we can all benefit immensely.

Our office remains closed under provincial requirements. We miss our meetings with you, and look forward to getting together soon. Personal meetings are the time to connect and comfortably discuss the important things on our minds. In the meantime, please let me know if you have any questions, comments, things you'd like to discuss, or anything at all. We are available for phone, Zoom, or Team meetings, and would love to hear from you.

Book Review

The Strange Career of Jim Crow
C Vann Woodward
Oxford University Press
Third Revised Edition, 1974, 220p

This book has changed my understanding of the racial history of the United States. I had previously been under the impression that the US Civil War was fought to end slavery, and that racial bias in the US since then operated primarily at the level of the individual or community. I thought the US Constitution and entire legal system stood for ‘equality before the law’.

The war may have formally ended slavery in the US in 1865, but it didn’t free the slaves from much.

Jim Crow was not a person. It is the name given to the laws and practices enacted and enforced by an unrepentant South to restrict the freedom of the black population - after the Civil War. The victorious North, themselves not entirely convinced of the idea of equality before the law, tired of the effort to police the South and withdrew, leaving the South to do as they pleased. From the 1890s until the 1950s and finally the 1960s riots, swirling currents conspired to create Jim Crow and deny the black population the right to vote and many other things.

An important read. Makes you think about what we’re doing in our own country.

Woodward was a Ph.D in History, taught at John Hopkins University from 1946 -1961, was Sterling professor of History at Yale from 1961-1977, and wrote a number of books, winning a Pulitzer in 1982.