Volume 6, Issue 1

Market Report

"Fixed-income investors worldwide – whether pension funds, insurance companies or retirees – face a bleak future", Warren Buffet

This newsletter is long overdue – the migration to a new back office last November, followed quickly by a busy RRSP and tax season, has led to many long workdays and my newsletter unfortunately had to sit on a back burner. I apologize for the delay.

The Toronto Stock Exchange (TSX) continued to underperform both the U.S. broad market (as measured by the S&P500 Index) and the Morgan Stanley World Index last year – this time by a very wide margin, turning in a mere 2.17% return vs. an S&P500 return of 16.26% and a Morgan Stanley (MSCI) World Index return of 14.06%. Mind you, much of the S&P500 index returns were driven by information technology stocks (ex this sector the index was up 8.44%) and the TSX simply has a lower exposure to this sector (9.3% according to a June 22, 2020 Investing News article).

MARKET INDICATORS & TRENDS

December 31, 2020	Index	MTD	YTD	2020	2019
S&P/TSX	17,433.36	1.41%	2.17%	2.17%	19.87%
S&P 500	3,756.07	3.71%	16.26%	16.26%	29.25%
MSCI EAFE	2,147.53	4.56%	5.43%	5.43%	18.78%
MSCI World	2,690.04	4.14%	14.06%	14.06%	25.53%

I continue to recommend remaining globally diversified, not only as the MSCI World Index has outperformed our Toronto Stock Exchange over the historic long-term but as it has done so with less risk due to better sector diversification.

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Clients who diversified internationally; were willing to buy into last year's market weakness; and had some high technology exposure fared well last year. Market forecasters are warning; however, to expect more modest returns over the coming decade. This is to be expected not only due to the run up in valuations (with this run up, the real earnings yield has plummeted which in the past, has triggered a sell-off – see graph at left-hand side), particularly in U.S. Growth stocks, but as stocks usually trade at some premium above the risk-free rate of return (generally a government bond matched to the investor's time horizon). As interest rates have plummeted to record lows, that same risk premium could translate into lower returns with many experts calling for low single-digit returns. This is acceptable as long as inflation remains low; however, there have been recent concerns raised about rising inflation.

"TINA" has become a mantra of bulls, arguing that yields have been so low that bonds were hardly worth owning as an asset class" - *CNBC*

Important Notices

PLEASE NOTE:

Worldsource's Annual Administration Fees are due this month. If there is not sufficient cash available in the accounts to which these fees are charged, I will follow-up via telephone.

Coronavirus As A Life Changing Event

Further to an article I wrote in my newsletter last year, Coronavirus has altered our lives forever. I believe there are long-term implications for the stock markets. I received my CFA certificate in 1990. The studies in that program were based on 100+ years of research. The fallout from Coronavirus seems to have thrown out a lot of the rules-of-thumb for portfolio management garnered in those studies. For example:

- Diversification by management style. The 2 core styles of investment management are "value" and "growth". Value investors look for stocks they believe are undervalued by the market. Often these investors look for "low P/E (Price of a stock/ the company's earnings)" stocks. As an example, companies like General Motors can be considered value stocks when their prices are low. A "growth" investor will pay a higher price (P) for a company making lower current earnings (E), with the expectation that those earnings will have superior earnings growth in the future (i.e. Apple). The growth style has vastly outperformed the value style since the bottom of the last major stock market correction on April 9, 2009. Last year, with the onset of Coronavrius, and many people working at home; shopping and entertaining/ teaching from home lead to increased growth in companies that cater to those needs. In addition, many have found there are efficiencies in working & shopping from home so our economy will not look the same when it re-opens. Many will continue to work and shop from home and so will remain dependent upon high tech companies that meet those needs. As a result, I believe that for those weightings in portfolios with a long-term time horizon, there should be a greater skew towards growth-style investing.
- Diversification by asset class. A traditional equity/ bond portfolio was usually considered to be 60% equities & 40% bonds. The greater weighting towards stocks as a hedge against inflation and to achieve some growth – in pension plans, for the long-term income needs of current retirees and those that are not yet retired. When stock markets fell, as they did in Y2008, there was generally a "flight to safety" and bonds would rise, so pensions funds could make payments to pensioners, without selling stocks into weakness. In March of Y2020, amidst the pandemic, both stocks and bonds plummeted together. Now interest rates stand near record lows (1 year Government of Canada Bond yield is 0.228%) and well below the rate of inflation (CPI was up 3.6% at the end of May), leaving pension plans to find alternatives to the traditional 40/60 balanced portfolio.
  [Global Pension Funds: The Coming Storm | CFA Institute Enterprising Investor]

What Does The Future Hold?

With the value-style of investing having underperformed for the last 12 years; interest rates near record lows; and, U.S. stock valuations near record highs, what is a pension fund manager to do let alone this K-W Investment Advisor?

As always, no one has that coveted crystal ball to project the future; however, here are a couple of interesting tidbits, which I feel point to investment themes, garnered from my readings:

* "Since the end of the financial crisis, growth stocks have outperformed their value counterparts by 144%.. An important question remains: Since growth stocks sell at a forward P/E multiple of 20.9 compared to 14.4 for value stocks, is the size of the valuation gap justified? Although a significant proportion of growth stocks' recent outperformance is justified, there is a legitimate case for favoring value stocks over growth stocks at this time." Gautam Dhingra, PhD, CFA [Growth vs. Value: Waiting for GODOT | CFA Institute Enterprising Investor]

* "By combining the expected returns from equities and bonds based on historical data, we can create a return matrix for a traditional 60/40 portfolio. Our model anticipates an annualized return of 3.1% for the next 10 years. That is well below the 7.25% assumed rate of return and is awful news for US public pension funds." Global Pension Funds. The Coming Storm. Nicolas Rabener, CFA Institute Dec. 16, 2019

* "Wharton professor Jeremy Siegel didn't mince words Tuesday morning when he shared his projection that U.S. bonds will be a terrible investment idea over the next year.", [Wharton's Jeremy Siegel says Treasurys could be worst investment in 2021 (cnbc.com)]

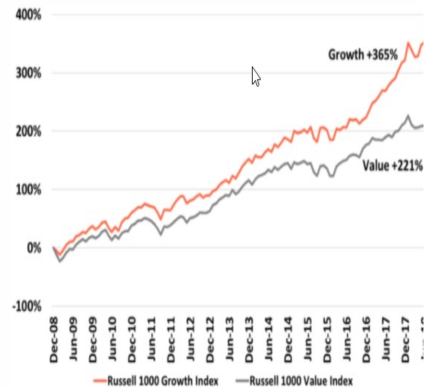
* Interestingly, according to a Sept. 2020 CNBC article, the Canada Pension Plan plans on taking a third of its assets in the emerging markets over the next few years.

[CPPIB on investing in emerging markets and India (cnbc.com)]

- An aging population, combined with ever increasing high tech capabilities, should bring interesting developments in the healthcare field.

  "*The earnings of healthcare companies are growing faster than the S&P500. Over the last 30 years, SP500 earnings grew at ~6% while health care earnings grew at ~9%*." TD Asset Management

- There has been an increasing interest in ESG investing by pension funds, which has been stepped up by President Joe Biden's environmental concerns and interest in reducing greenhouse gas emissions. Canada Pension Plan Investment Board (CPP Investments) has published an updated Policy on Sustainable Investing, reflecting its increased conviction in the importance of considering environmental, social and governance (ESG) risks and opportunities amid an increasingly competitive corporate operating environment. This interest is shared by many other pension plans and investors.

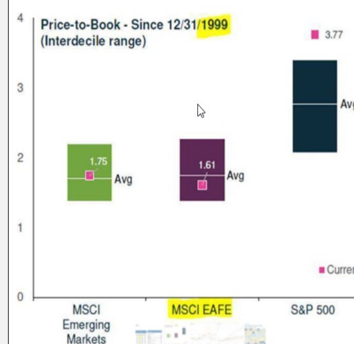


The Projection Assumption Guidelines for 2021 are as follows:

Inflation rate:	2.0%
Return rates	
Short-term:	2.3%
Fixed-income:	2.7%
Canadian equities:	6.2%
Foreign developed market equities:	6.6%
Emerging market equities:	7.8%
YMPE or MPE growth rate:	3.0%
Borrowing rate:	4.3%

Source: FP Canada.
FP Canada certifies professional financial planners.

U.S. Stock Market Valuations High relative to Emerging Markets and EAFE (Europe; Asia; & The Far East):



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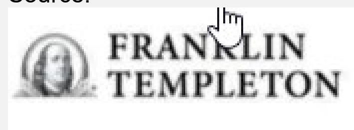

What Does The Future Hold? (cont'd):

In summary, themes for the balance of the decade will likely focus on:

(1) reducing fixed income exposure, particularly for portfolios with a long-term time horizon;

(2) looking for cheaper valuations outside of the United States, with an eye to the emerging markets;

(3) health care (i.e. personalized medicine; increased interest in health & wellness);

(4) interest in ESG stocks (i.e. renewable energy); and,

(5) diversification by style. To the latter point, it is easy to become dissatisfied waiting in value stocks, when the growth portion of our portfolios has grown so strongly. Given this era of technological innovation, I believe that the growth style (i.e. 5G technology; data security given the recent increase in cyberattacks) should continue to be an important weight, particularly in portfolios with a long-term time horizon. With regards to value-managers who have stuck stubbornly to that style over a decade of growth outperformance, I prefer fund managers who are style "agnostic" and so can move between the styles depending upon where they see the greatest opportunities.

I believe that the coming decade will favour active vs. passive Portfolio Managers and Investment Advisors, as they navigate the many changes that COVID has brought about (which includes a surge in ESG interest) as well as the changes dictated by an aging population.

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"The Secret of freedom lies in educating people.
Whereas the secret of tyranny is keeping them ignorant."
Robespierre

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