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The Krygier Report

An exclusive newsletter from Mark J. Krygier, Senior Portfolio Manager | July 2022 www.krygierwealthmanagement.ca

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Benchmarking to the index?

In a year in which the "markets" are getting "whacked", perhaps it's not surprising we are not being asked, "Why don't you just invest in the index?" The financial industry is very creative in dreaming up new solutions and products, accompanied by great marketing campaigns to fit the flavour of the month popular themes. There are mutual funds and exchange traded funds (ETFs) for practically every investing theme possible – cybersecurity, cloud investing, marijuana, crypto-currency, etc. If you can think of it there is likely a fund investing in it. In fact, there are ETFs of ETFs and "funds of funds" – whether it's in the mutual fund or the hedge fund industry. Years ago I took a course about hedge funds from the Canadian Securities Institute, thinking maybe I am missing something in not purchasing these for clients. What I discovered is that often when these ideas filter down to retail clients, there are layers and layers of obfuscation of information and added fees, which require some real sleuth work just to figure out what it is that one is buying and what are the fees involved. While the markets were moving higher by Central Bankers maintaining artificially low interest rates to try and stimulate growth in a stagnant environment, the financial industry popularized "passive" index funds (whether as mutual funds or ETFs) as the latest and greatest way to invest. Why use an advisor when "75% of portfolio managers don't beat the markets" or something to that effect. Next came "factoring" in which the world of investing could be boiled down to some quantitative measurements – again a byproduct of a generation accustomed to letting the "machines" do all the work. So what has changed this year?

When the market rockets up on artificial stimulation, the lowest quality investments often perform the best. Whether it was the dot-com era in the late 90s, finance companies in the mid-2000s prior to the subprime mortgage crisis, crypto or pot stocks in the Covid era, et al., cheap money made a lot of these lousy investments look great. When a lack of net profits can still result in a rising stock price, then "passive" investing and "buying the index" can outperform all rational strategies. Perhaps the reason 75% of portfolio managers don't "beat the index" is that portfolio managers, who are trained to value companies based on real earnings and real profits, would not in their right mind buy many of those things which drove markets higher – until this year when money is no longer cheap. That is what has changed this year. Decades of cheap money made leveraged investing, including speculation in the housing market, wildly outperform "sensible" investing. So far this year the benchmark indices are down 10% in Canada, 20-30% in the U.S. (S&P 500 and NASDAQ, respectively) without signs of having yet bottomed – and nobody is asking us to "invest in the index". Last year's "sure thing" bitcoin is down 60% year to date. Cathy Wood's ETF (ARKK), which stunned the investment world in 2020, with a 154% return, has dropped in value to pre-Covid levels – while proving Barnum & Bailey's mantra that "a sucker is born every minute" as retail investors are still pouring millions of dollars into her ETF. Folks, the times are a 'changin and those that don't recognize the changes are going to suffer in the coming years. As I keep reiterating in my newsletters and in conversations with clients and colleagues, this era reminds me of the year 2000 – those that stuck with what worked in the previous three years didn't recover for over a decade. However, the good news is those that recognized the changing environment and shifted accordingly, despite suffering through some short-term volatility, enjoyed solid returns over the coming years, despite the "market" and "index" collapse.

So what's in an "Index" anyway? Generally, a country's stock market index is comprised of an array of companies which represent its broader economy. The Toronto Stock Exchange's "TSX60" represents the 60 largest publicly traded Canadian stocks, which means about 30% in financial companies, 35% in resource companies, with a smattering of industrial, consumer and telecommunication companies – and very little exposure to health care or technology. In contrast, the S&P 500 of the U.S. is comprised of the 500 largest publically traded companies in America – with exposure to almost every sector including innovative technology and medical technology, yet with very little exposure to resources. The other oft-mentioned major U.S. index is the NASDAQ with concentrated exposure to high-tech and bio-tech companies – the so-called "innovators". Clearly, different indexes (indices) function very differently at any given time, depending on which sectors of the economy are doing well. Canada's TSX "outperformed" in the '70s and again in the 2000s, when resources were at the top of their cycle. The U.S. markets dominated the '90s and from 2010-20 when innovation and multi-national corporations dominated the global stage. It is therefore also clear that no one "index" can provide "outperformance" at all times.

It is really important to keep in mind when "benchmarking" to an index that the vast majority of indices are "market-weighted". Simply put, this means the movement of the stocks in the largest companies is disproportionate in its market impact versus that of smaller companies. This is extremely important and can lead to significant distortions in the "market" movement and worse, can mislead investors into assuming far more risk than they are likely aware. The "FAANG" stocks – Facebook (now "Meta"), Apple, Amazon, Netflix and Google (now "Alphabet") had been moving the U.S. markets way, way up but this year way, way down (-51%, -23%, -36%, -70% and -25%). As a result, the NASDAQ index is down almost 30% and the broader S&P is down over 20% - but that does NOT mean that the rest of the stocks in the "market" are down as much. The corollary to this, is that it also doesn't mean that when the markets were very high in the previous years, that the rest of the stocks in the "market" were up nearly as much – hence the unknown assumption of risk of investors in the "index". From a risk perspective, why would anyone want to "overweight" a handful of stocks to the extent that the "market-weighted" index does so? Note that no one asks this question when markets are up. In Canada, in 1999, two stocks - BCE and Nortel - comprised almost 28% of the entire Canadian stock market and yet they certainly did not represent 28% of the Canadian economy. When those stocks rose 150% and 200% respectively, it drove up the Canadian market to almost 30% in "return". However, when Nortel dropped from $124 in August 2000 to less than $1 by early 2002, the "market" dropped almost 30%!

Bottom line

Investors may have to rethink the whole idea of investing in a market index. Be sure you understand what it is that you are buying, what exposure it brings, and in which part of the economic cycle you are investing. In an era of "tight" money, one can't just throw a proverbial dart and hope to be successful. Success requires some effort. Happy investing!

Global benchmarks

As at June 30, 2022 (Canadian $ Returns – except where noted)

Asset class	YTD	1 year	3 years
S&P/TSX Composite T/R (Canada)	-9.9%	-3.9%	8.0%
S&P 500 TR - **US$**	-20.0%	-10.6%	10.6%
NASDAQ Composite - **US$**	-29.5%	-24.0%	11.3%
MSCI Europe Index Price Return	-20.8%	-16.6%	-1.7%
MSCI Emerging Markets	-17.2%	-24.4%	-2.3%
China S.E Shanghai A Price Return	-9.7%	-5.3%	4.8%
MSCI World Index Price Return	-19.7%	-12.4%	4.8%

Asset class	YTD	1 year	3 years
30-year U.S. T-Bond - **US$**	-22.8%	-18.9%	-2.9%
10-year U.S. T-Bond - **US$**	-11.7%	-11.4%	-1.6%
Long GOC Bond (2051)	-26.7%	-23.2%	-9.0%
10-year GOC Bond	-13.3%	-12.6%	-3.3%
5-year GOC Bond	-7.0%	-7.5%	-1.1%
3-month CDN T-bill	0.1%	0.1%	0.6%
US$/CDN$ (1.2872)	1.9%	3.9%	-0.6%

Source: RBC Capital Markets Quantitative Research

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