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The Krygier Report

An exclusive newsletter from Mark J. Krygier, Vice President & Portfolio Manager | June 2020 www.krygierwealthmanagement.ca

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Letter to a client.

Every educator knows that if someone in a classroom is bold enough to put up their hand and ask a question, there are at least 5 or 10 people with the same or similar question, but without the temerity to ask it. Last month, I received a query from a long-standing client who is now retired. He and his wife are living primarily off some government pension and the income we generate from their investments. I thought there may be "one or two" other clients with the same question. So, without tampering too much from the original Q&A, I wanted to share our discussion to offer some answers to the questions many investors may have and would like answered.

A client's queries in a recent email to me, dated May 1st, 2020:

1. **Which benchmark** is appropriate for judging relative performance of a portfolio?
2. **A portfolio holding more conservative equity (stocks) and fixed income** (bonds, preferred shares, etc.) should perform better in a down market than one holding (aggressive) stocks alone – correct?

My response to this client's queries, in an email dated May 6th, 2020:

You are asking great questions. I have thought about this long and hard and have come to the following conclusions:

1. **It is very difficult to benchmark** a portfolio, as each investor has their own set of goals and tolerances for risk.
2. **That being said**, for some portfolios it is easier to find appropriate benchmarks than for others. Growth-oriented investors, with no need for income from their portfolios and for whom taxation is not an issue, may use a straight TSX Total Return in Canada or the S&P 500 in the U.S. as reasonable indices to use as a benchmark.
3. **However, even for such portfolios**, using such straight-forward indices as benchmarks, the problem lies in that most indices are "market-weighted", so that the largest companies – a.k.a. Microsoft, Amazon, Apple, Google, have a disproportionate impact on the benchmark returns. Returns from these benchmarks can get skewed vs. the prudent investor's portfolio - who manages risk adjusted returns to ensure that no one security comprises more than 5 or even 10% of a portfolio i.e. diversifying individual "security risk". In the 2000 high-tech market, BCE and Nortel comprised almost 30% of the TSX – something no prudent investor would ever allow. A prudent investor likely "underperformed" the index in 1999, and "outperformed" it when Nortel dropped in price in 2001-02.
4. **For income-oriented investors**, I think it is even more difficult to "benchmark" their portfolios. For such investors, if long-term capital preservation is a goal, but secondary to the primary goal of maintaining a lifestyle-supporting source of income, then I believe an investor's **true benchmark** should be whether or not they have a portfolio that can provide them with steady cash flow, through both good markets and bad ones.
5. **If you would use this latter "benchmark"** as YOUR benchmark, then we are meeting or exceeding that standard, as we have done for all of our income-oriented clients for the past 20+ years, as I will elaborate below.

6. **I have been in this industry long enough** to have seen all sorts of different promises for generating income for clients above and beyond the “risk-free” rate of return (a “GIC” or a 5-year Government bond), which as you know yields barely above 0%. The promises usually assume that stocks will provide sufficient capital gains to allow those gains to be trimmed to supplement the actual income being produced from the underlying securities. Unfortunately, such approaches work well in “good” markets wherein stocks are rising in value. However, when markets drop dramatically, like in March of this year, and even more so in 2008-09, most if not all of those means of producing income collapse under the falling value of the securities.
7. **My approach has always been** to keep things simple. If you need income – let’s say the $9,000 a month that we send you from your joint account, then let’s buy the securities that can produce that income, plus enough excess to cover my management fees, and let the markets rise higher over time to protect your capital against inflation. In addition, let us diversify the risk between securities so that if one company cuts its dividends, as some have already done in this market and as some did back in 2008-09, we can sell the security and reinvest the proceeds into something else which can produce the same or similar income for you, still maintain the potential growth, and of course trying to stay within the risk parameters for your portfolio.
8. **I used this approach in 2008-09** with all of my income-oriented clients and it worked. Then, like now, those portfolios dropped in value even more than pure “growth-oriented” portfolios with similar mixes between stocks and bonds, yet because I was producing sufficient “cash-flow” to cover the outflows to clients, we were not forced to sell capital at “fire-sale” prices to supplement the income that clients needed to maintain their lifestyle. That is very important, as sales into cash at the bottom of the market are very, very difficult to recover and most don’t. The result was that clients maintained their lifestyle throughout the 2008-09 turmoil, didn’t sell capital to do so, and that capital was able to recover in value approximately 11 months after the bottom of that market. Will that happen again? I believe so, but, like then, I have absolutely no idea on the timeline, which is somewhat irrelevant, as all of our clients’ money which I have invested is capital to be invested for the “long-term.”
9. **Regarding whether a particular benchmark** may have outperformed the equities in your portfolio, firstly, I think it is clear that the straight S&P 500 index is not an appropriate benchmark for your equities as you need income. As for a high-yield index, like the Vanguard “High Yield” (VYM) index, consider that it produces 3.59% vs. the 5-6% average yield we are getting from your equities. Your goal was to maintain a certain level of income, which we have accomplished and I have every reason to believe we will continue to do so going forward, rather than seeking “total return” in the short-term as a primary goal. If VYM did in fact outperform your equities in the past year, it would be as a result of lower yielding securities that outperformed in gains, thereby supplementing the gains not achieved by the higher-yielding stocks from which you derive your standard of living.

Bottom line

Benchmarking is only relevant if it provides a true standard based on an individual’s own needs. At *Krygier Wealth Management*, we focus on meeting the changing needs of our clients and investing accordingly.

Global benchmarks
As at May 31, 2020 (Canadian $ Returns – except where noted)

Asset class	YTD	1 year	3 years
S&P/TSX Composite T/R (Canada)	-9.7%	-2.1%	2.8%
S&P 500 TR - US$	-5.0%	12.8%	10.2%
NASDAQ Composite - US$	5.8%	27.3%	15.3%
MSCI Europe Index Price Return	-12.3%	-4.7%	-3.7%
MSCI Emerging Markets	-11.5%	-5.0%	-1.9%
China S.E Shanghai A Price Return	-3.2%	-2.9%	-3.7%
MSCI World Index Price Return	-3.4%	7.0%	4.6%

Asset class	YTD	1 year	3 years
30-year U.S. T-Bond - US$	25.5%	31.6%	13.9%
10-year U.S. T-Bond - US$	13.0%	16.3%	7.2%
Long GOC Bond (2048)	15.7%	17.0%	9.1%
10-year GOC Bond	11.7%	10.7%	4.6%
5-year GOC Bond	6.9%	6.2%	2.8%
3-month CDN T-bill	0.7%	1.7%	1.3%
US$/CDN$ (1.3769)	6.0%	1.9%	0.7%

Source: RBC Capital Markets Quantitative Research

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