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The Krygier Report

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

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Why do bulls get gored?

I recall a conversation I had with a client sometime in 2012 or ‘13 about the performance of her portfolio. She posed to me the following question, “If historically the stock markets’ performance in North America has been 10% per year, then why was my portfolio only up 6% last year?” My answer to her was as follows: firstly, your portfolio is comprised of both stocks and bonds so it’s important to compare apples to apples. Secondly, the performance of stock markets are only mathematical averages, over very lengthy periods of time (25 years or more). In addition, the total “return” of the markets (or your portfolio) is comprised of both the market increase as well as the income generated. Being a mathematical “average” implies there are years in which markets perform well above the “average” returns and years in which performance is well below “average” returns. Furthermore, a historical “average” gives no ability to predict how any particular year in the future will turn out. As I like to joke when people ask me what will be the performance of the stock market, or their own portfolio, in the coming year, “If you can get me next year’s newspaper I will be able to tell you.” The only thing one can predict with some certainty about a given investment, whether in a stock portfolio or in real estate, is the amount of income one ought to generate from that investment. Even that “prediction” assumes the investment continues to pay its current level of yield. What one cannot do is to predict what will be the resultant “total return” including market gains or losses – the latter can only be measured in hindsight.

In my short 25 years of investing experience I have experienced both the pain and the pleasure of markets which have been up over 30% and down over 30%. According to the brilliant Howard Marks of *Oaktree Capital Management, L.P.*, from 1965 to 2004, the actual annual return of the U.S. S&P 500 stock market index was between 8% and 12% in only six years. Furthermore, the return was far from the “mean” average 90% of the time. That is an astounding fact and worthy of some consideration. That means investors have to be willing to withstand volatility in one direction or the other (although I have rarely heard complaints about “positive” volatility) in 90% of the years, in the hopes of achieving long-term average returns in the 10% range. In real estate investing of course, aside from “flipping” for quick profits in a “hot” market, it’s the leverage used that boosts returns from being just average, based on the annual growth in the property value over time, to spectacular returns. The converse of spectacular returns achieved through leverage is personal or corporate bankruptcy, and investors in that field have either witnessed or perhaps experienced both.

So the proverbial $64,000 question remains, why is there so much variation year-to-year in the annual performance of a long-term vehicle which has provided its investors with “average 10%” returns? Mr. Marks says it is due to the “excesses and corrections,” which result from the “substantial influence of psychology on investor’s decision-making.” When investors turn very “bullish” (positive or euphoric) they tend to believe their investments have only one direction to go, and as “Superman” would say, that’s “up, up and away.” The other symptom of a “bullish” market is the willingness of investors to pay any price for an asset, which falls under the “greater-fool theory” which assumes somebody else will come along and pay you an even higher price for it. As Marks notes, “The excess to the upside makes for a period of above average returns, and the swing toward excess on the downside makes for a period of below average returns.” In short, when things are going well, the mindset is that it will continue to go well, and when they are not going well, the mindset is that things will only get worse. As asset prices rise, even nervous people who are normally risk averse get convinced to assume risk, and rarely do people recognize that excessive gains may have come at the expense of future gains. In 1999 it was “Y2K” fears that lead to massive demand on the supply of both computer hardware and software – three years worth of demand in one year – so once everyone had bought, there was no one left to buy. Those who invested in 2000, assumed such demand would continue ad infinitum, suffered terrible losses in the coming years. In 2021, demand resulting from Covid-bound buyers of exercise machines, video conferencing services and movie “streaming” led many investors to assume such explosive growth would go on forever. Year to date, after only five months, investors in those companies are down 61%, 42% and 67%, respectively…ouch!

The trick to achieving long-term success in investing appears to be to try and avoid excesses, and in particular the mindset that can lead to such excesses – something easier said than done. It is said that at the top of economic cycles one should put on one’s fiscally conservative banker’s “hat”, and at the bottom of economic cycles one should put on one’s more aggressive venture capitalist “hat”. Unfortunately, most people lend or invest at the top and restrain from lending or investing at the bottom. In 2016, I saw a fascinating presentation by AGF Funds, which showed the ups and downs of a particular investment fund over a ten year period, overlaid by the timing of the “in-flows” and “out-flows” of investors’ cash into that fund. With amazing consistency, investors piled into the fund after a good year and pulled out after a bad year. Studies show that as a result of such fickle approach to investing, investors rarely achieve the success of the underlying funds into which they “invest.” If true, most investors in Cathie Wood’s ARKK innovative technology ETF piled into the ETF by the billions only following her spectacular success of over 150% in 2020, only to find the fund now down lower than it had been prior to 2020.

Bottom line

It is easy to be an “armchair quarterback” and talk about what one “should’ve, could’ve, or would’ve” done. In these volatile markets, which followed years of excess, it is clear that investors need a long-term focus and the stomach to stick with it. As I heard from a speaker in an investment conference which I recently “attended”, it is not so much as what you know that makes you successful as an investor, but rather it is knowing how you will behave in times of stress.

Global benchmarks
As at May 31, 2022 (Canadian $ Returns – except where noted)

Asset class	YTD	1 year	3 years
S&P/TSX Composite T/R (Canada)	-1.3%	7.9%	12.2%
S&P 500 TR - **US$**	-12.8%	-0.3%	16.4%
NASDAQ Composite - **US$**	-22.8%	-12.1%	17.5%
MSCI Europe Index Price Return	-13.5%	-7.8%	2.3%
MSCI Emerging Markets	-12.5%	-17.9%	0.3%
China S.E Shanghai A Price Return	-16.5%	-11.8%	2.1%
MSCI World Index Price Return	-13.6%	-1.7%	8.5%

Asset class	YTD	1 year	3 years
30-year U.S. T-Bond - **US$**	-20.9%	-13.1%	-1.8%
10-year U.S. T-Bond - **US$**	-10.6%	-9.1%	-0.8%
Long GOC Bond (2051)	-21.9%	-14.4%	-6.4%
10-year GOC Bond	-11.1%	-9.4%	-2.4%
5-year GOC Bond	-5.7%	-6.5%	-0.6%
3-month CDN T-bill	0.0%	0.1%	0.6%
US$/CDN$ (1.2644)	0.1%	4.8%	-2.2%

Source: RBC Capital Markets Quantitative Research

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