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The Krygier Report

An exclusive newsletter from Mark J. Krygier, Senior Portfolio Manager | October 2021 www.krygierwealthmanagement.ca

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Let's talk about...risk!

As we enter the final quarter of 2021, and being October, markets are once again heating up. Those who have invested in stocks this year have for the most part been well rewarded for assuming the risks of doing so, as both Canadian and U.S. stock market indices are up double digits so far this year. As I always like to point out however, one cannot assume that one will be rewarded automatically for taking capital risks – if that were the case then it would not be called risk! In addition, returns can vary greatly when assuming capital risk, and one cannot assume that by simply investing in the more "risky" assets that one will achieve the best returns. For instance, last year's superstar "disruptive technology" focused investment manager Cathie Woods of ARK ETF fame has a negative 11% return so far in 2021. The bitcoin crypto currency ETF (GBTC) is up a mediocre 5.8% with massive swings in volatility, and last year's Covid winners "Amazon" and "Zoom" are up a measly 1.66% and down a whopping 23.4%, respectively, so far in 2021. Clearly, taking on "risk" when investing is no guarantee of obtaining good returns. In contrast, former S&P 500 member Exxon Mobil, the oil producing behemoth, is up 43.9%, Cameco, the Canadian uranium producer is up 56% and Nutrient (formerly called "Potash"), one of the world's largest fertilizer producers based in Saskatchewan, is up 35.8% so far in 2021. It is also clear that picking and choosing carefully between available investment options can once again add value – or not – to one's investment returns.

For the risk-averse investor, the options are very limited. Traditionally, if one was to look in an "Investment 101" textbook, in order to figure out how much exposure to equities (stocks) versus bonds one should hold in one's portfolio, the answer was the "Rule of 100." Take one's age and subtract it from 100 and that is the amount of stock exposure one should have. A 30 year old would therefore have 70% of stock holdings whereas a 70 year-old would have 30% in stock exposure. I have argued for years that the Rule of 100 is not applicable in an era of sub-2% bond yields on "safe" fixed income (bonds, GICs, CDs, etc.). When one can obtain 3-5% dividend yields on relatively safe so-called "blue-chip" stocks, even investors seeking "yield" from their investments are hard-pressed to hold much if any exposure to such fixed income holdings. Therein lies the conundrum for balancing risk. Assuming risk is no guarantee of growth or even preserving one's capital. Taking virtually zero capital risk guarantees returns of less than the rate of inflation (and after deducting income tax for taxable investments the result is a negative "real" return). For an investor with a high tolerance for volatility, and a truly long-term outlook, and who is holding a diversified mix of stocks of financially solid companies, this may not be an issue. However, for the very many investors with less than a high tolerance for fluctuation, and for whom, given an environment of 5-7% bond yields, they would adhere rigorously to the Rule of 100, how is such an investor supposed to figure out what is a "reasonable" amount of risk?

Perhaps a reasonable way to calculate how much "risk" exposure (i.e. exposure to stocks) one should hold in one's portfolio is to consider what will be one's emotional reaction in the event of a period of negative returns in the markets. Most of us have been investing for enough years to have seen some pretty dramatic declines, some short-lived while other periods have dragged on for years. The steeper the decline and the more prolonged the downturn the more a toll it can take on one's investing confidence and resolve to stay invested for "the long-term." Generally, references as to the long-term returns of stock markets, such as "10-12%", refer to 20 or 25+ periods of time, and I have yet to meet someone who ignores the volatility in their investments for that length of time! Furthermore, the reference to "averages" is in no way a guarantee of achieving such numbers in any particular year, hence the reference to "averages". Implicitly this means markets can be up 5%, 10% or even 30% in a given year, or…down 5%, 10% or even 30% in a given year. For all those enamoured with the returns of the US markets over the past 10 years, consider that from the years 2000 to 2010 they had a 0% annualized return in USD$. For Canadians investing in the U.S. S&P 500 in 2000, in an era where rising oil prices drove the "petro" Loonie higher and even above par briefly, the S&P 500 index provided a negative 5% annualized return over that decade in CAD$.

So let's run through the simple numbers and consider the impact on one's blood pressure as the "litmus" test as to one's risk tolerance, and ultimately a guide as to the maximum exposure to stocks one can hold. This "test" is not purely theoretical as in the 2008-09 subprime market collapse, and more in March 2020, during the pits of Covid despair, many high-quality stocks dropped by over 40% before recovering in the ensuing months. On a market drop of 10%, a portfolio of $1 million is down $100,000, while one of $10 million is down $1 million. On a market drop of 30%, the portfolio of $1 million is down $300,000 and one of $10 million is down $3 million. So what's "too much"? Is it the percentage drop or the dollar drop that is most disturbing? At what point is one likely to throw in the proverbial towel and sell everything out of panic – I have been witness to such emotional upheaval. If 10% or 30% is too much to handle, the alternative is to reduce one's exposure to stocks and hold cash or low-yielding GICs or CDs with the rest of one's capital will reduce one's potential drop in capital value. If <u>any</u> drop in value is too much too handle, then no amount of stock exposure is appropriate – even if history tells us it's amongst the best asset classes to own to preserve one's purchasing power over the "long-term".

Bottom line

While most stock investors are focused on making money, in order to own investments that can "make money" one has to be tolerant of the "drawdown" or drop in value of such investments from time to time. There is no "one-size fits all" solution to this question. To balance one's needs and desires for returns versus one's true risk tolerance, consider boiling this question down to the simple numbers on your own portfolio – the numbers may speak for themselves.

Global benchmarks

As at September 30, 2021 (Canadian $ Returns – except where noted)

Asset class	YTD	1 year	3 years
S&P/TSX Composite T/R (Canada)	17.5%	28.0%	11.1%
S&P 500 TR - US$	15.9%	30.0%	16.0%
NASDAQ Composite - US$	12.1%	29.4%	21.5%
MSCI Europe Index Price Return	7.5%	18.5%	4.5%
MSCI Emerging Markets	-3.4%	10.2%	5.5%
China S.E Shanghai A Price Return	3.6%	11.2%	9.8%
MSCI World Index Price Return	11.3%	20.9%	10.6%

Asset class	YTD	1 year	3 years
30-year U.S. T-Bond - US$	-7.6%	-11.4%	10.1%
10-year U.S. T-Bond - US$	-4.3%	-6.2%	6.4%
Long GOC Bond (2051)	-15.5%	-17.3%	4.2%
10-year GOC Bond	-5.6%	-6.5%	4.4%
5-year GOC Bond	-2.0%	-2.0%	3.4%
3-month CDN T-bill	0.1%	0.1%	1.0%
US$/CDN$ (1.2678)	-0.4%	-4.8%	-0.6%

Source: RBC Capital Markets Quantitative Research

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