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The Krygier Report: SPECIAL EDITION

An exclusive newsletter from Mark J. Krygier, Vice President & Portfolio Manager | February 2018 www.krygierwealthmanagement.ca

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Volatility got you nervous? Embrace it!

Following a tremendous lift in the stock markets to start 2018, the markets have undergone a fair amount of volatility in recent days and we already received our first two panic calls in quite some time. I thought, therefore, that it was only apropos to deal with this volatility up front in a special mid-month edition of my newsletter to address this change of events in case it lasts more than a few short days.

Firstly, what is causing the recent negativity? Most pundits I read suggest that rising bond yields are the real culprit and the most fundamental reason for the negativity in both stock and bond markets of late. Rising bond yields can result in investors shunning lower-yielding bonds. As well, many high dividend yielding stocks may also come under selling pressure when bond yields rise sufficiently to a level comparable or higher than the stock yields. The reason is that often such stocks were purchased in lieu of bonds when bond rates are very low, despite the higher risk level implied in owning stocks over bonds. Rising bond yields can also imply some inflationary pressures are filtering into the economy. Historically, inflation can negatively impact most investment classes, whether they be stocks, bonds, real estate, et al., and the more important question then becomes, at what pace do we expect such changes to bond yields will occur.

In a rapidly rising yield environment almost all asset classes suffer. Imagine what would happen to real estate prices if mortgage rates (which rise and fall lockstep with bond yields) suddenly rose to 6%, 8% or dare I say 10% - for those aged 60 and over this will certainly conjure up tough times in the real estate market. However, if rates rise at a modest pace, both stocks and real estate can continue to post positive gains, although likely in fits and bursts (a.k.a “volatility”) as the markets adjust to the new rate environment. In my regular newsletter for February 2018, I quoted one of today’s largest and most successful bond portfolio managers, Jeff Gundlach, who points out that, “the global economy is in a synchronized upswing for the first time in a decade…this is good news for everything, except bond prices.” So while it’s true volatility can signal that things are changing, despite the headlines about the Dow Jones or the Toronto Stock Exchange, it may be that stock investors need not concern themselves as much as bond investors in this changing rate environment.

At the end of the day, the reason rates are rising is because the economy is improving, and as a certain magazine publisher would say, “that’s a good thing”. Employment is nearing capacity, governments in the U.S. and globally are starting to remove the “emergency” stimulus measures they had enacted after the 2008-09 subprime-market collapse, and as Mr. Gundlach also said, “for the first time since 2007, not one of the 45 economies in the OECD Expansion Contraction Growth Indicator is contracting.” Stocks represent businesses which either have or lack the capacity to pass on the rise in their own costs to their respective consumers and it is that passing on (or lack thereof) which represents inflation (or deflation) in the economy. Historically it has been hyper-inflation, more typical of emerging market economies, which has been a destroyer of wealth, whereas normal rates of inflation can represent healthy economic growth.

"Volatility" to many investors implies markets turning down when in reality volatility is a neutral term. Despite the neutrality of the word, it is interesting that we never receive calls from clients when markets are up 2 or 3 or even 5% in a given day or two. In short, this tells me intuitively that people are more emotionally charged over a drop of 2 or 3% or 5% than they are over a rise of the same magnitude. Behavioural finance studies actually prove empirically that this is in fact the case – that the pain of loss is much greater than the pleasure of gain of the same magnitude.

Behavioural finance studies also reveal that at the DIY (Do It Yourself i.e. discount broker) institutions the majority of retail DIY investors have the unfortunate habit of selling their winners ('cause it feels great to make gains) and holding their losers ('cause I'll wait until it rebounds) which is unfortunate as winners often keep climbing and conversely losers often tend to keep dropping and in some cases they may never rebound in price or not in a short amount of time. These studies further show that investors in mutual funds rarely achieve the returns posted by the mutual funds over time (and perhaps such results could be extrapolated to ETF investors today as well) as they invariably buy when things look great (i.e. after great returns have been achieved) and they sell when things look bad (i.e. after the bad news has been priced into the market).

So, at Krygier Wealth Management, what if anything are we doing in the face of such **negative** volatility? Firstly, as our clients have heard and read so many times over the past 21 years, we are not panicking. Secondly, during this past month of January when the markets exhibited extreme **positive** volatility we trimmed 25% of 10 different positions we held and continue to hold which had provided our clients with wonderful capital gains in recent years, as their valuations were high and they were clearly "overbought" in the short-term. Thirdly, we have continued to rotate our portfolios to less interest rate sensitive securities to reduce the negative pressure that is being brought on "bond-like" stocks which were rising when rates were at historically low levels. Finally, we are constantly reviewing our portfolios for opportunities to upgrade the quality of our holdings – both for ourselves personally and for our valued clients, as every security we personally hold are positions which we hold for our clients.

Bottom line

While the emotional challenge of negative volatility can peak, in particular when bombarded by media headlines and "talking heads", our advice is to embrace the volatility. As long as one's short-term money is not invested in long-term investments (such as stocks, real estate or long-term bonds) then volatility should be welcomed, not avoided. The reason is that only investments which can be volatile in a negative fashion can also be volatile in a positive fashion to the extent that they can provide returns above and beyond the rate of inflation over time – like stocks and real estate. Therefore, it is far more important for an investor to ensure one is being realistic with one's needs for current income from their portfolio, as well as for long-term growth, than focusing on short-term volatility of either type.

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