RBC Dominion Securities Inc.

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Financial Focus

Wealth Management
Dominion Securities

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Dear Clients and Friends,

The first few months of 2022 have reminded us that investing requires patience. Market volatility has returned and we are now seeing huge swings in stock market values each and every day. Do we sell? Do we buy? Do we hold? When markets get choppy, it is normal to feel anxious about your hard-earned savings.

My continued message to clients is that in the short-term, there will always be something to worry about with regards to investing. Panic is not part of a disciplined investment strategy. We need to zoom out, and this is especially true when markets are volatile. You don't want to make a short-term decision that could impact your longer-term financial outcomes.

I have reminded many clients over the last 2 months that "your investment accounts are not the stock market". In the majority of cases, we have other non-market investments to help offset some of the current short-term stock market volatility. Clients that have the need for income will have principal protected savings and GICs in place to protect and guarantee amounts that we know will be used for income. This is part of the short-term bucket strategy to ensure security and liquidity is free of market risk for amounts to be paid out within 1-2 years, and knowing that your long-term bucket is allowed to fluctuate in value over the next 5-10+ years before it is also needed to fund your income requirements.

Right now, we may be nervous about the war in Ukraine, high inflation, soaring energy prices, supply-chain disruptions, the political environment in the U.S., the COVID-19 pandemic or any other geopolitical issue that's out there. But if we step back and take a longer-term view, we know that the Canadian stock market has had far more good years than bad ones. History shows us that the stock market will generally pay you 7 out of 10 years, so it is really about how you react in those other 3 years that will determine your success as an investor.

It is important to note that despite the current gloom and doom, there is reason for some optimism. Inflation may be close to peaking, which would relieve some pressure on the central banks to hike rates aggressively, while there remains pent-up demand by consumers and corporations due to the supply chain issues. At the same time, a market sell-off always creates opportunities to pick up some great companies which have been unduly punished.

It is a stressful time right now to be an investor. There's no arguing that. But it's important to remember that a financial plan is not achieved overnight. More importantly, it also does not crumble in an instant. The biggest asset a financial plan has is time, not timing. By sticking to a well-designed financial plan, clients have the opportunity to achieve their financial goals. It just takes a bit of patience right now.

As always, I am happy to answer any questions.

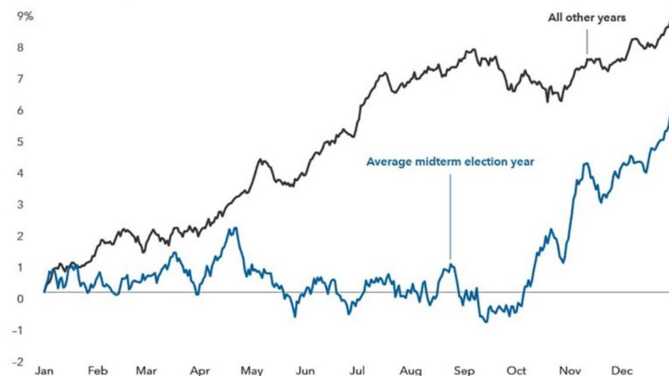
Kind Regards,

Sandra

US Mid-Term Elections – What to expect

The 2022 US midterm elections will be held on November 8, 2022. Midterm elections occur at the midpoint of a four-year U.S. presidential term. Do midterm elections have any effect on equity markets? To find out, we examined more than 90 years of data and found that the answer is yes, markets have behaved differently during midterm election years. Here are the key lessons you need to know about investing in this political cycle.

U.S. market returns tend to be muted until later in midterm years



Sources: Capital Group, RIMES, Standard & Poor's. The chart shows the average trajectory of equity returns throughout U.S. midterm election years compared to non-midterm election years. Each point on the lines represents the average year-to-date return in USD as of that particular month and day and is calculated using daily price returns from 1/1/31–12/31/21.

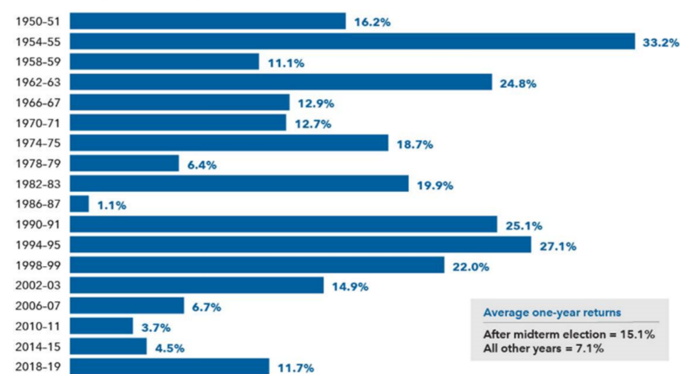
We found was that in the first several months of years with a midterm election, stocks tend to have lower average returns and often gain little ground until shortly before the election. Markets don't like uncertainty, and that adage seems to apply here. Earlier in the year there is less certainty about the election's outcome and impact. But markets tend to rally when results are easier to predict in the weeks before an election, and they continue to rise after the polls close.

Midterm election years have had higher volatility

Sources: Capital Group, RIMES, Standard & Poor's. As of 8/31/18. Volatility is calculated using the standard deviation of daily returns for each individual month. The median volatility is then displayed in the chart on an annualized basis. Standard deviation is a measure of how returns over time have varied from the mean. A lower number signifies lower volatility. Results in USD.

U.S. market volatility is higher in midterm election years, especially in the months leading up to Election Day. Since 1970, midterm years have a median standard deviation of returns of nearly 16%, compared with 13% in all other years. There may be a few bumps in the road, and investors should brace for short-term volatility, but we don't expect the election results to be a huge driver of investment outcomes one way or the other.

Market returns after midterm elections have been strong



Sources: Capital Group, RIMES, Standard & Poor's. Calculations use Election Day as the starting date in all election years and November 5th as a proxy for the starting date in other years. Only midterm election years are shown in the chart. As of 12/31/21. Returns are in USD.

The silver lining for investors is that after such bouts of volatility, markets tend to rebound strongly in subsequent months. And the rally that often starts shortly before Election Day isn't just a short-term blip. Above-average returns are typical for the full year following the election cycle. Since 1950, the average one-year return following a midterm election is 15% in U.S. dollar terms. That's more than twice the return of all other years during a similar period.

What's the bottom line for investors?

Midterm elections — and politics as a whole — generate a lot of noise and uncertainty. While midterm election years have exhibited these trends in aggregate over long periods, it is important to remember that each year is different and follows its own path. There is a good chance of higher volatility in 2022, but no need to fear it. Smart investors would be wise to look past the short-term highs and lows and maintain a long-term focus.

Staying the Course

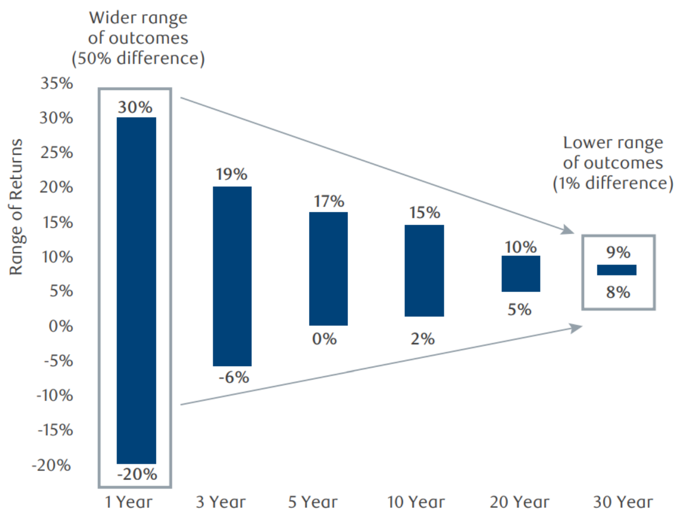
Daily market fluctuations highlight why a combination of discipline and perspective is key to reaching your investment goals. One way to achieve this fine balance is by having a plan and sticking to it through all types of market conditions. This may sound easy, but investors are typically put to the test once or twice a year. Veering off course from a carefully thought-out plan can turn a temporary loss of confidence into a realized loss on an investment portfolio. Here are two strategies that can help you reduce the impact of market fluctuations and help you reach your long-term goals:

1.Use time to your advantage

Investors who maintain perspective and stay mindful of their investment time horizon have a better chance of reaching their investment goals than those who react to short-term market fluctuations.

Staying invested and trying not to "enter and exit" the markets when volatility increases can help reduce fluctuations over the long term. The longer an investment is held in a portfolio, the less chance it has of incurring a negative rate of return. This is because fluctuations in value tend to smooth out over time as the impact of market volatility diminishes. Moreover, years of strong equity markets can outweigh periods of decline, resulting in long-term returns that outperform other asset classes.

The volatility of a diversified portfolio decreases over time



Rolling 1-, 3-, 5-, 10-, 20- and 30-year average annual returns from January 1988 to December 2021. All returns are total returns in Canadian dollars, unless otherwise noted. Diversified Portfolio represented by 2% Cash, 38% Fixed Income, 15% Canadian Equities, 25% U.S. Equities, 15% International Equities and 5% Emerging Markets Equities. Cash represented by FTSE Canada 30 Day TBill Index; Fixed Income represented by FTSE Canada Universe Bond Index; Canadian Equities represented by S&P/TSX Composite Index; U.S. Equities represented by S&P 500 Index; International Equities represented by MSCI EAFE Index; Emerging Markets represented by MSCI Emerging Markets Index. Source: Bloomberg, RBC Global Asset Management.

2.Maintain discipline

Reacting to short-term market "noise" by making dramatic portfolio changes, like moving in and out of the markets, can have a negative impact on achieving your long-term investment goals. History shows that by maintaining discipline and perspective during market downturns, patient investors have been rewarded when markets returned to an upward path.

As market volatility increases, investors have a natural tendency to want to move into safer investments, hoping to avoid further losses. However, this move can result in needlessly locking in losses on investments that, given time, are likely to recover. A key to overcoming this tendency is to refrain from trying to time the market. Selling at the wrong time and missing just a few days of a market recovery could have a significant long-term impact on your portfolio

Why it's best to stay invested

Based on the annualized returns of the S&P/TSX Composite Index for 10 years, ending December 31, 2021.
Source: Bloomberg, Morningstar, RBC Global Asset Management.

Blind spots

Combatting cognitive biases when investing

Volatile markets can tempt investors to follow their primal instincts and veer from their investment plans. Here are three typical investor behavioural traits to watch out for, and three ways to avoid falling prey to them.

We Homo sapiens have developed our brains over tens of thousands of years, and those brains are ideally designed to help us survive in what were very often hostile environments. For example, our instinct to fit in with "the tribe," which was essential to our survival 15,000 years ago, today can lead to "group think." This instinct works against us when investing, prompting us to blindly follow the "herd mentality" versus what is rational appropriate given our investment goals.

It's not easy to control these deeply instinctive emotions that drive our behavior and form cognitive biases, or "blind spots." Ninety-eight per cent of investors exhibit at least one behavioural bias.[1] These biases can be helpful in our day-to-day lives, allowing us to use shortcuts and discern patterns that help us process information to make rapid decisions.2 However, these same biases can lead us astray when it comes to investing.

Here are three common cognitive biases[2,3] to watch out for as an investor, and some ways to help correct for them:

1. Recency bias

Putting too much weight on recent experiences over historic ones. This "myopia" can lead investors to over- or under-estimate the probability of an outcome.

How to correct for it: Get the "big picture" – for example, look at the market's performance over the last 20 years versus the last 20 months. Recognizing that markets and investments evolve given changing circumstances over time helps us maintain a long-term view, and encourages us to stick with our investment plans regardless of short-term volatility.

2. Loss aversion bias

Emotionally, humans suffer more from a loss than enjoy an equivalent gain. This can lead to prioritizing the avoidance of short-term losses over the potential for long-term investment gains. No one enjoys a loss, but short-term downturns in markets are an inevitable part

of the investment journey. Losing sight of this can compromise your ability to achieve the risk-appropriate, long-term potential returns of investments such as equities.

How to correct for it: Ensure your investment plan aligns with your investment risk profile and capacity, and that the goals that underpin your plan truly reflect what matters to you. This can help keep you on track to your goals, and to prioritize the long term over the sometimes-unpleasant experiences generated by short-term volatility.

3. Familiarity bias

Investors are instinctively drawn to what is familiar to them, such as their own domestic equity market. This can lead them to overlook opportunities in foreign markets to diversify their portfolios – potentially enhancing returns and reducing risk.

How to correct for it: Review your asset mix to ensure you are properly diversified based on your investment risk profile. This can help overcome "home bias" and overly concentrated portfolios.

Sources:
1 "Who's influenced by behavioural biases? Everyone." Morningstar, 2021.
2 "How to avoid behavioural bias as an investor." RBC Global Asset Management, 2021.
3 "The Evolving Role of Behavioral Finance in 2020." Cerulli Associates, 2020.

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