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Markets Made Simple

Wealth Management
Dominion Securities

SECOND QUARTER REPORT – JUNE 30TH, 2021

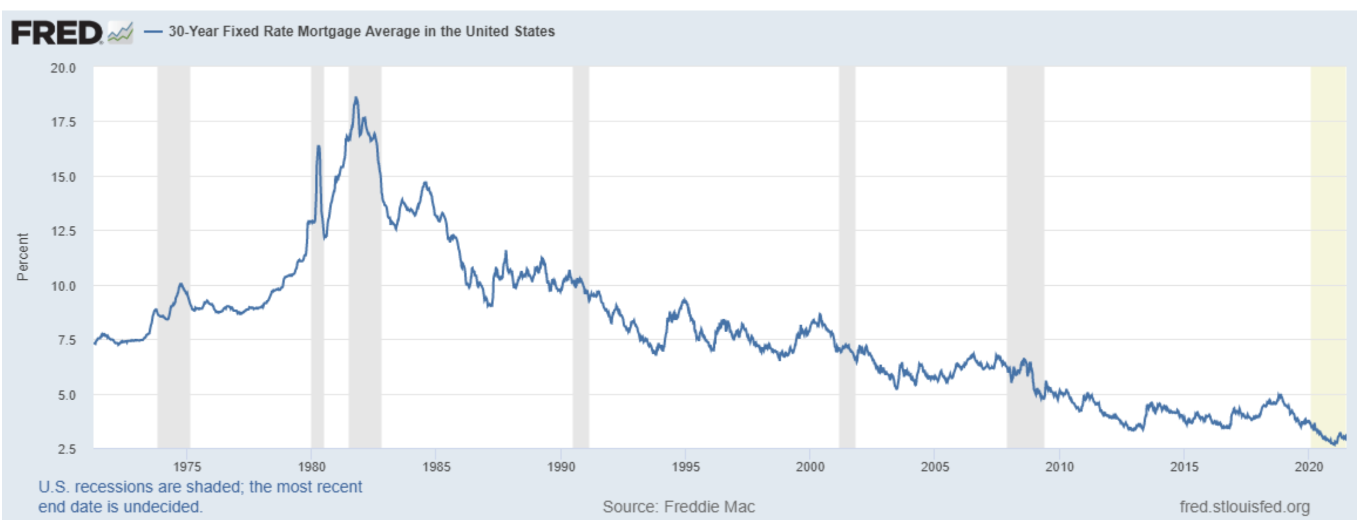
Over the past 100 years, there have been 5 periods of time when investors made no money over a decade in a traditional balanced portfolio of 40% bonds, 60% stocks.[1]

WHAT DO THE NEXT 10 YEARS LOOK LIKE?

During my entire life, interest rates have been declining. When I was born, I was given all the toys a baby could dream of, but if I had the sudden urge to stop playing with my favorite toy, a cardboard box and apply for a mortgage, the rate would have been just under 14%. This was a great deal, considering it was almost 21% a few years prior.[2] Entering high school with my 'very cool' bowl haircut, baggy jeans, and chain wallet, mortgages rates had dropped to 7%.[3] Finishing university, wide-eyed and dreaming of taking over the world, mortgages rates had again dropped to 5.5%. Today, emerging from a world-wide pandemic, 5-Year mortgages are available at around 2%.

The 40 year bond run of declining interest rates is unlike anything we have seen. Bond holders in the Barclays Bond Index over the past 40 years have returned 7.3% a year. The largest loss during that time was no more than 3% a year. As rates go down, bond prices go up. A bond that matures in 25 years with a 5% interest rate will gain 35% if interest rates drop by 2%. We have become very comfortable owning bonds.

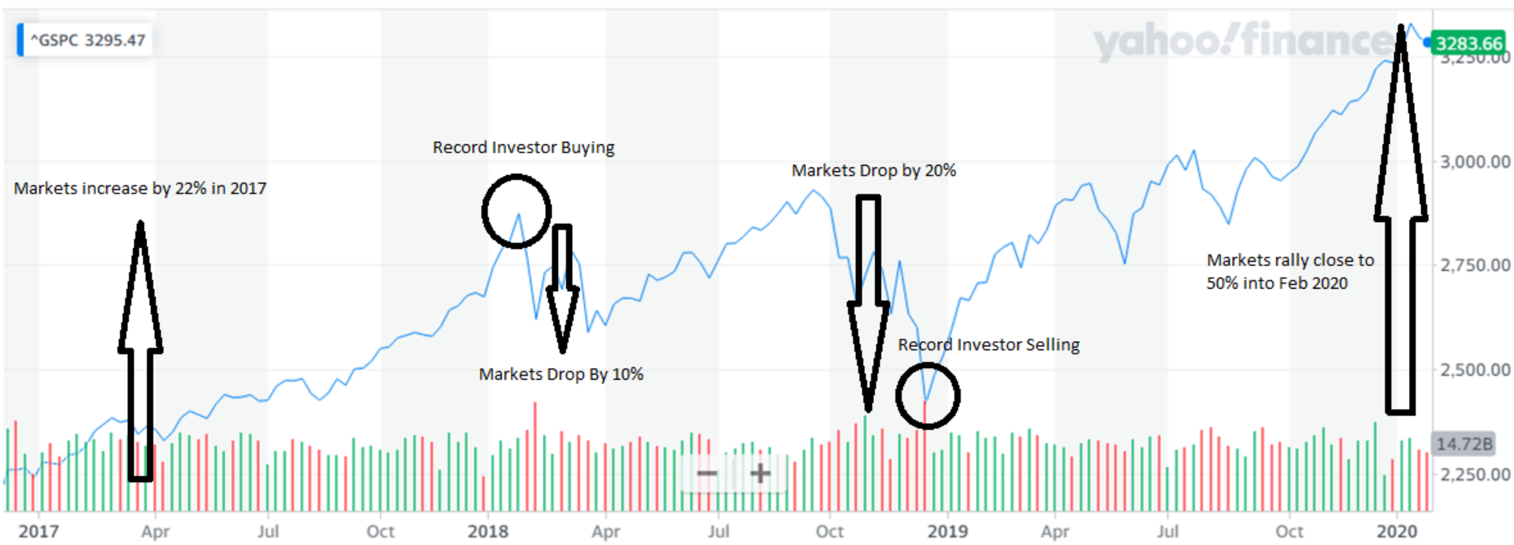
Below are mortgage rates in the US which peaked at levels slightly below Canada and both have followed the same path lower in the last 40 years.



[1] 60% in US stocks - S&P500 and 40% in US bonds - JP Morgan Government Bond Index, rebalanced monthly
[2] https://www150.statcan.gc.ca/n1/daily-quotidien/171012/cg-b003-eng.htm
[3] https://www150.statcan.gc.ca/n1/pub/11-210-x/2010000/t098-eng.htm

In the movie 50 First Dates with Adam Sandler and Drew Barrymore, Barrymore has amnesia and forgets everything that happened to her the day before. Sandler has to remind her each day, and creates a video to help her remember the past so she can wake up, watch the video and remember her past life. That is like us when it comes to investing. We have very short-term memories and forget the past. The stock market is a perfect example. We see stock markets move higher, and we see positive performance continuing. The higher it goes, the more we invest. The largest amounts of investor buying occurs at market tops. Back in my Q1 – 2018 newsletter, I mentioned that we had seen investors buy stocks at the fastest pace ever at the start of 2018 and it was time to get cautious. The S&P 500 returned 22% to investors in 2017. Investors saw these returns, and jumped into the markets, only to see the markets drop by 10%, followed by a 20% sell-off later at the end of the year.

We also do the opposite during market selloffs. Investor selling is the largest after market drops, and usually coincides with market bottoms. The end of 2018 was very different than the start. The markets sold off 20% at the end of the year, and as I referenced in my newsletter at the end of 2018, investors sold a record amount of stocks. It was time to start getting aggressive. The selling happened right before the market rallied almost 50% for over a year to the end of February in 2020. During the pandemic last year, one third of all investors over the age of 65 sold all their stock holdings from February to May, missing out on the biggest rally ever in the stock markets.[4] We see the markets going lower and our short-term memory tells us to get out before they go even lower. *We need someone to make us a video reminding us that we should be we buying when markets go down, not selling!*



Over the past 100 years, there have been 5 periods of time when investors made no money over a decade in a balanced portfolio of 40% bonds, 60% stocks

10 years, no returns! We work hard and send our money out to work for us. We don't expect it to take a 10 year holiday. If we told our boss we were going to Hawaii for a 10 year vacation, our job wouldn't be waiting for us when we got back. Whether it is saving for retirement, purchasing a house, helping out family, sustaining our current retirement, long-term health costs or leaving an estate to the next generation, not making anything on our money while inflation eats away at it could have a detrimental effect on the things we want to do in life.

What do these 5 lost decades all have in common?

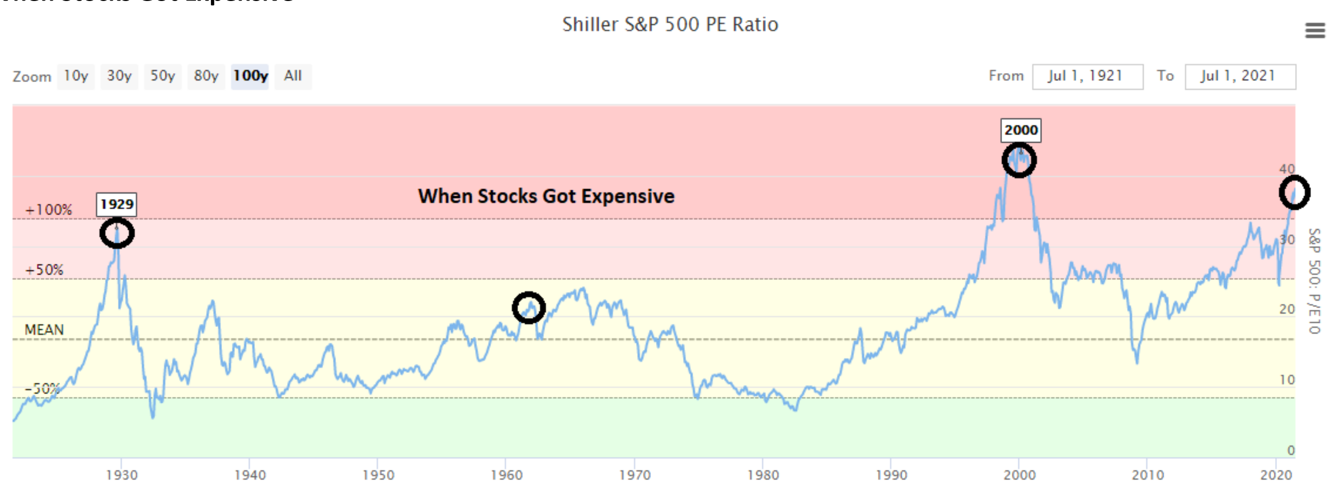
They all started with stocks prices or bonds being expensive. The more we pay for something, the lower our future returns. Buying a home today in a neighborhood of all similar homes for $3 million, when other homes are selling for $1 million, it is going to be difficult to sell that house for a profit. Buying that same house for $250,000, it will be a lot easier to make a profit.

[4] Fidelity Investments

The long-term average Shiller adjusted Price to Earnings Ratio (PE Ratio)[5] for the S&P500 since 1872 is 17X earnings[6]. A simple way to understand this is the PE Ratio is the number of years it would take to get your money back if earnings didn't grow. At 17X, it would take you 17 years to get your initial investment back. The lower the PE Ratio, the quicker you get your money back. In 1920, the PE Ratio was around 5X. You would receive your initial investment back in just 5 years! In 2000 during the tech boom, it hit 44X. If you were just finishing university in 2000 and bought the S&P500, you would have received your initial investment back by around the time you retired.

For bonds, the real long-term average interest rate (after inflation) since the 13th century is 1.56%[7]. This means that after inflation you should be getting a positive return of 1.56% on your bonds. The lower the real yield, the less bonds are keeping up with inflation. A negative yield means bonds aren't keeping up with inflation at all. If inflation was 3% and you went to the bank and bought a GIC for 1%, your real yield would be -2%. You would be losing 2% of your investment after inflation every year.

When Stocks Got Expensive



[8]

1929, 1962, and 1999 were times when stocks got expensive. In 1929 the S&P500 was trading at 31X earnings (85% higher than its long-term average), in 1962 it was trading at 22X earnings (32% higher than the long-term average), and in 1999 it hit a 37X earnings (120% higher than the long-term average).

Over the next decade investors in a balanced portfolio made no money.

When Bonds Have Got Expensive

1945 and 1974 were times when bonds got expensive. Real yields on a bonds were -1.1% in 1945 and -1.0% in 1974, well below the average real yield of +1.56%. Investors in bonds were losing money every year, after inflation.

Over the next decade investors in a balanced portfolio made no money.

How Are Stocks and Bonds Priced Today?

The S&P500 is currently trading at 37X earnings, 120% higher than it has historically traded. Real yields on bonds are currently -2.5%, one of the lowest yields on record.

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[5] Shiller adjusted Price to Earnings Ratio is based on average inflation-adjusted earnings from the previous 10 years for stocks
[6] https://www.multpl.com/shiller-pe
[7] https://economics.rutgers.edu/downloads-hidden-menu/news-and-events/workshops/money-history-and-finance/1823-paulschmelzing/file
[8] https://www.longtermtrends.net/ - Shiller S&P500 PE Ratio

Today, we have an environment where BOTH BONDS AND STOCKS ARE EXPENSIVE

Investors like to chase the best performing investments, similar to how they chase performance after markets have gone up. Buying after periods of strong outperformance usually means investors are buying in at expensive prices. This harms long-term returns. *Over the last 20 years, the average equity mutual fund returned 8% annually. The average investor returned 4% annually, in those exact same investments.*[9] Over the past decade, investors have been flocking into passive investing, buying Exchange Traded Funds (ETF's) and exciting technology names. The problem is that now many of the world's largest ETF's are heavily weighted towards the most expensive companies, Apple, Amazon, Microsoft, and Google (Alphabet), and Facebook. The Shiller PE Ratio of the S&P500 is 37X, similar to the same level at the top of the tech bubble, right before the S&P500 lost 50% of its value over the next few years.

Investors have also been flocking to bond funds. There is a lot of risk due to rising rates. In the largest 20 bond funds in Canada that manage trillions of dollars for Canadians, for every 1% increase in interest rates, they will lose 8%, and for every 1.5% increase in rates, they will lose 11.5%. As interest rates on Canadian 5-year bond have increased this year by 0.7%, from 0.3% to 1.0% in the first quarter[10], they lost an average of -5%.[11]

As I mentioned, fixed income has done great for investors over the past 40 years, but 40 years ago US 10-Year Treasury Bonds were paying over 15%. Today they are paying 1.45%.[12]

What should investors do?

Leave their money in cash? With rates on saving accounts well below inflation, investors are guaranteed to lose money and it is not an option for most investors.

As I highlighted in my last newsletter, today's environment is very similar to after WW2, with record government deficits, artificially low interest rates held down by the FED, and inflation exploding. After WW2, cash lost 25% of its value after 5 years, 33% after 10 years and 80% after 40 years.

Just because the overall markets are expensive, doesn't mean we aren't finding attractive opportunities. For our US and International exposure, which includes companies such as Merck and Verizon, the average PE Ratio of our portfolio is around 15X, right in line with the historic average and very attractive based on the other investment options available to investors. We are even more excited about our Canadian exposure where the average PE Ratio is around 12X, which owns companies such as Element Fleet and Onex. Investors have forgotten about the Canadian stock market over the past decade and we are finding the best bargains in this space. Bank of America strategists recently released a report showing Canadian stocks are at the biggest discount to the US markets over the past 20 years.[13]

For fixed income exposure, we have been protecting against rising rates and inflation. Short-term bonds that can roll over at higher rates, floating rate bonds that pay more as rates go up, and exposure to foreign bonds that have provided much better yields than in North America. We were able to increase the yields on bonds over the last year after the sell-off in March 2020 and it has paid off. The Canadian Bond market is down -2.4% over the past year[14], while our global bond exposure is up 7.0%.

It is imperative that investors are properly positioned. The next decade will not be good to investors who are not properly positioned.

Our job is to protect and grow your capital. We analyze all the risks on the horizon, and protect against them. It has become easy to become complacent with easy returns in the stock and bond markets over the last decade. We continue to watch the economic landscape, making changes and positioning portfolios appropriately to continue to protect against risks and take

[9] DALBAR
[10] https://www.marketwatch.com/investing/bond/tmbmkca-05y?countrycode=bx
[11] Morningstar Direct
[12] BLS, FactSet, Federal Reserve, J.P. Morgan Asset Management
[13] https://www.bloomberg.com/news/articles/2021-06-22/buy-canada-stocks-at-biggest-discount-in-decades-bofa-says
[14] FTSE Canada Universe Bond Index™

advantage of opportunities. Opportunities like in March of last year by adding to stocks after they declined by 30%, and now protecting against inflation and high stock market valuations.

In the next 10 years, when I am stepping out of my driver-less, electric flying car and booking my first trip to the moon, I bet interest rates will be higher than they are today, and bowls cuts, baggy jeans and chain wallets will be back in style.

-Kind regards,

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