Review of Second Quarter

In the second quarter of 2020 equity markets saw a continuation of the historically high levels of volatility experienced in the first quarter. Fortunately, this quarter the volatility has been positive with global markets rebounding significantly.

In Canadian dollar terms the Canadian Market[1] was up 17.0%, the U.S. Market[2] up 16.3% and the International Markets[3] up 11.0% for the quarter. Despite strong second quarter rebounds the Canadian Market remains down 7.5% for the year and the International Markets are down 6.6%. The outlier is the U.S. Market. Driven by significant gains in large technology stocks and the strength of the U.S. dollar, the U.S. Market is up 1.8% for the year in Canadian dollar terms.

Bond yields remain historically low. At the end of the quarter, the 10-year Government of Canada bond yield was 0.53% versus 1.47% a year ago. Given this, we view bonds to be very expensive and do not believe they will provide investors a real long-term return.

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What is with this volatility?

To say that equity markets are unpredictable in the short-run is an understatement. In the short-term pretty much anything can happen as prices in the equity markets often move quickly, both up and down. Volatility in the first half of 2020 was much higher than normal, but this was simply an extreme example of a well-known feature of the equity market. A helpful analogy is the weather, where the recent volatility is the equivalent of a once in a decade weather event. Much like extreme weather events, the prudent course of action to deal with equity market volatility is to have a plan that allows for the possibility of extreme moves.

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The reason equity markets are more volatile in the short-term compared to other markets is primarily a function of scale, the speed at which prices adjust, and the ease of making a transaction in these markets. Equity transactions can be executed between counterparties globally, on any day the market is open, at essentially no cost. This makes the equity markets a convenient source of liquidity when investors are looking to raise cash. Any event that causes investors to be more cautious in the short-term tends to have a larger impact on the equity markets than other markets. We have seen this phenomenon play out with terrorist attacks, banking collapses, oil price shocks and now a pandemic.

To understand why equity markets can be so volatile think about the range of assets an investor can own. Investors with exposure to the equity markets may own houses, vehicles, private business and a whole range of other assets. For whatever reason, if a large group of investors become cautious, an easy way to reflect that caution is through selling equities to raise cash. Other markets will see pressure as well, but not with the same speed as the equity markets. While investors cannot easily sell 10% or 20% of their house or business, they can sell a percentage of their equity holdings with essentially no transaction costs, making equities a natural source of liquidity.

Finally, the constant updating of prices in the equity markets makes for the possibility of a feedback loop that leads to more selling. Cautious investors raise

[1] S&P/TSX Composite
[2] S&P 500 (C$)
[2] MSCI EAFE (C$)

cash causing prices to go down, which makes investors even more cautious and wanting to raise more cash and on it goes. This dynamic can also play out in the opposite direction when prices are rising and investors fear missing out on equity market gains. We have discussed this behavioural bias in previous letters.

Volatility is a feature, not a flaw, of the equity markets and something that investors must learn to live with. The upside is that the equity markets provide investors with liquidity, at low cost, and allow investors to gain access to investments across numerous sectors and geographies. The downside is the short-term volatility of the equity markets.

What is the long-term impact of the response to Covid-19 on valuations?

We typically try to avoid extreme language in our quarterly reports, however it is not hyperbole to suggest the response to the current pandemic has led to an unprecedented level of uncertainty.

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There is uncertainty around the medical outlook, including the development of a vaccine and effective treatments. There is uncertainty around the public health policy response and whether it leads to additional lockdowns and the associated economic disruption. There is uncertainty around the fiscal and monetary policy response to the economic impact of lockdowns. Finally, there is uncertainty around how the public will respond to any of these policies.

Given these uncertainties, it may be reasonable to conclude the significant equity market sell-off in March was justified and the subsequent rebound is unwarranted. However, if we look at equity valuations on a longer term time horizon the current valuation appears more reasonable.

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The value of a given company is a function of the future earnings of that company, not just the earnings over the next year. This may seem obvious, but it is important to remember as much of the commentary in the media is focused on the short-term. To illustrate this point we can look at price to earnings (P/E) multiple, which is a common valuation metric used to evaluate the value of a stock. We have discussed P/E in previous letters, but as a reminder it divides the price of a stock (P) by a company's annual earnings per share (E). While the ratio has fluctuated over time, the average forward P/E for the overall market has been around 17x over the past 25 years, meaning if a company is forecast to make $1 per share in earnings next year the stock price would be $17. All else being equal if earnings went to zero for one year and fully recovered after that it should translate into a 6% (1/17) decrease in the share price.

Clearly all else is not equal during a pandemic and perhaps valuation multiples will adjust down. But the point is that regardless of how you choose to value an investment, very little of the current value is attributed to near-term earnings. Overall earnings have not gone to zero but are expected to be down 25-40%. Assuming earnings recover fully over the next 3 to 5 years, this translates into an expected price decline of 5% to 10% - roughly what global equity market have experienced this year.

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None of this is to suggest markets cannot fall further in the short-term and perhaps the recession will be longer and deeper than currently anticipated putting additional pressure on equity valuations. We simply want to remind investors that are truly long-term not to be particularly concerned with current year earnings and to focus instead on the long-term earnings of the companies they own.

Outlook and strategy

The recent market volatility does not change our belief that a well-diversified basket of equities remains the best way to protect and grow the purchasing power of capital over the long-term. The high level of volatility serves as a reminder of the necessity of having near- term spending needs set aside in assets not subject to the volatility of the equity markets. An investor never wants to be forced to sell their equities during a time of depressed prices.

With many segments of the market having recovered most of the first quarter losses, now may be an appropriate time for investors to review their level of equity market exposure. In the long-run the higher volatility of the equity markets should translate into higher returns. However, if the higher returns are not necessary to meet investment goals, it is possible that the additional volatility may simply lead to increased stress which can translate into panicked, and often bad, decisions.

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As always, if you wish to review your liquidity needs or asset allocation please contact us. The overall asset allocation is the most important decision, so it is necessary that clients are comfortable that their allocation reflects their circumstances and goals.

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