2021 Market Review

2021 was positive for equity markets globally, but gains were not spread evenly. Two of the best performing markets were the U.S and Canada, up 27.1%[1] and 25.1%[2] respectively. Developed Markets outside of North America were not as strong, up10.9%[3] collectively, but with much variation. The U.K and European markets were up over 15%, while Developed Asia was up less than 1%. Emerging Markets were down 3.4%[4] on the year.

Interest rates moved up during the year, resulting in negative returns for bonds generally. Most broad bond benchmarks were down between 2% to 3% for the year.

The range of outcomes across geographies once again highlights the importance of diversification within an investment portfolio. The returns equity markets generated in 2021 were not predictable and taking an outsized position in any one geography or sector could have led to poor results.

Predictions are hard, especially about the future

Looking back at 2021 we are reminded, once again, how difficult, if not impossible, it is to make accurate short-term predictions of market movements. Back on January 1, 2021 it would have been very difficult to predict that all, or even many, of the following would take place during the year.

- Large U.S. companies would continue to dominate stock market returns.
- Despite cheaper valuations and better long-term growth potential, Emerging Market equities would underperform large U.S. companies by 30% (+27.1% vs – 2.5% in U.S. dollar terms)
- In Canada, Energy stocks would be up 49%, while Gold stocks would be down 10%.
- The total value of cryptocurrency would exceed $3 trillion dollars. Regardless of one's view of crypto as a viable long-term investment, there is 'real' money being allocated to the space.
- Inflation would rise to close to 5% in Canada and over 6% in the U.S., the highest rates in over 40 years.
- Despite the ongoing pandemic, unemployment rates would continue to decline across almost all geographies.
- The largest drawdown during the year for the S&P 500 would be only 5%, when historically the average has been over 14%. 2021 was remarkable for how little volatility there was in the U.S. markets.

The list could go on and on, and this is only concentrating on financial markets. One could make a similar list for everything from politics to fashion trends.

Why are short-term market movements so unpredictable?

It is not particularly insightful to point out that short-term market movements are unpredictable, as we often highlight this unpredictability in our quarterly letters and other communications. This short-term unpredictability is the primary reason for keeping near-term spending needs set aside in an asset not subject to the volatility of the equity markets and ensuring a portfolio is diversified across geographies and sectors.

However, we do not often address the question of why markets are so volatile in

[1] S&P 500
[2] TSX Composite
[3] Morgan Stanley EAFE (C$)
[4] MSCI Emerging Markets Index (C$)

the short-term. Intuitively it would seem logical that with enough experience, expertise and analysis one could start to make reasonably accurate forecasts about short-term market movements, but history clearly shows that this is not the case. Forecasting failure is a well-researched topic in financial literature and there is no consensus as to why the markets are as volatile as they are, but we will highlight some of the key points that we believe explain much of the market's volatility.

Markets are made up of independent participants. This statement may seem obvious, but it is important to consider that the 'market' is simply the coming together of millions of independent participants to transact, each with their own goals and biases, and these goals and biases can change at any moment. Trying to develop a reliable forecast in these conditions is not possible.

True insight is hard to come by. Experience, expertise and analysis are important when constructing a portfolio and evaluating an investment, however when there are thousands of people with similar expertise and experience, conducting similar analyses; how much insight can one expect to gain relative to the collective wisdom of the market? Perhaps the only true insight an investor has is into their own circumstances and emotions, which is why it makes the most sense to construct a portfolio that focuses on the investor's needs and goals, not making large bets on any given market move.

Individual actions are driven by emotions which are often irrational and hard to predict. Since market movements are the net outcome of the cumulative action of millions of people, to predict market movements one would need to consistently predict the actions of individuals. One does not need a degree in behavioural psychology to understand that emotions such as greed, envy, euphoria and many others can lead to irrational actions. The aggregation of individual irrational actions leads to the unpredictably of the markets. We recently came across a quote in the Psychology of Money by Morgan Housel which sums it up nicely - "Richard Feynman, the great physicist, once said, 'Imagine how much harder physics would be if electrons had feelings.' Well, investors have feelings."

Unknown-unknowns. The information impacting the markets can largely be categorized into one of three groups: 1) known-knowns – information that is known by all to be true, 2) known-unknowns – information that is not known, but the market knows it is not known, and 3) unknown-unknowns – that which is not only unknown, but unforeseeable. Markets are very efficient at 'pricing-in' the first two, but will swing wildly with the third. Unknown-unknowns was perhaps more famously cited by US Secretary of Defense Donald Rumsfeld during a news briefing discussing weapons of mass destruction back in 2012. However, the concept has been known and cited for many years in psychology and means that regardless of how much experience or expertise one has, or the depth of any analysis, there are some things that simply cannot be known or anticipated.

Looking at early 2020 and the emergence of COVID 19 may help to illustrate the concept further:

> Known-known: Seasonal viruses such as influenza circulate and mutate causing various levels of disease, hospitalization and death globally.
>
> Known-unknown – New pathogens will appear from time to time that can lead to pandemics the severity of which is not known.
>
> Unknown-unknown – In response to a pandemic public health officials will send workers home causing huge disruptions in how markets function, resulting in large price swings as the normal operations of markets are essentially halted.

The policy response to COVID-19 and subsequent impact on market operations was simply not foreseeable based on all available evidence and experience – it was an unknown-unknown. We often get questions about how the outcome of some event is likely to impact the market, for example federal elections, central bank policy decisions or government budget announcements. These are example of known-unknowns and tend not to move markets much. It is the truly unforeseeable events that move markets dramatically in the short-term.

If the market is so unpredictable, why bother making predictions at all? Dwight Eisenhower is believed to have once said that 'plans are worthless, but planning is everything', and we believe market predictions serve a similar function. Predictions are less about being right or wrong, and more about evaluating investment options and holding oneself accountable over time. Recording predictions and comparing them to actual events can be a very humbling experience and humility is a good trait for a long-term investor to possess.

Dealing with unpredictability

All roads in investing ultimately lead to diversification.

Understanding that the unpredictability of the market is a feature, not a bug, means an investor should build a portfolio that meets one's goals regardless of how events unfold. This means allocating capital across many sectors and geographies and ensuring there is sufficient liquidity to meet short-term spending needs in the event of a substantial market decline.

In the long-run the markets are much more predictable. The unknown-unknowns become knowns and are reflected in prices, contrasting emotions that lead to irrational behaviour offset each other, and the underlying participants in the market and the economy adjust to reflect new realities. This has been true for hundreds of years and there is no reason to believe this will not continue into the future.

Outlook

The strong equity markets over the past few years likely means that future returns will be lower than what we have recently experienced. At the very least we believe it prudent to keep return expectations in check. Over the very long-term, global equity market returns have been close to 10% a year, while in the last 5 years that number has been over 14%. Assuming returns ultimately revert to the average makes it reasonable to plan for a period of below average returns. However, below average certainly does not mean negative and even below average equity returns are compelling when compared to the primary alternative of bonds.

We, therefore, encourage clients to stay the course and continue holding a broadly diversified portfolio of equities, with spending needs set aside as necessary. As always do not hesitate to contact us if you have any questions or concerns, or wish to give us the update on your circumstances.

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