2024 Market Review

2024 saw equity markets up double-digit percentages across the globe. The U.S. equity market led the way, up 35.7%[1] during the year. The Canadian market was up 21.7%[2], Developed Markets outside of North America were up 12.9%[3], while Emerging Markets were up 17.3%[4]. Fixed income returns were more modest, with the Canadian bond index up 4.2%[5]. 2024 was undoubtedly a strong year for the market, but as seen below, it was not at all an anomaly.

Below are the total annual returns for the world index going back to 2009. For the past 6 years the world market has moved double digits either up or down. Markets move significantly in both directions all the time. In the long-term, the return on the equity markets globally have averaged around 9% annually, but only a single year in the last 16 years, 2016, was anywhere close to 9%. Historic long-term annual returns are not good predictors of short-term returns.

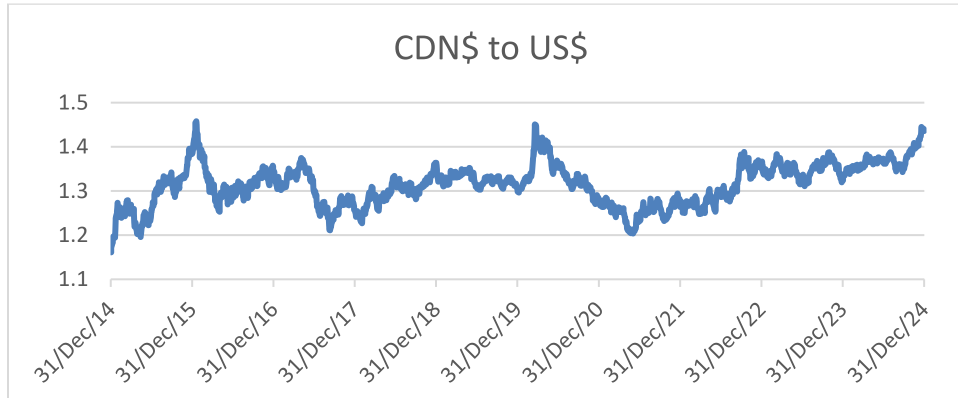
FTSE Global All Cap Index – US $ Return %

2024	2023	2022	2021	2020	2019	2018	2017	2016	2015	2014	2013	2012	2011	2010	2009
16.7	22.0	-18.0	18.4	16.6	26.9	-9.7	24.2	8.8	-1.8	4.4	23.7	16.7	-7.6	13.1	35.7

Source: Vanguard US

Of potential interest to Canadian investors was the movement of the Canadian dollar during the year. At year end, the Canadian dollar was CAD$1.44 to USD $1.00, a change of roughly 8% on the year. This movement significantly enhanced Canadian dollar returns on markets outside of Canada. Based on history and purchasing power parity, at current levels, the Canadian dollar is arguably undervalued compared to the U.S. dollar. However, we do not anticipate making significant portfolio adjustments based on the recent movements in currency, only marginal changes.

The logic of making only marginal changes is that currency gains and losses do not compound over time. Regardless of how positive or negative one might be about the state of the Canadian economy, believing the dollar is going to zero or infinity is not, in our view, a reasonable investment proposition, even over a very long-time horizon. The fact that the gains do not compound means that to profit from currency movements, an investor must actively trade the currency. This active trading is more speculation than investing, in our view. As can be seen below, in the past 10 years the Canadian dollar has reached similar levels on several occasions, but the total return over the period is less than 2% annually. The cumulative return of the U.S. dollar versus the Canadian dollar for the last 10 years was 24%, while the cumulative return on the world equity markets was 145%. For long-term investors, the impact of currency is modest compared to the broad movements of the markets.



Source: Bloomberg

The benchmark 10-year Government of Canada yield rose very slightly on the year to 3.3%, up from 3.1%. In contrast, the 10-year U.S. Treasury yield finished the year hovering around 4.6%; this interest rate differential is one of the primary drivers of the weakness in the Canadian dollar compared to the U.S. dollar.

On Risk

In our previous quarterly letter we wrote about value, arguing value is largely a function of the views and circumstances of the individual determining the value. Below we will argue risk is similarly a function of individual circumstances. Appropriately evaluating risk is arguably the most important consideration when building the appropriate investment portfolio.

[1] S&P 500 (C$)
[2] S&P TSX Composite
[3] MSCI EAFE ($C)
[4] MSCI Emerging Markets (C$)
[5] RBC Canadian Bond Broad Composite Index

What is Risk?

Defining risk is straightforward; it is the probability of a negative outcome. Where the nuance arises is distinguishing between individualized risk and population wide risk. In some cases, risk is fairly homogenous across the population, whereas in other cases, it is entirely dependent on individual circumstances.

Some examples may help clarify what we mean, let's compare jumping out of an airplane to eating a peanut.

If an individual jumps out of an airplane at 10,000m without a parachute and plummets to the earth, the outcome will be consistent regardless of the individual's circumstances. Age, ethnicity, socioeconomic status, health, etc. do not matter. The probability of a negative outcome when jumping out a plane without a parachute (i.e. risk) is consistent across the entire population. Conversely, if an individual eats a peanut, the outcome may be catastrophic for someone with a severe peanut allergy but totally benign to somebody without an allergy. The probability of a negative outcome from eating a peanut (i.e. risk) is not consistent across the population and is entirely dependent on the circumstances of the individual.

Recognizing that risk is often dependent on the circumstances of the individual seems obvious. However, risk in investing is often described in terms more consistent with jumping out of an airplane without a parachute; while the risks in investing bear more resemblance to eating a peanut. What is a risky investment for one individual will not be risky for another. Ironically, investors' efforts to reduce risk may actually increase the likelihood of a negative outcome, something we will discuss in more detail below.

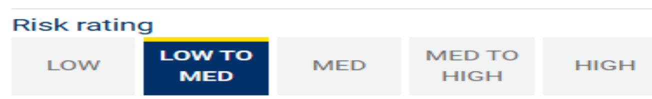
The folly of trying to calculate risk across the population

Let's imagine two extreme examples of very different investors. Investor A has $1m and knows with complete certainty they will have no cash needs forever – the assets are purely excess to their goals. Investor B has $1m, but no other assets or earnings whatsoever and owes a $1m tax bill in 6 months.

What is a risky investment to investor B will clearly not be risky to investor A. The $1m can go to $0 for investor A and that is not a negative outcome since the funds are excess; no investment is risky to investor A given their circumstances. For investor B, even a modest drop in value is disastrous. That the riskiness of an asset is different for investor A and B is glaringly obvious, but investable assets are typically described in terms that assume risk is consistent across investors.

Search 'Risk-Free Asset' online and the summary is: '*A risk-free asset is an investment with a guaranteed return and almost no chance of loss.*' At first glance this may seem like a reasonable definition, but what if the investor needs to grow the underlying purchasing power of the capital (a reasonable goal in our view) and the guaranteed rate of return is below inflation? In that scenario, the probability of a negative outcome approaches 100%, in which case it makes no sense to call an asset 'risk-free'. The scenario of the guaranteed return rate being below inflation is hardly hypothetical, as it describes the reality of interest rates and inflation for much of the last two decades.

If one looks up the information on any mutual fund or exchange traded fund (ETF) in Canada, there is typically a Risk Rating that looks something like the following from the RBC Balanced Fund.



A single Risk Rating is given for an investment, implying risk is consistent across investors, (similar to jumping out of an airplane without a parachute), but this is demonstrably false. The simple thought exercise of investor A and B above, and common sense, tells us risk is not consistent across investors. Risk in investing is more similar to eating a peanut, where the risk is entirely a function of how the investment fits within the investor's circumstances.

So, what is 'Risk' telling us?

The 'Risk' in the Risk-Free Rate or the Risk Rating above is clearly not the probability of a negative outcome for every individual investor, so what is it? The 'Risk' being described is the probability of short-term downside volatility of the particular investment. For some investors, such as Investor B above, this measure of risk may be appropriate, but for long-term investors, this is obviously not an appropriate measure. The fact that an investment has some probability of going down in the next 12 months is not a relevant consideration for investors with time horizons measured in multiple years or decades.

What makes this false measure of risk so insidious is that it can lead to long-term investors taking on more real risk. As we have discussed in numerous quarterly letters and other client communications, the acceptance of short-term price volatility translates into higher expected long-term returns. If an investor needs a return in excess of the so-called risk-free rate in order to meet investment goals, it is possible that reducing short-term volatility *(false risk)* will increase the likelihood that the long-term investing goals are not met *(real risk).* Most investors consider themselves risk-averse, so risk reduction is a reasonable and rational goal, but it is crucial risk be appropriately measured and defined to reduce it.

An obvious question is why the finance and investment industry uses short-term price volatility as a proxy for risk even though it is clearly a poor proxy. The simple answer is volatility is easy to measure, but risk is not, and people like clear metrics to guide decision making. Investors, quite rationally, want to understand the risks they are taking and potentially take steps to reduce it, so the investment industry provides investors with a simple, easily quantifiable metric to do so. However, the relevance (or lack thereof) of the metric is rarely discussed.

The tendency to rely heavily on easily observable quantitative metrics and ignoring hard to quantify or immeasurable metrics is often described as the Quantitative or McNamara Fallacy. Just because something is easy to measure (volatility) does not make it important, conversely just because something is hard to measure (long-term risk) does not make it unimportant.

Investing Insight

We are often asked what we believe the market is going to do over some specific time period or how the market will react to some geopolitical event. While we can make informed guesses based on experience and history, the fact is we don't have any great insight into what the market is going to do – nobody does. Any relevant information about current and historical market movements is available to anybody who cares to study it, and there are literally millions of people, not to mention artificial intelligence, pouring over the data. Given this reality, it would be the height of hubris to believe we know something nobody else knows about what the market is going to do.

Understanding there is no insight to be found in what the market is going to do does not mean investing insight is not available, it is simply that one must look elsewhere to find it. Paradoxically, obtaining investing insight is straightforward since one need only to focus on individual circumstances, behaviours and emotions. Everyone has insight into their own circumstances, behaviours and emotions. The key to investing success is appropriately marrying those traits with what is available in the investable market.

A usual analogy is to think of a doctor diagnosing and treating a disease. The real value of a doctor does not come from a unique understanding of a particular disease, it comes from appropriately diagnosing the patient to determine the best course of treatment. All the insight in the world into some rare disease is of little value if the patient has been misdiagnosed.

Fortunately, diagnosing an investor's circumstance is straightforward. The key is that investors should maintain their focus on those circumstances and not get drawn into looking for insight into the overall market. With a proper understanding of circumstances, behaviours and emotions, the value add is to use experience and investment knowledge to build the appropriate portfolio of investable assets. It is not about being consistently smarter than other market participants.

Outlook and Strategy

A couple of strong years in the equity markets make it prudent to recalibrate return expectations. Historically long-term returns in the equity markets have been in the range of 9% per annum with plenty of volatility. At current valuation levels, and given recent market strength, it makes sense to plan for returns somewhat below the average, perhaps 7% to 8%. The path of those returns is unknowable, and actual returns may prove to be higher or lower than those expectations, but for the purposes of asset allocation, this seems a reasonable expectation to us. While below average, the long-term return potential on equities remains superior to what is available in most other asset classes and, therefore, continues to be our focus. We will continue to make modest changes based on country and sector valuations and, to a lesser extent, currency, but our focus will be on maintaining the appropriate equity allocation based on specific client circumstances.

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