Where Do You Stand Now?

By Giles D. Marshall

A few months ago, equity markets closed 2019 with the S&P/TSX Composite Index and the S&P 500 (CDN$) up 22.9% and 24.9%, respectively.[1] The investment consensus in early 2020 was very optimistic for the year ahead, founded on easy monetary policy, the Phase 1 US/China trade deal and expectations for an earnings recovery. By the time most equity markets peaked on February 19, equities were "priced for perfection" while sentiment bordered on euphoric.

How quickly investor sentiment changed. The spread of COVID-19 beyond China, the subsequent collapse in oil prices and stress in credit markets prompted an abrupt reversal in sentiment as investors grappled with the potential duration and magnitude of the shock and its impact on humans, as well as on corporate growth and earnings for the balance of 2020.

Shocks, by definition, are very hard to predict. As the 2009-2020 bull market unfolded, many investors began questioning the benefits of defensive assets such as bonds and cash, given their modest yields. However, the history of financial markets suggests shocks occur quite frequently, so investors should be prepared for the unexpected.

Of all the documents we ask you to sign, none is more central than the Investment Policy Statement (IPS) for each portfolio. The IPS determines the constraints within which we must execute our discretionary powers. It details the portfolio's long-term investment strategy—notably the mix of bonds and equities—that will overridingly determine the portfolio's long-term expected return and the risk that can be assumed. Risk is defined as volatility (i.e., the variability around long-term historic return). Mathematically, volatility is easy to calculate so it's widely used in investment management. However, it may not be the most appropriate measure of risk for many clients.

Thinking about recent market behaviour, which has been extremely volatile by any historical standards, how have you fared?

- Are you more troubled by the day-to-day swings or declines in dollar terms?
- Can you distinguish realized or terminal losses, on the one hand, from unrealized or "paper losses" on the other?
- Are you considering your aggregate investments? For example, have you included your Fiduciary Trust Canada portfolio as well as other assets such as a defined benefit pension, government entitlement, GICs and cash at the bank, the cash value of any insurance policies or a portfolio at another firm? Were these assets disclosed and included in the design of your investment strategy?
- Have you needed to make a large, unexpected withdrawal that caused a liquidity problem?
- Are you generally optimistic COVID-19 will be contained and that markets will recover, or is your primary focus the overwhelmingly negative media coverage?
- Quite literally, are you losing sleep at night?

Risk tolerance is very personal and there's a difference between risk "appetite" and risk "capacity." In other words, your personality may be comfortable with a high-risk appetite but you may not have the capacity—sufficient assets relative to your spending needs and a relatively long time horizon to regain losses—to assume a high level of risk. Questionnaires and conversation at the inception of our relationship are helpful in gauging risk tolerance. However, we know from experience that risk tolerance requires a regular checkup.

Significant market corrections, such as the one we're currently experiencing, truly test an investor's resolve. Is the strategic asset mix in the IPS biased by your return needs or expectations or by your risk tolerance and capacity to assume risk? These are difficult questions to answer, but they should be discussed and addressed whenever you review your portfolio with your investment advisor and/or Fiduciary Trust Canada portfolio manager.

1. Source: FactSet, as at December 31, 2019.