

# The Recent Market Volatility: Our Thoughts

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The ongoing US mortgage crisis has developed into a banking crisis, which has, in turn, led to the stock market decline we have experienced in the last few weeks. Several analysts and commentators think we're heading into a recession and an equity bear market. Regarding the recession, they may have it right. One of our favourite leading indicators, US Housing Starts, has fallen to just 1 million units, compared to numbers that were well above 2 million less than 2 years ago. In short, US residential construction has almost come to a halt, which has had a negative impact on sales of appliances, furniture and a variety of other durable goods. However, as Alan Greenspan recently pointed out, recessions are almost always identified after they have run most of their course—if not after the fact. This is due to the complexity of gauging economic activity and to the fact that most data is published with a significant time lag. Furthermore, due to the emergence of giants like China and India, the relative importance of the US consumer in the global economy has declined substantially over the last decade, thereby reducing the likelihood of a worldwide recession.

Regarding the stock market, the commonly used definition of a bear market is a decline of 20% or more. The S&P/TSX is currently down 12%, while the S&P500 is down 14%; so, in North America, we're not quite there, but it may yet happen. In Europe, the market is down 19% and Japan is down 29%. So let's just assume we're in a bear equity market. *What should we do now?*

It's when markets are highly volatile that it is beneficial to have an investment philosophy. Such a philosophy is made up of principles that are stable and unaffected by the mood of the day. It is important to note that PWL Capital has a solid investment philosophy made up of seven key elements:

**1. The science of investing creates an advantage**

Financial economists have studied the stock market for over 50 years. They have made a variety of findings on topics ranging from how to build an efficient portfolio, to how securities are priced. But, to our knowledge, none of them have concluded that it is profitable to sell out in a market panic.

**2. Most active managers don't beat market indices**

As demonstrated by research from Standard & Poor's, 90% of Canadian Equity mutual funds were not able to beat the S&P/TSX in the five years ending on December 31, 2006 (2007 results are not yet available). Our intuition is that this number is a pretty good reflection of active management in general: those who try to sell out of the market and re-enter later will probably lose money 9 times out of 10.

### **3. Three factors drive long-term returns**

*a. The relative allocation between stocks and bonds*

Stocks have higher expected returns than do bonds. This is called a risk premium, as stocks are a lot more volatile than bonds.

*b. Within stocks, the relative allocation between Value and Growth Equities*

We maintain that value stocks have a higher expected risk and return than do growth stocks. Research has demonstrated that these companies are generally more indebted, their earnings are more volatile, and the growth of their earnings is far weaker than that of growth companies. So the market demands an additional risk premium.

*c. Within stocks, the relative allocation between Small Cap and Large Cap Equities*

Much like Value Equities, Small Cap Equities have a higher expected risk and return than do their Large Cap counterpart, as small companies are generally less solid than large ones.

So, in short, the weighting of these three components within a portfolio determines its long-term return, not the money manager's ability to forecast the future. Historically, equities have produced a premium of approximately 4% per annum over bonds. Value and Small Cap Equities have historically produced risk premiums hovering around 2% above the average equity return. However, the expression "risk premium" does not mean that riskier asset classes will outperform their less risky counterparts every year. In fact, they can sometimes underperform for many years, which explains the "risk" component in the expression "risk premium." But over a long investment horizon, risk premiums are very likely to deliver their expected added-value for the benefit of patient investors.

### **4. International diversification produces better risk-adjusted returns**

International diversification has many advantages. It reduces portfolio volatility, as country markets do not move in perfect synchronicity. As Canadians, investing outside of the country allows us to expand portfolio diversification, since 75% of our market is concentrated in financial services, energy, and basic materials. Another key advantage of diversifying internationally is that it leads to a more reliable return, as sometimes, Canadian Equities can lag behind other country markets for decades.

### **5. Defer portfolio taxes as long as possible**

A key side effect of having a tax-deferral strategy is that it leads us to favour the lowest possible portfolio turnover, in order to minimize taxable capital gains each and every year. Avoiding capital gain realization allows investors to generate a return on the money that is implicitly owed to the government, because unrealized capital gains are not taxed. In the long run, deferring taxes will systematically lead to the accumulation of significantly greater wealth, with no incremental portfolio risk. Of course, if an investor liquidates his equity holdings each time the market becomes volatile, he will sacrifice these significant gains.

### **6. Buying and rebalancing leads to better risk-adjusted returns**

Our research leads us to conclude that disciplined, periodic portfolio rebalancing reduces volatility, and may slightly increase returns. Let's take the simplified example of a portfolio with a policy asset mix of 50% stocks and 50% bonds. If stocks return -25% while bonds return 5%, then stocks will become underweighted (42% vs. 58%). Rebalancing involves buying 8% in stocks and selling 8% in bonds to bring the asset mix back to the desired 50/50 policy asset

mix. The reverse will happen when stocks outperform bonds. Therefore, rebalancing involves systematically taking profits from the outperforming asset classes and reinvesting the proceeds into the underperforming ones.

**7. Diversification reduces risk**

We believe that the best way to invest in equities is through ultra-diversified pools. Whether a portfolio includes 20 stocks or 1,000 stocks, its expected return will be determined by the three factors reviewed in Principle #3. In addition, with the efficiency of today’s information technology, ultra-diversified stock pools are created at a very low cost. *So why not eliminate the risk of some poorly performing stocks hurting your portfolio?* PWL portfolios typically include over 5,000 stocks, through mutual funds and exchange-traded funds, so that even if many companies go bankrupt at the same time, it will not significantly affect the capital. In addition, diversification also means participating in other asset classes, such as bonds and Real Estate Investment Trusts (REITs), thereby reducing the portfolio’s exposure to equity market risk.

*Conclusion*

As you reviewed the seven key principles of the PWL investment philosophy, you may have noticed that we don’t recommend following the crowd when the market is in a panic. Consider the following argument: if we assume we are in a bear equity market, and if they tend to last longer than just a few weeks, then why not reduce equity positions and jump back into the market later?

Please take a look at the following table where we list all Canadian bear markets since 1956. As you will see, there is no pattern whatsoever. Two of the declines lasted only four months while another lasted 25 months. Cumulative losses ranged from -20% to -43%. So our conclusion is that we’re not fully certain we’re in a bear market, and even if we were, we don’t know how long it’s going to last. Our best advice is to avoid playing roulette: stick with equity investments and rebalance the portfolio by buying additional equities if they become significantly underweight relative to your investment policy.

<b>S&amp;P/TSX Composite: Declines of 20% and more</b>				
<b>Peak Date</b>	<b>Trough Date</b>	<b>Decline (%)</b>	<b>Decline Duration (months)</b>	<b>Recovery Duration (months)</b>
May 1957	December 1957	-26.90	7	16
May 1969	June 1970	-25.39	13	19
October 1973	September 1974	-34.96	11	43
June 1981	June 1982	-39.15	12	10
July 1987	November 1987	-25.45	4	20
December 1989	October 1990	-20.08	10	29
April 1998	August 1998	-27.47	4	15
August 2000	September 2002	-43.20	25	34
<b>Average</b>		<b>-30.33</b>	<b>11</b>	<b>23</b>

Source: Ibbotson Associates