UNDERSTANDING WHAT THE REAL RISK IS (AND ISN'T) IN YOUR PORTFOLIO

Scott M. Yates, *CIM*
Portfolio Manager

Raymond James Ltd.
Suite 4100, 525 – 8th Avenue S.W.
Calgary, AB T2P 1G1

T: **403-221-0359**
TF: **1-844-459-0359**

scott.yates@raymondjames.ca

www.raymondjames.ca/scottyates

To my valued client and fellow investor,

In a previously written quarterly letter (2Q2020 titled "Worry Free Investing"), I detailed how your investments should never cause you to worry, regardless of the current state of the economy, the market "outlook", or your own stage in life.

In follow up to that letter, I can only see two possible scenarios where an investor perhaps should actually worry about their investments (for all the good worrying has ever done!): (1) they don't have a prudent, professionally managed investment plan, or (2) they don't have a clear understanding of what the real risk is to their portfolio.

"Nothing in life is to be feared, it is only to be understood.
Now is the time to understand more, so that we may fear less."
- Widely accredited to Marie Curie

Given that my audience here represents my own clientele, we can immediately eliminate the first scenario above. As a client of mine, you don't simply own investments. You have an investment plan designed to meet your own unique long term investment goals and objectives. (If you're at all uncertain about your investment plan, or how it truly should allow you to invest worry free, please let me know so we can arrange a thorough review and make any necessary updates or changes).

With that out of the way, let's move on to the second scenario mentioned above. The purpose of this letter is to ensure that you have a clear understanding of what the real risk is in your portfolio, and - perhaps most important – what the real risk isn't. Allow me to start with the latter…

What the real risk isn't

Stock market volatility is NOT the risk, although most investors confuse volatility with risk. I'll even go so far as to say that, not only is market volatility not THE risk, it's not even A risk! Allow me to explain…

The financial "news" media propagates this confusion by constantly reacting to each and every market drop with "it's the end of the world" reporting. They seem completely remiss of the fact that the stock market goes UP almost 70% of the time? But clearly the reality that the long term trajectory for the market has always, and will always (barring some form of Armageddon), be UP - is not "newsworthy" enough. Tough to make any "breaking news" out of the fact that equities have

averaged roughly 10% per year over the past two or three decades. Far better to make mountains out of molehills, as the financial news media always does, on a daily basis. As we all know, in the "news" industry its bad news that sells! Worse yet, they "report" on the gyrations of the stock market in microscopic detail; i.e. by the second. And yet, as you and I know, stocks are a long term investment asset class.

Somehow remiss of the historical long term market advance, when a novice investor sees their portfolio drop in value (e.g. on a monthly or annual statement) they are inclined to say (or at least, think) that they just lost money (…I must admit, this is my pet peeve!). Of course, no investor wants to lose money. As such, many believe stock market volatility is THE risk, given that it results in the current market value of their portfolio to temporarily lose some of its value. However, what we're really talking about here is a "loss" on paper only. In other words, such a scenario is more accurately described as an unrealized loss – if it can be described as a "loss" at all.

The exact same goes for market volatility when it is to the UP-side (…although of course, the media never describes a big move UP, as "volatility" – even though technically that's exactly what it is). When your portfolio moves up a great deal – let's say in a week, month, or year – what you have (if anything) is a nice unrealized gain, on paper only.

To be clear, the only price that really matters is the price you pay – and the price you eventually receive when you sell. As long term investors (and yes, this includes retirees!) that selling price is likely to be many years if not decades into the future. Everything in between is really just noise, and should be treated as such. Remember…

"The investor who permits himself to be stampeded or unduly worried by unjustified market declines in his holdings is perversely transforming his basic advantage into a basic disadvantage.

\- Benjamin Graham

Just in case you're still trying to wrap your head around this, here is a personal example. The house my family and I live in is worth less money today than we paid for it almost exactly seven years ago (…I know, for my Toronto and Vancouver based clients this seems almost unfathomable!). But that wasn't always the case. Our home didn't immediately begin to drop in value the day after we moved in. In fact, it actually went up in market value for the first couple of years, before it then proceeded to drop along with the rest of the Calgary housing market (in general, of course - and in some correlation to oil and gas prices).

What I've experienced is some volatility in the market value of my home. Did I actually somehow make money when the value of my home temporarily went up after we bought it? And given that, as of today, our home is worth less than what we paid for it, have we actually now somehow lost money? We can't have both, can we? And if it goes back up in value next month, did we make money – again? I'm sure you get the point here. The sole determinant of whether or not we will have made or lost money on our homes or our stocks, will be the price we get when we decide to sell, in relation to what we originally paid. Once again, everything else in between is hardly more than noise and really should be viewed as such, if at all.

Here's the really good news. While we have absolutely no control over all of the minor (and admittedly, sometimes major) vicissitudes of the economy and the stock market – we DO have complete control over how we react to them. By seeking to actually take advantage of the short term gyrations when they're significant enough, adding to equities when prices are attractive and trimming them when they're not, we will be among the few who turn volatility to our benefit – as we should.

"Stocks will fluctuate substantially in value. For a true investor, the only significant meaning of price fluctuations is that they offer an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal."

\- Benjamin Graham

Enough about what the real risk isn't. Let's move on to some of the real, actual risks we all face as investors, and how I seek to mitigate them in my role here as your portfolio manager.

The long term impact of inflation

One of first risks I feel I should mention (even though it's not THE risk), is the long term impact of inflation. If you're an investor, by definition you have a long time horizon. I say yet again, "short term investor" is an oxymoron (and please, always keep in mind - your true investment time horizon is to your approximate life expectancy). So, as long term investors we must offset the long term impact inflation will have on our purchasing power.

Here is some rather anecdotal evidence of the impact of inflation: you probably paid more money for your last car than your parents paid for their first house. And if you yourself have been around long enough, YOU probably paid more for your last car than you paid for your first house. Of course, that's not because vehicles are such great investments that go up so much in value. Rather, this is simply an example of the long term impact of inflation.

Here is a more practical example: at a rate of inflation of 3% per year, our cost of living is going to more than double in 25 years. So, as your portfolio manager, what am I doing to mitigate the very real 'risk' of inflation? The answer: own equities. As much of them as you can stomach. Here's why...

We know that we need to offset a 'hurdle rate' of ~3% per year in order to negate the impact of inflation. At today's paltry interest rates, actual "cash" (i.e. with liquidity) is paying around 0.50% for one year. You may be able to find some sort of savings product paying closer to 1%? So does cash, at today's rates, allow us to offset the threat of inflation? At 1% (at best) – 3% (inflation) = -2%. Nope, cash won't do the trick.

Without going into too much minutiae here, bonds clearly don't cut it either. In fact, with current bond yields we would have to go out as much as TEN years to find an investment grade corporate bond that beats cash, paying ~1.51% per year. The math here: 1.51% - 3% = bonds don't work either. Even a 30 year bond, at current rates of ~2.51% annual yield can't offset the long term rate of inflation!

Finally, moving on to stocks, I'm happy to report that just the dividend income alone will mitigate the impact of inflation. At current prices, the annual dividend yield for the Canadian stock market (per the S&P/TSX index) is roughly 3.3% per year. That is what you'd get if you just owned the index though. Clearly no intelligent investor just simply wants to own the index (…that's who serious investors like you and I would kindly refer to as the new "dumb" money)! Not willing to settle for mere index-like dividend yields, we own high quality businesses that pay us dividend income of as much as 5% to 7% per year, and rising!

That's the key with owning equities as a long-term solution for the negative impact that inflation has on our purchasing power. The interest paid on GICs and bonds is fixed. Meanwhile our cost of living is anything but fixed. As such, we need to do better. In other words, we need to own a healthy weight of equities in order to mitigate this particular risk. (Equity prices are volatile – in the short term, but we've already addressed the fact that volatility is NOT risk).

So far we've only talked about the dividend income we receive by owning a diversified portfolio of great businesses. But what about the total return, including the underlying share price appreciation? Suffice to say, the average annual rate of return for the Canadian the stock market (including dividends) over the past fifty years has been 9.1% per year (to the end of 2019).

The math now reads something like this:

Cash – Inflation = You Lose

Bonds – Inflation = You Lose

Stocks – Inflation = YOU WIN

(I know…some of you are likely to respond with – 'but I don't have fifty years to invest'. While this is true for many of us, the math above still does not change. The far superior dividend yield alone from the stocks we own (which in and of itself is enough to offset inflation), versus the interest on cash and bonds (negative after inflation, AND fixed) should provide all the consolation we need. Treat your stocks like a quasi-bond portfolio, but with a better yield AND with upside!).

While we're on the subject of 'risk', and based on the 'math' above, one might ask: *if one of the necessities of successful investing is the need to offset inflation, what's more "risky" - owning cash, bonds, or stocks?*

The risk of a range-bound stock market

Another real risk I see for any serious investor is the risk that equities will not provide us with the 'equity-like' returns that we have come to expect. What happens when we invest in the stock market, complete with the "burden" of market volatility, and the market simply doesn't deliver?

As somewhat of a student of market history, I can tell you that this does happen – more often than we might like. Prolonged periods of time (I'm talking even a decade and longer), where the stock market does not grow at 8% to 10% per year, and sometimes even provides little-to-no return, IS a real risk. As such, we must seek to mitigate it. But how?

First off, during these prolonged periods of 'flattish' stock market returns, this is where your bond exposure may actually shine. Typically (but not always) stocks and bonds tend to perform counter-cyclical to one another. So during a prolonged period of weak equity results, chances are bonds may actually be outperforming.

Another fact to consider is that, during a 'range-bound' market, you won't see much if anything in the way of share price appreciation. But your dividends are still being paid. In other words, you're still growing your money at least enough to continue to offset inflation. I know…that's not enough, but it is something.

And finally, the best way to mitigate this particular risk is really fairly simple: once again, don't just own "the stock market", i.e. the index. Note that I said above that "the market" has experienced prolonged periods of underperformance. But we don't own an index or "the market" (…WE are not "the dumb money"). You own a professionally managed portfolio that will often look almost nothing like the index. So you can rest assured that when equity returns have been flattish and range-bound, it's "all hands on deck" to at least try to beat the market. This can be done by stock selection (where, as you know – I follow a Buffett-like approach), and by focusing on great businesses that not only pay, but increase, the income you receive via dividends – inclusive of any prolonged period of weaker-than-expected total returns.

The risk of manager underperformance

What happens when the stock market does what it normally does; provide great long term returns – but your money manager doesn't? In other words, he or she simply poops the bed. Obviously this does happen. In fact, underperformance is the norm for any so-called 'money manager' who is really nothing more than a "closet-indexer". These are the so-called investment professionals who simply 'hug' their underlying index or benchmark (often as a form of 'job security'), while charging a fee that is indicative of someone who is actually doing their job; managing money. Clearly this is not my modus operandi! (If it was, I wouldn't be highlighting it here!).

Aside from the dreaded 'closet-indexer', even seasoned professionals who are responsibly and actively doing their job can tend to underperform – despite the best efforts. To say otherwise is to say that we've found someone who not only adds value over time, but who also outperforms ALL of the time in between. Needless to say, such a money manager simply does not exist (… and when it does, it's likely to be revealed soon enough as some sort of a Ponzi scheme!).

In my piece titled, "When Bad Things Happen to Good Portfolios" (4Q2019), I pointed out that the absolute, world's greatest – Warren Buffett himself – could not outperform the market ALL the time. So if HE can't, surely no-one else can either, including yours truly! (And yet some of you still seek such a scenario; both great results over time AND at all times in between. In other words, you want your portfolio to 'perform' each and every year. I can't provide you with that, and clearly no-one else can either. I'm sorry, but you're searching for the Holy Grail…).

Having said the above, 'portfolio manager underperformance' is a real and valid risk. So, how on earth can this risk be mitigated? The answer here again is actually fairly simple: I will seek to mitigate this risk on your behalf by providing you with diversification. Not just among the specific investments that make up the holdings in your portfolio, but among the very managers who manage those investment holdings.

What you own as part of my service to you is very much a 'multi-manager' approach. While I will always take full responsibility for your overall results over time, we've essentially hired out what I believe to be your very own 'dream team' of professional, diverse, and proven portfolio managers. Of course, the goal here is to mitigate the risk and impact of any ONE member of your team of managers temporarily underperforming. In fact you have no fewer than five different experienced, professional money managers (including ME) working full time toward the common goal of helping YOU achieve your long term investment goals.

While I only wish that I alone could somehow 'do it all'; attempting to do so would be naïve and irresponsible in my opinion (… despite my ongoing effort to be the absolute best that I can be). So rest assured, I've done all I can to mitigate the very real risk of manager underperformance in your portfolio.

However…

> ***"The best way to measure your investing success is not by whether you're beating the market but by whether you've put in place a financial plan and a behavioral discipline that are likely to get you where you want to go."***
>
> \- Benjamin Graham

Which leads me to…

The REAL risk in your portfolio is

Drum roll please… Here it is, finally! ***Ultimately the real risk, of course, is not reaching your goals.*** This has almost nothing to do with the current economic environment, where interest rates are (or aren't) headed, the next election results, the trade war, inflation expectations, etc. etc. And heaven forbid, this has absolutely nothing to do with any economic or market "outlook" or "forecast". All of this is really just more noise.

Additionally, as I hope I've cleared up above, the real risk is also not volatility, range-bound markets, or even manager underperformance – which can all be mitigated at least to some degree, if not entirely. At the end of the day, the one and only real risk is not reaching your long term investment goals.

So, here goes. ***We will seek to mitigate the real risk in your portfolio by having a plan.*** Most investors own investments. Very few own any sort of an actual investment plan.

Your plan is based upon your true investment time horizon. Most important, it's designed with your long term investment goals always remaining front and center (…not your "risk tolerance", whatever that means?!). With the courage of our conviction, which comes only with having an actual plan, we can strive to take advantage of market volatility – when great businesses are temporarily on sale. In retrospect…

"All financial success comes from acting on a plan.
A lot of financial failure comes from reacting to the market."
\- Nick Murray

As an owner of a professionally managed, diversified portfolio of hand-picked investments (AND investment managers), hopefully you now have a clear understanding of what the real risk is – and isn't! Armed with an understanding of that risk, you own as much equity exposure as you need and can stomach, and no more.

This plan of yours is to be managed, monitored, and reviewed – with you. My goal is to ensure that you have the same level of comfort and conviction in your plan as I do.

In addition to the quote above, I'll leave the last word to author Nick Murray, from chapter three of his book '*Simple Wealth, Inevitable Wealth*'…

> *'The single biggest reason that people fail to achieve wealth in equities – bigger than all the other reasons put together – is that they never really understand risk.*
>
> *Misperception of risk actually takes two distinct forms. And most investors, without ever realizing that they're doing so, fall victim to both of them.*
>
> *First, people greatly overestimate the long-term risk of owning stocks. Second, and much more insidious, people seriously underestimate the long-term risk of not owning stocks.'*

RAYMOND JAMES®

Scott Yates is a portfolio manager with Raymond James Ltd. Information provided is not a solicitation and although obtained from sources considered reliable, is not guaranteed. The view and opinions contained in the article are those of the author, not Raymond James Ltd. Raymond James Ltd. member of Canadian Investor Protection Fund.