Quadrant

ASSET MANAGEMENT

Human Nature Can Hurt Your Portfolio

QAM Perspectives – April 2015

Quadrant's regular newsletter that highlights topics we believe will affect markets or are important in understanding them.

"Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria" - Sir John Templeton

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Q1 2015 in Review

Equities offered positive returns globally over the first quarter of 2015 with Central Banks in both the Eurozone and China easing monetary policy.

The S&P/TSX Composite Index returned 2.58% with eight out of the ten sectors ending the quarter in positive territory. Energy (-1.11%) and Financials (-0.17%) were the laggards.

The S&P 500 delivered modest positive return in local currency (0.95%), however, for Canadian investors that translated into 10.18% given the impressive appreciation of the US dollar relative to the loonie.

Small cap equities (represented by the Russell 2000 Index) returned 4.3%, outpacing large cap equities. Relative outperformance for smaller cap stocks may be an indication of investor expectations for further U.S. economic expansion.

Eurozone equities enjoyed strong returns after the European Central Bank (ECB) announced it would buy sovereign bonds. Emerging markets also posted positive returns as Chinese equities were supported by the Government's steps to boost growth, while Russia rebounded due to the stabilizing oil price and hopes of a peace deal with Ukraine.

Yields (interest rates) on bonds across the maturity spectrum fell again in Q1 2015. The timing of the first interest rate hike by the Fed now appears more distant.

Equity Market Total Returns (in CAD dollars)	Q1 - 2015	1 Yr
Canada (S&P/TSX Composite)	2.58%	6.92%
S&P/TSX Capped REIT Index	7.95%	12.48%
U.S. Large Caps (S&P 500)	10.18%	29.47%
U.S. Small Caps (Russell 2000)	13.85%	24.28%
MSCI EAFE	14.64%	14.51%
MSCI Emerging Markets	11.57%	15.71%

Fixed Income Total Returns (in CAD dollars)	Q1 - 2015	1 Yr
Canada Universe Bond Index	4.15%	10.26%
Canada Real Return Bond Index	6.62%	14.30%
US Investment Grade Index	10.81%	21.43%
US High Yield Bond Index	11.92%	15.36%
US Treasury Inflation Protected Index	10.52%	19.01%

In the United States, the majority of employees save for retirement using a 401(k) plan. A 401(k) is the U.S. equivalent of RRSPs and Defined Contribution Pension Plans in Canada. Aon Hewitt, an international pension consulting firm, publishes the Aon Hewitt 401(k) index which tracks the investment activity within 401(k) plans.

In February 2015, the Aon Hewitt 401(k) index showed that the allocation to equities had reached 66.5%. The highest level since December of 2007; but still below the June 2007 peak of 69%.

When was the allocation to Equities inside 401(k) highest? Its all-time high (near 75%) was in 2000, just before the tech bubble burst with the associated stock market crash stripping 49% of the S&P 500's value from March 2000 to October 2002.

Human nature influences investors to buy investments after they have gone up and sell after they have declined. When markets turn up, as invariably they have, those who fall prey to their instincts have less capital invested and their portfolio recovery is much slower when compared to the stock averages.

This actually happened with 401(k) investors over the past 15 years. According to Aon Hewitt, the biggest outflows from stock funds during that period occurred near the market lows in February 2003 and October 2008 – both times to buy, not sell, equities.

The increasing weighting in equities in 401(k) plans through this spring is a result of significant positive returns in equity markets coupled with plan holders adding capital to equity asset classes. So instead of rebalancing away from equities during strong return periods plan holders purchased more. This, and the resulting weighting in equities in 401(k) plans, is of no surprise to us.

According to a recent poll by Gallup, for the first time since 2007 more than half of Americans believe that their personal financial situation is getting better. This is consistent with the rise in Americans' confidence in the national economy. Americans' optimism about finances is at an 11-Year high.

Beyond the general population of the U.S., investor sentiment has continued to be positive. This also comes as no surprise as the S&P 500 has appreciated by more than 200% (in USD terms) since its bottom in March 2009. The current bull market has celebrated its sixth anniversary making it one of the longest in history.

Behavioral finance reminds us that we shouldn't stress over price volatility and momentum, but focus instead on the fundamental outlook for Equities and Fixed Income. While overall equity markets don't look terribly overpriced to us, we are conscious that some areas of the market are getting fairly valued to slightly over valued. With recent moderation of economic growth rates, investment pundits are questioning if equity markets are becoming overvalued. As with anything, time will tell. What is clear is that as we continue to enjoy a growing string of positive quarters, a correction of some sort becomes more probable.

Since the end of World War II in 1945, there have been 27 corrections (defined as a decline of 10% or more), versus only 12 bear markets (defined as a loss of market value of over 20%). Most corrections do not become bear markets and certainly most bear markets are not crashes, and every single one of them have historically turned out to be buying opportunities for long term investors.

In our opinion, the probability of a systematic shock affecting the price of risky assets has risen and has created a more unstable investment environment. On the other hand, we're cognizant that we are in an ultralow interest rate environment with ongoing and aggressive Central Bank intervention that is supportive of asset prices and leave little margin of safety on the Fixed Income space.

We are monitoring our clients' portfolios to make sure they are in line with their long-term asset mix (as opposed to the average 401(k) in the U.S.A.) so that the Equity side of the portfolios continue to benefit from the accommodative monetary policy that fuels higher asset prices, but at the same time we have sufficient Cash and Fixed Income exposure to act as a balancing element should external shocks put an end to the comfort of this now 6-year old bull market.

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