All-time Highs…… Again

QPW Perspectives – February 2021

Given the notable performance of equity markets over the past six months, several recurring questions are being asked.

- Markets are at all-time highs. Are we in a bubble?
- Markets are at all-time highs. Does this make sense given the pandemic?
- Markets are at all-time highs. Should I be reducing equity in my portfolio?
- Markets are at all-time highs. I have some cash to invest, should I hold off?

Each of these questions has some unique considerations but the main theme is the same. Many equity markets are close to or at all-time highs – is there cause for concern?

Equity Market Overview

In looking at reported calendar year equity market returns, the very real economic effects of the pandemic are invisible.

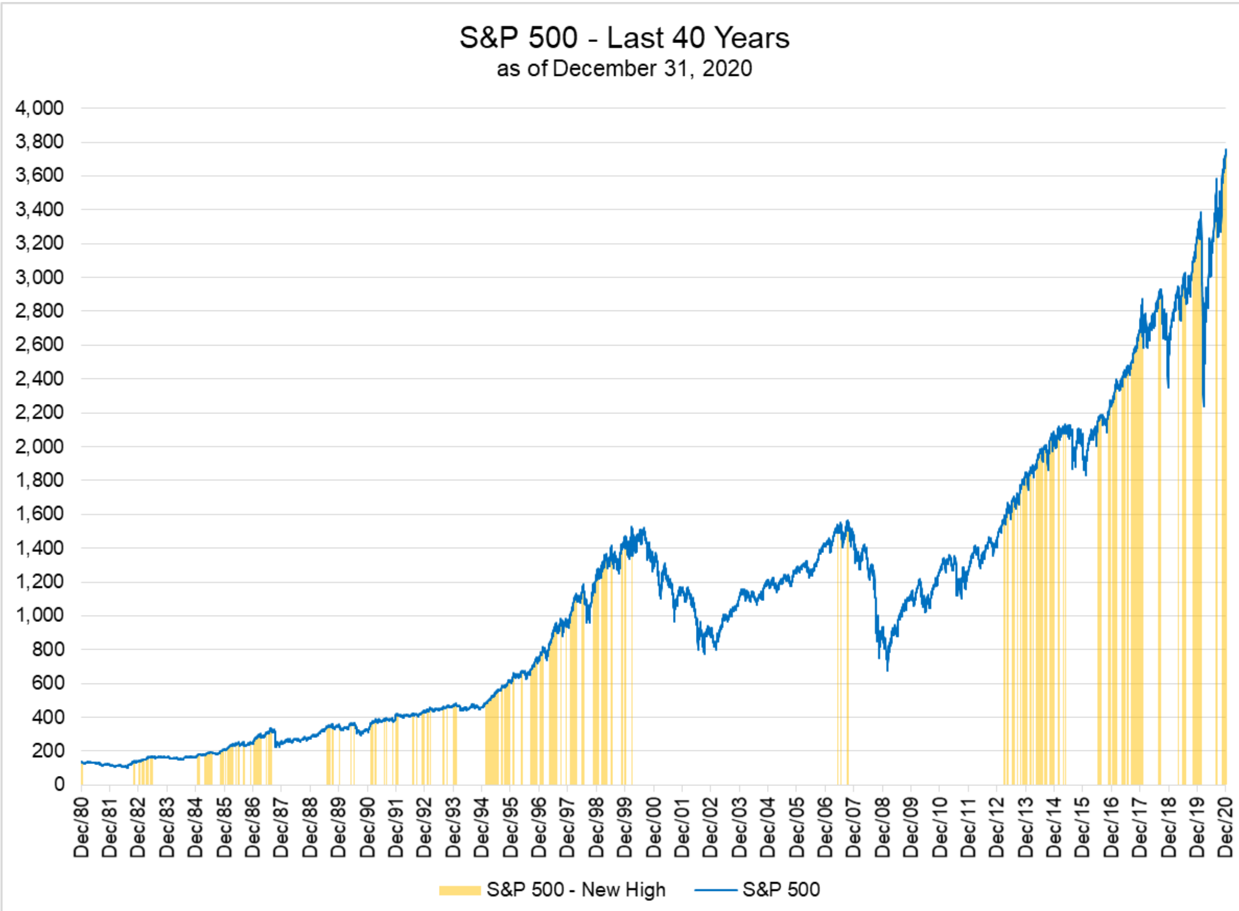
	2020 Calendar Year	**2021 YTD***
Canadian equities (S&P/TSX Index) CAD$	+5.6%	+6.2%
U.S. equities (S&P 500 Index) USD$	+18.4%	+4.9%
International equities (MSCI EAFE Index) USD$	+7.8%	+3.8%

*January 1, 2021 to February 12, 2021.

Taking a closer look at 2020 equity market performance by isolating the first quarter versus the remainder of the year reveals the tremendous volatility experienced. This has left many investors feeling uncomfortable with the magnitude and speed at which markets recovered. This positive momentum has continued into 2021 to date, causing many investors to question its sustainability.

	Q1 2020 Jan. 1 – Mar. 31	**Q2 – Q4 2020 Apr. 1 – Dec. 31**	**2020 Calendar Year**
Canadian equities (S&P/TSX Index) CAD$	-20.9%	+33.5%	+5.6%
U.S. equities (S&P 500 Index) USD$	-19.6%	+47.3%	+18.4%
International equities (MSCI EAFE Index) USD$	-22.8%	+39.7%	+7.8%

Taking a different (and longer term) perspective, the following chart depicts the absolute levels of the U.S. equity market using the S&P 500 Index. Over the past 40 years, the S&P 500 Index reached a new high 772 times. During this same time period, new all-time highs were experienced 469 times in Canadian equity markets (S&P/TSX Index) and 423 times in international equity markets (MSCI EAFE Index).



Cause for Concern?

One can certainly challenge the sustainability of the equity markets' rise over the past decade, however, there should be no concerns over these markets repeatedly reaching new all-time highs. In fact, the structure of equity markets necessitates this.

Basic portfolio management and investing tenets have taught us that the long-term real rate of return for equities is positive and an investor expects to be compensated adequately for providing capital. Equity returns, therefore, need to be higher than other less risky investments such as fixed income. If long term equity returns did not meet this expectation, people would not invest in equities. As companies require capital in order to grow their businesses and operate, returns to shareholders need to be higher than the lower risk alternatives. Higher risk needs to equate to higher reward. This basic functioning of the equity markets is why long-term growth (and equity market returns) are positive over the long term, meaning that new all-time highs will continually need to be achieved.

Another way to think about this is to consider how economies and financial markets move forward in time. The notion of moving forward in time implies progress for the most part. Sometimes there are two steps forward and one step back but the long-term trend progresses forward. World economies generally move forward in terms of economic growth but take some steps back during recessionary time periods. The development of new technologies or products can accelerate this process. The current pandemic represents at least a few steps back, but once health stability is regained economies will continue to move forward. Equity index levels are already reflecting this expectation, as they are generally forward looking.

Up to this point, the discussion has been about broad equity indices. It's important to remember that indices themselves are a collection of companies which evolve and change over time. The companies reflected in an index 40 years ago are not all the same ones today.

In considering the life of an individual company, many will not grow indefinitely over time and some will cease operations for many reasons. Investing in an index means owning all of these companies, for better or for worse. This is where the importance of a competent investment manager can come into play; one who seeks to identify the best companies to invest in and make adjustments over time, as needed. An effective investment manager has the skillset to identify these companies at attractive entry levels and also the discipline to sell these companies as may be warranted. This is irrespective of manager style, as each investment style has, in its own right, a philosophy on how to find these companies who are "moving forward" and reaching their own new heights in terms of revenues, assets, cash flows or some other measure.

How to Get Comfortable at New Heights

Understanding the long-term functioning of equity markets and return behaviour is an important principle to keep in mind. Reaching new highs is normal, just as ups and downs along the way are normal. Feeling a bit nervous at new highs is also normal.

Peace of mind is an important component of your financial well-being, which can be challenging at new all-time highs in equity markets. At Quadrant, we deliver peace of mind to clients in our disciplined investment approach and portfolio management principles, the use of best-in-class institutional investment managers who seek to provide an appropriate level of return while minimizing downside risk, and by taking the time to understand our clients' integrated financial position which extends beyond their investment portfolios. We are always available to address any and all questions clients may have and offer our best advice.

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