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A Strong Rebound in Q2

Review of Markets

Surprise market rebound

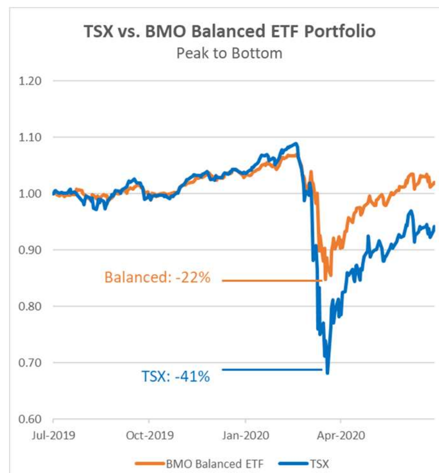
In my last Smart Investor you read about the sharp decline in equities markets around the world in February and March. The situation was negative and uncertainty about the markets was heightened. Look back, it appears that the markets reached a bottom on March 23rd from which they have staged an impressive V-shaped rebound.

Source: Thomson Financial as of June 30, 2020

The chart above shows the S&P 500 Index (S&P 500) in the U.S. and S&P/TSX Composite Index (TSX) in Canada for the past year leading up to June 30 this year. The S&P 500 is up about 5% while the TSX is down 6% in one year. Back in March the debate centred around the shape of the economic recovery, with the alphabets "V", "U" or "L" being the most commonly cited. With the COVID-19 pandemic still very much an on-going issue, there were few, or indeed any, analyst who predicted a V-shaped stock market recovery.

While financial reports tend to focus on stock market indices, the typical investor has a portfolio that consists of a combination of cash, bonds and stocks; and those stocks may comprise Canadian, U.S. or international companies. In other words, when you read about a certain index being up or down, that may not reflect what is happening to your portfolio.

Below is a chart showing the TSX and the price of a balanced portfolio as represented by the BMO Balanced ETF Portfolio which typically invests 55%-60% in equities and 40%-45% in fixed income.



Source: Thomson Financial as of June 30, 2020

While the TSX suffered a 41% decline from peak (February 19) to the bottom (March 23), the balanced portfolio dropped substantially less at "only" 22%. The BMO Balanced ETF Portfolio is also showing a positive one-year return while the TSX is still below breakeven. See Table 1 below.

Table 1: performance compared

	YTD	1 yr.	3 yrs.	5 yrs.
TSX (total return)	-7.47%	-2.17%	3.91%	4.45%
BMO Balanced ETF Portfolio	-0.43%	3.00%	4.19%	4.33%

Source: TD Securities Inc., Bloomberg Finance L.P., BMO Mutual Funds as of June 30, 2020

Lessons from the Market

Don't try to predict

As the saying goes, "stock market predictors make weather forecasters look good". Back in March, there wasn't a single market report I read that dared to predict a strong V-shaped rebound, just as none had foretold in February the subsequent decline.

Central banks hold the keys

Stock markets started to reverse course the moment the U.S. Federal Reserve and other major central banks including the Bank of Canada announced massive intervention at the end of March. Even though the market correction was set off by a global pandemic and not a financial crisis, the strong messages sent by central bankers assured market participants of sufficient liquidity and smooth functioning of financial markets. At the same time, governments announced financial support to businesses and workers who were furloughed due to the lockdown. This support was essential to avert impairment of household budgets. Low interest rates will continue to benefit businesses and should stimulate economic activity.

Technology becomes a way of life

During the lockdown, video conferencing for business meetings or social gatherings have replaced actual face-to-face interactions. Retail and grocery stores have experienced a spike in online commerce. It is possible that even after a vaccine is found and the pandemic subsides that we will settle into a higher adoption rate of technology in our daily lives. This is reflected in the outperformance of the technology sector. The Dow Jones US Technology Index was up 16.7% in the first half of 2020 compared with the S&P 500 which was down 3% in the same period.

You need true diversification

You have heard me repeat this mantra "diversify, diversify, diversify" many times over the years. This can mean different things. The most important diversification is to own different asset classes. If you own only stocks then you will experience the same ups and downs of the stock market. Adding bonds will tend to dampen the advances and declines so the journey will likely be smoother. You may have seen charts that look like periodic tables we had to learn in school, but these show the performance of different asset classes year by year. One glance will tell you that no single category will be the top (or bottom) performer year after year. While we can make judgement calls, we need to be broadly diversified without too much concentration.

Your portfolio is not the index

The Dow Jones Industrial Average (DJIA) commonly known as the "Dow" is probably the benchmark that appears in media reports. Amongst the most common benchmarks the DJIA has the highest numerical value, so any changes will be amplified and sound more dramatic. A one percent change in the Dow will be approximately 260 points whereas it will only be about 30 points on the S&P 500.

So, what is wrong with the Dow? It is an average of 30 large companies traded in the U.S. and thus is not as representative of the entire market as either the S&P 500 or the Russell 1000 indices. Also, the latter two are weighted by the size of each company – the higher the value of a company the more weight in the index – whereas the Dow is an average of the company stock price.

If you hold a diversified balanced portfolio then your personalized performance figures will likely be different from any major index. It will be more relevant to refer to that figure than anything you see in media reports. Moreover, if your objective is retirement income, and if your dividends and interest payments remain the same, what use is it to pay attention to the DJIA? If you are saving for retirement, then it will be more constructive to measure your progress towards your goal than to react to short-term movements in the Dow.

Shiuman's Corner

Lockdown update

Daily bread (photo: Shiuman Ho)

When the lockdown started I had naively thought that it might last a month or two. Now more than four months later, I am settled in for another long stretch – I finally cancelled my monthly parking downtown last month. I count myself very fortunate to be able to continue to work. It is a good thing I have always had a home office because my wife and I reverted from being empty-nesters to having a full house, with both of our children here, at least while my daughter continues with online classes, and my son works from home.

Having my daughter home has the added bonus of a talented chef and home baker who keeps us going with treats all the time. To burn calories I have been riding every week, at over 2,000 kilometers so far this year, which is the same distance from Vancouver to Los Angeles – not that one can cross the border. Since the stay-at-home order I have learnt to appreciate the most important aspects of life: health, family and having the basics of shelter and food. I am sure we are all very thankful for the healthcare and other essential workers who help sustain our lives. Stay safe and well.