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CIO Strategy Bulletin

Why Not Just Sit This One Out?

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SUMMARY

At this moment, it would be easy for investors to throw up their hands in resignation and simply refrain from investing altogether. Markets have dealt investors a pretty rough hand so far in 2022. A continuous patter of market-churning news paints a picture of stubbornly high inflation, tightening monetary conditions, a slowing economy and disrupted global energy supplies. Citi Global Wealth Investments raised the chance of recession in 2023 to 70%. Why not just sit this one out?

In this CIO Bulletin, we look backwards to look forwards. What happened to investors who stayed invested through the dot-com bubble and the Great Financial Crisis versus someone who did not? And what are the real drivers of wealth creation that we may be less aware of? A few words for the wise as we consider investing through turbulent times.

This “Moment” in the Life of Your Portfolio

This week, a currency crisis in the UK. Last week, a market tumble due to the Fed’s “get tough on inflation” policies. We are in “bear market territory” again. You might be thinking, “We all know there’s bad news on the horizon! You’ve written that there is a 70% chance of recession. Why not just sit this one out?” And even though we have underweighted equities, favored dividend shares, made some “smart”

decisions to invest more of our portfolio assets in US dollars, we have still managed to lose money in 2022. Why not, indeed?!

Jack and Jill, Investors

Let us begin with a very simple illustration.

Imagine an investor – we’ll call him Jack – who recognized the wild over-valuation of US equities at the peak of early 2000. At that point, US and global equity valuations had hit the highest levels in a century. Jack, having made 25% per annum since initiating his portfolio five years earlier in 1995 and knowing this was unsustainable, then liquidated his equity portfolio with *perfect market timing* at the end of February 2000. Jack missed the entire 49% drop in the S&P 500. He then took his profits – including those hefty returns over the first five years – and stuck his money in US Treasury bills. Jack felt really good about doing this.

And then there was Jill. She started investing the exact same day as Jack (though they did not know one another) and maintained a US all-equity portfolio. She stayed invested and proceeded to see her portfolio drop 49% from 2000-2002. Jill also stayed invested through the Global Financial Crisis of 2008-2009 which caused her portfolio to decline 51% and subsequently lost another 20% this year. Jill felt really good about doing this (see Figure 1).

As of Sept. 30, 2022, Jill's portfolio wealth, measured in real terms, would be about three times the level of Jack's.

Figure 1: Portfolio performance of two hypothetical investors: Jack and Jill – Illustrative example

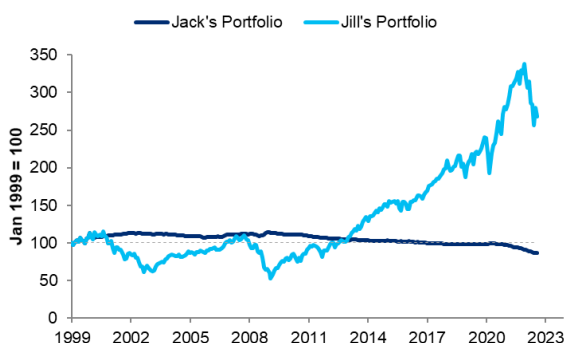


Figure 2: Performance of 1999 dot-com winners (by largest market cap) vs cash (3-month T-bills), S&P 500 index and MSCI AC World index



Source: Haver and Bloomberg as of September 29, 2022. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary. The illustrative example of Jack and Jill do not reflect the actual investments of any portfolio and are shown purely as examples.

The Dot-Com Know-It-All

Imagine now another illustrative investor, Jonny Hitech, who bought the 10 largest market cap winners of the dot-com bubble period on Jan. 1, 2000. Jonny paid 73X trailing earnings for these shares (vs. 27X for the S&P 500 at that time). His “sister,” Bonnie Hitech, thought her brother was crazy and stuck her savings in cash (specifically, 3-month US Treasury bills). Today, Jonny’s imaginary portfolio would have outperformed Bonnie’s cash by 2.43% per annum. (See Figure 2.)

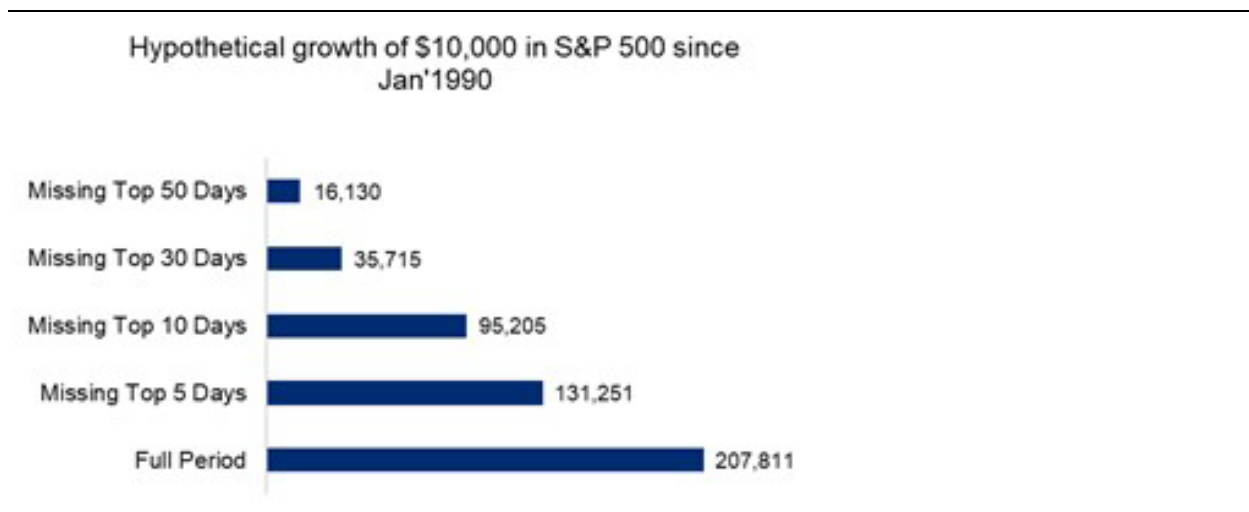
The Cost of Being Very Defensive (aka Market Timing)

Historically, there are many reasons why “going to cash” is a costly decision over the long run.

The first of these is the loss of value creation on the market’s best days. Great “up days” can happen at any time, of course, but often occur around market turning points. If we look back to January of 1990, a period of 11,961 calendar days encompassing approximately 8,258 trading days, and one misses just the top 10 trading days for the S&P during that period, the loss of potential value would have been more than 50% of the total return for the entire period (Figure 3).

The period from 2020-2022 has seen eight of the top 50 trading days since 1990. While we have no way to predict when or how big the next set of “top days” will occur, based on historical market data it is likely that at some point before the economic downturn reverses, markets will. And with that pivot toward recovery may come some of the days investors cannot afford to miss.

Figure 3: Hypothetical growth of \$10,000 in S&P 500 since January 1990



Source: Bloomberg as of Sept. 29, 2022. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary. Hypothetical performance results have many inherent limitations. The portfolio performance and return information reflects the benefit of hindsight and does not reflect the impact that material economic and market factors might have had on decision making of the Investment Lab or its affiliates were actually advising an investor in investing in these investments or managing an actual portfolio. Since the trades of the simulated performance results have not actually been executed, the results may have under or over-compensated for the impact of certain economic and market factors, such as lack of liquidity. Also, hypothetical trading cannot fully consider the impact of financial risk, such as ability to withstand losses. An investor’s investment in an actual portfolio will be made in different economic and market conditions than those applicable during the period presented. It should not be assumed that an actual investor portfolio will experience returns comparable to the portfolio performance and return information presented herein. Past performance does not guarantee future results. Real results will vary. As a result of market activity following the date of the period presented, current performance may be different from that shown herein.

Earning Dividends, Countering Inflation (and Vice-Versa)

Dividend reinvestment is *more* than a powerful contributor to total equity returns. As you can see in Figure 4, more than 2% per annum may be earned just by “checking the box” and reinvesting your dividends. But that’s not all. From 1990 to now, the average inflation rate has been 2.74% per annum. The gain from reinvesting dividends has been 2.19% a year. Simply put, earning and reinvesting dividends have been one way of alleviating the detrimental effects of inflation.

Corporate earnings, dividends and stock prices are inflation hedges, meaning they include price adjustments due to inflation. When you buy a bond, in contrast, the return of principal is not adjusted for inflation. Therefore, when we are “out of the market” we lose the ability to have equities maintain (and possibly enhance) the value of our portfolios, net of inflation.

Figure 4: Reinvesting dividends helps counteract the adverse effects of inflation.

From January 1, 1990 to September 29, 2022	<u>S&P Return</u>	<u>S&P Return (dividends reinvested)</u>	<u>S&P Return (net of inflation)</u>	<u>S&P Return (net of inflation, dividends reinvested)</u>
Total Return	986.3%	1997.8%	368.2%	804.1%
Annual Return	7.58%	9.77%	4.84%	6.97%
Differential		2.19%		2.13%

Source: Haver Analytics as of Sept. 30, 2022. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

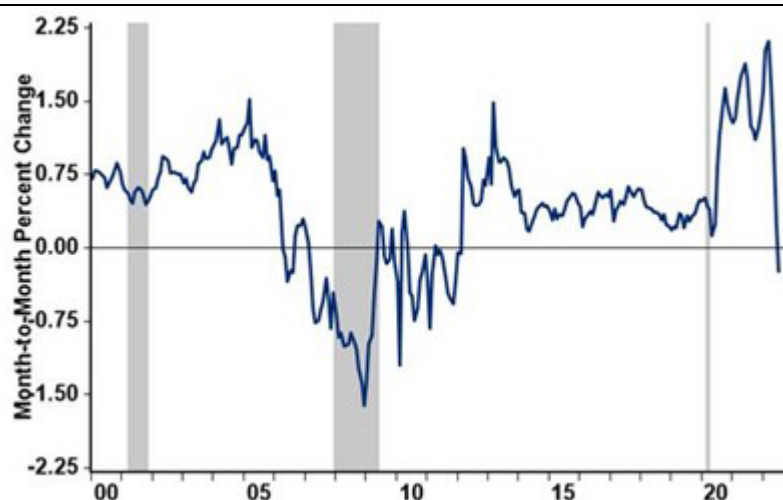
Living Through Macro Policy Madness

Week after week, month after month, we have assessed the macro policy moves of central bankers globally. We have seen them address a global pandemic, a major European war, and a Chinese real estate meltdown using tools that are never “fit for purpose.” Tighter or looser monetary policies are blunt instruments when applied to specific, exogenous economic circumstances.

The world economy is poised to suffer a hangover in the year to come (see our forecast update in the [August Quadrant](#) and CIO Bulletin, [“What Hasn’t Happened Yet”](#)). In response, markets are showing increased signs of stress and even disfunction.

- The price of food has skyrocketed on global supply issues. As a policy answer, the Fed is using the blunt force of US monetary policy to send the housing market into a tailspin. While rent measures in the CPI will continue to climb, August saw the first decline in national home prices since 2011 (see figure 5).
- The Bank of England is again intervening in its bond market with “unlimited long-term bond purchases” to control interest rates following a record yield spike and currency plunge (see our latest [Europe Strategy Bulletin](#) and [Global Strategy Bulletin](#)). This is after the BoE raised base lending rates 7 times in accelerated fashion during the past two months.

Figure 5: US home prices month/month % change



Source: Haver Analytics as of Sept. 30, 2022. Note: Grey areas are recessions. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Developing Perspective Creates Investment Discipline

The boom and bust of markets of 2021-2022 need to be understood with perspective. Both the rise and fall in markets are just “moments” in the life of one’s portfolio.

In recent years, we lamented the sharp decline in bond yields to levels we believed would harm asset allocation portfolios. The Global Investment Committee’s underweight in global bonds was as much as -12% last year. We feared that quality fixed income securities were so richly priced that they would not be able to rally when equities fell. This calculus has now changed as yields have surged.

The Fed is working to increase the value of money relative to goods and services. It appears poised to deliver the largest single year rate hikes in its history. While dropping sharply in value this year, the rise in bond yields in 2022-to-date has raised the prospective nominal 10-year return of the US bond market by about 2.5 percentage points per annum.

As equities fall, the same will hold true. Investors who won’t recognize the value of equities in long-term portfolios will suffer if they fail to stay allocated to the asset class or fail to reallocate to equities as their value builds.

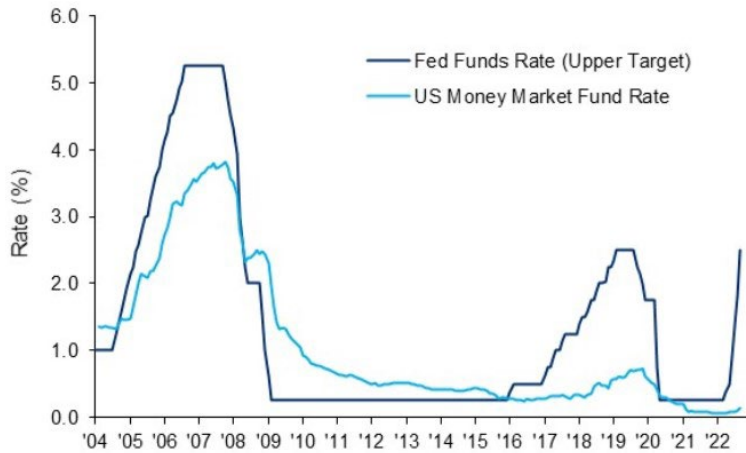
When the Turn Comes...

History shows the Fed is usually unable to sustain policy (see Figure 6). And with the Fed set to reach peak rates in 2023, a series of market opportunities will present themselves. The dollar may reach peak value, encouraging a reallocation to other developed market and emerging market assets. Inflation will moderate and, in a lower interest rate environment, we can imagine growth and technology shares taking a shine again. It’s the “when” that we cannot be sure of.

Looking more broadly, this period of severe turmoil will impact emerging economies and the poor severely. There are likely to be global food and energy shortages in 2023, as well as further disruptions in markets. De-globalization will cause frictional costs to rise, as companies diversify their supply chains.

Yet, as we exit the post-Covid environment, there are a series of known opportunities that will spur further innovation and growth around the world. In the gloomy “[World Economic Forum Report](#)” of September 2022, the roundtable of chief economists cited digital inclusivity (the use of digital finance by more of the world’s population), sustainability and the energy transition, the rise of Asia, health care and technology as well as risk management as reasons to be optimistic about the medium to long term. These unstoppable trends are accelerating in the face of difficult markets and unusual macroeconomic tides. Our portfolios seek to capture them as we remain wisely invested.

Figure 6: Fed policy rate vs. US average money market fund yield




Source: Haver Analytics as of Sept. 30, 2022. Past performance is no guarantee of future results. Real results may vary.

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