June 2022

Investor Strategy

The latest market insights from Richardson Wealth

Passive or Active? Why not both?

Executive summary

1. May market recap
2. Portfolio Construction: Passive vs Active management
3. Market Cycle: Opposite Land?
4. Portfolio Positioning: Ready for a bounce

This month, after our lookback to May's market activity, we will get into the debate between active and passive management. Or more appropriately, dispel that it should be a debate at all. The two styles are a good compliment to each other, when used properly and in the right sectors.

We will then have a look at current market dynamics, where good news might be bad news, and bad news good. Are we in opposite land? Maybe so.

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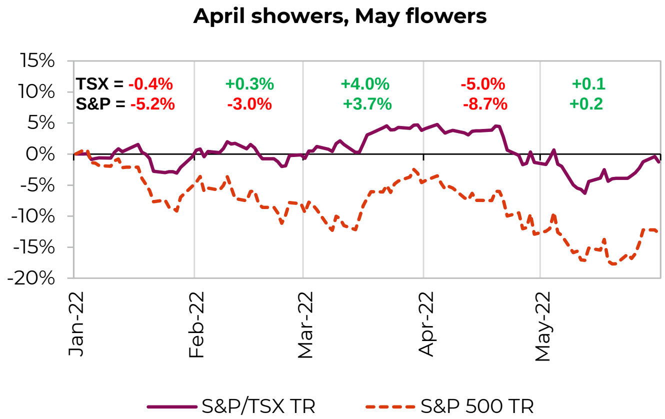
…May flowers?



You might recall our last market recap noted the April showers. Equities continued lower into May, however, we saw some positive moves in the back half of the month - despite dropping to its lowest point in a year. The "flowers" part came in the final week, as global equity markets rallied to finish the month mostly flat. Economic data showed that despite hawkish central banks, overall demand remains resilient. Even with consumer sentiment lower in May, personal spending continued to rise.

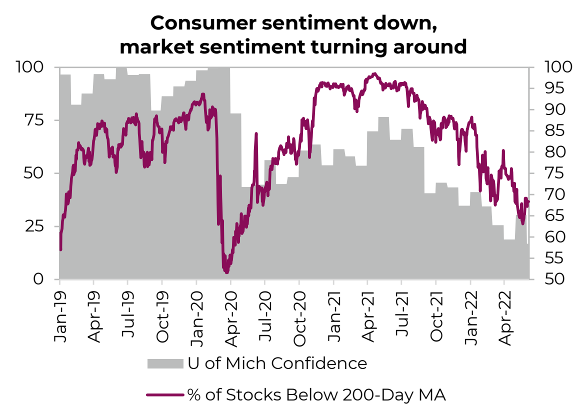
The **S&P/TSX Composite Total Return Index** ended the month up a modest 0.1% with energy once again the top performer. Data released this month showed that Canada's economic growth was not as robust as expected in the first quarter, hindered by lower export volumes. In the U.S., after a rocky start to the month, the **S&P 500 TR Index** also managed to finish positive. Meanwhile the NASDAQ remains firmly in bear market territory, down -22.8% even after last week's rally, finishing the month at -2%. The **EURO STOXX 50** index participated as well last week and was relatively flat returning -0.4% in local terms. This came despite consumer prices in Europe surging to a record 8.1% year-over-year in May. Meanwhile, oil prices held near its highest level in 12-weeks after the European Union said they would place a partial ban on Russian crude imports.

Good return from Energy and Financials

	Canada		U.S.	
Sector	May-2022	YTD	May-2022	YTD
Comm Svs	-2.0%	4.0%	1.8%	-24.6%
Cons Disc	-1.9%	-12.5%	-4.9%	-24.9%
Cons Staples	-1.0%	4.4%	-4.7%	-4.0%
Energy	7.9%	41.1%	15.0%	55.7%
Financials	1.4%	-4.1%	2.6%	-9.5%
Health Care	-25.5%	-44.1%	1.3%	-6.4%
Industrials	-4.2%	-8.7%	-0.8%	-10.8%
Info Tech	-4.9%	-50.9%	-1.0%	-19.7%
Materials	-6.0%	7.0%	1.0%	-5.4%
Real Estate	-3.2%	-14.2%	-5.1%	-14.9%
Utilities	0.3%	2.7%	3.8%	3.3%

Inflation concerns remained front of mind for investors. In Canada, inflation reached 6.8% for the month of April, well above the Bank of Canada's (BoC) forecast. A tight labour market and wage pressures have many believing inflation is unlikely to fall anytime soon. Central banks remain hawkish, and market expectations for the overnight rate at the end of the year are now over 3%. On June 1, the BoC hiked interest rates by 50 basis points bringing the overnight rate to 1.50%. Even Europe, where rates have not risen since 2011, is starting to talk of rate hikes in July, as the urgency to fight inflation increases. Despite hawks circling central banks, bond markets were bid this month after downwards pressure for the past four. The **Canadian Aggregate Bond Index** was flat in May, and the **U.S. Aggregate Bond Index** posted a May total return of 0.6%.

Sentiment is showing mixed signals. With inflation at multi-decade highs, high prices and rising rates, we are seeing *consumer* sentiment at a low not seen since 2011. However, *market* sentiment is showing some optimism. After seeing the S&P 500 Index briefly hit bear market territory, markets rebounded as did sentiment. A decent earnings season also helped to boost market sentiment, though certain sectors did feel more pain than others due to supply constraints. 77% of companies reported positive EPS surprises, 73% have good revenues to the upside and the forward 12-month P/E is about 17x, below the 5-year average of 18.6x. Interestingly, the number of companies that said "inflation" on their earnings call is up to 400, up from 350 in Q4-2021 and 300 in Q3-2021.



As we move into summer, markets continue to digest the incoming economic data to discern whether central banks will be able to orchestrate a soft landing. The Fed's next meeting will be June 15, where it will also begin quantitative tightening. It is unlikely that we will see too much summer doldrums. In the meantime, we continue down the road of portfolio construction looking at the choice between active and passive.

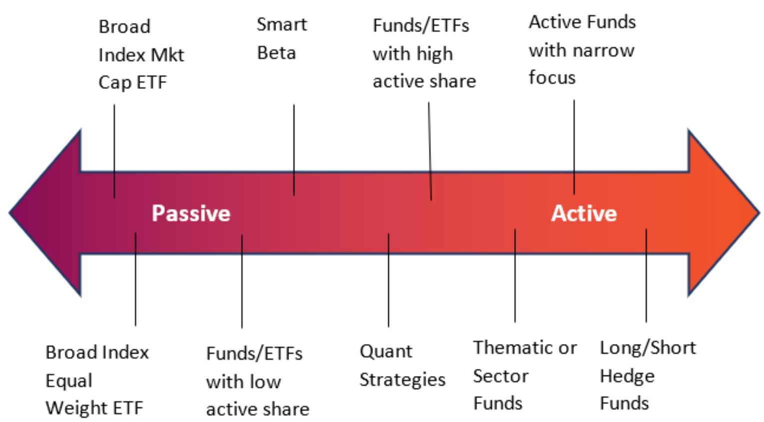
Active & ~~vs~~ Passive

The debate between active and passive portfolio management is not new, with strong arguments on both sides. Fans of passive index following strategies often argue a fee advantage and clear strong performance. Proponents of active management often cite the mutual social good of price discovery, markets with less efficiency and risk management controls around concentration. The debate is often framed in a binary fashion, either active or passive. Yet from a portfolio construction perspective, investments, whether active or passive, are building blocks for a portfolio. How the pieces are selected, fit together, given exposures to different factors at different costs in different markets, is much more important than an academic debate. After all, at the portfolio construction level, all investment decisions are active, even if opting to use market capitalization weighted passive vehicles or more active strategies designed to gain or reduce exposure to certain factors.

Let's dive into the active vs passive debate, considerations for each given the market and environment. Our approach to portfolio construction is "Why not both?", using both active and passive, sometimes even in the same markets.

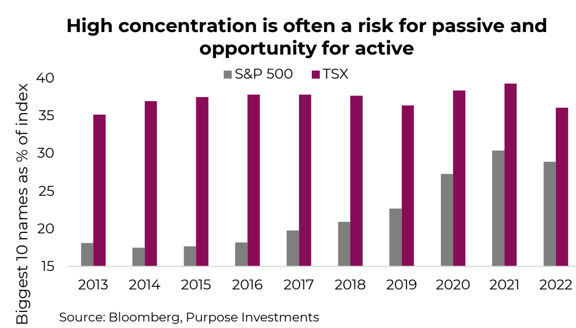
Shades of grey

Terms can be misleading, so before we get into the weeds of the active vs. passive debate, we should clarify a few things. Passive investing has changed a lot since Jack Bogle championed the case for index investing years ago. Historically most indices were aggregates of a certain market and weighted based on market cap. These types of funds are some of the largest in Canada and the United States. They feature deep liquidity and tiny fees. Active investing is any deviation from a set benchmark with the aim of a different performance experience. This can be in search of higher returns, less volatility, or even uncorrelated returns.



Given the plethora of available strategies, it is better to think of active-to-passive as a spectrum. A fund or ETF can sit anywhere along this spectrum depending on the strategy being implemented. And worth noting that structure does not imply the strategy any longer. There are funds that are passive and ETFs that are active. Life used to be simpler.

The far left



The passive end of our spectrum is where you would find pure beta, low fee index exposure ETFs/Funds. The goal is to match market returns. It is crucial to understand the underlying index. Are there concentration issues? The NASDAQ has a 12% weight in Apple and 10% in Microsoft. Nothing wrong with that, as long as you are aware of your exposures. Even the broad-based S&P 500 Index can become very top heavy. The S&P/TSX Composite is mostly Financials, Energy and Materials, and has always been more concentrated. The S&P 500 has seen the megacap names become increasingly weighted. Concentration is a risk that is worth considering. It can be an opportunity for active as well, if those megacaps begin to underperform.

There is also market efficiency. For a passive strategy, is it easy to trade or are there market inefficiencies? Fixed Income indices are often difficult to fully replicate as underlying bonds can be illiquid. Don't forget about index construction too. Fixed Income indexes inherently provide higher weighting to the most indebted companies. Perhaps that is not the most ideal weighting scheme. Real estate and other private markets are also not well served by passive investments due to their structure and illiquidity.

The far right

No, this isn't political. Often the most active strategies are simply trying to produce a materially different performance experience. Some are focused on outperformance of their respective asset class. Others are attempting to lower volatility, provide uncorrelated performance for diversification benefits, or generate absolute returns in any market environment.

Manager selection and strategy is paramount here. Costs tend to be higher so one needs to make sure it is truly a differentiating strategy. *Active share* can be a useful way to determine how closely a fund mimics its underlying benchmark. Research would suggest that the deck is stacked against active managers when it comes to long term performance. However active management can still outperform – given the right combination of talent, discipline and a little luck never hurts either. Also, it's not always strictly about returns. Volatility matters. It's important to pick your markets. Active managers typically have a better edge in markets that are less efficient, or poorly designed in the first place. It's very difficult to have an edge in large cap U.S. equites but Emerging Markets, preferred shares and other smaller less liquid markets is where active managers have a real edge. Due diligence for any investment is important, but more so for actively managed funds. There is a big divide between the best and worst, whereas there are only small differences when it comes selecting between passive ETFs.

Everything in between

The middle of the spectrum is where the lines begin to blur. It's where we'd place smart beta, factor and quant funds. Their primary aim is to provide alpha at lower prices by being systematic in nature to isolate certain exposures. Whether its equal weighted ETFs or single factor-based ETFs to gain exposure to dividends, value, momentum, etc. these investments typically are quant or machine-based and don't have a team doing bottom-up analysis. The actual management may be mechanically passive, but it is certainly an active call leaving it up to induvial investors to decide which risk factors to get exposure to. In essence these tools now make it easier than ever to unbundle a portfolio and allow investors to actively select which risk factors will be purchased. Systematic strategies can help enhance portfolios by providing a cost-effective option to gain specific exposures, but even if they utilize passive ETFs these types of investments begin to lean more active. Similarly, actively managed mutual funds that have a low active share, low turnover probably lie somewhere in the middle of the spectrum. You might be paying active management fees, but the returns will largely resemble benchmark returns less fees. As new products continue to evolve the lines between passive and active will continue to blur. Terms such as enhanced index construction or adding ESG considerations to market indexes are both examples of how product manufacturers can create something new, with a bit of a tilt. Beware the marketing machine though – often new is simply the old repackaged with a higher fee.

The Great Debate

The narrative we are attempting to change is that perhaps the active vs. passive debate is not as important as it is made out to be. While it can't be ignored, we feel it gets too much attention. In this table, a negative percentage shows passive outperforming active, while a positive percentage is active winning. While passive mostly outperformed, it isn't by very much. This drives home the point that the active v. passive debate has some importance, but perhaps not as much as the airtime it is given suggests.

Does the Passive/Active decision matter?

Asset Weighted Annualized Performance Spread
Active vs Passive

	US Large Blend Equities	US Large Value Equities	US Large Growth Equities	Intermediate Cdn Bond
10 - Year Spread	-1.60%	0.00%	-2.20%	0.40%
15 - Year Spread	-1.30%	-0.10%	-2.10%	-0.50%
20 - Year Spread	-0.30%	0.10%	-1.40%	-0.40%

Source: Morningstar Data & Purpose Investments

Higher on the scale of importance in portfolio construction is how the pieces of the portfolio complement each other. To achieve the goals set out for the portfolio, the components must work with and against each other to manifest strong portfolio diversification, and as little correlation as possible. Actively managing *the pieces* of your portfolio is what is going to achieve success, not whether you chose an active equity mutual fund or a passive equity index ETF. The allocation decision should come down to whether we should be adding to a certain sector, country or factor determined by the current portfolio exposures & tilts. While the most favorable result may come from combining a little bit of passive here and a little bit of active there, the overarching concern should always be the asset allocation.

Every portfolio construction decision is active

Breaking away from the active vs. passive debate is easy when making asset allocation decisions from a portfolio perspective. In constructing and managing portfolios, you make active decisions, regardless of the solutions or products you chose to include. Even setting a 60/40 equity-to-fixed income mix, rebalancing quarterly and buying index ETFs is an active decision.

When adding specific exposure or tilting a portfolio more (sector, country, growth, momentum), those are decisions you must actively make. Even if you use a passive investment, you still actively made that decision at the portfolio level. Below is a checklist of sorts or specific areas to consider during the investment vehicle selection process for potential inclusion into a portfolio, from the lens of active vs passive. This is not an exhaustive list:

Consideration	Note	Advantage
Market Liquidity	Is it a liquid market that can easily be traded, such as U.S. large cap equities. If less liquid indexing can prove costly and dangerous, such as preferred shares, high yield, small cap equities.	Passive
Market Concentration	If a highly concentrated market, there is greater risk in using a passive index tracking strategy. Remember, nobody controls the risk in a capitalization weighted index. TSX has a high concentration risk, often corporate bond ETFs will weigh the most indebted companies the most.	Active
Fees	Fees matter but it is one factor. There are often performance, diversification or risk reduction considerations and sometimes there portfolio benefits come with a higher fee.	Passive
Active Share	For active managers, make sure the manager is significantly different than the cheaper index option.	Active
Factor/ sector / geographic exposures	Whether passive sector/thematic ETFs, broad market ETFs, active managers, understand the underlying sector, style, geographic allocations in relation to the portfolios allocations. Is it additive, or is it simply duplicating exposures.	Varies
Strategy	Does the investment strategy offer a diversification benefit to other holdings in the portfolio? There are many variations compared to a passive buy and hold the index constituents approach, which can add value to a portfolio.	Active

The decision tree does not lead with active or passive. What does an investment bring to the existing portfolio? Does it provide added exposure to a factor that you believe will benefit the portfolio given the macro market environment and outlook? Will it let you sleep easier? Whether to go active or passive is down the list of decisions. We have found complementing low-cost passive with active provides a much more diverse and resilient exposure in various asset classes from bonds to equities. There is no winner, they are simply building blocks for a portfolio.

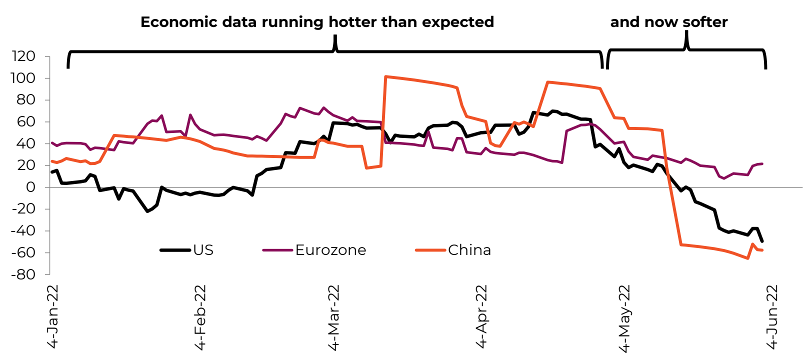
Market Cycle: Opposite Land

From a markets' perspective, in normal times, good news is good and bad news is bad. Who doesn't like getting some surprisingly good news? A positive surprise on the health of the economy, implying prospects for improving corporate earnings growth, is welcomed and has a positive influence on stock prices. Disappointing data is the opposite. But sometimes, the markets appear to enter a phase that literally sees the opposite relationship. Bad news can elicit a positive market response and good news weakness. This may very well be the situation today as a confluence of factors has created this kind of upside-down market:

- **Prices are down**: The speed and magnitude of the market declines this year have created 'oversold' technical conditions. Given how much negative news the markets have absorbed so far this year, even bad news that is just 'less bad' would likely contribute to a relief rally.
- **Inflation**: High inflation has remained one of the biggest concerns and continues to embolden central banks to tighten monetary policy faster in response. This also lifts yields higher. Higher yields means higher discount rates, meaning valuations have to come down for equities and bonds. Hence, prices are down.
- **Softening economic data:** Normally, softer economic data would raise concerns for slowing corporate earnings growth, which leads to lower equity prices. But today, softening economic data also implies less inflationary pressures, which means central banks may not be as aggressive in their tightening of financial conditions. That means the rising discount rate may not rise as far and that equals a move up in markets, especially since they are starting from oversold territory.

This may create a bit of a sweet spot for the markets. Softer data, leading to less inflationary pressures, may slow or cap the rise in yields and soften expectations for the path of central bank rate hikes. This is clearly the glass half full perspective. The negative implications of slowing economic growth more than offset the positive implications of the resultant slowing inflationary pressures.

Citigroup Eco Surprise indices - from strength to softness

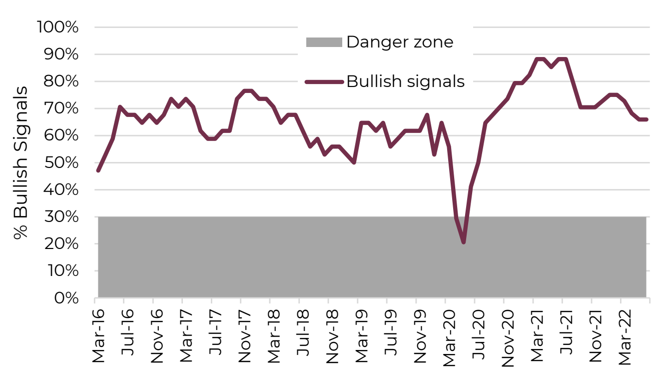


Source: Bloomberg, Citigroup, Purpose Investments

So if bad economic news is now good for the market, what if the economic data were to improve? Well, we certainly can't have it both ways. If we were to experience a sudden run of improving economic data, yields would likely rise faster and that would not be welcome for equity markets. Plus, that would not help alleviate any of the inflation pressures. While this is possible, the current trend in the data is to weakening.

This trend has been evident in our Market Cycle framework which has seen a steady decline in bullish signals. Still well above the danger zone which warns of a high likelihood of recession or end of a market cycle.

Market cycle indicators healthy



Source: Purpose Investments, Bloomberg

Among the indicators:

Market cycle indicators

Grouping	Metric			Better/ Worse
Rates				0 / 3
	Net Cuts		✓	-
	Yield Curve	✓		-
	Yield Curve 3m	✓		-
US Economy				9 / 10
	Leading Ind (3m)	✓		+
	Leading Ind (6m)	✓		-
	Phili Fed Coincident	✓		
	Credit (3m)	✓		+
	Recession Prob (NY Fed)	✓		+
	Recession Prob (Clev Fed)	✓		-
	Citi Eco Surprise		✓	-
	GPD Now (Atlanta Fed)		✓	-
	US Unemployment	✓		
	Consumer Sentiment (3m)		✓	-
	PMI	✓		+
	PMI New Orders	✓		+
	Chemical Activity (3m)		✓	-
	Energy Demand (YoY)	✓		+
	Truck Demand (YoY)		✓	-
	Rail (YoY)		✓	+
	Starts (6m)	✓		+
	Months Supply (6m)	✓		+
	Home Sales		✓	-
	New Home Sales	✓		-
	NAHB Mkt Activity		✓	-
Global Economy				1 / 7
	Global PMI	✓		-
	Copper (6m)		✓	-
	DRAM (3m)		✓	-
	Oil (3m)	✓		+
	Commodities (3m)	✓		-
	Baltic Freight (3m)	✓		-
	Kospi (3m)		✓	-
	EM (3m)		✓	-
Fundamentals				7 / 5
	US: PE	✓		+
	US: EPS Growth	✓		+
	US: EPS 2FY v 1FY	✓		-
	US: 3m EPS Revision	✓		-
	Canada: PE	✓		+
	Canada: EPS Growth	✓		+
	Canada: EPS 2FY v 1FY		✓	-
	Canada: 3m EPS Revision	✓		-
	International: PE	✓		+
	Int: EPS Growth	✓		+
	Int: EPS 2FY v 1FY		✓	-
	Int: 3m EPS Revision	✓		+

Rates – clearly central bank rate hikes are a negative, and this one should carry a larger weight. Yield curve remains positively sloped but has been flattening.

US Economy – Leading indicators, recession probabilities and employment remains supportive. As does manufacturing, which is still playing a degree of catch up given past supply and fulfillment issues. Housing is starting to wobble a bit, likely due to higher mortgage rates.

Global Economy – The story does grow a bit more worrisome outside North America. While the signals are evenly mixed, there has been a deterioration across almost all the signals during the past month [the 'Better / Worse' column is whether the indicator got better or worse during the past month].

Fundamentals – These are encouraging given valuations have fallen and margins remain healthy despite rising cost inputs. However, the longer forecasts are starting to show slowing earnings growth.

You can have too much of a good thing.

Slowing economic momentum may be a positive today, but just like most things in life, too much can quickly become a negative.

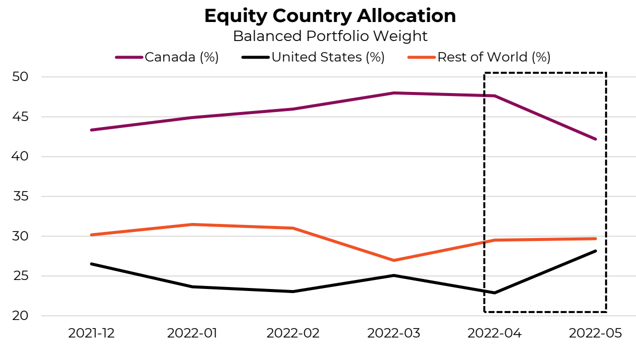
So far much of the weakening economic data has been in the 'soft categories'. Soft economic data is typically populated with surveys, anecdotal indicators, less direct measurements of the actual economy. For instance consumer confidence is a survey where people are asked about their spending patterns and intentions. It can be a good indicator but it does not necessarily reflect what people are actually doing. It has been in the dumps for a couple years now, yet the consumer has been spending away. Sometimes people say one thing and do another.

Hard economic data is actual measurements of economic activity, such as GDP, employment, industrial activity. Perhaps more reliable but it does suffer from a longer lag times in reporting and is often revised after being reported. Yes, economics is a bit more of art than a science. An art with a good dose of math.

If the weaker data continues and spreads to the harder data, the noise around recession will start to grow louder. This may build as the year progresses and potentially become a bigger issue than inflation fears later this year. Plus, we believe margin pressure and slowing earning growth may become an issue later this year. For now, we are in opposite land. This softening economic data trend should start to alleviate some of the inflation and rate-hiking fears in the market, opening the door for a potential summer rebound in risk assets.

Portfolio Positioning - Ready for a bounce

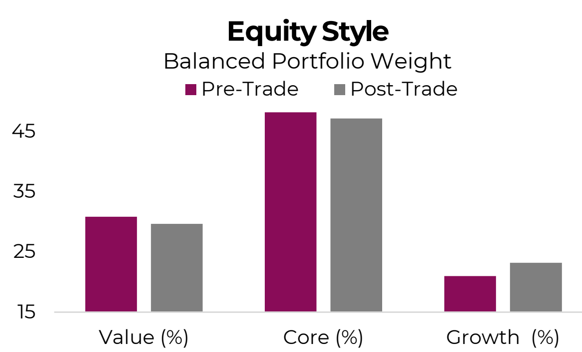
One thing many investors have learned over the years, corrections often present opportunities. Sometimes those opportunities play out to be long-term strategies and sometimes they are tactical. However, during a correction, we also know that the hardest thing to do when managing a portfolio is to be bold and take advantage of those opportunities. No one's timing is perfect, even the greatest portfolio managers in the world will admit to that. The best that anyone can do is stick to their investment thesis and manage risk accordingly.



Source: Purpose Investments

With so much in the economic world being upside down, 2022 has proven to be a tough year to have conviction. Still, coming into the year we made the decision to overweight Canadian equities, at the peak reaching 48% of the balanced portfolio equity allocation. Some may call it a home country bias, but Canada is a much heavier 'value' index than our neighbours and when presented with a rising rate environment, Canada is a good place to take refuge. Then tensions continued to escalate between the Ukraine and Russia, which added some fuel to our resource-heavy index. Safe to say that call has been the correct one with the TSX down -1.3% and the S&P 500 down -12.9% in Canadian dollars. Furthermore, U.S. exposure that we did have was comprised of two parts, the U.S. exposure in the North American dividend active fund and an equal weighted S&P 500 ETF. The fund's U.S. holdings have a strong value/dividend tilt, which have held up much better than the overall U.S. market. Plus, the equal weight ETF avoided the concentration risk of the market, and has outperformed by approximately +4% year to date.

Our most recent allocation change is tactical in nature and reversed a bit of our previous positioning. Around mid-May, we trimmed Canadian equities and initiated a position in a Nasdaq 100 ETF. The decision was based on many factors such as valuations, rate hikes being priced in, and the overall depth of the correction. But the overarching factor in the decision always comes down to – how is the portfolio currently allocated? Already being underweight the beat-up US market allowed us to take advantage of what we believe is an opportunity.



Source: Purpose Investments

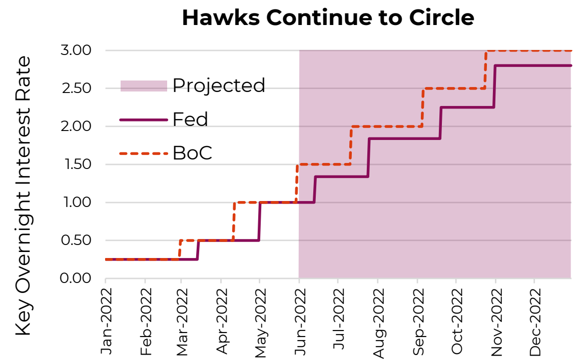
The trade also changed the portfolio's equity factor exposures. Value investors have been rewarded this year with the S&P 500 value index only down -5.0% while the S&P 500 Growth Index is down -22.1%. Reducing Canadian equity and adding to the U.S. Nasdaq reduced our value & core exposures and increased growth. The portfolio still remains tilted more towards dividend paying companies that are largely populated in Value and Core. Just a bit less than before.

Keep in mind that the approach to this trade is tactical, taking advantage of the relative outperformance in one market and underperformance in another. Longer term we continue to be tilted towards dividends, a factor more common in value or core names. This correction also may not be over, given our view that a bounce from technically oversold conditions has decent probability, the valuations are simply too good to pass up.

Remember, "Be greedy when others are fearful".

Bonds – we see some yield!

Speaking of being greedy when others are fearful… With inflation running hot and interest rates rising, bond investors have had a tough couple of years. 2021 was loser for the aggregate index, and so far 2022 has been significantly worse. Inflation remains at multi-decade highs and central banks will continue to hike rates, making the outlook grim. That said, as we hypothesized a few weeks ago in "Peak Hawkishness", much of that may already priced into the market. While our position had been one of very short duration, we are now starting to normalize that position. From here, where longer term rates go is more uncertain, but the selloff provides opportunity in a couple of ways.



The typical role in a portfolio for bonds is protection of principal, while providing some income. Recently it's fair to say that broad fixed income instruments failed at this goal. That's not to say that over the long term the asset class is broken, but 2021/22 has not been kind to bond holders. So, what can investors do? Focus on what you can control. The certainty that the CRA will come collecting again a little less than a year from now is 100% and pre-emptive tax motivated trading does not need to be just a November/December occurrence. We believe the market has largely priced in in the bulk of the expected rate hike cycle, and the time is right to do some tax loss harvesting amongst fixed income portion of your portfolio. With the plethora of ETFs and funds available it is easy to maintain similar exposures and crystalize any unrealized capital losses. Of course, this isn't specific tax advice as everybody has a different unique situation, but flipping bond positions to realize a loss may have some benefits. Just keep in mind that superficial loss rules apply so ensure that any replacement fund can't be deemed "identical property", as in it tracks the same index just from a different fund provider.

Crystalize losses, and take advantage of cheaper bonds, but don't abandon the asset class. There are still lots of reasons to own bonds.

Source: Charts are sourced to Bloomberg L.P., Purpose Investments Inc., and Richardson Wealth unless otherwise noted.