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Investor Strategy

The latest market insights from Richardson Wealth

RICHARDSON Wealth

Portfolio Construction

Executive summary

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Market recap: A tale of two markets

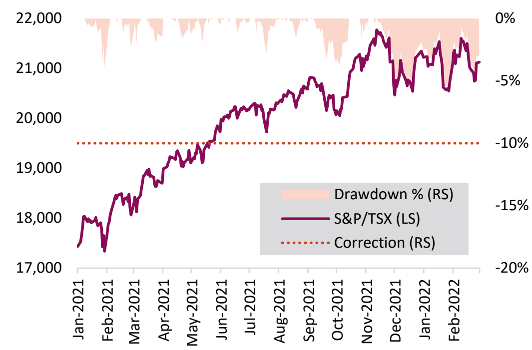
Despite pandemic optimism gaining traction with countries loosening mandates and economies opening, February began where January left off with market sentiment weighed down by central bank tightening to deal with inflation at multi-decade highs. Now, geopolitics are weighing following Russia's invasion of Ukraine. Markets recovered quickly from the Russia-driven selling, making a huge turnaround as countries imposed increasingly stiff economic sanctions against Russia. North American equity markets showed their resilience and performed well following Feb 24, but ultimately lost several percent during the month.

February was indeed a volatile month, although the Canadian market had a much different experience than our southern neighbour. Commodities surged and safe-haven gold came back in favour, driving the S&P/TSX Composite up +0.21% compared to the S&P 500 which was down -3.14%. Bonds outperformed stocks in the U.S., but also declined. Inflation continues to be sticky and has now been exacerbated by the Ukraine crisis, driving commodities prices up. Oil gapped higher from anticipated supply problems, given Russia produces 10% of global oil. This is on top of economies who have increasing demand with many going back to work and hopping on planes to go on long-awaited vacations. The growth underperforming value trend continued in February with tech stocks taking the biggest hit. Names like Meta and Shopify weighed down indexes. However, with Canada heavy in resources, and the U.S. in technology, we saw divergent performances. The S&P 500 entered correction territory and the tech-laden Nasdaq briefly hit a bear market 20% drawdown. Small caps also did quite well, with the Russell 2000 rising 1% in February, a welcome change considering the index is still down -8.8% YTD. International performance was disappointing, with major European markets down significantly, led by Germany which fell -6.5%. On a positive note, there were several better-than-expected economic data points on payrolls and GDP, and an optimistic earnings reporting season with 76% of S&P 500 companies reporting positive surprises. All these points, however, ended up taking a backseat.

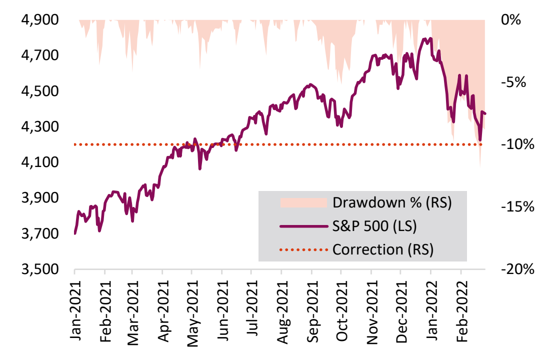
In terms of central bank action, the Ukraine crisis has not derailed what is expected to be a year of rate hikes, just decelerated it. Interest rate markets had the Fed expected to raise rates five times and the BoC six before the invasion; these have now been ratcheted down by one.

As investors, exogenous events like Russia/Ukraine cannot be expected, but must be endured. So, from an investing standpoint how do we participate in a market that can be predictable at times but can also have unexpected, and quickly changing events? In this issue, we will start down the road on a special series dedicated to portfolio construction. With all the different investment products available from hedge funds, leveraged alternatives, to cryptocurrency in the market, investors are bombarded with the latest and greatest strategy promising to grow your wealth with as little risk as possible. We are not here to build a bullet-proof portfolio, but rather one that can withstand the extreme volatility of the markets and help an investor sleep at night. We will start with the obvious big investing buckets and get more granular as the series progresses. Let's begin.

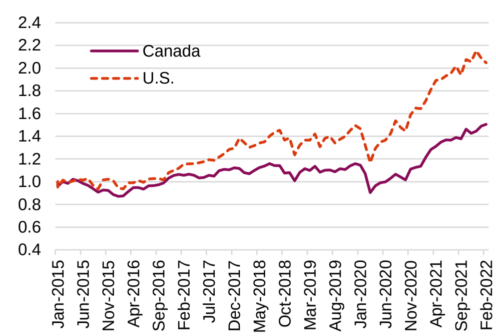
Resources Limit Drawdown in Canada



Info Tech Weighs Down the U.S.



Stocks Relative to Bonds: Rolling Over in the U.S.



Commodity Performance: As at Feb 28, 2022

	1mo	3mo	6mo	12mo	YTD
Energy					
Nat Gas (US/MMBtu)	-9.7	-3.6	0.6	58.9	18.0
WTI Crude (US/bbl)	8.6	44.6	39.7	55.6	27.3
Gasoline (USd/gal)	9.5	41.3	22.5	49.0	25.5
Heating Oil (USd/gal)	9.2	46.0	41.4	62.3	29.3
Industrials					
Aluminum (US/lb)	11.4	28.5	24.6	54.1	20.2
Nickel (US/lb)	8.9	23.7	25.9	32.0	18.3
Copper (US/lb)	4.0	4.7	3.8	8.9	1.7
Lumber (US/1000bf)	36.4	62.1	176.9	34.3	16.4
Precious Metals					
Gold (US/oz)	5.9	7.2	4.7	9.9	3.9
Silver (US/oz)	8.8	7.0	1.7	-7.7	4.3
Grains					
Corn (US/bu)	11.4	23.0	30.6	25.6	17.6
Wheat (US/bu)	21.9	19.9	31.3	41.7	20.4

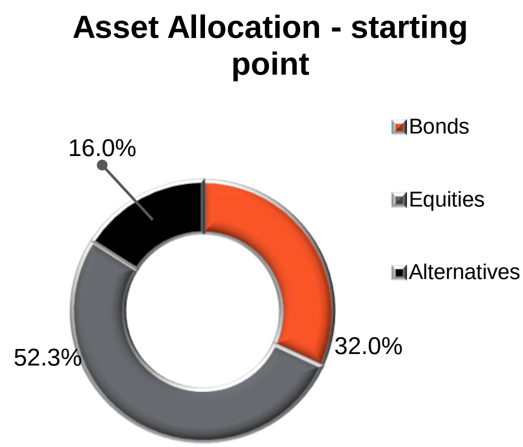
Portfolio construction insights

How do you build and manage multi-asset portfolios? This may sound like an innocuous question but given this is literally what all of us in the finance industry do, to one extent or another, it is kind of an important question. And we believe there is a shortage of thoughtful content on the topic. While there is lots of content on what you should buy, whether it's a stock, fund, sector or asset, there is not much on how to put it all together, how to manage it, how to conduct due diligence etc. We are like the auto industry that keeps talking about a single part of the car, when it is really how those parts work together that gets you to where you are going.

The financial industry delivers / manages / advises on portfolios to help clients reach their longer-term objectives. In this first instalment of portfolio construction insights, we will share our thoughts and processes for generating a deeper understanding of a portfolio's allocation and exposures, as well as our thoughts on exposure tilts given the current market environment. In future installments, we will tackle many of the hurdles faced by practitioners, such as monitoring, due diligence, measuring the impact of changes, fees, active/passive, etc. Our goal is to help provide readers with tools and ideas on how to improve their process.

Know what you own: Asset allocation down to exposures

Constructing portfolios is both an art and a science. On the surface, it is creating a portfolio with an asset mix that is best designed for the client's long-term risk and return objectives. Ideally, this asset mix can be tilted to incorporate the current macro environment, to take advantage of opportunities or try to reduce certain risks. Sadly, this is an oversimplification in a rather complex world. One equity strategy may have very different underlying exposures compared to another, and simply bucketing into broad asset classes masks many of the nuances that become very important in driving portfolio performance and volatility. In fact, many investments may cross over asset class lines in how they behave in different market environments. Some equities, such as utilities, health care or consumer staples may behave closer to some bond allocations, while some bond allocations, such as high yield or preferers, may behave more akin to equities. This is where the art of portfolio construction comes in.



In our portfolio analyzing and consulting services, we have found slicing a portfolio based on multiple levels of exposures can provide much deeper insights compared to surface level asset allocations. With deeper insight, we can make better and more informed decisions. This is a quick rundown of those lenses.

Asset allocation

While asset allocation may miss many of the nuances within a portfolio, it is the clear starting point for breaking down a portfolio to ensure you know what you own. Given the available investment vehicles, we have found equities, bonds and alternatives to be the ideal three broad classifications. Equities and bonds (we include cash in bonds) are pretty straightforward. Alternatives become a bit of a catch all for strategies that produce a materially different performance experience relative to long strategies.

Perhaps the more challenging aspect of asset allocation comes from the fact that most investment vehicles, whether a fund, ETF or alternative, have various asset class exposures within it. This precludes simply putting each investment into a single asset class. To truly understand the portfolio exposures at even the simplest asset allocation level, looking through into the underlying holdings of each investment is crucial.

Asset allocation is straightforward and does enable some modeling. The greater portfolio insight comes from the deeper analytics in each of the following asset class sections, and determining how it all fits together.

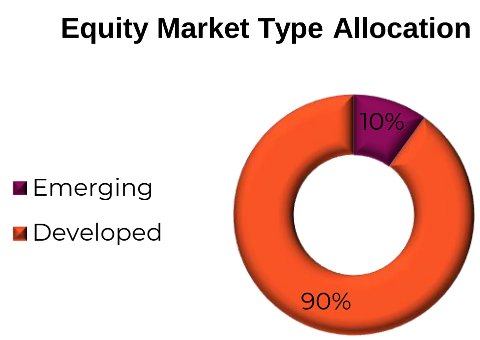
Equities

If portfolio construction is akin to manufacturing an automobile, equities are without a doubt the engine. Equity is the piece of the car that most often makes the portfolio go. And the engine has never promised a smoother ride. Equities captures such a wide swath of potential strategies and exposures, that simply calling the allocation equity is almost a disservice. Small cap Canadian venture capital companies are equities, as are trillion-dollar global technology giants and commodity producers located in emerging economies. Add to this list different active management strategies and various passive strategies, the variations are limitless.

Digging into equities we have found several additional lenses crucial for understanding the overall portfolios exposures and risks.

Geography

The starting point of any investment lens is geographical positioning. Typically, the main goal of the portfolio is to maximize return while minimizing risk, and what better way to do so than diversifying your allocation amongst a wide array of countries. Global economies do not always move in unison, allowing investors to reduce the correlation in their equity portfolio. Plus, the composition of markets is very different. This adds to diversification benefits, such as global pharmaceuticals or consumer brands that are not available in such markets as Canada.

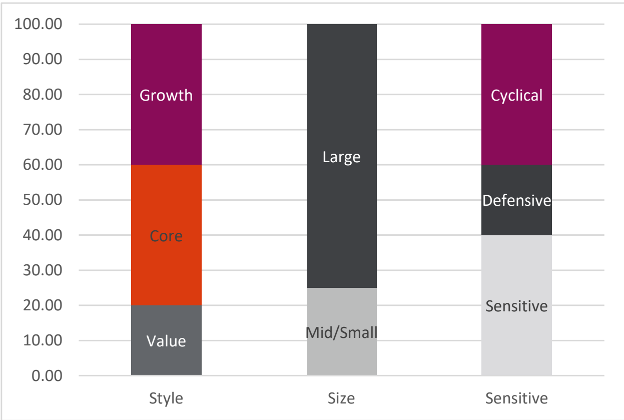


Going one step further, there are benefits to investing in developing economies. Emerging markets allow for even more diversification potential. While there are many benefits to investing globally, it is not all sunshine and rainbows. From an overall perspective, keep an eye on how much currency risk and political risk there is amongst the nations you invest in.

The important takeaway is to be certain of what you are adding; if an investment says ‘global’ in the name, ensure that is the case. Many times, a ‘global’ investment is simply 60% U.S. equities which may not actually be global in the terms of your overall portfolio. On top of the country exposure, if risk is a concern, be certain of the developing nation exposure you would be adding to the portfolio.

Size, style & cyclicality

Next consider the style, size and cyclicality of the portfolio. Style and size of a fund is typically fairly static, while the cyclicality can change given the manager’s outlook on economic conditions. For example, if a manager runs a large cap value fund, that is what an investor is expecting out of the allocation to their portfolio. It is not very often that the manager will transition to buying up small cap growth companies. It is much more likely that a manager may believe we are in the trough of the business cycle and a tilt towards more cyclical industries is appropriate moving forward.

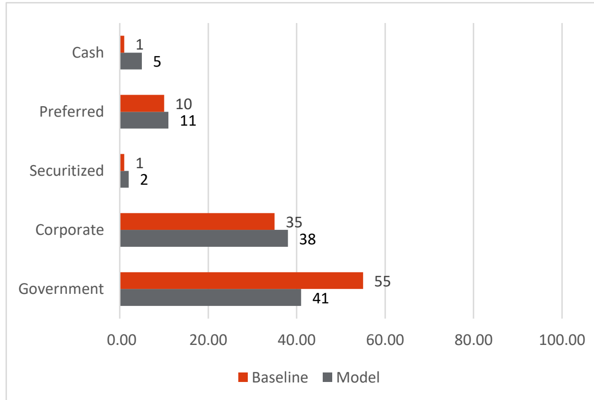


The goal is to align portfolio tilts based on style, size and cyclicality with the overall outlook view while keeping diversification in mind. Sometimes those outlooks simply don’t work out as expected.

Monitoring equity allocations of an overall portfolio is crucial to the success. While globalization has increased correlation amongst global equities, diversifying internationally still offers benefits. There have been strong divergences between style performance, especially as of late, which depending on how you are allocated can either contribute to the success or downfall of a model. Within a portfolio, every piece of the pie has their job and as Henry Ford once said ‘nothing is particularly hard if you divide it into small jobs’.

Bonds & fixed income

The early inventors of the automobile soon concluded that the forward propulsion needs to be counteracted to make it safe. Thus, the braking system was invented. Similarly, a portfolio's fixed income investments cannot be overlooked, and are necessary in avoiding unexpected obstacles.



Fixed income instruments are typically used in a portfolio to reduce volatility and provide more consistent steady returns for clients. During times of market volatility, government bonds can offer significant protection to portfolios, however with yields still near historic lows, the role of fixed income investments has been a growing concern for asset allocators. It's become even harder to find the delicate balance between portfolio stability and the larger opportunity costs of diverting assets from potentially higher returns elsewhere.

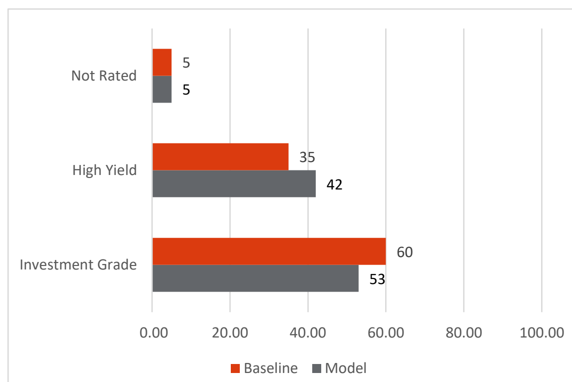
From our perspective, the fixed income portion of the portfolio consists of cash, corporate bonds, government bonds, securitized instruments as well as preferred shares. Each brings different elements to a diversified portfolio. We focus on three key aspects to further aid in the portfolio analysis.

Geography

Geographic exposure is straightforward. Our preferred approach focuses on just three broad buckets; Canada, the United States and International. Perhaps more so than with equities, most Canadians have a large home country bias within their fixed income allocations. While this makes sense from a liability matching standpoint, the potential pool of investments in Canada is rather limited especially in credit markets. Thus it is important to look outside of our borders to some degree for a broader range of corporate bonds. The common argument towards home country bias is to limit the potential volatility caused by swings in the currencies. This risk is magnified in a low-rate environment, especially considering hedging costs can also be high relative to expected returns.

Credit

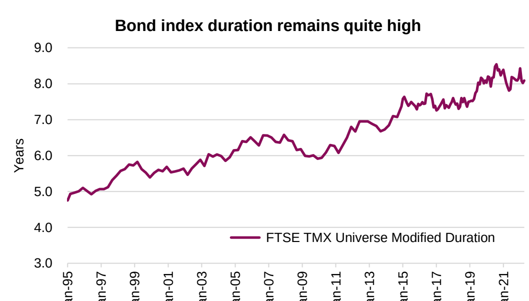
To compensate for lower returns, some advisors increase their fixed-income allocation with instruments that exhibit riskier equity-like characteristics such as high-yield bonds. It is during market downturns, however, when fixed-income instruments serve to significantly reduce portfolio volatility and outperform riskier assets. As such, it is important to analyze the credit composition of individual fixed income mandates to get a sense of the total exposure with a portfolio. It's easy to get into the weeds when dissecting credit exposure. From a portfolio approach we're less interested in individual company exposure or specific credit ratings, but rather we use larger buckets and break them up into Investment Grade (AAA to BBB), High Yield (BB or lower) or Not-Rated.



Using this simple framework, it's quick and easy to see if a portfolio's overall exposure and perhaps if it is overly tilted towards credit. In this environment, investors unwilling to take on any credit risk nearly guarantees a low-return outcome. However, tilting too far into preferred shares or high yield bonds does offer more attractive yields, but exposes clients to a much higher drawdown risk and a higher correlation to equities.

Duration

Bond market benchmarks themselves have changed over time as you can see in the chart below. As yields have fallen in duration, a measure of the sensitivity to interest rates has increased from a little over five years to over eight years. In other words, broad index exposure now takes on 50% more interest rate risk than 20 years ago, with only one third of the yield.



Determining the appropriate overall duration of a portfolio largely depends on the outlook for interest rates. For instance, in a rising rate environment, a shorter duration is more appropriate to minimize interest rate risk. Typically, portfolios are compared to an appropriate baseline duration to determine the extent of rate exposure embedded within the portfolio.

Advisors have access to many investment options to construct a diversified fixed portfolio. Options have grown considerably over the past few years with a wide array of new ETFs, private debt funds and liquid alternatives all geared toward the credit space. Using individual bonds in a laddered strategy can also be an effective and highly cost-effective option. Large tilts within any of these key exposures should follow a well-thought-out strategic rationale – with a clear understanding of what exactly the exposures want to achieve. The tricky but end goal is to combine investments across the fixed income spectrum to find balance between these three factors.

Alternatives

The definition of alternative strategies has changed over time. Years ago, "hedge funds" were the mainstay, attempting to offer absolute returns and lower volatility. Today, that universe has expanded considerably, including not just market neutral and long/short strategies, but also leveraged strategies, private assets, hard assets. We view alternatives as largely falling in one of four broad categories to emphasize a certain aspect of portfolios. Sticking with the car parts analogy, alternatives could be a turbocharger, a suspension system, or after-market tires. We see them as:

Diversifiers – reduce equity market risk for the portfolio to smooth out the ride.

Credit / Income – reduce fixed income risk and/or enhance cash flow to generate more income, especially in a low yielding world.

Growth – enhance the return of the portfolio.

Real Assets – help protect portfolio purchasing power against inflation.

These sub-classifications for alternatives are a bit more art than science. For instance, gold exposure is clearly a real asset but at times can be a diversifier. Many income strategies can offer some diversification benefits unless there is a credit event. The breadth of alternative offerings makes the categories a loose fit. The goal of breaking down alternatives into these buckets is to help ensure the holdings or positions are diversified and pointed at the desired objective.

One of the biggest concerns in the alternatives world is liquidity. This will be the subject of future portfolio construction papers, together with due diligence.

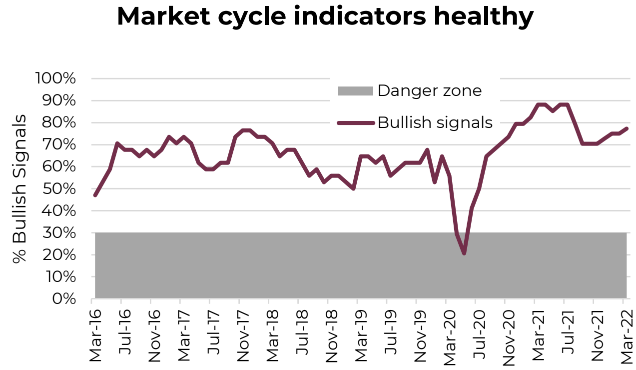
Putting it together

Every individual is different. Risk tolerance and return goal vary by an investor's age, preferences, and lifestyle. Of course, the base element of any portfolio construction starts with the individual. We can't help to guide that part without knowing the client. However, once we get past that, the elements must be selected not only to work on their own, but to work with each other in a variety of market conditions. Understanding and combining these exposures and factors will avoid over-concentration. "It's all the same trade" is something we often hear when looking at portfolios that were hastily constructed or put together by selecting investments in a vacuum.

Up next – we hope this deeper-dive portfolio approach is helpful; while it is extra work, it is time well spent. In coming instalments, we will continue to provide solutions for practitioners, whether that be managing a disciplined model or an individual investor managing a single portfolio. We'll also continue to explore equities, bonds and liquidity in more detail.

Current market thoughts

If you read any amount of content opining on the markets (ours included), you have likely come across reports favouring an exposure, for example value over growth. Does that mean you should only buy strategies with value in their name? Are those actually value and should there be zero growth exposure? This is the critical phase where views on the market meet the equally important requirement of a well-diversified portfolio. There are rarely absolutes like this in the market, so we generally construct a “baseline” or “neutral” allocation, and tilt in one direction or the other. For example, you may have noticed our recent writing has been tilted to value as opposed to growth, and short duration bonds as opposed to long.



Source: Purpose Investments,

Correction & the market cycle

2022 has had a rocky start. At first it appeared more of a style rotation away from growth names, combined with rising yields, inflation and a pending pivot by central bankers. Then war broke out. This put global equities into a correction. There is a kind of simple rule when it comes to correction – if there is no pending recession, they are buying opportunities. If a recession is on the horizon, they are NOT buying opportunities. The hard part is knowing if a recession is coming, which brings us to our Market Cycle framework. This multidisciplined approach combines economy, rates and fundamental indicators that help paint a picture on the health of the cycle. The good news: the cycle appears healthy.

This would normally have us a bit more excited to put cash to work in this pullback. But since declines have been narrowly focused on the growth factor, we have not jumped in (see March 1 Ethos). For instance, the TSX is down about 2% from its high. Hardly a bargain.

Nonetheless, the healthy market cycle indicator has us with a slight overweight in equities. Within this overweight is a decent tilt towards Canadian equities and minor tilt for international. These are more value-heavy markets which results in style tilt away from growth. We are also underweight U.S. equities on valuation, style and concentration issues.

Current Portfolio Tilts							
Overall Asset Allocation	**-**				**+**	**Model**	**Baseline**
Equities				■		52%	50%
Fixed Income		■				32%	35%
Alternatives				■		16%	15%
Global Equities	**-**				**+**		
Canada				■		44%	40%
U.S.		■				25%	30%
International				■		30%	30%
Value to Growth Tilt		■				40%	33%
Small to Large Tilt		■				25%	20%
Fixed Income	**-**				**+**		
Cash				■		6%	5%
Duration		■					
Credit				■			
Alternatives	**-**				**+**		
Growth			■			5%	5.0%
Diversifiers				■		70%	50.0%
Alternative Credit		■				0%	30.0%
Real Assets					■	25%	20.0%

Fixed income is an underweight as our current view is that yields have a bit more to rise and spreads are compressed (albeit starting to look more interesting of late). Within this asset class our duration remains low and we are tilted more towards credit. We are also holding elevated cash. This view is currently very challenged by the Russia/Ukraine conflict and rising oil prices.

Alternatives, for which we have a slight overweight, is mainly focused on diversifiers and real assets.

For diversifiers, given how far equity markets have advanced (up over 30% relative to pre-pandemic levels), we are increasingly concerned that 2022 may prove to be a year with multiple corrections. Adding to the uncertainty is the pending pivot in central bank policy as a global tightening cycle appears to be getting underway. Complicating matters further is higher inflation putting upward pressure on bond yields; finding quality defensive diversifiers in traditional asset classes has become more challenging.

While we do not believe runaway inflation is on the horizon, inflation risk is elevated. Headline CPI has remained at decade highs due to supply bottlenecks and robust demand, especially for durable goods. While this should come back down in 2022, longer-term inflation expectations are creeping higher. Wage pressure is mounting and the longer CPI remains high, the more behaviours begin to change. A diversified approach to real assets helps protect purchasing power should inflation remain elevated for an extended period.

Authors: Craig Basinger, Purpose Investments; Phil Kwon, Richardson Wealth; Andrew Innis, Richardson Wealth; An Nguyen, Richardson Wealth; James Price, Richardson Wealth; Joey Mack, RF Securities.

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