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Market Ethos

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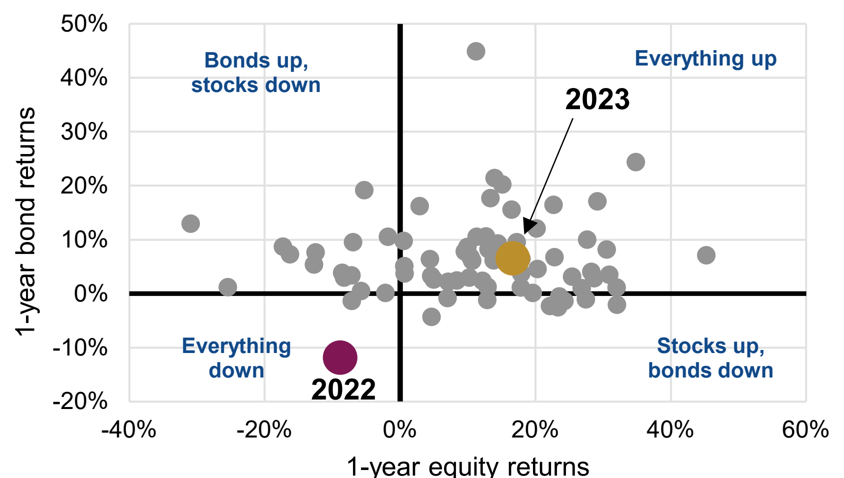
RICHARDSON Wealth

Plain vanilla is still a good flavour

It was not that long ago, about a year at its peak frequency, that you couldn't go far without coming across another report extolling the death of the plain vanilla 60/40 portfolio allocation. 'Time to rethink portfolio construction' was the prevalent theme of the reports, often encouraging increased use of everything from commodities, market neutrals, CTAs, real assets, etc. The messaging resonated with investors, given their experiences of 2022 – a year in which that type of portfolio construction didn't perform particularly well. But much like everything in the investment world, some strategies do better in some market environments while struggling in others.

We are not downplaying just how much portfolio construction using plain vanilla inputs sucked in 2022. The chart below is based on 73 years of calendar year returns for bonds and equities. That is a long period that encompasses many recessions, inflationary environments, wars, etc. While it wasn't the worst year on aggregate, 2022 was the worst year for both equities and bonds falling. Now, our equity proxy is a 50% TSX and 50% global equity; this would look a bit worse if you used less TSX, given our equity market held up better in 2022. However, 2023 did end up much back to normal, right in the middle of the cluster.



Source: Purpose Investments, 1950-2023, calendar year total returns in CAD, equities = 50% TSX 50% global equity, Bonds = Canadian bond universe

Adding to the frustration of 2022, your risk profile was largely meaningless. Given that stocks and bonds fell in similar fashion, it was a unique year in which your weightings across asset classes didn't really have much of an impact on performance. Growth investors holding more equity and fewer bonds are generally more comfortable with market

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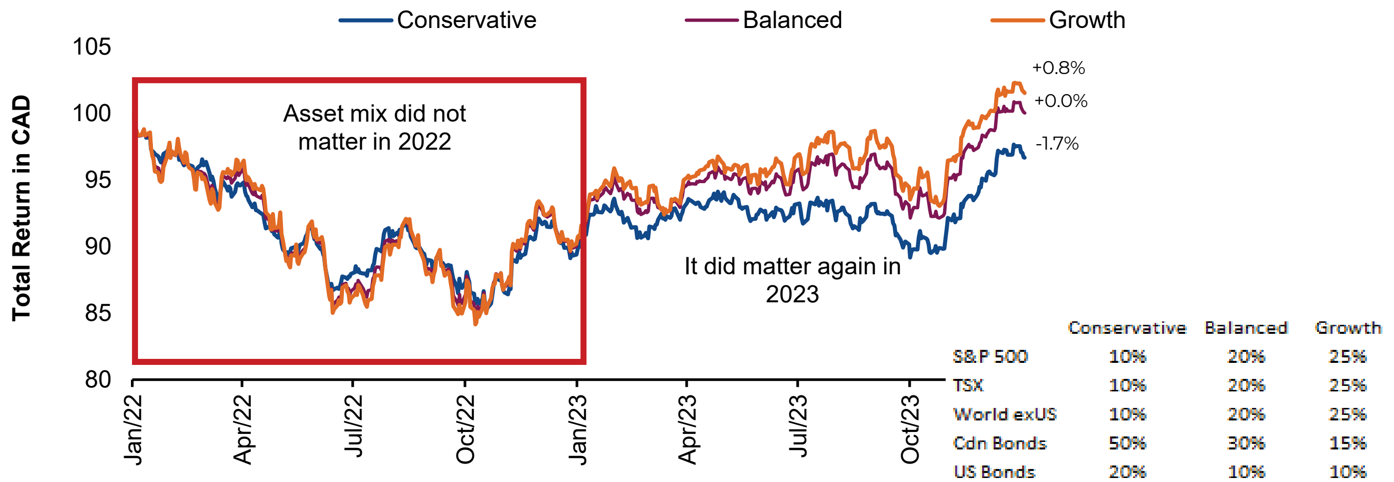
volatility as they see it as an acceptable by-product of greater return expectations over time. Yet conservative investors are more comfortable sacrificing return expectations in return for less oscillation in the market value of their portfolio.

This is key to portfolio construction and it did not work in 2022. The chart below is based on proxies for conservative, balanced, and growth investor allocations using plain vanilla index returns. As you can see, in 2022, they all travelled together, from the young growth investor to the conservative grandparent. In 2023, asset allocation once again mattered. Dare we say back to “normal?”



	Conservative	Balanced	Growth
S&P 500	10%	20%	25%
TSX	10%	20%	25%
World exUS	10%	20%	25%
Cdn Bonds	50%	30%	15%
US Bonds	20%	10%	10%

Source: Bloomberg, Purpose Investments

Knowledge matters

One of the attributes of good investors is knowledge. Don’t worry, it doesn’t need to be knowledge of market cycles, the economy, corporate financial statements, manager selection, or portfolio construction; that is more of a team’s full-time job and why the majority of investors use advice. Don’t rush out to sign up for the CFA just yet. But a base understanding of how markets work and how your portfolio is allocated goes a long way. Sometimes, returns are scarce, sometimes abundant. Sometimes a portfolio’s construction will struggle in certain market environments and often bounce back in the subsequent. The balanced proxy from above returned about 12% in 2023. Knowledge helps keep investors calm and, most importantly, helps them avoid making knee-jerk reactions to market oscillations. Such as abandoning portfolio construction after 2022 to load up on commodities and CTAs [Bloomberg commodity index fell 8% in 2023 after gaining 16% in 2022, Barclay Hedge US Managed Futures, proxy of CTA managers, was down 1% in 2023 (end of November) after gaining 15% in 2022].

Asset allocation works and is still the best tool for constructing portfolios for various risk/return objectives. Sure, it doesn’t work all the time as expected, but markets rarely go as expected. The average annual return for global equities is about 11% over the past 70+ years. That is a long-term average. Care to guess how many of those years are within +/- 5% of that average? Or in other words, how many years are within +6% and +17%? About 30%, which means 70% of the time, equity returns were below 6% or over 17%.

2022, and to a certain degree 2021, were unique because of how things were set up beforehand as well as some pretty big macro drivers. The cost and availability of credit were reset from low cost and abundant to higher cost and less abundant. The cause is actually irrelevant; it was this changing dynamic that caused various asset classes to move together. The good news is that may be over. There will be reverberations that continue but it is safe to say capital now demands a certain return that is higher than before, and there does appear to be less capital to be accessed.

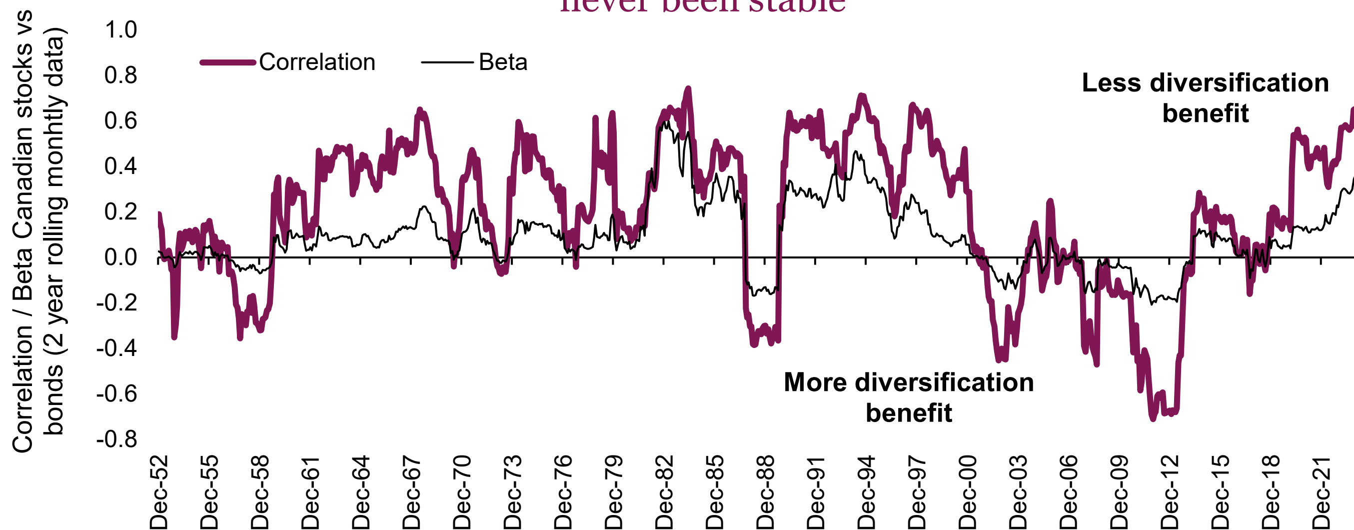
Understanding that when the risk-free rate (using overnight central bank rates as a proxy) moves very quickly from a really low level to, let's say, a normal or slightly high level, the price of all assets tends to adjust together. However, rates can only go from 0.25% to 5.5% once. Now that things have "reset," it has become a healthier market. It won't be a pleasant journey to get there, and we may not be all the way there just yet, but it is certainly a key part of the foundation for the next cycle.

We still like alternatives, but we just like plain vanilla asset allocation as well

Increased access to different asset classes, strategies, and vehicles is a trend that continues, and offers investors many more choices. This is a positive and significantly expands the building blocks for portfolio construction. Volatility management, defensive strategies, income enhancers, real assets, privates, the list goes on and continues to expand.

In fact, we are increasingly inclined towards real assets as our longer-term view is that inflation will become a recurring market issue in the years to come – not just as a threat to markets but to your financial plan. Privates also continue to gain traction as accessibility to capital changes. Diversification has become harder to find in an ever-increasingly connected world. The chart below shows the correlation and beta (measuring degree of move) between Canadian stocks and bonds. Periods when stocks and bonds move together are not uncommon; in fact, it has been more common than not over the past 70 years. Some of those periods, like during the 1990s, were a great time to invest. However, the positive correlation/beta does mean the diversification benefits of a simple asset mix may be a bit less effective. Alternative sources of diversification could certainly help.

The correlation and beta between Canadian stocks and bonds have never been stable



Source: Bloomberg, Purpose Investments

But not so fast. The availability of different strategies in the traditional long-only (non-alternative) universe have also expanded considerably over the years. Certainly on the lower-cost side via the rise of passive ETFs, but also with different strategies developed to gain different performance exposures. Momentum strategies can be designed to produce a very different experience. Bond strategies can range from ultra-long duration government bonds to syndicated bank loans.

And let's not forget, even if the diversification benefit between stocks and bonds is lower today than in the past decade or so, there is a silver lining. Bonds have a yield again, meaning they are not simply for diversification anymore and can have a more pronounced positive performance contribution to the portfolio. The yield-to-worse for the U.S. Aggregate Bond index is 4.7% ... getting that kind of return from your bonds means that equities don’t have to do all the heavy lifting.

Final thoughts

The positive of having more tools in the portfolio construction toolbox is that it offers greater flexibility in how to build portfolios. Alternatives certainly offer some very different investment experiences to address either opportunities or risk that goes beyond just expected returns and volatility. And the plainer vanilla long-only investment options now offer exposures at ultra-low cost to active strategies that can be quite different than the overall market.

It may feel like choice overload, but the good news is there are many different paths that lead to a successful investment journey. Traditional asset allocation will remain the core for most, yet there are many ways to enhance a portfolio, given ever-increasing options. Alternatives, combining both active and passive vehicles, and being more tactical with allocations all can help.

Equally important to portfolio construction is portfolio understanding. Understanding the true exposures and how they will likely behave in different market environments is critical in avoiding making knee-jerk reaction mistakes. Or more directly, don’t make it too complicated. Simple may not be sexy, but when investing, it tends to work much better.

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

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*This report is authored by Craig Basinger, Chief Market Strategist at Purpose Investments Inc. Effective September 1, 2021, Craig Basinger has transitioned to Purpose Investments Inc.

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