Wealth Management
PH&N Investment Counsel

Stu's View

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Are we there yet?

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After an historic sell-off in March, markets responded with a near-historic rebound late in the month. Is this the beginning of a new bull market, or a rally within a more prolonged bear market? While it's too soon to tell, we will continue to rely on three key strategies: dollar-cost averaging, systematic rebalancing and portfolio diversification.

It's the classic road trip line that often gets uttered at some point. Sitting in the car for hours can be challenging, even for grown-ups, so it's no surprise kids get antsy. "Patience is a virtue" was always the line that I heard back when I asked "Are we there yet?" You may have noticed the rebound in markets in March, and wondered the same thing. The S&P 500 closed on March 26 on a near-historic three-day surge of 17.6% (i.e. sharpest rally since 1931). Despite this positive development, we believe in this current environment that patience is still a virtue, and that the bear market which began last month may have more to go yet.

What drove the rebound in stocks in March?

There are three main reasons, according to RBC Global Asset Management. First, an avalanche of support for the economy has been applied in the form of emergency rate cuts, fiscal relief and specific backstops designed to keep credit flowing and markets from seizing up.

Second, valuations for risk assets have improved very significantly from levels prior to the collapse, and for many that may have been enough to trigger rebalancing programs or even to encourage some targeted "bottom fishing." Finally, panic selling and forced liquidation by leveraged funds/traders may finally be dissipating.

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Does this market rebound signal that the bear market we wrote about last week is coming to an end as quickly as it arrived? Or is this a short-lived counter-trend rally?

We do not believe the bear market is over just yet, but we cannot say with certainty. The short-term impacts on economic growth, business activity and individual behaviour are undeniable and, while the current consensus is for a rebound in the global economy, in the second half of 2020, the exact trajectory is unknowable. Rather than betting on any bold predictions, we believe that dollar-cost averaging and portfolio diversification across a number of elements is the best way to prepare for a wide range of potential outcomes.

Despite the recent market rally, in the near term, we caution investors to be prepared for days, weeks and even months that may seem unforgiving, yet provide for long-term investment opportunities. It's likely we still see fits and starts in the stock market, in the economy and with our daily routine for a while now. Having seen my beloved hockey season come to a crashing halt, I am holding my breath for the golf season to get the go-ahead. (But don't worry, given how I strike the ball, social distancing will never be an issue for me on the golf course.)

Bear market rallies – hindsight is 20/20

In this note, we discuss bear market rallies, or counter-trend advances, and how to position the portfolio for such markets. Spoiler alert – dollar-cost averaging, portfolio diversification and staying invested are sound ways to invest for any bear market scenario that may play out, even for shorter bear markets. We remain optimistic that we will get through this crisis period with some degree of patience required not only in our daily lives, but also when it comes to expectations for near-term investment returns.

A "bear market rally" is typically defined as a counter-trend rally, or a material rally/advance during a bear market. Bear markets are defined by a market environment whereby prices decline at least 20% from their prior highs. Another term for a bear market rally is a "dead cat bounce" to imply that the rise in prices are only temporary, and not here to stay. Previous bear market rallies are listed in Table 1, where "official" bear markets periods are shaded, and the corresponding bear market rallies shown below. Looking back, the average bear market rally lasted about 43 trading days, returning 12.2% on average. There has been a wide dispersion in terms of the length of

Table 1: Bear market rallies of the past (S&P 500 Index, USD)

Start	End	Start Level	End Level	Percent change	Length (days)
May-46	**May-47**	**19**	**14**	**-28.5%**	**355**
22-Nov-46	23-Dec-46	14	15	9.1%	31
15-Jan-47	12-Feb-47	15	16	9.3%	28
Aug-56	**Oct-57**	**50**	**39**	**-21.5%**	**446**
12-Feb-57	16-Jul-57	42	49	15.3%	154
Dec-61	**Jun-62**	**73**	**52**	**-28.0%**	**196**
28-May-62	3-Jun-62	56	59	7.0%	6
Nov-68	**May-70**	**108**	**69**	**-36.1%**	**543**
27-Feb-69	19-May-69	98	105	7.0%	81
Jan-73	**Oct-74**	**120**	**62**	**-48.2%**	**630**
21-Aug-73	28-Oct-73	101	111	10.4%	68
11-Feb-74	16-Mar-74	91	99	9.5%	33
Nov-80	**Aug-82**	**141**	**102**	**-27.1%**	**622**
16-Feb-81	25-Mar-81	127	137	8.0%	37
25-Sep-81	1-Dec-81	113	126	11.8%	67
8-Mar-82	26-Apr-82	107	119	11.1%	49
Aug-87	**Dec-87**	**337**	**224**	**-33.5%**	**101**
19-Oct-87	21-Oct-87	225	258	14.9%	2
Mar-00	**Oct-02**	**1527**	**777**	**-49.1%**	**929**
12-Oct-00	7-Nov-00	1330	1432	7.7%	26
20-Dec-00	1-Feb-01	1265	1373	8.6%	43
3-Apr-01	22-May-01	1106	1309	18.3%	49
21-Sep-01	7-Dec-01	966	1158	19.9%	77
21-Feb-02	12-Mar-02	1081	1166	7.8%	19
23-Jul-02	22-Aug-02	798	963	20.7%	30
Oct-07	**Mar-09**	**1565**	**677**	**-56.8%**	**517**
17-Sep-08	19-Sep-08	1156	1255	8.5%	2
27-Oct-08	4-Nov-08	849	1006	18.5%	8
20-Nov-08	31-Dec-08	752	903	20.0%	41
Feb-20		**3386**			
23-Mar-20	30-Mar-20	2237	2627	17.4%	7
Average (bear market rally)				**12.2%**	**43**

Source: Credit Suisse Group LLC. Used with permission. Returns in this table are in U.S. dollars, do not include dividends, and are not compound annual rates of return. Length of days represents number of trading days from start to end period. An investment cannot be made directly into an index. The table does not include transaction costs, investment management fees or taxes. If such costs and fees were reflected, returns would be lower. Past performance is not a guarantee of future results. The S&P 500 Index includes 500 companies across many sectors of the U.S. economy. The index is weighted by market capitalization so bigger companies make up a larger proportion of the index than smaller companies. The index is designed to measure performance of the broad U.S. economy through changes in the aggregate market value of the largest U.S. companies.

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bear market rallies, ranging from a low of two days, up to 154 days. With a limited data set of bear market rallies to extrapolate from, we are extra cautious about doing so in the current environment.

There are similarities and differences to each of these periods with today's environment. History doesn't repeat itself but it often rhymes, to quote Mark Twain. Today's recession and bear market are a direct result of a global pandemic and an intentional shut-down of most economies, in order to try and reduce its spread. This is different from other bear market periods identified in Table 1. For example, the Hong Kong Flu epidemic in 1969 somewhat "rhymes" with today, but that health scare did not involve a complete shutdown of most of the global economy, and the world was certainly less mobile then, which prevented much spreading beyond certain borders. Also different from today compared to previous periods, including the financial crisis of 2008, is the massive amount of fiscal and monetary stimulus being put to work across the global economy and financial markets.

Unfortunately the downside to a bear market rally is that you cannot identify a bear market rally until after the fact. It's not possible to know if prices will continue to decline, or not. Again, as we wrote last week, it is difficult trying to time market entry and exit points. For example, even after bottoming in October of 2002 and quickly rising more than 20%, there was yet another 15% decline in the S&P 500 before it advanced all the way to 2007. Historically, when stocks do bottom, they tend to see strong gains coming out of the gate. Of course you don't get confirmation of the official market bottom until after the fact. Importantly, our investment process is not based on market timing.

How to deal with the uncertainty of bear market rallies through dollar-cost averaging, systematic rebalancing and portfolio diversification

The first strategy to navigate through various market environments, where we know nobody can consistently predict the highs and the lows, is dollar-cost averaging. The idea behind dollar-cost averaging is that you buy a fixed amount of whatever you've decided to invest in over regular intervals, regardless of the price. This strategy helps to take the emotion out of investing, through the ups and downs in the market.

And for investors who are no longer in the wealth accumulation phase of their lives, we can also take the emotion out of the investment decision process by systematically rebalancing portfolios to ensure that the weights in each asset class (stocks, bonds, cash, real estate, etc.) correspond to their goals and objectives, and comfort level or capacity to take on risk. For instance, over the last three months, an investor who may have started the year with 60% invested in equities, 30% in bonds and 10% in cash, may find that those weights at the end of March were quite different. Depending on how each of those asset classes was invested, hypothetically equities might be 50%, bonds might be 40% and cash unchanged at 10%, for example. The extreme movement in markets has mean that portfolio weights have deviated from the target allocation which was established based on individual goals and objectives and risk tolerance. Rebalancing the portfolio back to the intended weights has proven over time to add value by increasing the likelihood of staying invested, and establishing a "buy low, sell high" discipline. Our research shows that systematic rebalancing of the portfolio while in bull markets and over the short term rebalancing may seem to force unpopular actions, in down markets, rebalancing and asset mix can play a critical role in smoothing volatility.

The second strategy to navigate the current environment is portfolio diversification. Traditional portfolio diversification considers the mix of equities, bonds and cash in the portfolio, based on individual goals, objectives, risk tolerance/capacity and time horizon. At RBC PH&N Investment Counsel, our portfolio construction process utilizes traditional portfolio diversification techniques, such as diversifying by asset class (equities, fixed income and cash). However, it also employs diversification across geographic regions and across different investment strategies based on various factors (company size, value, growth, quantitative, fundamental/bottom-up, and passive investments). We may also consider adding exposure to private markets such as real estate and private equity, depending on your tolerance/capacity for risk, and your specific investment time horizon.

Real estate assets, such as the RBC Canadian Core Real Estate Fund, have provided good stability in the portfolio as valuations in the fund stay more closely connected to the long-term cash-generating value of the underlying asset. Valuations for real assets are determined by the expected net operating income generated

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by a property, projected out over many years. "Core" office, retail and industrial real estate assets typically have long-term (three- to 10-year) lease contracts in place, with staggered maturities to help to stabilize operating income. Cash flows have tended to be more predictable over a cycle, and this stabilizes values.

Do bonds still have a role?

With interest rates globally at/near all-time lows, you might be wondering what role bonds play in the portfolio today. Bonds can play an important role in a well-diversified portfolio by helping to reduce volatility. They can play three important roles in a portfolio:

- **Stability:** Shorter duration bonds have relatively low sensitivity to changes in interest rates. As a result, these securities tend to generate more consistent returns than other types of bonds. However, they may also provide less protection from equity market volatility than longer duration bonds.
- **Equity diversification:** Higher-quality longer duration bonds have relatively high sensitivity to changes in interest rates. As interest rates tend to fall during periods of equity market volatility, these securities can act as a ballast for a portfolio in periods of equity market weakness. However, the reverse is also true. They may provide less upside, or even decline in value, when equity markets are strong.
- **Income:** This category includes specialty credit like high yield bonds, emerging market bonds, and mortgage-backed securities. These securities tend to offer higher yields than traditional fixed income vehicles, and are important in a low-rate environment. However, they can also be more volatile.

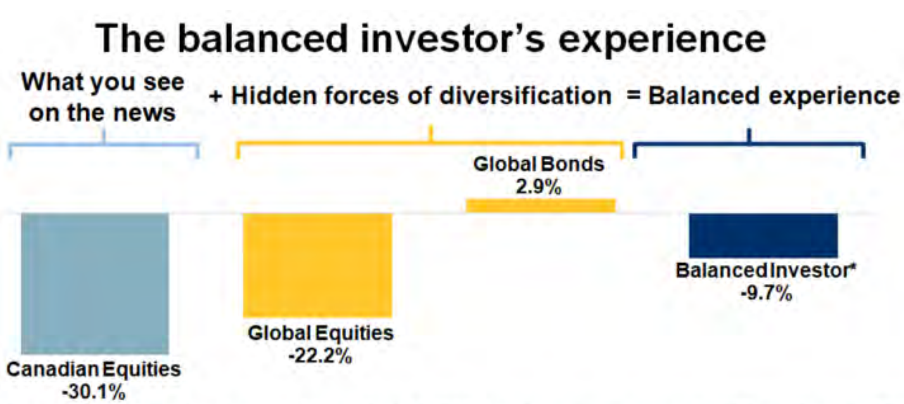
A balanced view

What was the investment experience of a balanced investor over the most recent period?

To illustrate how portfolio diversification can help you navigate this environment, the example below breaks down the return components to a balanced investor who held Canadian equities, global equities and global bonds from January 1, 2020 to March 20, 2020. A hypothetical balanced investor would have earned -9.7%, which would have been more favorable to those who were only invested in Canadian equities. Global bond returns were positive +2.9% over this period. Global bonds have done their job acting as a ballast for a portfolio during the period of equity market weakness. The low correlation of price between global bonds and the other parts of the portfolio provided for some relative protection to what could have been a deeper decline in performance.

Select opportunities in bond markets

According to RBC Global Asset Management, the change in both the absolute level of yields and credit spreads between February 19 and March 23 was nothing short of awesome. Coming from rock bottom levels and with credit spreads at their narrowest in two decades, yields on investment-grade bonds have ratcheted up to approach their long-term average. Even more impressive is the spike in the high-yield bond market. Yields for these more leveraged credits moved from 3.9% below the long-term



Source: RBC GAM, Morningstar. Total returns from January 1, 2020 to March 20, 2020. Canadian equities represented by S&P/TSX Composite TR Index. Global Equities represented by MSCI World NR (CAD). Global Bonds represented by FTSE WGBI (Hgd CAD). *Balanced Investor comprised of 50% MSCI World NR (CAD) and 50% FTSE WGBI (Hgd CAD). An investment cannot be made directly into an index. The graph does not reflect transaction costs, investment management fees or taxes. If such costs and fees were reflected, returns would be lower. Past performance is not a guarantee of future results.

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average to 1.5% in only three weeks. As investors flocked to the safety of government bonds more recently, and away from investment-grade corporate bonds, the premium bond investors get paid for accepting credit risk, increased almost four times to 3.92%, and doubled to 10.64% for high-yield bonds. Bond investors haven't been compensated to take on this amount of credit risk for some 30 years.

Update: What we are watching

We are monitoring several potential developments which could impact financial markets. The list starts with developments that could theoretically arrive fairly soon, and finishes with items that will likely take longer to achieve:

We fully recognize that this is a period in time that is highly stressful for you, and your family. Your portfolio is likely down and you have questions and concerns. Your Investment Counselling team is here for you. We welcome any, and all, of your questions related to financial markets and the impact COVID-19 may have on your investment portfolio, at any time. As we move through this period of uncertainty, we promise to consistently provide you with relevant market and portfolio updates, and wish you and your family all the best.

Be well,
Stu

What We Are Watching

Factor	Result
Significant disease containment	Partially
Major government stimulus	Yes
A decline in the number of new daily cases in Italy	No
A decline in the number of new daily cases in the U.S.	No
A decline in the daily global fatality rate	No
A decline in the total number of people actively sick	No
Development of an important therapeutic treatment for COVID-19	No
End of quarantining = No, China starting to return to work	No
A return to economic growth	No
Development of a vaccine	No

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