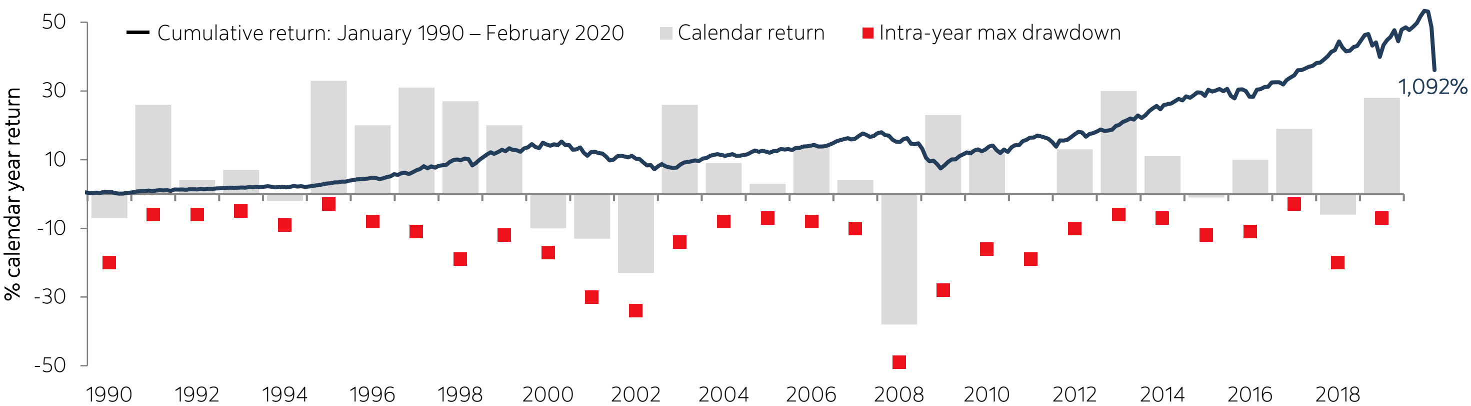
Bear necessities: strategies that can help you weather market volatility

The spike in equity market volatility has resulted in renewed anxiety for many investors. March 23, 2020 marked the most significant 30-day decline in the history of the S&P 500 since 1940. While it may be difficult to maintain composure during periods of market declines, making reactive, emotionally-driven decisions may be more detrimental to your long-term financial success than the drawdown itself. History shows that periods of turmoil and steep market declines have subsequently been among the best times to invest. Longer-term perspective can help you manage through the market turbulence and ensure you are positioned for a rebound, which is inevitable too.

Maintain a long-term perspective

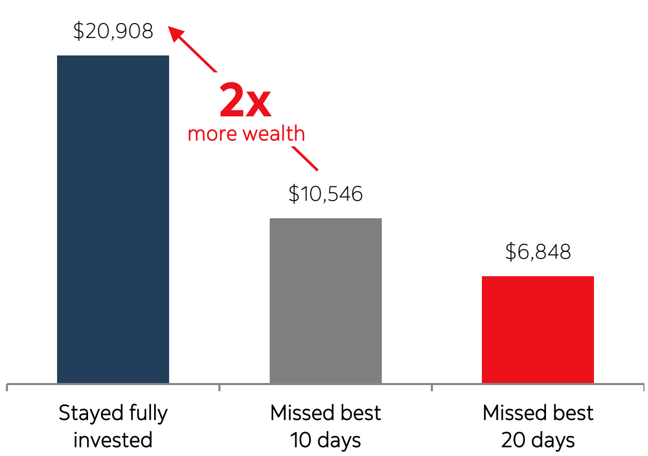
Figure 1: S&P 500 Total Return Index (January 1990 – February 2020)[1]



Dramatic market swings can be unsettling, but with uncertainty present at all times, they have always been a part of the investing environment. Periods of heightened volatility can take a toll on investors but as the chart in Figure 1 shows, the S&P 500 Total Return Index has delivered a cumulative return of over 1000% since 1990 despite experiencing two recessions, an average intra-year decline of 14%, 7 bear markets (including the current one), and 15 corrections. Investors that have stayed the course have been rewarded, and a $100,000 investment at the start of 1990 would have grown to over $1,000,000 – increasing tenfold - by the end of February 2020.

Stay invested and position for a rebound, which is also inevitable

Figure 2: Growth of $10,000 in the S&P 500 over the past 15 years[2]



Staying the course in periods of extreme market volatility may be difficult, but making drastic changes to your investment strategy based on short-term events can be detrimental to your long-term financial success. Notably, it is when asset prices decline that their future long-term expected returns typically increase. History has shown that markets move in cycles, and drawdowns have been followed by powerful rallies. If you sell and remain on the sidelines during a recovery, the impact on your wealth can be material, even if you only miss a few of the best days in the market. Figure 2 shows that remaining fully invested in the S&P 500 over the past 15 years would have doubled your money, while missing only 10 of the best days would produce half the wealth, effectively eliminating any gains over that period.

Diversify to help manage volatility

While volatility cannot be avoided, it can be managed through asset allocation and prudent diversification.

Asset allocation

Can determine up to[3]

90%

of portfolio returns

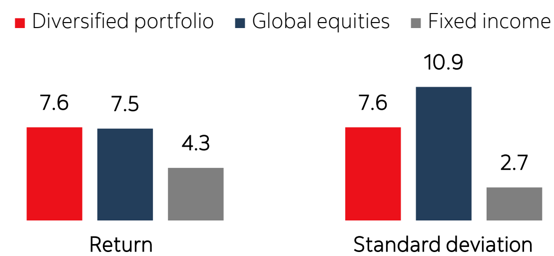
A well-diversified portfolio

Has generated a return similar to that of global equities[4] with

~30%

less volatility

Figure 3: 15-year annualized statistics[5]



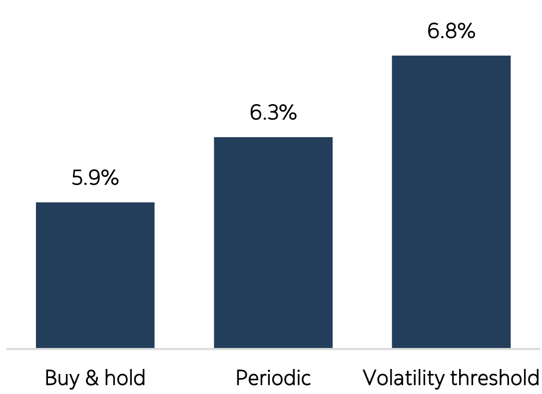
Strategic asset allocation, which involves determining an appropriate long-term mix between equities, bonds, and other major asset categories is critical, as it may account for as much as 90% of a portfolio's long-term return. Beyond that, a portfolio can also be diversified within each major asset category - by sub-asset class, geography, industry, and company.

Asset class returns are unpredictable, therefore a broadly diversified portfolio offers an opportunity to participate in the potential gains generated by each year's winners while minimizing exposure to the volatility of any particular asset class or security. As such, it helps protect capital and reduce the risk of loss. Importantly, as Figure 3 demonstrates, the benefit of risk reduction does not necessarily mean you need to sacrifice long-term performance. The Diversified Portfolio[6] delivered a 15-year annualized return similar to that of global equities, as measured by the MSCI World Total Return Index, but with ~30% less volatility. Perhaps the value of diversification is best highlighted by the downside protection it has provided so far this year, as market volatility reached historic highs. In this environment, the Diversified Portfolio has outperformed the global equity index by ~10% on a year-to-date basis[7]!

Rebalance to enhance long-term risk-adjusted returns

In addition to improving the consistency of long-term risk-adjusted returns, diversification enables you to take advantage of fluctuations in the value of asset classes by rebalancing your portfolio. We found, that this is particularly valuable during periods of high volatility, such as the one we are experiencing today. The drastic change in the value of investments has shifted asset class weightings within many diversified portfolios. Since the outbreak of COVID-19 began in mid-January, global sovereign bonds have been the best performing asset class, while equity indices have declined by approximately 30%. As such, many portfolios are now underweight equities relative to their strategic weights. Investors are faced with two options – allow the drifted asset class weights to remain, or rebalance the portfolio.

Figure 4: Rebalancing matters: correcting asset class drift can improve portfolio returns.



According to our analysis, rebalancing can improve portfolio returns. We compared two different rebalancing strategies – periodic and volatility threshold – with the status quo of "buy and hold". In our analysis, rebalancing on a set schedule (semi-annually, for example), improved returns by ~40 basis points compared with doing nothing and allowing the drifted asset class weightings to remain in place.

We also analyzed rebalancing when volatility is high. For this analysis, we examined a strategy of rebalancing monthly when volatility is one standard deviation above the 20-year average. This strategy improved returns by 90 basis points compared with the status quo.

It is important to note that the drifted weights have likely changed the profile of a portfolio to one that may not accurately reflect a person's risk tolerance and investment objectives. As such, rebalancing helps to align the portfolio with longer-term goals.

Stick to your Total Wealth plan

Short-term market ups and downs can cause even the most experienced of investors to lose sight of the big picture. A Total Wealth plan, which goes beyond investments and can incorporate sophisticated, non-traditional strategies to help you protect your assets and maximize your total wealth may prove a valuable tool.

Wealth accumulation

Investors who work with an advisor accumulate

3.9x

More wealth than those that do not[8]

Confidence

Of those Canadians that engage in comprehensive financial planning

81%

Feel more confident in their financial affairs[9]

Extraordinary service

Scotia Wealth Management was named

Best holistic wealth management service

In Canada[10]

References:

[1]Source: Bloomberg, Scotia Wealth Management, as at February 28, 2020. S&P 500 returns in $US.

[2]Source: Bloomberg, Scotia Wealth Management as at February 28, 2020. S&P 500 Total Return Index. It is not possible to invest directly in an index. Assumes reinvestment of all income and no transaction costs or taxes. Value of investment calculated using compounded daily returns. Missing 10 and 20 best days, excludes the top respective return days.

[3]Source: Brinson, Singer and Beebower, Financial Analyst Journal, Determinants of Portfolio Performance, 1991.

[4,5,6]Sources: Bloomberg, Scotia Wealth Management. Notes: Equity index total returns in CAD. Fixed income index returns in CAD, 100% hedged. Indices used are MSCI World (equities), Bloomberg Barclays Global Aggregate Bond Index(Fixed income), Static Diversified Portfolio is 65% equities (20% S&P/TSX Composite Total Return, 30% S%P 500 Total Return Index, 15% MSCI World ex-US Index), 25% fixed income (5% Bank of America Merrill Lynch (BAML) Global Government Bond Index, 10% BAML Global Corporate Bond Index, 10% BAML Global High Yield Index) and 10% Alts (5% Gold and 5% HFRX Global Hedge Fund Index). Based on 15-year annualized returns and standard deviation as at December 31, 2019, which are (return, standard deviation): Diversified Portfolio (7.6%,7.6%), Global Equities (7.5%, 10.9%), Fixed Income (4.3%, 2.7%).

[7]Source: Scotia Wealth Management, Bloomberg, as at March 31, 2020 based on the performance of the Diversified Portfolio (see note 6) which returned -11.4% and MSCI World Index which returned -20.9%.

[8]Source: Advisor Insights, IFIC, May 2017, referencing the Gamma Factor and the Value of Advice, Claude Montmarquette Viennot-Briot, 2016.

[9]Source: The Gamma Factor and the Value of Advice, Claude Montmarquette (CIRANO and the University of Montreal) and Nathalie Viennot-Briot (CIRANO)., 2017.

[10] Source: 2019 Global Banking & Finance awards®. Awarded Best Holistic Wealth Management Service in Canada. Publication.

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