Putting Recent Market Volatility into Perspective

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Human nature being what it is, considerable focus has been placed on recent market downdrafts. The US Equity market, given its dominance in global portfolios, has garnered much of the headline attention. On February 5, a late-night TV talk show host, in his opening monologue, stated the Dow Jones that day had suffered its worst single day loss of all time. Clearly, we are at an interesting juncture when even late-night TV talk show hosts are discussing the daily movements in the stock market.

The purpose of this memo is to provide some perspective. Before doing so, let me address a couple of issues:

1. Points vs Percent - In truth, the Dow Jones did shed 1,175 points on February 5 making it the Dow's single largest daily point loss in history. However, in percentage terms, the drop (4.6%) doesn't even rank in the Dow's worst 20 days. Headlines are designed to grab attention. And, "**the single largest loss in the history of the Dow**" is a successful attention grabber. However, the reality is that the February 5 decline is not as catastrophic as the headline suggests. Don't feel, having read the headlines, that you are informed. When it comes to the news providing a clear picture of what is going on, I always think of this graphic. The graphic illustrates, even reading the paper "cover to cover" doesn't provide the entire picture.

   Given this reality, let's look at the picture in greater detail.

2. Valuations and earnings - Pundits have stated that the US market is expensive, making it "ripe for a correction". (ps. Some have been saying this for years) Using the last twelve months of reported earnings, the S&P 500 is trading at 19.2 times earnings. This is expensive versus an historical norm of 14-16 times. But, earnings are also well above historical norms, justifying valuation levels. In fact, earnings and earnings expectations are currently very robust:

    - Earnings are on pace to grow by 18% for 2017 over 2016
    - The growth rate for 2018 over 2017 is expected to be 19%
    - Earnings in each of the last three quarters have been at record-setting levels
    - 75% of companies reporting Q4 2017 earnings reported better revenue and earnings than what was expected (as of today 80% of the index have reported)

    High valuation levels might be a catalyst for fear. However, the current state of the US market is not one of unbridled euphoria as earnings currently justify the market levels.

Let's put recent market moves into perspective by addressing time horizons and balanced portfolios.

Long-term horizon – Headlines about recent market declines shift perspective in two ways. One, attention is focused on the short-term (today!!!). Two, attention is diverted away from the overall balanced portfolio to one sub-component. For instance, the late-night TV talk show host solely mentioned the Dow Jones, which reflects the value of only 30 US equities. He didn't talk about global bond market returns for that day, nor were they the feature of headlines.

Short-term focus - Let's look at the folly of focusing on short-term returns. The Dow's best day was a gain of 11.08% (Oct. 2008) while the worst day was a loss of 22.61% (Oct. 1987). This is a huge range for possible returns into which any given future day may fit. Moving away from daily returns, the chart below shows the expected range of returns for 1-year and 5-year periods plus actual 25-year returns.

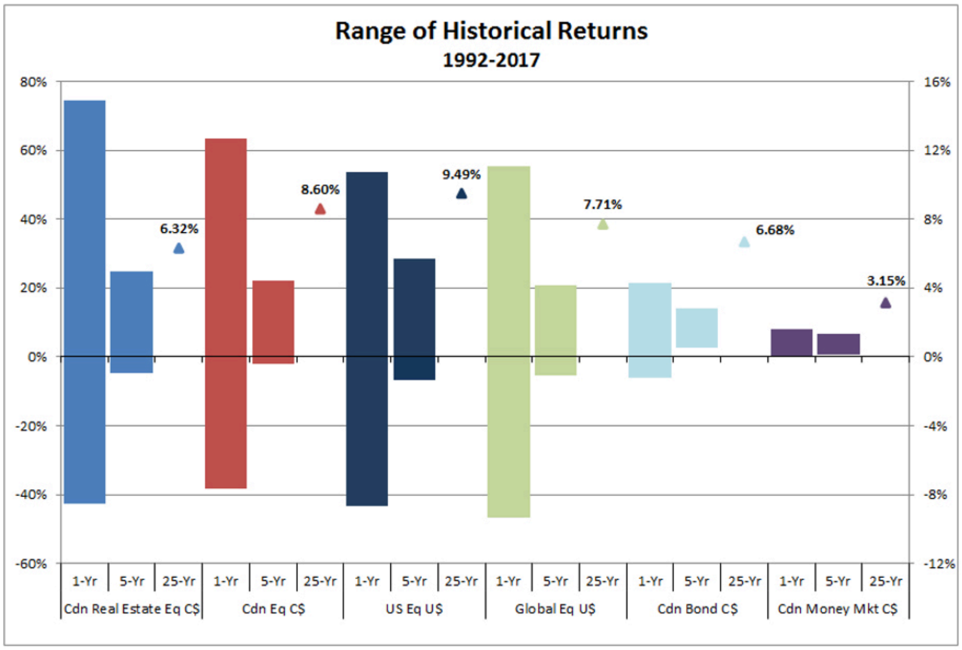

Chart depicts the range (min/max) and overall compound annual returns by asset class for stated periods.

For each of the asset classes (listed on the horizontal axis) the range of returns narrows greatly moving from short to longer-term. For instance, the worst losses in Real Estate in any given 12-month period exceeded 40%. However, the worst annualized return for any given 5-year period is barely negative. And, the 25-year return is over 6% annualized. In other words, when looking at daily to 25-year returns, almost anything can happen in the short-term. However, the range of possibilities narrows considerably as the time horizon lengthens. And, of great importance, the longer-term risk of loss is reduced.

Balanced portfolios - Balanced portfolios are built upon the very foundation that:

- Not all asset classes will move in the same direction or by the same magnitude at the same time. This is why one shouldn't have all one's eggs in the same basket.
- No one knows when which asset class will be moving up our down or when the current trend in any given asset class will change

Consider the following graph. It shows the exact same 1-year, 5-year and 25-year returns as the prior graph. However, this time, rather than the returns of asset classes being examined we show the returns of balanced portfolios with specific allocations to equities and bonds.

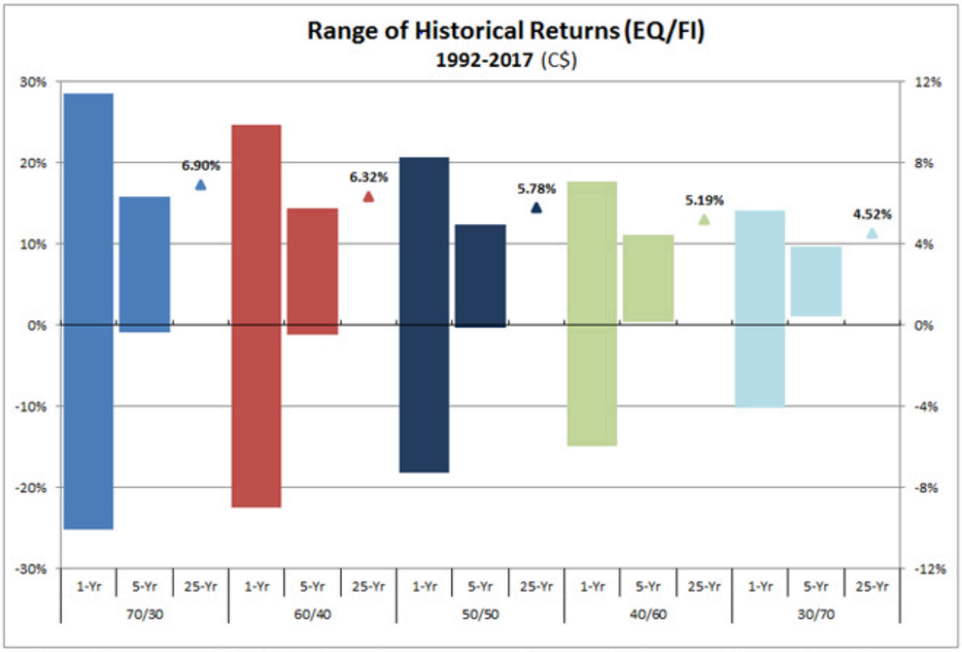

Chart depicts the range (min/max) and overall compound annual returns of each asset mix for stated periods.

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For instance, the first blue bars represent a balanced portfolio with 70% in equities (split between allocations to Canadian, US and International equities) and 30% in fixed income. Note that, like the prior graph, the range of returns narrow as the time horizon increases. There is a benefit to diversifying as, in all cases, the worst 1-year return for any of these balanced portfolios is less than the worst 1-year return for the asset classes.

It can be difficult to ignore short-term market fluctuations when everyone (including late-night TV talk show hosts) wants to talk about them and headlines are provocative and plentiful. However, during such periods of market 'noise' it is important to remember:

The value of a balanced portfolio, diversified across numerous asset classes, comes from having a long-term view and then sticking to that view. A day (or month, quarter or year) shouldn't change the plan. A headline or a late-night TV talk show monologue shouldn't have any impact either.