

# PERSPECTIVES

## Year-end REVIEW



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### Year-End Review: In times of volatility, keep emotions in check and think long-term

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Welcome to our special year-end review

How were the stock markets in 2018? Michael Chu and I have put together this concise review of what went on in Canada, the United States and other important economies around the world – and how it affected stock markets. We also look ahead to the rest of 2019 and beyond.

We hope you find this review informative and useful.

Enjoy!

**With a new year beginning, we thought it would be useful to review the events of last year. Then, to look at what 2019 and beyond may hold for us.**

After years of rising markets, toward the end of 2018 we saw stock market declines and higher volatility. The World Equity Index was down 1% (in C\$). The largest weighting in that index is the U.S., which was up 3.7% (in C\$). At home, the TSX was down 8.9%. The main worries appear to be around rising interest rates, global trade, slower economic growth, Brexit and the flattening yield curve.

These year-end numbers somewhat mask the intra-year volatility. From the all-time record high in September to the year low on Christmas Eve, the S&P 500 came close to the technical bear market definition, down 19.8%. But in the last few days of 2018, signs of optimism crept back in. Perhaps this was a combination of cheaper stocks and a realization that things weren't as bad as they seemed.

#### How did we do?

Despite good long-term track records, our strategies did not do well relative to the markets last year.

Our Canadian stock strategies (Disciplined Canadian Stock) returned -11.3%, underperforming the TSX benchmark by 2.4%. Our U.S. stock strategies (Disciplined U.S. Stock), returned -19.3%, underperforming the S&P 500 by 15% (in US\$).

We also have two global portfolios made up of all 12 of our stock strategies. The Disciplined World Equity composite returned -9.8%, underperforming its benchmark by 5.8%. This portfolio is 40% in Canada, 40% in the U.S. and 20% in international.

Our second global portfolio, the Dividend Select World Equity composite, returned -8.7%, underperforming the benchmark by 3.7%. This portfolio has a slightly higher weighting in Canada and dividend payers. This portfolio is 50% in Canada, 35% in the U.S. and 15% in international.

We also have a North American composite, which returned -12%, underperforming its benchmark by 10.9%. This portfolio is invested 40% in Canada and 60% in the U.S.

Note: These returns are just for stocks. Clients with less than 100% in stocks will have proportionately less returns. These returns are also before fees.

#### Why did we underperform?

The majority of our underperformance came from our U.S. stocks. We see three main reasons for the underperformance:

#### Value vs. growth

In 2018, growth stocks significantly outperformed value stocks. According to MSCI, U.S. value stocks returned -9.8% vs. -3% for growth stocks. Our strategies have a value tilt, which works well in the long term, but in 2018 value stocks

	Index Returns (in C\$)				
	Q1	Q2	Q3	Q4	2018
<b>Canada (S&amp;P/TSX)</b>	-4.5%	6.8%	-0.6%	-10.1%	-8.9%
<b>U.S. (S&amp;P 500)</b>	1.8%	5.3%	5.9%	-8.6%	3.7%
<b>EAFE (Europe, Australasia, Far East)</b>	1.0%	0.5%	-0.4%	-7.6%	-6.5%
<b>Emerging Markets</b>	4.1%	-6.3%	-2.8%	-2.2%	-7.3%
<b>World</b>	1.3%	3.6%	3.2%	-8.5%	-1.0%

Source: Bloomberg

### Stan Clark Financial Team Strategy Returns

Composite	2018 Strategy	2018 Benchmark	2018 Outperformance	5-year Strategy	5-year Benchmark	5-year Outperformance
<b>Disciplined Canadian Stock</b>	-11.3%	-8.9%	-2.4%	6.9%	4.1%	2.8%
<b>Disciplined U.S. Stock (in US\$)</b>	-19.3%	-4.4%	-15.0%	5.8%	8.5%	-2.7%
<b>Disciplined World Equity</b>	-9.8%	-4.1%	-5.8%	9.2%	7.9%	1.3%
<b>Dividend Select World Equity</b>	-8.7%	-5.1%	-3.7%	8.0%	7.1%	0.9%
<b>Disciplined North American Equity</b>	-12.0%	-1.2%	-10.9%			

underperformed by a large margin. Traditionally, value stocks do well because they beat the low expectations and growth stocks often miss their lofty expectations. But 2018 was quite the opposite. Growth stocks, with their higher valuations, actually met or exceeded their expectations.

Value and momentum usually tend to move in the opposite direction, offsetting each other to reduce risk. But last year they failed to offset each other; instead, they dropped in unison. In other words, value and momentum, on opposite sides of the spectrum, both failed.

#### Size of company

Typically, smaller companies perform better than mid-sized companies, and mid-size companies perform better than larger companies. But in 2018 the opposite happened. The Russell 1000 index represents the largest 1,000 companies in the U.S. This works out to about 90% of the total U.S. investable market, essentially most of the publicly traded companies. There are two subsets of this index. The Russell Top 200 comprises the top 200 companies by size out of the original Russell 1000. And the Russell Midcap consists of the remaining 800 companies. As you can see in the chart below, the larger companies (-5%) did much better than medium (-10.6%) as well as smaller companies (-12.2%) in 2018. This is contrary to what normally happens over the long term. While we have a wide range of company sizes in our portfolios, including large, many are in the mid-size range.

Category	Size of Company Index	2018 Returns (US\$)
<b>Large companies</b>	Russell 200 (biggest 200 of Russell 1000)	-5.0%
<b>Medium companies</b>	Russell Midcap (smallest 800 of the Russell 1000)	-10.6%
<b>Small companies</b>	Russell 2000 (smallest 2000 companies)	-12.2%

Source: Bloomberg

#### Weightings

Mainstream stock indexes, like the S&P 500 and TSX, are market-capitalization-weighted to calculate performance. That means companies are weighted in the index according to the size of the company. So, a company that is \$500 billion has 100 times its weight in the index compared to a \$5 billion company. Sometimes this method misrepresents the performance of the overall market, as large companies have much more influence than smaller companies. An alternative method, called *equal weighting*, weights all the companies the same. Neither method is perfect, but it's important to be aware of the differences.

In 2018, the regular market-capitalization-weighted S&P 500 was down 6.2% (in US\$). The equal weight version of the same S&P 500 was down 9.4%. What this tells us is that last year, the largest companies were responsible for most of the positive returns, and the remaining stocks did not do as well. To reduce risk, the positions in our portfolios are roughly equal-weighted.

In summary, there were three main reasons we underperformed the indexes: 1) value vs. growth; 2) small vs. big companies; and 3)

indexes misrepresenting the markets. Individually, these factors are not that significant. But a perfect storm, with all three occurring at the same time as they did last year, will add up and detract from performance.

#### What are we doing about it?

Like you, we do not like it when our strategies don't outperform over periods of one, two or three years. However, we accept the situation – because the *long-term performance of the strategies* makes it worthwhile. Over the last 10 years (including 2018), the Canadian strategies have outperformed by 4.6% per year. The U.S. strategies have underperformed by 0.8% per year. The Disciplined World outperformed by 2.1% per year and the Dividend Select outperformed by 2.3% per year.

#### Stan Clark Financial Team Strategy Returns (annualized)

Composite	Strategy Composite	Benchmark	Outperformance (per year)
<b>Disciplined Canadian Stock</b>	10 years 12.5%	7.9%	4.6%
<b>Disciplined U.S. Stock (in US\$)</b>	10 years 12.3%	13.1%	-0.8%
<b>Disciplined World Equity</b>	10 years 11.9%	9.8%	2.1%
<b>Dividend Select World Equity</b>	8 years 9.6%	7.3%	2.3%

Longer-term evidence, across several decades, also strongly supports this approach to disciplined investing. The back-tested results of our individual stock strategies go back to 1986 (33 years); international strategies go back as far as 1975 (44 years). Studies on individual value and momentum factors go back much further. For example, factors documented in David Dreman's *Contrarian Investment Strategies* (2012) go back 48 years to 1970, and those in James O'Shaughnessy's *What Works on Wall Street* (2012) go back 67 years to 1951. **Over those periods, value and momentum significantly outperformed the averages. Yet there were many shorter periods (one-year, five-year, even 10-year) when they underperformed.**

The outperformance over the longer term is caused, we believe, by humans' strong tendencies to both overreact and under-react to certain things. We have not found any evidence that human nature has changed to eliminate these errors. We therefore feel strongly that our disciplined, rules-based approach to investing still makes sense – and is likely to produce above-average returns in the future.

What are we doing about the underperformance? Something that is one of the hardest and yet most rewarding things in investing. We are staying the course. One of the most common errors in investing is overreacting to short-term underperformance. We are very aware of this emotional error, and very committed to avoiding it for ourselves and our clients.

#### Buying when stocks are down

We all know that the last quarter of 2018 wasn't great for stocks. Ben Carlson compiled a list of the worst quarters since 1926:

S&P 500: Quarter Ending	Quarterly Performance
June 1932	-37.7%
Sept 1931	-33.6%
Dec 1929	-27.8%
Sept 1974	-25.2%
Dec 1987	-22.6%
Dec 2008	-21.9%
Dec 1937	-21.4%
June 1962	-20.6%
Dec 2018*	-19.3%
Mar 1938	-18.6%
Sept 1946	-18.0%
June 1970	-18.0%
June 1930	-17.7%
Sept 2002	-17.3%

\*Dec 2018 performance is the low, not quarter end

There have been some pretty big declines and they don't promote much confidence in the stock market. About half of the worst quarters occurred in the 1930s, the worst economic and stock market environment in history. This list also includes the bear market of the 1970s, the Nifty Fifty crash, Black Monday and the tail-end of the dot-com bust. Losses of this size can be paralyzing, making it difficult to think about what can happen next. Reviewing the past is much easier than living in the present. But it provides a range of potential outcomes that can help guide our thinking going forward.

Let's see what happened after these terrible quarters in the stock market. The following chart shows the same periods as above, but now includes the subsequent one-, three- and five-year performance numbers.

S&P 500 Quarter Ending	Quarterly Performance	Forward Performance		
		One Year	Three Years	Five Years
June 1932	-37.7%	162.9%	170.5%	344.8%
Sept 1931	-33.6%	-9.6%	13.1%	118.2%
Dec 1929	-27.8%	-24.9%	-60.9%	-40.7%
Sept 1974	-25.2%	38.1%	72.7%	117.5%
Dec 1987	-22.6%	16.8%	48.8%	109.0%
Dec 2008	-21.9%	26.5%	48.6%	128.2%
Dec 1937	-21.4%	31.1%	17.8%	25.4%
June 1962	-20.6%	31.2%	69.2%	94.8%
Mar 1938	-18.6%	35.2%	38.2%	84.5%
Sept 1946	-18.0%	6.4%	24.5%	115.4%
June 1970	-18.0%	41.9%	57.4%	56.3%
June 1930	-17.7%	-23.4%	-34.7%	-32.8%
Sept 2002	-17.3%	0.3%	27.0%	66.3%
	-23.1%	25.6%	37.9%	91.3%

Source: Ben Carlson

As you can see, the ensuing one-, three- and five-year periods were mostly positive and high. (The negative cases were in the 1930s in the Great Depression, an extraordinary period.) In most cases, losses were recovered within a year or soon after.

Of course, no one knows what will happen in the future. But based on what we've learned in behavioral finance, human nature makes

it difficult to handle losses. Emotions lead to overreactions and increased volatility. Sure, it's possible that this quarter is an outlier and things could get worse. But what we *do* know is that the longer you extend your time horizon (i.e., the longer you can invest for), the greater the chance you will see gains.

### Maybe it's for the best

Sometimes market downturns, while not desirable, are a good thing over the long term. We need them once in a while to remind investors that risk is real in the stock market. If the market keeps going up and no one is scared – well, that would be a genuine time to worry.

Whenever stocks fall, it's natural for investors to go to a dark emotional place and brood about the Great Recession, the dot-com bust, the 1987 Black Monday crash, the 1973 bear market or the Great Depression. It's easy to assume the worst can happen. But more often than not, markets can go down driven purely by emotions, even when the fundamentals don't warrant it.

There have been plenty of smaller market crashes that didn't evolve into meltdowns and were basically forgotten: 1938, 1939, 1940, 1946, 1948, 1957, 1961, 1966, 1968, 1976, 1980, 1990, 1998 and 2011. The average decline for these forgotten bear markets was 25%, lasting about a year. Eight of the 14 did not coincide with a recession.

Coming back to what's happening today, stocks could get worse. But don't expect another Great Depression every time. Bad periods are natural. Sometimes they just happen and no one really knows why, even after the fact.

### Valuations

How do stocks now compare to bonds in terms of valuations? The table below shows how earnings (based on the last 12 months' earnings) and dividends from stocks of various regions compare to Canadian and U.S. 10-year bonds.

As you can see, dividends from stocks in Canada are higher than the 10-year bonds, and those in the U.S. are close behind. Both of these look favourable. And dividend yields from international markets look even better.

	Trailing P/E	Trailing Earnings Yield	Dividend Yield	10-Year Bonds
Canada	15.6	6.4%	3.5	2.0%
U.S.	18.4	5.4%	2.2	2.7%
EAFE (Europe, Australasia, Far East)	13.2	7.6%	3.7	
Emerging Markets	12.0	8.3%	2.9	
World	16.1	6.2%	2.8	

Source: Bloomberg

The earnings yields shown above are based on earnings reported over the past 12 months. It's also useful to look at *future* earnings to see how these compare.

Earnings in the U.S. grew very strongly last year, largely as a result of corporate tax cuts. Profit margins are likely to be squeezed somewhat in the future by higher labour costs and the impact of tariffs. However, profit margins could be maintained by increases in productivity and cost-cutting.

Given the above, earnings for the U.S. S&P 500 stocks are expected to grow in 2019 by 5.6% and in 2020 by 10%. Based on these future earnings, the resulting earnings yield is 6.7% and 7.4%, respectively. These are higher (better valued) than the five-year average of 6% and about the same as the 10-year average of 6.8%. Given current valuations are similar or better than the five- and 10-year average, coupled with the fact that we had good returns over these periods, bodes well for stocks. Of course, these are estimates and can be expected to change. But valuations are pretty compelling at these levels.

## What global slowdown?

We are currently in the sixth correction of 10% or more in the nearly 10-year history of this bull market. The last correction was in early 2016, over concerns of a global slowdown. But what really happened? The world did not stop growing. In fact, by 2017 stories of a global slowdown were soon replaced by stories of "coordinated global growth." Every nation among the top 50 was growing (except Venezuela) and the growth rate surged from 3.2% in 2016 to 3.7% in 2017.

Today, there are renewed concerns about another global slowdown. True, the International Monetary Fund (IMF) reduced its growth projections in 2019 from 3.9% to 3.7%. But that's hardly a slowdown. Asian countries continue to lead the pack. And even the slowest growth rates are still positive, meaning no recessions exist anywhere.

## Fed up

At its December meeting, the U.S. Federal Reserve raised interest rates 0.25% to 2.50%. It also signalled two additional rate hikes for 2019. The Fed has now raised rates nine times since it started raising rates in December 2016. Additionally, the Fed continues to reduce its balance sheet and has now shed about \$365 billion of its \$4 trillion balance sheet since it began doing so in October 2017. One theory is that every \$100 billion reduction is the equivalent of raising interest rates 0.25%. So, adding up the nine rate hikes plus the equivalent of four more means the market has had to absorb 13 rate hikes.

Interestingly, interest rates on 10-year treasury bonds fell. It's unusual for treasury yields to move in the opposite direction of Fed guidance. Basically the market is saying that rates should be lower. This may cause the Fed to rethink its plan for 2019, as it prefers not to invert the yield curve.

The Fed originally predicted four rate hikes for 2019. It recently reduced that prediction to two. According to Ed Yardeni, the two-year bond rate is a very good leading indicator of what the Fed funds rate will be a year from now. Currently, that rate is indicating no rate hikes for 2019. If this turns out to be true, it could be very positive for stocks.

## Unemployment rate too low?

We're closing in on the 10th year of this economic expansion. Just a few more months and it will be the longest expansion in modern U.S. history. The U.S. economy has added jobs for 99 straight months. That works out to almost 20 million jobs since the start of the cycle.

The current unemployment rate is 3.9%. Low unemployment rates are typically associated with lower stock market returns, while higher unemployment leads to higher performance. This might seem counterintuitive. But consider that high rates of unemployment tend

to come after a recession, which is also when stocks tend to have gotten beaten up. Low unemployment occurs when everything is going well, and most likely stocks have already done well, too.

But the unemployment rate alone doesn't tell us what will happen. Various levels of unemployment led previous recessions going back to the 1940s. There's no line in the sand. And stock returns leading up to recessions are also seemingly random. There's no perfect level that says *buy* or *sell*, as the market is complex and constantly changing.

## Two positive indicators

Two indicators with good histories of success are now looking positive for stocks. The first is the bull-bear ratio, which measures how many investors are optimistic compared to pessimistic. According to Ed Yardeni, the current bull-bear ratio stands at around 1.2. It has declined significantly from over 5.0 in early 2018 as the market sold off. This means that investors are bearish, which, as a contrarian indicator, is bullish for stocks. A *contrarian indicator* means that when we get a lot of bearishness the market tends to do well. And the opposite is also true. The last time the indicator was this bullish was in 2015/16 – which ended up being a good buying opportunity.

The second indicator is the *presidential cycle*, which says that the markets tend to do poorly in the first two years of a U.S. president's term and then well in years three and four. The theory behind why this happens is that politicians will do everything they can to get re-elected; meanwhile, investors look forward to positive changes in government. According to this indicator, year three (2019) and four (2020) should be kind to the U.S. stock market.

However, no one can predict what will happen in the next two years for U.S. politics. With the Democrats winning the House, resulting in a divided Congress, it will be difficult to legislate over the next two years. Add the Mueller investigation and chaos may ensue, making it even harder to get anything done. While this may cause problems, markets sometimes do very well when politicians are unable to make substantial changes.

## Looking ahead

Corporate earnings growth, while slower, is expected to continue and stock valuations are better after the recent sell-off. This should provide good support for the stock market going forward. But anything can happen in the short term, especially given the concerns around interest rates, U.S. politics and global trade. Events are difficult to predict, as are their consequences. That's why it's important to determine an appropriate mix for you through resilient financial planning, as well as owning a diversified portfolio of companies with strong characteristics of doing well. ■



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Performance results in this document are based on a composite of CIBC Wood Gundy Advisor Managed Account ("AMA") retail accounts with more than \$75,000 invested in the "Disciplined Canadian Stock strategy" (created in March 2008 and includes AMA performance data from May 1, 2008, two months after the Strategy's inception in the AMA program), "Disciplined U.S. Stock strategy" (created in March 2008 and includes AMA performance data from May 1, 2008, two months after the Strategy's inception in the AMA program), "Disciplined World Equity (CAD) strategy" (created in November 2008 and includes AMA performance data from January 1, 2009, two months after the Strategy's inception in the AMA program), "Dividend Select World Equity strategy" (created in November 2010 and includes AMA performance data from January 1, 2011, two months after the Strategy's inception in the AMA program), "Disciplined North America Stock strategy" (created in November 2015 and includes AMA performance data from January 1, 2016, two months after the Strategy's inception in the AMA program).

The composite includes open fee-paying discretionary managed accounts where the Strategy has been held for at least two months, through a purchase or a switch from another investment or a different AMA strategy. Also included in the composite are closed accounts that held the Strategy, up to the last full month the Strategy was held.

Composite performance returns are geometrically linked and calculated by weighting each account's monthly performance, including changes in securities' values, and accrued income (i.e., dividends and interest), against its market value at the beginning of each month, as represented by the market value at the opening of the first business day of each month. This Strategy can be purchased either in U.S. or Canadian dollars. Unless specified otherwise, performance returns in this document are expressed in Canadian dollars and are calculated by converting U.S. dollar accounts into Canadian dollars using the month-end Bank of Canada noon rate. Performance returns are gross of AMA investment management fees, and other expenses, if any. Each individual account's performance returns will be reduced by these fees and expenses.

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