Market Perspectives

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Markets – Are they Working?

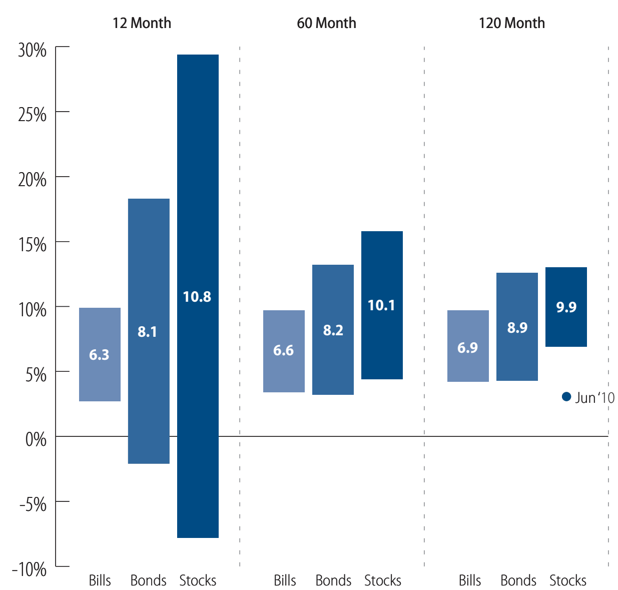
A client recently expressed frustration that "markets don't seem to be working." While it is always difficult to discuss investment returns that fall short of expectations, the reality is that equity markets have been through the roughest patch seen in decades, and as a result, the premise of risk and expected return needs a fresh review.

Despite the massive rally witnessed in 2009, the S&P/TSX has fallen by 21% since peaking in June 2008, and the Dow Jones is down 28% from its peak in 2007. While Leon Frazer portfolios have generally fared better than the market indices, nonetheless, we have also experienced periods of negative returns over the past two years. This runs counter to investor expectations developed since 1982, where all asset classes did exceptionally well as interest rates fell from their peak. The meltdown of 2008 reintroduced risk in a way that few expected, and dramatically changed the uptrend the equity markets have experienced for nearly three decades.

The following chart provides a historical review of asset class returns and volatility since 1956. The results offer an interesting perspective on what is happening today.

Historical Returns and Volatility–Canadian Asset Classes

1956–2010 Monthly Total Returns



Source: CIBC World Markets; Bills: CIBC Cash Proxy Index; Bonds: CIBC Bond Proxy Index; Stocks: S&P TSX Composite. Volatility measured as standard deviation of holding period returns over all time periods from 1956–2010.

Disclaimer: Historical returns presented above should not be considered indicative of future returns. They are provided solely to provide a sense of how volatile asset returns have been and may be over short and long holding periods. Expected asset class returns will depend on the interest rate and market environment at time of commitment.

Returns and volatility are shown in one, five and ten year holding periods. The average return earned by each asset class is shown in the middle of each bar, with the bar representing the average volatility of that return, as measured by one standard deviation.

As most investors know, short-term volatility is highest for equity markets and lowest for t-bills (cash). That is the traditional risk/return tradeoff – for the higher expected return of equities, greater risk, thus volatility, must be assumed. Equity markets are not ideal for those with short-term investment horizons. Over longer periods of time, however, the volatility of equity returns is smoothed-out, as apparent when comparing the 120-month (10-year) bars to the 12-month (one-year) bars. The mantra "invest for the long-term" becomes strikingly clear. (Surprisingly, bond returns were actually more volatile than stock returns over 10-year periods – but that is another article!)

Most interesting, as well as distressing, is that at 3%, the 10-year TSX return for the period ending June 2010 was the worst 10-year return of all 10-year periods measured since 1955! No wonder the comment "markets don't seem to be working."

Why is that interesting? As investors, the best way to do well is to buy when others are selling, and sell when others are buying. Market bottoms occur when no one wants to own stocks. Whether we are currently at the bottom or not, markets today are reflecting a caution already being reflected in low historical returns. When everyone believes things are bad, investment risk is at a minimum; when everyone believes how good things are, risk is usually highest. ■