Serber Speaking

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Commentary for the quarter ended March 31, 2020

Hello, thank you for calling The Economy. Please Hold.

So much has happened since I wrote my last quarterly report in January, it is hard to know where to begin. The tsunami of COVID-19 has swept aside much of the global economy and wreaked havoc on financial markets. Let's start by surveying the damage...

After falling as much as 35 percent from their February peak to the March low, stocks were down about 15-to-20 percent for the quarter overall, as seen on the chart below. As would be expected in a crisis, bonds held their value and made some small gains. Gold was a bright spot and, thankfully, we hold some in most of our client portfolios. On the other hand, preferred shares were hammered, which hurts, as we also own a fair bit of them.

Performance by Asset Class: January 1 to March 31, 2020 (in Canadian $)

Source: RBC, Thomson and Factset

The Uncertainty Principle

Pundits often say that markets hate uncertainty. This sounds intuitively logical, but I think on further examination that it turns out to be one of those phrases that sound good but mean nothing. Although uncertainty always seems higher "now" than it was "back then," the future was equally uncertain a year ago, a decade ago or a century ago. Markets have big drops not because of a change in uncertainty, but because people get scared and feel compelled to sell at any price. Conversely, markets have big rallies not because of lowered uncertainty, but because people on the sidelines pile in, fearing they are missing out.

In my experience, people always perceive the immediate future as particularly uncertain. I've never heard anyone say, "You know, the future seems more certain now than ever!" I suppose uncertainty seems greater in the present than in the past because we know how the past turned out. Why is this important? Because, if we are thinking about making investment decisions, we need to be clear what to base those decisions on. The fact that everything seems so uncertain right now is not a valid input because, if the above is true, that will never change. It is highly uncertain when the coronavirus threat will materially subside. When it does, it will be uncertain when the economy will recover. When it does, it will be uncertain how corporate profits will recover. When they do, it will be uncertain by how much or for how long. And so on, to infinity.

Investing in stocks has nothing to do with certainty or uncertainty. Rather, it is (or should be) based on one simple belief -- that owning a particular business, or a diversified collection of businesses, will generate a higher return for your capital over the long haul, compared to holding cash or safer fixed-income investments. The portion of your financial savings that you are prepared to devote to stocks for the long-term reflects the degree to which you hold this belief to be true. And that informs your investment plan, knowing that returns for stocks are never guaranteed and will always be uncertain.

The most important investment decision everyone makes is how to split their portfolio between lending out their money (also known as fixed income, such and bonds, GICs, etc.) and owning businesses (stocks). If you have this mix right, then you should not feel panic during the inevitable periodic market free-falls. Fear, concern and worry, yes. Panic, no.

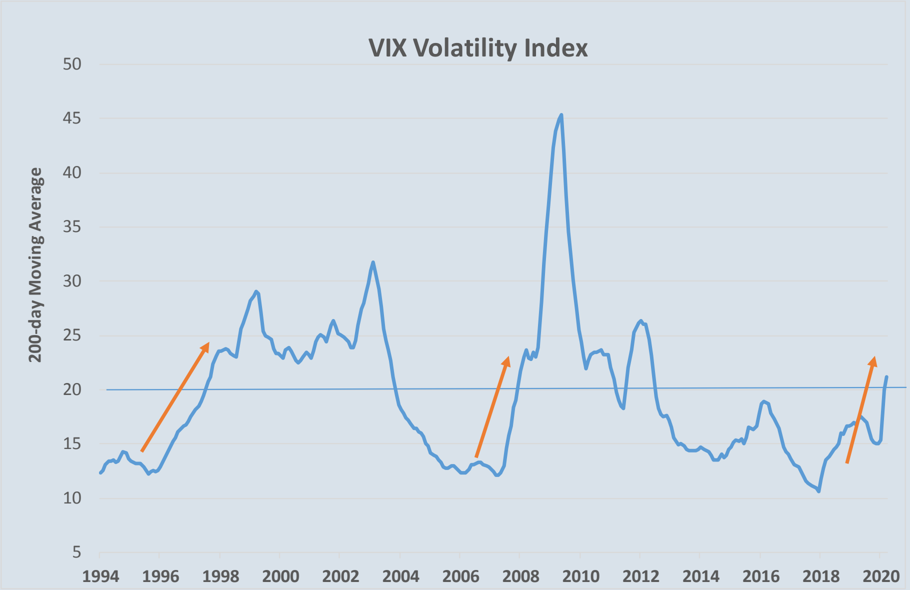
The mix that is right for you -- 50/50, 60/40, 20/80, or whatever it is, represents your investment comfort zone - and you should simply stick with it, regardless of what the markets throw at you. You can change that mix, based on changes in your life circumstances -- but never in response to world or market events. Furthermore, you should periodically rebalance. So, if stocks have had a strong run, you sell some stocks and buy fixed income to get the balance back to your target. Conversely, if stock markets fall significantly, you sell fixed income and buy some stocks to get your ratio back into line. This rebalancing approach means you will, at the margins, tend to buy low and sell high. Other approaches, such as trying to time when “things will be more certain,” will likely lead to buying high and selling low.

Following the rebalancing approach, I shifted some capital from cash to stocks, in small increments, during the big drop from March 16 to 23. I have more rebalancing to do and plan to do so over the coming weeks and months.

Indicator Update

I have written in the past that I watch the volatility index for the US market (known as the VIX) for signs of trouble, noting that the last two bear markets (2000-2003 and 2008-2009) were preceded by sustained volatility increases.

To keep tabs on this, I follow the chart at the right which shows the VIX index’s 200-day moving average. As can be seen, this index rose above 20, after spending an extended period between 10 and 20, in both 1998 and 2008. In the first case, a serious bear market (the tech crash) occurred two years later, and in the latter case the crash came within nine months.



Source: Factset

As can also be seen, the indicator has just crossed north of 20 -- a bad sign. While there is nothing magic about “20,” and I have picked it somewhat arbitrarily, I think we need to accept the possibility that some kind of bear market is unfolding. What type of bear market remains to be seen. It could be like 1998, where an initial drop (coincidentally, caused by what was then called the “Asian Contagion”), was met with aggressive policy responses, which in the end fuelled a big rally from 1998 to 2000, followed by a big crash. Or it could be like 2008, where things just get worse between now and the end of the year. Or it could be entirely different.

For their part, the analysts at BCA Research, who I have high regard for, are leaning more toward the former scenario in which the massive policy responses, both monetary and fiscal, cap the near-term downside and fuel a sharp rally in markets once the worst of the virus threat is behind us. A “hangover crash,” a year or two later, would then become a distinct possibility.

Whichever way it goes, one thing is certain -- the future is, and always will be, uncertain. Make sure you understand your investment comfort zone, and then stick with it. Oh, and don’t forget to rebalance.

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From the Planning Notebook

The way to improve portfolio returns without increasing portfolio risk is by reducing tax

Depending on your province of residence, you may be subject to tax at a rate of 50 percent or higher when your income exceeds $200,000. Here are some tax minimization strategies to consider.

- Income splitting with family members involves moving taxable income from a member in a higher tax bracket to one in a lower tax bracket. By spreading taxable income this way among family members, a family should be able to lower its total tax bill.

- If you have a low-income spouse, consider establishing a spousal loan to shift investment income from you to them. This allows you to take advantage of your spouse's lower tax rate. The strategy involves lending funds to your spouse at the Canada Revenue Agency's prescribed interest rate. Your spouse then invests the loaned funds to earn investment income, paying taxes on that income at their lower tax rate.

- Similarly, if you have low-income children, grandchildren, nieces, nephews or parents whom you support, you may consider establishing a family trust to shift investment income that would otherwise be taxed in your hands at a high marginal tax rate to your low-income family members. If the trust is properly structured, income and capital gains earned by the trust beneficiaries will be taxed at their marginal rate. Like the spousal loan above, the trust is funded with a loan from the high-income earner at CRA's prescribed rate.

Note – The prescribed rate is scheduled to fall from two percent to one percent on July 1. This presents an opportunity to implement this strategy on even more favourable terms.

In addition to the above, make sure you have maximized use of the following tax-saving plans, as appropriate:

- Tax-Free Savings Account (TFSA);
- Registered Retirement Savings Plan (RRSP);
- Registered Education Savings Plan (RESP);
- Tax-exempt life insurance; and
- Charitable donations of appreciated shares.

As always, please consult tax and legal experts before implementing any tax strategies. In any event, please feel free to call me or send an email to discuss or find out more.

Until next time, best regards,

David Serber

Feel free to forward ***Serber Speaking*** to anyone you think would find it of interest.