FALL 2021

Info SIGMA

Are we protected against a market correction?

The stock markets have been generous this year. After such gains, it is understandable that an investor might wonder if a market correction is looming. Given the nature of the stock market, corrections are inevitable and part of their natural cycle. When that will happen however is anyone's guess. It could be next month, or it could be next year, or the year after that. Should we try to time the stock market in the hope of avoiding a possible downturn? Can we predict the right time to sell? Even with the volatility of the stock market, selling at tops and buying at the troughs is extremely difficult and is not a reliable strategy. Trying to time a well-diversified portfolio with lower volatility is even more difficult because the performance gaps are so much smaller between the peaks and the troughs as to be non- exploitable. Risk management strategies must be in place well before corrections occur. Once in correction, it is too late to start rethinking our approach. So, how do you protect yourself from a fall in the stock market?

1. Being diversified is the first line of defense. Obviously, a portfolio that only holds stocks will experience a lot of volatility and be hit hard by a market correction. It is therefore important to also hold asset classes that do not behave in tandem with stocks. Bonds, gold, safe haven currencies, preferred stocks are just a few examples of asset classes that all offer good diversification potential.

2. Taking profits in those positions that have shown strong returns during the bull run. Our rebalancing discipline allows us to take some profit in those asset classes that led the way up and buy asset classes recently shunned by the average investor at a good price. This allows us a portfolio that is always ready for an eventual downturn.

3. Having strategies in place that complement each other. Some strategies are more reliable than others. However, even the more reliable strategies are not infallible 100% of the time. Every strategy has its own little vulnerability. We can increase the reliability of returns and the robustness of the portfolio by applying strategies that do not experience their best and worst performance at the same time and under the same conditions. This does not prevent them from having good returns simultaneously, but they will rarely have their weak moment at the same time. It is with this in mind that we have introduced the Asset Class Rotation baskets in 2016. The selection of asset classes based on their relative performance is an effective complement to the rebalancing discipline of the Sigma Balanced and Sigma Income baskets.

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Market review

The global economic recovery continues, despite the recent appearance of the Omicron variant. reflecting the progress made on the pandemic. Still, it is two steps forward and one step back, as we poised to embark on a fifth (or is it sixth?) wave in many areas, the feeling seems to be that one day COVID 19 will at least be manageable. This recovery brings with it a phenomenon that has not been seen for a long time: inflation.

Inflation has not been on the markets' radar in a very long time. But now it seems to have returned in recent months. Initially, central banks including the Fed and the Bank of Canada predicted that this inflation would be transitory in nature, mainly due to a rapid recovery in demand and temporary supply issues. But it looks like the pressure on prices could persist longer than expected. The labor shortage and the semiconductor shortage are not situations that can be solved overnight. Inflation occurs when there is an imbalance between supply and demand. The more demand exceeds supply capacity, the more upward pressure there is on the price level until supply adjusts itself structurally. The persistence of inflation depends in large part on its cause. Is the problem with too much demand, or an inability to increase supply to meet demand? In the event of excess demand, such as during a period of strong economic expansion, central banks may intervene with a more restrictive monetary policy which will help to curb that demand and thus reduce the pressure on prices. The impact rate increases can have in supply-side issues is more limited. Although they may raise interest rates to slow demand, that does not resolve the structural problems affecting supply. Protectionist trade policies, hyper-concentrated production capacities of essential components such as microprocessors, climate related shocks, socio-demographic changes such as early retirement and professional repositioning do not find their solutions in monetary policies but in structural adaptations that all take some time to achieve. It is quite possible that the inflation that is currently avoided will stay with us for some time. So, inflation may not be transient after all, but should come off recent excessive levels that compare to 1982 levels.

Are we well protected against inflation?

There are several types of risk factors: the risk of recession, interest rate risk, credit risk, currency risk, etc. As investors, we get paid return for exposing our capital to these risks. Sigma portfolios were designed to never be hit hard by one particular type of risk. Being diversified among many asset classes, exposure is distributed among a large number of factors, without any of them being too significant. The same is true for the exposure of portfolios to the risk of inflation. Some asset classes we own are negatively affected by inflation, while others will benefit:

- The Canadian stock market, with a relatively large proportion in the materials, metals and energy sectors, generally performs better than the US stock market which, for its part, is more heavily weighted in technology and consumer services.
- Stocks paying good dividends which are better protected against inflation and interest rate hikes than growth stocks whose potential lies several years into the future.
- Real return bonds issued by the federal government, and some provinces offer a coupon based on the rate of inflation.
- Real estate is viewed as a real asset, which is favored more by inflation.
- Gold is the classic «hedge» against inflation.

Sigma Balanced and Sigma Income portfolio rebalancing and Sigma asset class rotation positioning

The principle remains the same, to sell into strength and buy into weakness, in other words, to take profits in the asset classes which have done better and to invest in the asset classes which are shunned by the investors knowing that they will inevitably catch up. Given the uptrend in stock indices, the majority of our rebalances have been to sell stock or real estate companies and buy bonds and other conservative asset classes. During this stock market rise, 15% of the portfolio's value was rebalanced. 90% of this 15% represents profit taking in securities and real estate, which represent profit taking on 25% of stock and REITs positions.

The Asset class rotation basket has been either 100% or 80% invested in stocks and real estate since the announcement of the Pfizer vaccine in November 2020. Since then, risk assets have outperformed, safe have assets underperformed and interest rates have been on a choppy uptrend. The only fixed income asset class to have been in the portfolio since November have has been the Preferred shares index, which unlike traditional bonds tend to rise along with interest rates.

Bulletin Board

Congratulations to Christian Lamarre who won the Jean-Louis Lévesque award, which recognizes advisers who have had a positive and remarkable impact on NBF through their exemplary careers. We would like to wish to Christian an agreeable and well-deserved retirement.

Do you know of anyone that could benefit from our services?
Don't hesitate to contact a member of our team!

YOUR TEAM

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