QV UPDATE
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Gordon's Market Cycle

Gordon is an imaginary investor who we will investigate over a market cycle. Please picture the following scenario. It is 2009 and Gordon is a typical, middle class, 50 year old bachelor. His retirement is suffering large losses in the financial crisis. He cannot continue watching his life savings disintegrate day after day as the market collapses so he liquidates everything. He is devastated because he thinks he will now have to work until he is at least 70 before retiring.

Three years pass and he regrettably has missed out on robust returns. Growth stocks have been outperforming so he invests all of his cash in growth-based equities.

Three more years go by and it is now 2015. Gordon's investments have done well, interest rates are near all-time lows, and he feels that with a little bit of luck he might yet be able to retire in less than ten years. His golfing buddy informs him of a mechanism called margin debt whereby he can borrow against his holdings to buy more of his portfolio. With rates so low, Gordon feels it would be foolish not to take advantage of this to amplify his returns. Maybe he can retire in five years!

Fast-forward to 2018. Gordon is 59 and spends a lot of time researching which community has the best golf courses for him to settle down in to enjoy his upcoming retirement. Unemployment is near record lows and he recently received a pay raise as incentive to stay at his current company because job hopping has been rampant. Interest rates have risen and his margin loan is a little more expensive than it used to be, but the return from the additional stocks he purchased exceeds the higher carrying cost. He hired an advisor who is urging him to reduce the risk in his portfolio by diversifying into some fixed income products and closing the margin loan. Gordon is considering this when some influential world leaders get into a verbal tiff that causes widespread panic across global equity markets. Gordon experiences his first margin call, which happens when the value of the underlying securities decreases to a certain point below the value of the loan. He is forced to sell some equities at a loss to cover it. He yearns to make that money back with his remaining investments. Gordon is dumbfounded when he notices that almost all of his holdings are down sharply. He faces more margin calls, forcing him to sell enough stock to close the loan. When the dust settles he is bewildered that his portfolio is scarcely larger, factoring inflation, than it was a decade ago when the bull market started. It appears as though he will be working into his 70's after all.

Gordon’s financial actions were governed primarily by his emotions and were fraught with theoretical mistakes. The most crucial of which was the acceptance of excessive risk without means to absorb the potential loss. Unfortunately, there are millions of 'Gordons' who are either unaware of the risk or who, driven by greed, knowingly accept the risk no matter the cost.

Elevated levels of margin debt as a percent of GDP signify excessive risk taking in the marketplace. It is now nearly as high as it has ever been. The 'Gordons' are thirsty for gains! Peaks in margin debt tend to un-coincidentally coincide with peaks in markets.

Gordon was also invested in growth stocks which often trade on momentum and investor fervour, but not necessarily on the fundamental value. There can be a lot of money made in growth investments, but the potential downside may be substantial if the macro environment degrades or the companies fail to execute as expected.

We are not certain that the current bull market will end abruptly in the near future as it did for Gordon, but we are positioned for it if it does. Our strategies are comprised of quality companies trading at attractive valuations. Our Canadian balanced strategies are positioned conservatively and our fixed income strategies have relatively short durations to better withstand rising interest rates. If current conditions persist, we are ok with that too. We may not keep up with the high flyers as the old bull staggers on, but we have been finding grounded pockets of value in sectors that have fallen out of favour and will continue to deploy cash in those areas. We combat emotional biases with a structured risk management process that holds fast through any cycle.