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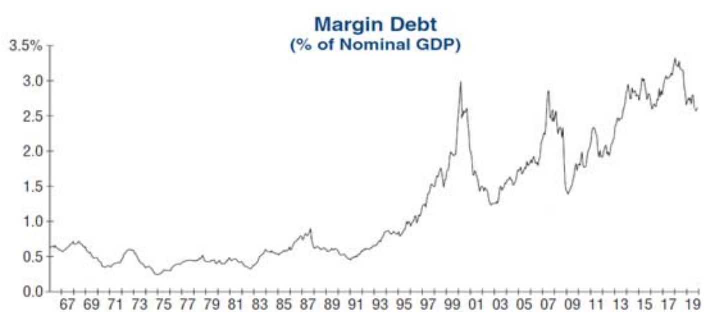
Navigating the Storm

It's been nothing but a sea of red across global stock markets this week as investors fear the worst about the quickly spreading coronavirus disease (COVID-19) and its implications for the global economy. Headlines come and go, often with jarring volatility. But amidst the short-term chaos we must remain focused on investing for the years, not months, to come.

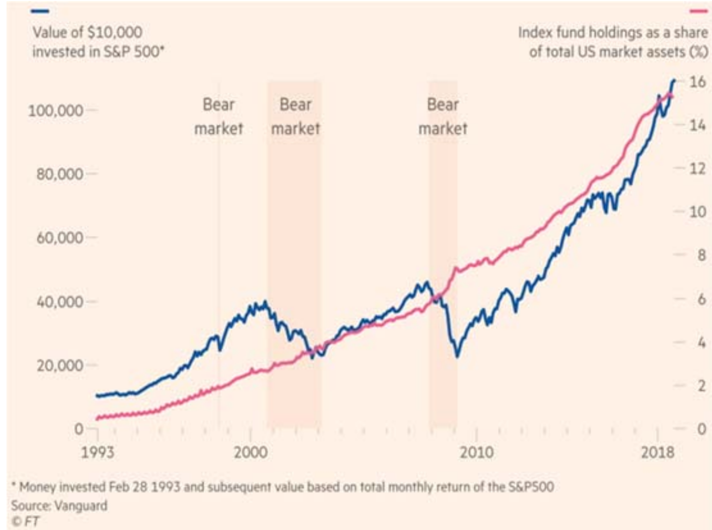
One of the hallmarks of this long bull market has been its ability to shrug off perceived bad news – trade wars, impeachment proceedings and geo-political escalations, to name a few. As a result, valuations have continued to stretch far beyond sustainable levels. With very little margin of safety baked into the market, the countdown was on for a negative reaction like the one we saw this week. If it hadn't been the quickly-spreading COVID-19, it would have eventually been something else.

The steady rise in margin debt (money borrowed to invest in the stock market) is a factor that may be exacerbating the magnitude of the selloff. When equities fall, investors with margin requirements often become forced sellers (at exactly the wrong time) in order to cover their capital requirements. The chart below showing the increase in margin debt over time demonstrates how relevant this factor may be today compared to history.



Source: InvesTech Research / January, 2020

Also, consider the enormous growth in passive (index) investing over the last two decades. The pink line in the following chart shows that passive market share has more than doubled since the global financial crisis. With hundreds of companies effectively lumped and traded together, strong, attractively valued businesses also get caught up in the selloff. A benefit to this phenomenon is that it may provide opportunities to purchase high quality businesses on sale. The corollary in the near term, however, is weaker performance across the board.



Source: https://www.ft.com/content/ed5542a0-db69-11e8-b173-ebef6ab1374a

What we are (and aren't) doing

We know that the fundamentals of the businesses we invest in and the prices we pay for them are what deliver returns in the long run. This is what matters most and is where we concentrate our efforts. When faced with volatility and uncertainty, we remain focused on our philosophy. We attempt to use the fear of others to add to existing positions and fund new opportunities at the more attractive valuations we have been waiting for.

Over the last 40 years, the average intra-year decline of the S&P 500 has been 13.8%. From its February 19th peak, the S&P 500 has now fallen 12.8% (11.5% in CAD). While this may help to provide some context around the magnitude we have experienced so far, we can never know how deep a selloff will go. We do know that using market weakness to add to strong positions (or, at the very least, sitting tight) has historically been the right decision.

Corrections are part of market cycles. This one has been swift, given the degree of uncertainty around economic consequences that may play out as a result of COVID-19. Like you, we will be watching closely as the situation develops.