The Just Word Podcast

Transcript of Episode 27: Justwealth 2021 Review & 2022 Outlook

Guest: James Gauthier

Pat Bolland 00:00
James Gauthier joins us, he's the Chief Investment Officer at Justwealth Financial and James, great to see in 2022. Happy New Year

James Gauthier 00:10
Thanks very much. Same to you, Pat.

Pat Bolland 00:12
James. Okay. Let's get a quick review of what happened to the stock markets in 2021. We'll start there.

James Gauthier 00:20
Okay. Well, you know, anybody who was looking at their account balances throughout the year would have known that equity markets were pretty good in 2021, you know, depends on the market, there was some variants, looking at different markets across the world. But generally speaking, North American equities were fantastic. Both indices returned more than 25% for the year, which is a remarkable achievement for for an index. Outside of North America, they weren't quite as rosy but still up double digits about 10% for developed markets outside of North America.

Pat Bolland 00:53
Okay, now, well, that was good for the stock markets. And yeah, 2021 was good for the stock markets, not so the bond market, right?

James Gauthier 01:02
Right. The it was the opposite story for bonds. So bonds actually had a negative return in 2021, which is unusual for the bond market. That doesn't happen very often. It was the worst return we've seen in bonds going all the way back to 1994. So that's, you know, that's a bad return. And it wasn't a huge negative number. Bonds were down about 2.5% last year, which, you know, you never like to see a negative return. But if 2.5% is the worst return in 25 plus years, there's not a lot of downside potential there.

Pat Bolland 01:37
Yeah. What do you think what drove the markets? I guess the stock market's up and the bond markets flat to down?

James Gauthier 01:45
Well, I think the primary, I guess, impetus behind the, the big increase in the stock market was a recovering economy. So we had the problems caused by Coronavirus in 2020, which sent a big downward spiral in economic output. So for much of 2020 and 2021, we saw recovery in place, you

know, basically globally. And anytime you have an increasing economic output, combined with increasing profits, that's very good for the stock market. That worked really well, throughout the first half of the year, slowed down a little bit. But at the same time, with all that increasing demand, or economic output was upward pressure on interest rates. So fear that the central banks were going to start raising interest rates and in the bond markets, where interest rates try to anticipate what's going to happen, people were fearing higher interest rates, and sold off the bonds. So ultimately, it was the economic output that caused the consequences in both of those markets.

Pat Bolland 02:52
You know, it's interesting and inflation is running at numbers we haven't seen in a long time, you and I might remember them. And the bond market certainly reflected that. But haven't stock markets in the past reflected when the inflation numbers are bad.

James Gauthier 03:06
Well, there's two aspects of inflation that pertains to the stock market. One is the the increasing prices in terms of how that affects, you know, what company's make in profit. And for the most part, companies have been able to pass along the cost of inflation. So it's really a non factor. Higher prices mean higher revenues, and ultimately higher profit if they're able to pass it along. So that aspect of inflation is not bad for the stock market. The bad aspect for the stock market is the fear of rising interest rates. So when inflation starts getting too hot, the central banks will raise interest rates to slow down the economy. When that happens, when interest rates go up, the value of stocks, if they're being the representative of the value of the future profits, when you start discounting at a higher interest rate, it shows a lower net present value, which means the stock prices would go down. So that's the aspect. Specifically, you know, tech stocks were hit pretty hard as interest rate anticipation of rates going up increased, tech stocks, which have profits to kind of earmarked a little further into the future ... that has a bigger impact on their prices. So that discounting impact of higher interest rates is what causes the stock price's to go down.

Pat Bolland 04:31
You know, James, I don't know about you, but I was a little bit surprised the stock markets paid relatively little attention to the pandemic. Why do you think that was?

James Gauthier 04:43
Well, I think there was a pretty big impact in 2020. Right, there was a third largest decline in stock market history. So you know, by the time we got to 2021, having lived through the pandemic for almost a year, and then another entire year for 2021. It's kind of like old news. The stock market reacts to new news. And the pandemic is not really even though we have new variants. There's always, you know, something good or something bad happening. It's a bit of a roller coaster, with the different waves that have come through with the different variants of the Coronavirus. So I think you know, that story is getting a little old and it doesn't have as much impact. We've proven as a as a human race that we're able to deal with this to live with this. It's not great, you know, people are still dying, people are still getting sick. But we're able to operate economies in face of this Coronavirus challenge. So, you know, I don't think that's as much of a concern, as it was, say, a year and a half ago.

Pat Bolland 05:41
Interesting. So as we head into 2022, and we're in our, what, fourth wave and some would say a fifth wave is coming kind of thing, pandemic is not going to be an issue in the market, or how are you approaching 2022 pandemic? And, you know, economic growth and those kinds of things.

James Gauthier 05:57
Yeah, we I mean, we don't change our positioning very much, we build our portfolios for the long run, we recognize that short term events are going to impact markets both positively and negatively. Over longer periods of time, it's a smoother ride. So we don't want to start guessing or speculating and moving things around to, you know, gamble in clients portfolios, when we know that the way we position things should work out in the long run. So we're just going to kind of keep things as isn't if there's a, you know, a big shock to the stock market or the bond market or anything else, we'll always address that in the future as it comes along.

Pat Bolland 06:35
Okay, so how do you address that? Suppose, I mean, it's fine and dandy as long as the stock market keeps going up. But if the stock market goes down sharply, let's say it's, I don't know, 15, 20%, some fairly big move, how do you dress that in your portfolios and in your approach to the markets?

James Gauthier 06:53
Well, there's a few different ways that we can address it. There's the the rebalancing aspect of our portfolios. So anytime, any particular holding goes off of its target allocation by more than 5%, we have triggers that will be, you know, initiated to put in orders to correct the imbalances. So we're always bringing things back to where they're supposed to be. In terms of trying to take a proactive approach and guessing where the markets are, we don't do that. We don't try and guess in the portfolios. If a market goes down 10 or 15%, it could go down further, or it could go back up. We don't know and nobody else does, either. So we expect that the rebalancing will keep client portfolios where they're supposed to be. If people have a change in their, you know, future expectations of what they want to achieve, for example, someone retires, you know, we might make a change to the portfolio, but we're not going to go in and swing from equities to bonds or bonds to equities, just based on on a short term view.

Pat Bolland 07:54
Okay, you know, you mentioned bonds, and you also mentioned bonds are down two and a half percent last year, not so your portfolio, how did you manage to do that?

James Gauthier 08:05
So, yeah, that the bond market, which is the overall Canadian bond market, mostly governments, about two thirds governments, 1/3, corporates, it was down two and a half percent. Our client portfolios we don't invest exactly like the Canadian bond market is, even though we use exchange traded funds, which are basically index replicating funds, we have a diversified approach towards fixed income. So we use the standard Canadian bond fund, which would have been down about two and a half percent, that particular exchange traded fund, but we also have short term bonds, which didn't do as bad. We have higher yielding bonds, which perform better. And then we have preferred equity as part of our

fixed income component, which was up 20% last year. So when you take that diversified approach, and there's a few other things in there as well, but when you take that diversified approach, and invest differently than the standard benchmark index, you can get returns that are significantly better. So the stock market was or the the bond market was down two and a half percent, our 100% fixed income portfolio was up 0.65%. So ... and we basically do the same process for for all accounts, we try to have the same similar experience for all clients in the fixed income components of their portfolios for those who have it. So everyone would have had positive returns in their fixed income component, even though it was a negative 2.5% year.

Pat Bolland 09:30
Yeah, it makes a huge difference to your portfolios. And I'll point out Justwealth has a lot of portfolios. How do you actually manage them all? What what is the number 60 or 70 now?

James Gauthier 09:41
That's actually pretty close to 80 now. It seems to go up every year. Yeah, it's getting it's getting up there. This is something I've been doing for years Pat, I've managed money for a lot of the banks and some of their asset management programs. And when you think about a bank and all of their different platforms and different levels of client service and different ways of providing advice. The number that I used to manage was in the hundreds. So to me doing 80 is pretty easy. Even though you know, the other typical online portfolio managers have like five or 10.

Pat Bolland 10:15
Yeah, phenomenal. I want to change the conversation a little bit, because a lot of people are starting to talk about getting returns out of other assets, alternative assets, cryptocurrencies, you know, real estate... your thoughts on those other assets? Let's start with the plain ones, like real estate, what are your thoughts on that? And then maybe we can get into the cryptos?

James Gauthier 10:37
Sure, well, I mean, I always separate assets into two different categories, there are real assets, such as real estate, or commodities, or other tangible assets, that you can touch and feel that have a practical purpose. And then there are financial assets. So the typical investment assets, stocks, bonds, even cash can be considered a financial asset, even though it might not earn much. And when you look at the two different asset classes, financial assets, people like them, because they they create wealth. If you purchase a stock, you're buying equity ownership in a company, and that company is expected to earn profits. At some point, some, you know, initial companies don't always make profits in the early years, that might take a while. But generally speaking, these companies will create profits and presumably grow. So as the company grows and becomes more valuable, you participate and that's the benefit of the financial asset of stocks. Bonds are also a wealth creator. So the way a bond works is you lend somebody some money, let's say 100 bucks, they agree to pay you fixed amount of interest per year on that bond, say 2%. And at the end of the term of the bond, you get your interest payments, plus the $100 back that you gave them. So you always create wealth with the bond, even though the bond markets might go up and down. When you think about owning a bond from end to end, they always create wealth. When you look at real estate, which is a real asset, it's a little different, you're buying something that the asset itself will pay you rent, that's the typical money that you make on real

estate. So you buy a property, or you buy land, and somebody uses the land or the property and they pay you rent. So in addition to you know, potentially prices going up, you get this ongoing stream of rent, which also creates wealth. Commodities are a bit different. So commodities if you talk about gold, or copper or oil, they're all based on supply and demand. So commodities themselves do not create wealth, but they're used as an input in a process to create consumable goods. So you know, oil is used to make many things. Gold is used to make jewelry or other scientific applications. Other commodities are consumables. So there is a value in commodities and but it's based on supply and demand. It's not the same kind of pricing mechanism as other asset classes. When we talk about currency, currency itself does not create wealth, currency is a medium of exchange. So you use currency to buy something, whether it's a financial asset, a real asset, or anything else, a consumable product for that matter. A currency does not create profit, a currency does not earn a interest other than you know, the marginal amount you might get in a in a high interest savings accounts briefly. So a currency itself does not create wealth. And if we ... so moving on to crypto currency, when you talk about cryptocurrency, it's it's priced the same way as commodities, as supply and demand. So right now, there's a there's a fixed supply of Bitcoin for example, as a cryptocurrency and more people want to buy it, than want to sell it. So that drives the price up. But if you think about cryptocurrency, it does not have the same attributes as a commodity. So gold, for example, if someone decided today that you know, gold was worthless, and the price went to zero, you at least have a nice shiny rock in your hand that you can show everybody and say hey, this is worth something, I can make a ring out of this I can make a necklace out of it, whatever. Or if you have a barrel of oil, you can go produce some plastics or whatever. If you if cryptocurrencies go to zero because they're based on supply and demand and it can, if you own a you know, a mark on a spreadsheet, that's not worth anything. It's going to be worth zero and there's nothing you can do with it. You can show it to people but there's no value to it. So it is ... it does not have to say attributes as other assets, either commodities which are priced in the same way or real or financial assets which create wealth. Cryptocurrency does nothing. It just is, is based on supply and demand right now, I think it's a bit of a mirage that's going on. And I'm worried about the prospects for people who have blindly bought into this asset class without realizing the risks.

Pat Bolland 15:23
Yeah, so we're not going to discuss NFTs and Metaverse, for probably the same reasons but James how and when you do look at your you've got financial assets, obviously stocks and bonds, do you deal in commodities or other real assets like real estate or like even a an exchange traded fund that deals in shopping malls, for instance.

James Gauthier 15:45
So we do, I mean, we look at, we'll entertain any asset class, anything that's available to us as a as an investable product, we'll look at it. So there are exchange traded funds for REITs or commodities for other alternative asset classes, you can even get them for cryptocurrencies. Now you can get them quite exotic for, you know, specialty asset classes, such as infrastructure, or robotics, or you can get quite clever in finding something very specialized because they exist. They tend to charge a little more when you get specialized, because people are obviously very interested in that asset class for a reason. And the demand is not nearly as high. So they tend to try to charge higher fees for those kinds of products. So we look at them, but we try to assess what is the value that that brings for paying a higher fee, it better be doing something pretty unique. REITs are one example of something that does

add something unique, it's it's hard to find an ETF or exchange traded fund that pays the level of dividends that REITs do. So we're willing to pay a little bit more money for a REIT exchange traded fund and put it into one of our income oriented portfolios where that's the objective. If we want to put out as much income as we can, we're gonna have to go out and find the best income generating ETFs that exist out there, and REITs happen to be one. Other things like commodities, like I said, they, they don't really have a practical purpose. They're not wealth creators, they might have some value. But in the long term, you know, they really shouldn't appreciate by much more than the price of inflation, and we have better asset classes that can do that for us. So we typically don't use any exchange traded funds that focus on commodities.

Pat Bolland 17:32
Okay, just to summarize, you excited for the coming year?

James Gauthier 17:38
I'm always excited. It's gonna be interesting, right? Like we had such a strong year last year. It does a few things. You know, first of all, it might give people kind of a false sense of security. Stock markets aren't going to go up 25% every year, that's just not sustainable. So how we, how it reacts this year following a 25% up year? We don't know. Right? Nobody knows. It could be another strong year. It could be a big down year. We'll just have to wait and see. But certainly, I think the amount of interest in stocks and the stories that are going on right now, what's going to happen to crypto currencies, what's going to happen to these 'meme' stocks that drew a lot of headlines in 2021. You know, that's another example of something that's just, it's a recipe for disaster, just waiting to happen.

Pat Bolland 18:30
Give me an example of a meme where ... I hate to do this on the last question, but what the heck, what's a meme?

James Gauthier 18:37
So a meme stock is one of these things that was created in 2021. Going back earlier in the year, there was a Reddit board. So one of these, you know, online chats where investors decided to get together ...

Pat Bolland 18:56
Like Gamestop ... those hot moment kind of stocks.

James Gauthier 18:59
Gamestop, AMC, Blackberry was another one. And there's, you know, a list of others AMC and GameStop were the two biggest ones. And basically what happened is a bunch of people got together, colluded, decided to work together and force a short squeeze on on on a particular security ... Gamestop was the first one. And they were effective. They did it. They achieve their objective, and they took a stock price was dangling in a low single digits and drove it up over $400 by forcing hedge funds and other institutional investors that were short the position to go in and buy. And when you have a limited float of securities, that short squeeze can result in a spike in the price and that's exactly what happened. So they were successful. I can't believe they got away with it. This should be a regulated

activity. But that's kind of what happens with cryptocurrency as well. You have a limited supply and a lot of people that are creating this false expectation or spreading, you know, hype.

Pat Bolland 20:07
Yeah, so it's more than just a meme killer.

James Gauthier 20:10
And when you get so many people jumping in ... sorry, I didn't catch that Pat ...

Pat Bolland 20:15
No, so it's more than just a fad in the marketplace. It's the investors getting together and ganging up on the traditional investment community.

James Gauthier 20:26
Yeah, it's a mania as well, I would call it ... So you get a number of people jumping in, perhaps not doing the upfront research that they should be doing. They just, you know, went on a tip from their neighbor or their friend at work or somebody else that said, you know, I made some money on this you should get in there's a there's a movement underway and everybody's making money. It's great until it doesn't work. And when it, when the bubble bursts. A lot of people can get burned and that's that's my fear for cryptocurrency it's already happening in the meme stocks, they've sold off pretty sharply in the last couple of months. And they've got a lot further to fall. So that's another interesting story that I'm looking forward to seeing develop in 2022.

Pat Bolland 21:06
Well, I'm hoping it goes away in 2022 to be honest with you if that's the case, but James always a pleasure having a chat.

James Gauthier 21:12
Likewise Pat ... great talking to you.

Pat Bolland 21:15
James Gauthier, Chief Investment Officer Justwealth Financial