TD Asset Management

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= New Thinking

TDAM 5 Part Series: Part 3

Evolving the Traditional Balanced Portfolio

Not All Equities Are Equal

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At a glance

- Traditional balanced portfolios comprised of 60% equity and 40% fixed income served investors well for many years; however, fundamentals have changed, and an evolution in portfolio construction and asset allocation may be warranted.
- Not all equities are the same and the various equity styles can experience different returns and sensitivities when compared to the broader equity market.
- An allocation to equities over the long-term can potentially provide investors with strong returns from the exposure to the positive compounding effect of economic growth through the progress of society and innovation.

Memories of the Dot-com crash, the Global Financial Crisis in 2008/09 and more recently the COVID-19 Pandemic market crash of 2020, have led many to believe that investing in equities is very risky. This belief isn't necessarily wrong, it just depends on who you ask. If an equity investor is unable to maintain composure and resist the urge to sell their investments during these periods of heightened market volatility, it can be catastrophic to their portfolio and financial plans. The old adage "time in the market being more important than timing the market" couldn't be more accurate. Timing the market is exceedingly difficult, so being prepared to hold and resist the urge to sell a portfolio of equities for a long enough period of time is a crucial factor for achieving investment goals.

Why equities remain a core allocation

Our first paper in our 5-part series discussed how the traditional 60/40 portfolio has served investors well in the past, how markets and economies have evolved since the theory's origins, and why portfolio evolution is needed now more than ever. Part two of the series highlighted how global central bank monetary policies have had a significant and potentially long-lasting impact on fixed income and its role as a "goalie" for a portfolio.

This paper will discuss why equities should remain a core allocation in an investor's portfolio, the various risks to be mindful of and the particular types of equities investors should be considering as part of their portfolio.

Growth fuels growth; playing the long game

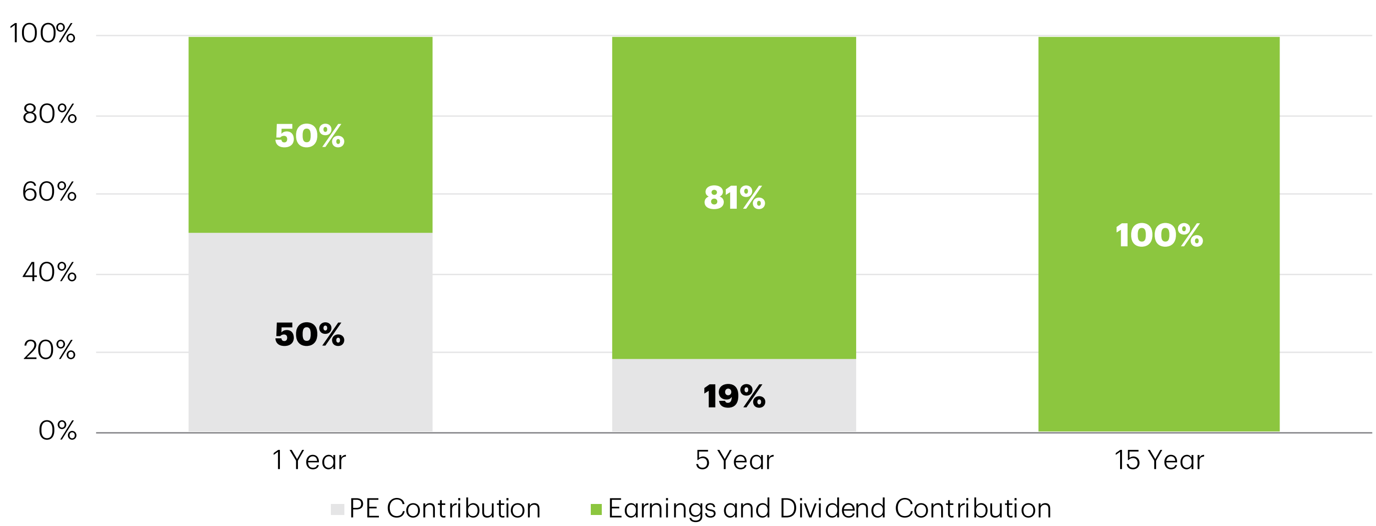
The broad equity market in most developed countries represents the universe of the world's largest companies and these companies are deeply involved in global economic activity and innovation. As the global economy grows over time, due to key factors like population growth and productivity, these companies in turn produce higher revenues and earnings. Through dividends, these earnings in turn, trickle down to shareholders. Participating in the equity market gives investors the means to take advantage of the expanding economy. Through the participation in the equity market, you are investing in and reaping the rewards of global innovation and growth. While it sounds simple enough, in the short-term it doesn't always work this way.

GDP Growth > Revenue > Profits > Equity Returns

For illustrative purposes only.

Equity returns can at times be volatile in the short run as sentiment, flows and investor fear and greed all impact daily stock prices. However, as the time horizon increases, stock prices are less impacted by sentiment and increasingly driven by actual earnings growth and dividends. As seen in the chart below, valuation and sentiment (shown as price earnings contribution), heavily impact returns in the short run, while over the long-term, equities are driven entirely by earnings (as seen in the 15-year mark).

Drivers of U.S. equity returns and volatility over time



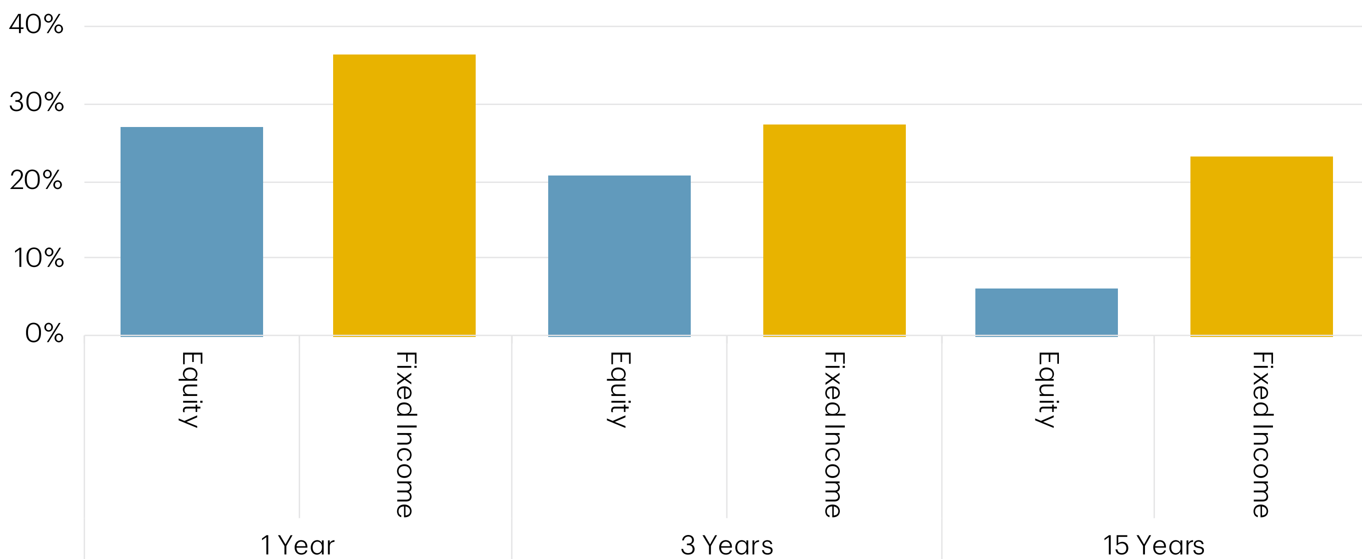
Source: TDAM as at September 30, 2021. U.S equity is represented by the S&P 500 Index.

A hedge against inflation

Inflation is an enemy for any investor as it will consistently erode wealth over time. However, there are ways to mitigate this challenge. Historically, equities have provided strong inflation protection when compared to fixed income, largely due to the exposure to the equity earnings stream. Many companies have the capability to be able to pass on inflation to their customers through higher prices, which by extension, provides some inflation protection.

Fixed income on the other hand generally only pays a fixed coupon (interest payment) over many years, so it is very susceptible to the negative effects of inflation over the life of the bond. The chart below illustrates that on a real basis (when inflation is taken into consideration), fixed income is more likely to experience negative real returns when compared to equities.

Frequency of negative real returns by asset class



Source: For Illustrative proposes only. Data from Bloomberg Finance L.P, TDAM. Equity returns represented by the S&P 500 Index and Fixed Income represented by the 10 Year U.S. Treasury Yield. Data as of September 30, 2021.

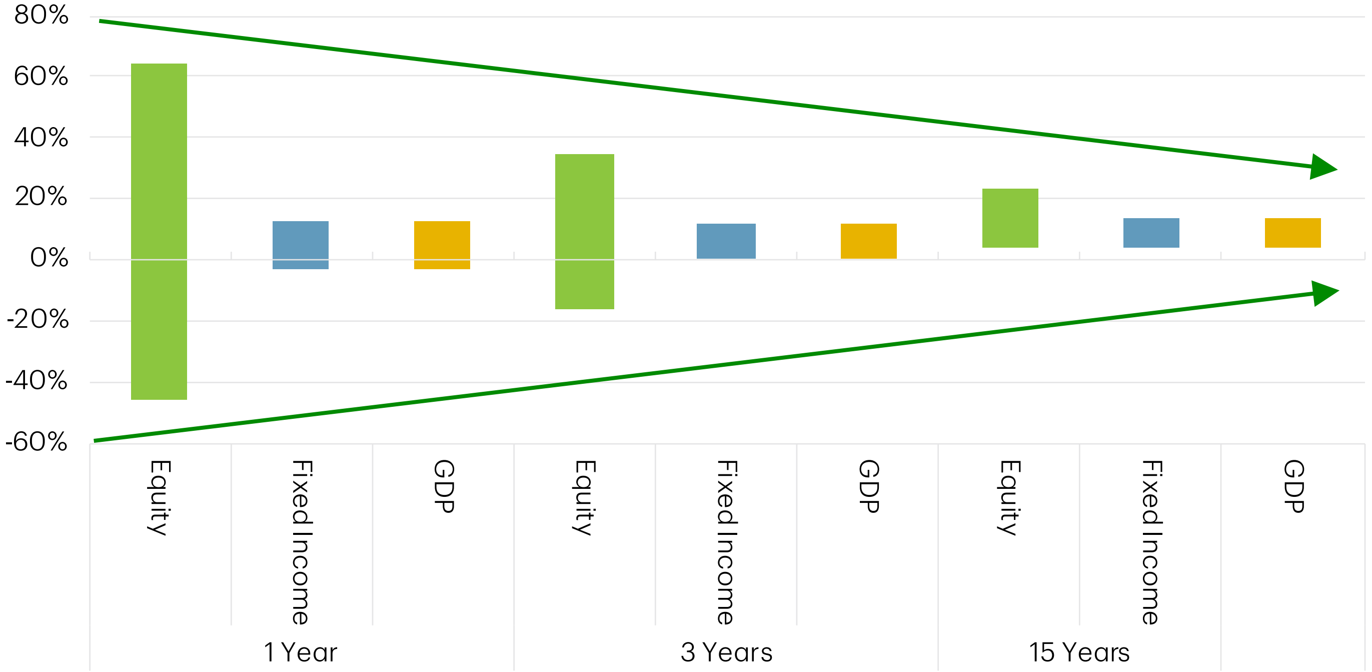
Time is on your side

The range of returns on equities can be extremely wide, depending on the time frame being observed. Within one year, investors can experience extreme volatility (2020 is a great example of this). However, over a longer period of time, the experience is very different. As illustrated in the chart on the following page, as time increases, the range of returns decreases and become much more "predictable".

Economic growth and the impact of positive average returns are strong forces. So much so that the U.S market has not (since 1956) experienced a negative return over any 15-year period.

This is why it's vital to understand an investment time horizon to make an appropriate allocation to equities. If an investor has a long time horizon, such as a retirement or saving for a young child's postsecondary education, then time is on their side to reap the benefits of economic growth and wait through recessionary periods and periods of high market volatility.

Rolling range of returns (1953-2021)



Source: For Illustrative purposes only. Data from Bloomberg Finance L.P., TDAM. Equity returns represented by the S&P 500 Index and Fixed Income represented by the 10 Year U.S. Treasury Yield. GDP is represented by U.S Nominal GDP. Data as of September 30, 2021 and ranging from April 30, 1953 to September 30, 2021.

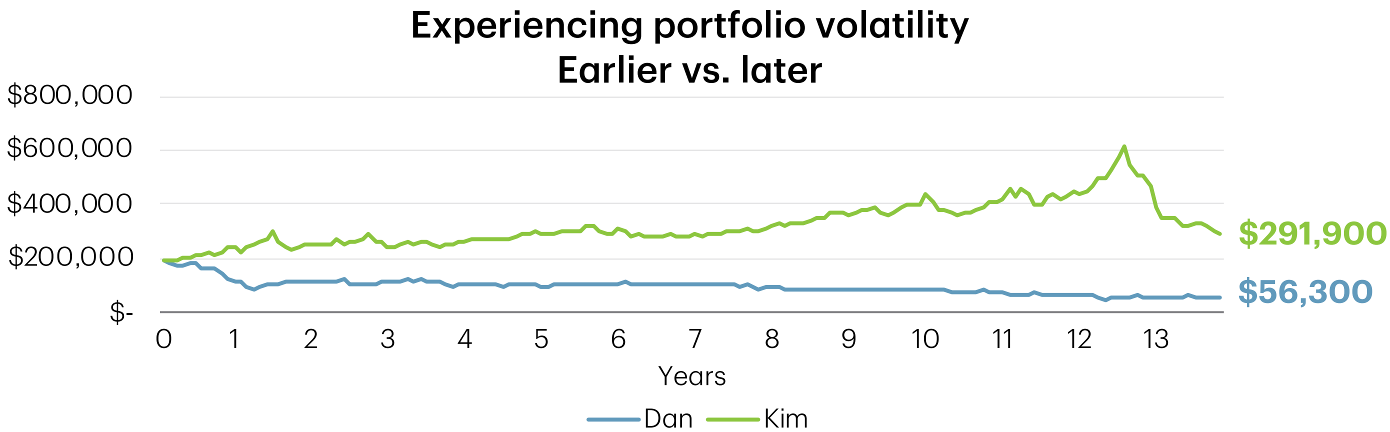
The benefits of finding balance

Because equities have offered higher returns over the long run and better inflation protection when compared to fixed income, one might be tempted to think that their portfolio should be comprised entirely of equities. At the surface this may make sense, but the reality is that this would be an example of "too much of a good thing".

The higher volatility equities can pose two risks: First, in the short-term, an all equity portfolio can change substantially in value when riding through the highs and lows – this experience is not for everyone. It is one thing for an investor to say they can "weather the storm" and another to actually live through a market correction. This risk here would be if the investor just couldn't stomach the experience and sell their investments during a downturn as opposed to holding on for the long term.

Secondly, there is a risk called sequence of returns, which simply means that the order in which an investor experiences returns is very important for asset longevity. This risk arises when an investor is regularly withdrawing money from their investment to, for example, fund their retirement. When retirees are withdrawing fixed amounts, they withdraw more as a percentage of their assets during a market crash and less at market peaks. This translates to selling more of their investment when markets are down and selling less when markets are up. Selling during down markets is exactly what investors should avoid and can result in the erosion of their asset base.

To illustrate an example of this, the chart below shows two retirees, Dan and Kim, who both experience the exact same returns but in reverse order. Dan experiences the market downturn early in retirement, while Kim experiences it later on. Even though both retirees begin with the same amount of assets, when withdrawing regularly, the timing of a market downturn can result in very different retirement outcomes. Because of this, it is especially important for investors with regular withdrawals to have a diversified portfolio.



Source: TD Asset Management Inc. For illustrative purposes only. Assumptions are that Kim and Dan start with $200,000 and have monthly withdrawals of $1,250 ($15,000 per year) with both entirely invested in SPY US EQUITY (S&P500). The time period is from January,1 2008 to September 30,2021 and the returns are from the of S&P 500 Index. For this illustration, we reverse the order in the experiences. Dan experiences it is beginning in 2008 while Kim experiences it in reverse starting in 2008 and ending in 2021. This helps illustrate how the large volatility seen in 2008 can impact a portfolio depending on if it is experienced early or later in the investors time horizon.

When style is the substance

Choosing the right style - Not all equities are the same. There are various styles and factor exposures (value, growth, low volatility, dividend growth and quality) and with each exposure come different return experiences, sensitivities to the broad equity market and diversification benefits. Because equity styles can underperform for long periods of time, it is important to hold a mix of the different styles. Having exposure to only one style may result in long periods of underperformance which could result in a more volatile portfolio and jeopardize an investment plan.

For more conservative investors, who would like to potentially have more equity exposure without taking on too much risk, choosing the right exposure, like lower beta equities[1], may solve for this desire. Specific equity exposures like low volatility or quality can have less risk when compared to the broader equity market and a more stable return.

The right exposure is one that solves for an investors desired outcome and goal. While active management can dynamically ensure that the weight and mix of these exposures are managed as market conditions evolve.

Utilizing equity options (derivatives) - Equity strategies that use options[2] may also be helpful in maintaining an allocation to equities as a core part of a portfolio, while also generating additional income. For example, a protected equity strategy[3] can help limit drops in a portfolio's value during periods of heightened volatility; however, the tradeoff is it also gives up some gains when the market is going up. This effectively creates a path for more stable and less volatile returns from the equity market.

Tactical management - There can be a significant difference in returns across equity sectors, countries and styles over the economic cycle. Tactical management can be used by portfolio managers to adjust exposure to equities across the economic cycle to add value and decrease risk. The addition of tactical management to a portfolio may be prudent in mitigating possible losses and taking advantage of opportunities that can arise across global equity markets.

[1] A stock that is less volatile, or has fewer price swings, than the aggregate market has a beta value of less than one. A low beta value typically means that the stock is considered less risky but will likely offer low returns as well.

[2] An equity derivative is a financial instrument whose value is based on equity movements of the underlying asset. For example, a stock option is an equity derivative, because its value is based on the price movements of the underlying stock. Investors can use equity derivatives to hedge the risk associated with taking long or short positions in stocks, or they can use them to speculate on the price movements of the underlying asset.

[3] A protected equity strategy seeks to provide investors with high growth potential while mitigating risk via downside protection over each individual shareholding. The strategy develops a focused investment philosophy by limiting the shares held in the portfolio to a select number with high growth potential.

The game plan for determining equity exposure

There are many different factors investors need to consider when it comes to investing in equities, with the most important arguably being their time horizon. Because equity returns are more predictable in the long run, and the chance of a portfolio performing poorly is lower over longer periods of time, it is generally prudent to adjust the equity exposure based on how the portfolio is intended to remain invested without the need to begin withdrawals (e.g. Registered Retirement Savings Plan in retirement).

Equity investors should also consider how much volatility they are willing to accept. For those who are new to investing, this may be hard to gauge, but for those who have had time in the markets and have experienced past market corrections, will know how their emotions fared. Wherever an investor may fall in the risk spectrum, what remains vital is to ensure that the portfolio hasn't taken on a level of risk that could lead them to abandon an investment strategy early if (and when) a market correction does take place.

Lastly, the type of equities matter. A very cyclical equity style compared to a low beta style will have very different levels of risk, even with the same equity weight. Equity exposure needs to be viewed holistically and should be diversified across various styles, factors and regions in order to strive for a smoother equity return experience.

Be sure to look for our last 2 articles from the 5-part series that discuss the new ways in which TDAM views the modern portfolio. These topics include:

- Alternative investments
- Combining our ideas to build better portfolios for balanced investors

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