The Importance of Process

Volume 17, Issue 3, July 2020

The Hammer and Dance – The second quarter of 2020 featured a sharp rebound in most asset classes following the steep decline in March. Most equity categories remain negative year-to-date. However, US technology stocks managed to push into new record territory. The dramatic recovery was supported by government programs and Federal Reserve actions which expanded the Fed balance sheet above $7 trillion by the end of the quarter. While market prices improved, the economy still faces a long road to recovery. Unemployment claims hit record levels while corporate earnings are expected to fall 20% year-over-year.

Commodities rallied strongly in Q2, clawing back some of the ground lost in Q1. This was helped by US dollar weakness and temporary oil production cuts from OPEC and Russia. Copper was a big gainer, rising nearly 22%, as the demand outlook improved while Coronavirus cases in South America ramped higher.

Government bond yields remained near all-time lows. Loose monetary policy, benign economic growth and the expectation for a continuation of "the Hammer and Dance" to contain COVID-19 pushed global rates lower.

INDEX TOTAL RETURN	2Q20	1-YEAR
MSCI All Country World Index (USD)	19.22%	2.11%
S&P 500 Index (USD)	20.54%	7.51%
S&P/TSX Compostie Index (CAD)	16.97%	(2.17%)
MSCI Emerging Markets (USD)	18.08%	(3.39%)
MSCI EAFE Index (USD)	14.88%	(5.13%)
Barclays Global Agg Bond Index (USD)	3.32%	4.22%
Barclays US Agg Bond Index (USD)	2.90%	8.74%

Source: Bloomberg

Proficiency with a Strong Foundation – It often seems that the best way to achieve a desired outcome is to focus exclusively on it. Afterall, results are much easier to measure and evaluate than a process. This approach however is far from optimal. Elite athletes gain proficiency at their craft by developing procedural memory – doing the same thing over and over. While this does not guarantee success, the probability of a favourable outcome improves through a disciplined process with many iterations.

Investing is a long-term process that has historically yielded the greatest rewards to those adhering to a consistent, disciplined, and replicable approach. This helps to remove the emotion involved in decision making that is often so detrimental when trying to generate a return. According to the 2010 Davis Advisor study[1], emotional interference has a sizeable impact on investment results. The study showed that while the average stock-based mutual fund returned 8.7% annually from 1994 to 2013, the average investor earned only 5% per year.

Think about the training process needed to achieve elite status in any field. It begins with building a solid foundation. For investing, an individual needs to have a good understanding of their current financial standing. Fair value assets should be greater than liabilities and sources of cash flows must exceed uses. This combination will allow for more capacity to invest and generally a higher risk tolerance which provides the prospects for higher returns.

Next, individuals should set clear financial goals. An investment plan is most effective when there is more detail about the individual characteristics, objectives and time frame. An investment portfolio should be constructed to achieve objectives with as little risk as possible. This allows investors to remain focused on meeting goals regardless of external factors such as job security or market conditions. The two primary decisions for portfolio design are asset allocation and investment selection.

- Asset allocation determines the amount to assign across different investment classes defined broadly as equities, fixed income, real estate, commodities, and cash.
- Investment selection is the step where securities that make up the asset class are chosen.

Once a framework is established, the final part of the investment process is implementation and monitoring. Establish best practices to ensure slippage is minimal. It is important to monitor both the financial position as well as the investment portfolio. No part of the process will be static. Being consistent and disciplined in evaluating and monitoring the process should not be confused with rigidity. It is important to be adaptable given an ever-changing financial position, opportunity set and market structure.

In summary, the process is more complex than simply buying a heavily promoted or popular stock or index. The short-term results can vary, but when assets are being managed for a lifetime, the process becomes increasingly important. The frequency of changes to external and internal factors necessitate a strong foundation. In the same way that a foundation provides confidence for an athlete to execute while outside forces wreak havoc; the portfolio process can protect the investor from destructive actions.

1 https://www.davisadvisors.com/davissma/downloads/WGI.pdf