2023 Year-End Commentary

“A Year at the Rodeo”

Just like a skilled rider managing the unpredictable movements of a bucking horse, successful investors needed a combination of skill, patience, and focus during the ups and downs of 2023.

At the beginning of the year, headlines were mostly negative, with many economists, market strategists, and news outlets predicting a recession. Blackrock Investments, the world's largest asset manager, stated: “*a recession is foretold.*”[1] Meanwhile, RBC's Canadian Market Outlook opined that “*a moderate macroeconomic downturn is expected.*"[2]

As spring approached, worrisome signs did manifest as Silicon Valley Bank, First Republic, and Signature Bank faced difficulties. To the casual observer this seemed like an event likely to knock the economy ‘off the bull’. However, U.S. regulators took an unusual step of guaranteeing all deposits to ensure financial stability and limit potential contagion, ultimately stabilizing financial markets.

By November, investors began anticipating monetary easing by the Federal Reserve, leading to a broad rally in stocks and bonds. By early December, the Federal Reserve alluded to what markets were anticipating; the potential for rate cuts in 2024, based on the Fed's latest projections.

A Lesson From Every Ride

The events of 2023 served as a reminder of the difficulty in accurately predicting economic or market events. Achieving investment success based on short-term predictions requires not only predicting the event but also getting the timing right.

Its easy to see why someone would have wanted to get off the ride in 2023 but doing so would have meant missing a great year for investors.

Stay calm, Stay Invested.

1. Blackrock Investment Institute: 2023 Global Investment Outlook
2. RBC Capital Markets: Global Market Outlook 2023: Economic Outlooks: The Year Ahead, 2023

What Happened in the Bond Markets?

FTSE Canada Universe Bond Index — 6.71%[1] **2023**

Bloomberg US Agg Bond Index (USD) — 5.77%[2] **2023**

Over the past two years (2022 and 2023), rapidly rising interest rates led to disappointing returns for bond investors (Chart 1). In fact, 2022 returns (measured by the Bloomberg US Agg Index) were the worst seen in over 40 years.

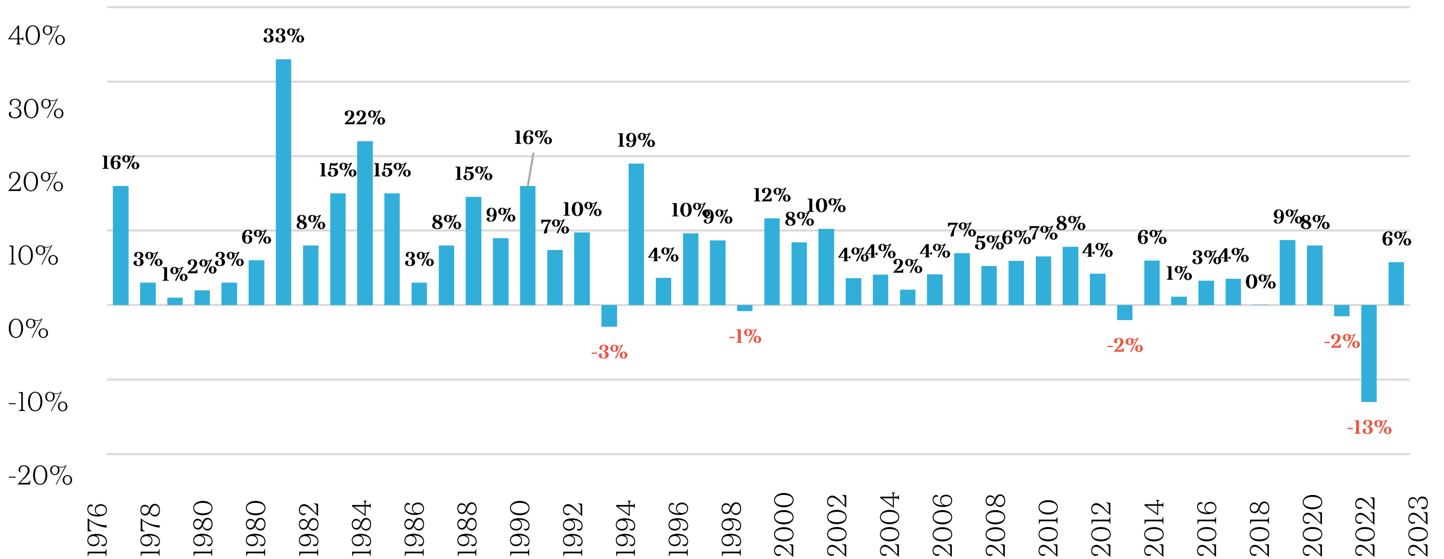
The pain seems to have subsided. Bond indices in both Canada and the U.S rebounded in 2023 with lower inflation data and the U.S. Federal Reserve signaling the likely of end rate hikes.

The backdrop for bonds is now quite attractive with:

1. tight monetary policy likely behind us,
2. the return of attractive yields, and
3. the potential for a bump in the demand for bonds as cash yields decline and money is moved back into the stock and bond markets.

We have kept most of our bond exposure in investment grade domestic bonds while allowing for a portion to invest across credit quality and geography. We feel this strategic allocation can provide a ballast to our equities while allowing for some additional yield (income).

Chart 1: Bloomberg US Aggregate Bond Index Calendar Year Returns[3]



1, 2, Source: Bloomberg L.P, Accessed 19 Jan. 2024, Total Returns for the period of Jan 1, 2023 to Dec 31, 2023

3. Source: Bloomberg. Factset, J.P. Morgan Asset Management. Returns are based on total returns. For illustrative purposes only. Returns shown are calendar year returns from 1976 to 2023, over which time period the average annual return was 6.6%. Returns from 1976 to 1989 are calculated on a monthly basis; daily data used afterwards. Guides to the Markets – U.S. Data as of December 31, 2023.

What Happened in the Stock Markets?

In 2023, global equity markets defied expectations, transitioning from initial recession concerns to optimism about US policymakers ensuring a smooth economic landing. Despite modest returns until October, a notable late-year surge transformed 2023 into a strong year for equity markets.

Beyond economic factors, 2023 wouldn't be complete without mentioning the arrival of **artificial intelligence (AI)** as a new investment theme that contributed to the spectacular outperformance of the U.S. technology giants.

In fact, the 10 largest companies[5] in the S&P 500 Index were responsible for 86%[6] of it's 2023 return, with 7 of them having a direct narrative to AI: Microsoft, Apple, Alphabet (Google), Amazon, NVIDIA, Meta Platforms (Facebook), and Tesla.

By the end of the year these 10 companies represented 32.1%[7] of the total market value of all 500 companies in the S&P500. By any measure this is highly concentrated. For reference it is almost twice as concentrated as the top 10 stocks in that index represented a mere 7 years ago (see Chart 2 below).

Canadian Stocks — S&P/TSX Comp. Index — 11.75%[1] — **2023**

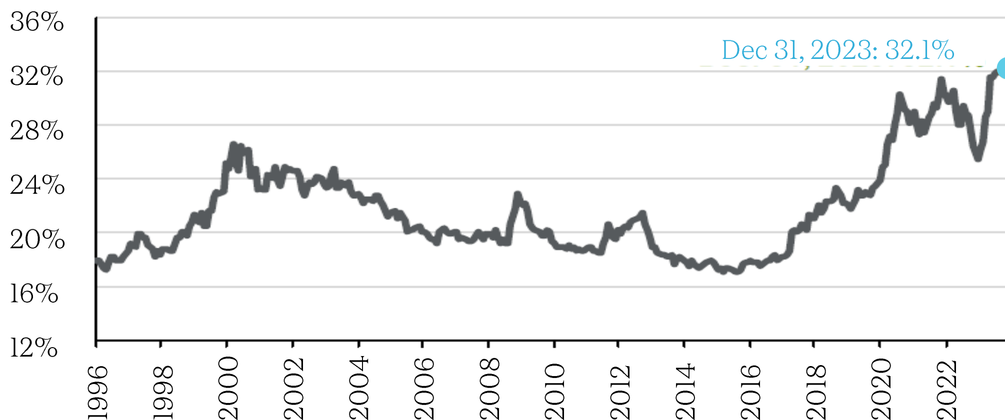
US Stocks — S&P 500 (USD) Index — 26.29%[2] — **2023**

US Stocks — NASDAQ Comp. (USD) Index — 43.42%[3] — **2023**

International Stocks — MSCI EAFE (CAD) Index — 15.07%[4] — **2023**

Chart 2: Weight of the Top 10 Stocks in the S&P 500[7]

% of market capitalization of the S&P 500



While we **believe in an index style of equity management, we also like to avoid concentration** where possible. As a result, we adjusted our U.S equities portfolio by substituting some of our U.S. Total Market position (VUN) with the **equal-weight S&P500 index** (EQL.F). This ETF allocates an even 0.2% weight to each of the 500 constituents thereby lowering our concentrated exposure to the top 10 companies.

1, 2, S&P Global: S&PTSX Composite TR as of Dec 31, 2023, S&P500 (USD) TR as of Dec 31, 2023
3, Nasdaq: Nasdaq Composite USD (COMP) as of Dec 31 ,2023
4, MSCI: MSCI EAFE Index (CAD) Net Returns as of Dec 31 ,2023
5, 6: J.P Morgan Guide to the Markets – Dec 31, 2023. The top 10 companies (AAPL, MSFT, AMZN, NVDA, GOOGL, BRK.B, GOOG, META, XOM, UNH and TSLA) used for this analysis are held constant and represent the S&P500s 10 largest index constituents at the start of 2023.
7: J.P Morgan Guide to the Markets – Dec 31, 2023. Top 10 companies are updated monthly and are based on the 10 largest index constituents at the beginning

Portfolio Construction

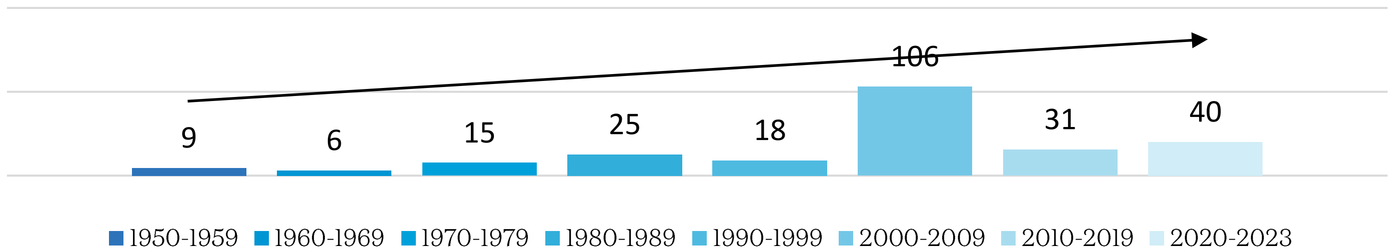
In 1952, Harry Markowitz outlined a framework called Modern Portfolio Theory which became the foundational idea behind portfolio construction for almost three-quarters of a century. Markowitz argued that by owning assets that move independently of each other (low to negative correlation), you could reduce overall portfolio risk (volatility) without sacrificing potential returns. Modern Portfolio Theory created the framework of the 'balanced' portfolio, composed of 60% stocks and 40% bonds, which still underpins how most portfolios are constructed today.

That seminal piece was released 72 years ago. Since then, there have been many changes to financial markets, which begs the question if Markowitz' theory still holds up today.

One is that **stock market volatility has been gradually increasing** over the decades as seen in Chart 3 below. The output of any financial model depends on the quality of the inputs. If the historical volatility used in the Markowitz model doesn't accurately reflect current volatility, its recommendation for the optimal portfolio will be incorrect.

Chart 3. Number of Daily Swings Greater than 3% for the S&P 500[1]

(1950-2023)



1. Source: Westmount, Bloomberg data accessed 9 Feb 2024, Daily returns of S&P500 TR from Jan 1950 to Dec 2024

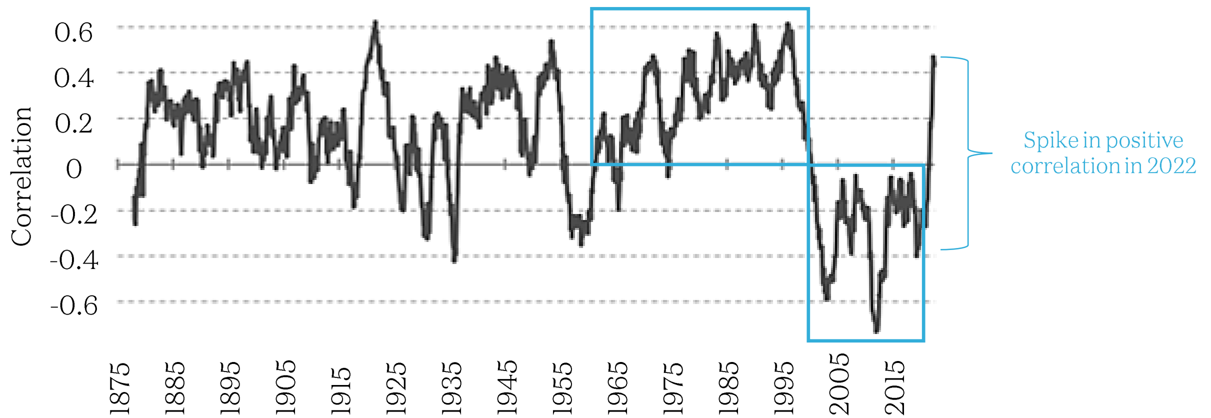
Portfolio Construction Con't

Another related criticism concerns the changing correlations between US stocks and bonds over time. Chart 4 shows how the correlation between US stocks and bonds has changed over a 150-year period.

In the early 1950's when Markowitz released his theory, the correlation was generally negative. This changed in the late 1950's where for the next 40 years the correlation between these two asset classes were predominately positive. Then for the first two decades of the 2000's correlations reverted to being negative until in 2022 when they shot back up into positive territory.

This was the year where the diversification benefit of bonds failed spectacularly as the US Bloomberg Aggregate Bond Index fell 13.01%[1] following the S%P 500's 18.13%[2] decline.

Chart 4. US Stock-Bond Correlations January 1875 - June 2023[3]



So, is the 60/40 dead?

We agree with Markowitz's theory of owning assets which move independently of each other; however, stocks and bonds are not the only investable assets. For those that have the risk appetite, timeframe, and adequate liquidity, we believe a modern investment approach should include Private and Alternative Investments. Stocks and bonds are still the primary building blocks of our portfolios, but the 60/40 ratio can be adjusted to reflect today's investing environment.

1 & 2. Source: Bloomberg L.P, Accessed 19 Jan. 2023., Total Returns for the period of Jan 1, 2022 to Dec 31, 2022

3.Research Paper: "Empirical evidence on the stock-bond correlation." by Molenaar, Senechal, Swinkels, & Wang – Published 9 Feb 2023 - https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4514947

Portfolio Construction Cont'd

Recent data suggests that certain alternative asset classes have delivered strong returns with lower volatility compared to public market equivalents.

Looking at data below, we can see that between 1986-2023, private equities have not only had better returns but also done so with less volatility than their public market equivalents. Furthermore, investors may be surprised to learn that **86% of companies with revenues exceeding $250M per year are privately held[1]**.

US Private Equity vs **US Public Equity**

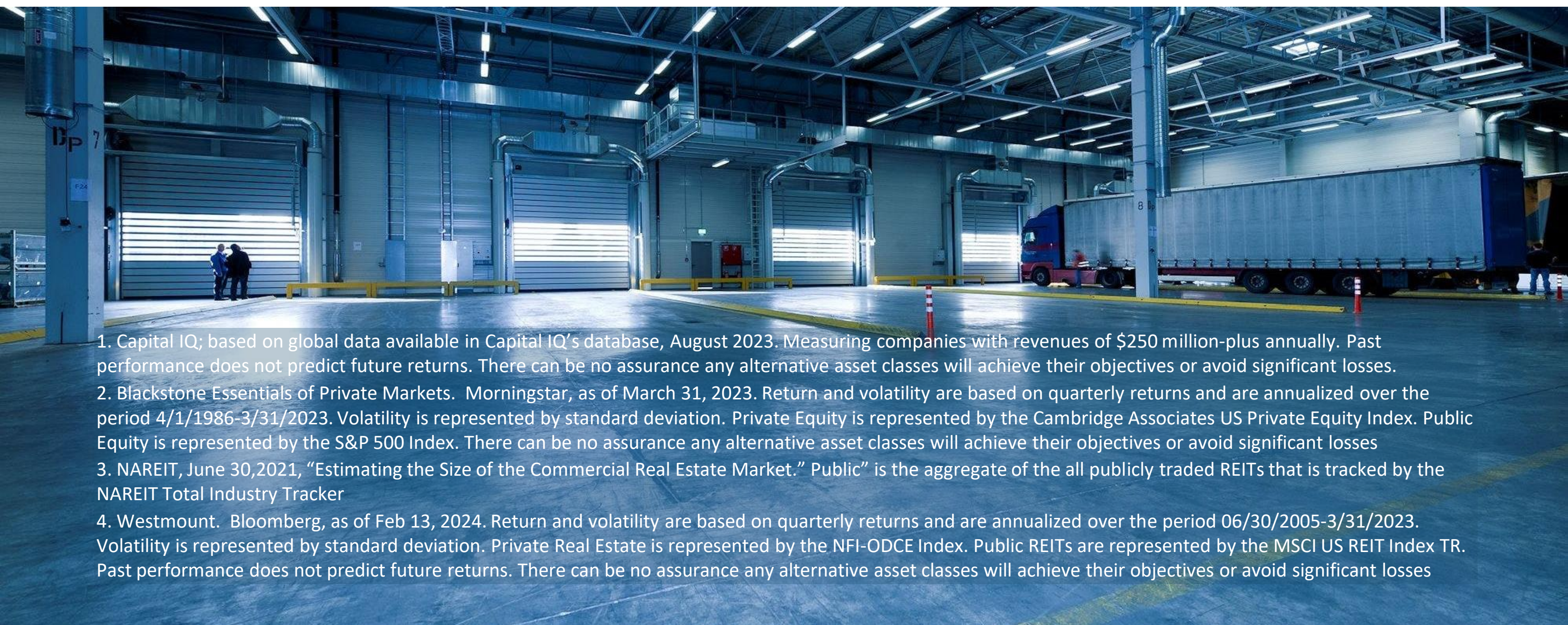
US Private Equity Cambridge Assoc. US Private Equity Index		US Public Equity S&P 500 Total Return Index	
Returns[2]	14.7%	Returns[2]	10.4%
Volatility[2]	9.8%	Volatility[2]	16.8%

Similarly, 92% of US commercial real estate is privately held[3]. Between 2005 and 2023, again the private equivalents performed slightly better than their public market equivalences but did so with almost 1/3 of the volatility.

US Private Real Estate vs **US Public Real Estate**

US Private Real Estate NFI-ODCE Index		US Public Real Estate MSCI US REIT Total Return Index	
Returns[4]	7.4%	Returns[4]	5.1%
Volatility[4]	7.5%	Volatility[4]	23.1%

The addition of high-quality alternative investments can provide another source of returns to a portfolio and may do so with lower volatility. This effect was especially pronounced in 2022 where Westmount investors saw the performance of their private holdings help to offset some of the losses experienced in the stock and bond markets.



1. Capital IQ; based on global data available in Capital IQ's database, August 2023. Measuring companies with revenues of $250 million-plus annually. Past performance does not predict future returns. There can be no assurance any alternative asset classes will achieve their objectives or avoid significant losses.
2. Blackstone Essentials of Private Markets. Morningstar, as of March 31, 2023. Return and volatility are based on quarterly returns and are annualized over the period 4/1/1986-3/31/2023. Volatility is represented by standard deviation. Private Equity is represented by the Cambridge Associates US Private Equity Index. Public Equity is represented by the S&P 500 Index. There can be no assurance any alternative asset classes will achieve their objectives or avoid significant losses
3. NAREIT, June 30,2021, "Estimating the Size of the Commercial Real Estate Market." Public" is the aggregate of the all publicly traded REITs that is tracked by the NAREIT Total Industry Tracker
4. Westmount. Bloomberg, as of Feb 13, 2024. Return and volatility are based on quarterly returns and are annualized over the period 06/30/2005-3/31/2023. Volatility is represented by standard deviation. Private Real Estate is represented by the NFI-ODCE Index. Public REITs are represented by the MSCI US REIT Index TR. Past performance does not predict future returns. There can be no assurance any alternative asset classes will achieve their objectives or avoid significant losses

The Bottom Line

2023 ended on a positive note, with market participants generally believing that the last interest rate hikes of the cycle had occurred. Investors are now speculating that North American central banks will start cutting rates in early to mid 2024. This type of thinking creates high expectations among investors and thus room for potential disappointment (and losses).

> *"When you watch a bull rider at a rodeo, you have some idea of which direction things are going but no idea how long the ride will last."*

The stock markets in 2024 will be no different in this respect, which is why we maintain that the safest investment strategy is to properly diversify. We continue to believe that the best way to achieve this strategy is to combine **broad-based stock market** exposure with **high-quality bonds** and a wide selection of **alternative asset classes** to cushion the bumps from the unpredictable bull.

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