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HOW QUICKLY COULD INVESTORS SEE THEIR PORTFOLIO PERFORMANCE RECOVER?

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2022 was certainly a difficult year. For only the fourth time in close to a century, both equity and bonds recorded calendar year declines (Chart 1). Even during the 2007/08 Global Financial Crisis (GFC) investors didn't face such a challenging environment. 2023 has started on a better note, but challenging economic conditions suggest heightened market volatility ahead. With this in mind, we encourage investors to focus on long-term goals when looking at their portfolios, and to avoid making short-term changes based on current market volatility.

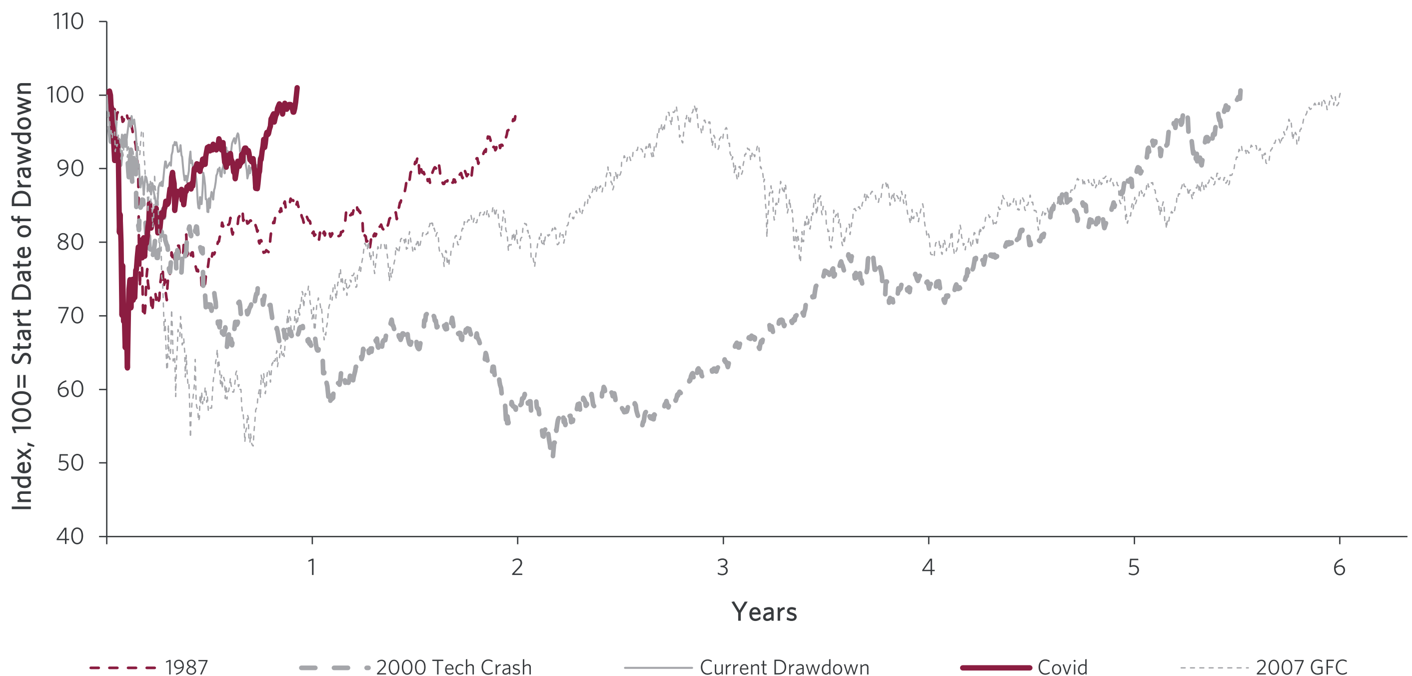
Chart 1 - Annual returns to equity and bonds since 1928

The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: Bloomberg; https://pages.stern.nyu.edu/~adamodar/New_Home_Page/datacurrent.html. Annual data. Sample: 1928 – 2022. Data accessed as at January 11, 2023.

What can we expect from markets?

Equity market recoveries have taken various paths (Chart 2). Some have been short and sharp, like the post-Covid recovery. Others have been longer, such as the recoveries after the 2001 Tech Bubble burst and the GFC. For bond markets, the recovery precedents are fewer and more mixed (Table 1).

Chart 2 - S&P/TSX Price behaviour from local market peaks



The information was prepared by CIBC Asset Management Inc. using the following third-party service provider's data: Bloomberg. Maximum sample is January 1, 1987 to January 11, 2023.

In the middle of a market downturn, it's tempting to lean towards pessimism and focus on how long and intense the pain of loss may last. We prefer to resist this urge. Instead, we consider the more productive and positive view, as we ask how quickly will equities and bonds fully recover all ground lost in 2022.

Table 1 – Historical bond market drawdowns

Period January 1, 1958 to November 30, 2020	Benchmark return	# of months	# of months to recovery	Full hi-lo-hi cycle (months)	Yield at recovery
May 1958 to Sep 1959	-6.1%	16	9	25	4.7%
Feb 1974 to Aug 1974	-9.8%	6	4	10	8.0%
Feb 1975 to Sep 1975	-5.5%	7	4	11	8.4%
Jul 1979 to Mar 1980	-11.1%	8	3	11	12.8%
Jun 1980 to Jul 1981	-11.4%	13	4	17	14.3%
Jan 1984 to May 1984	-5.2%	4	3	7	13.4%
Mar 1987 to Sep 1987	-6.5%	6	4	10	9.4%
Dec 1989 to Apr 1990	-6.1%	4	3	7	8.8%
Jan 1994 to Jun 1994	-11.2%	5	10	15	7.1%
May 2013 to Sep 2013	-5.3%	4	7	11	2.8%
Mar 9 2020 to Mar 26 2020	-6.5%	0.5	3	3.5	0.8%
Aug 4 2020 to Nov 30 2022	-12.98%	29	??	??	4.0%
Average	**-8.3%**	**8**	**5**	**13**	**8.2%**

The information was prepared by CIBC Asset Management Inc. using the following third-party service provider's data: Bloomberg. Maximum sample is January 1958 to November 16, 2022. Data calculated using FTSE Canada Universe Index.

We can't predict the future, and past performance doesn't indicate future potential returns, so we turn to statistical analysis to map out the potential path of the next bull market recovery.

As a starting point, we use five simulated portfolios each representing a different investor return/risk profile. Each portfolio is constructed using strategic asset allocation weights from CIBC Asset Management's Long-Term Strategic Asset Allocation (LTSAA) recommendations (Table 2).

Table 2 – 2022 Long-term strategic asset allocation recommendations for Canadian investors, % of total portfolio

	Capital Preservation	Income	Income and growth	Growth	Aggressive growth
Global equities	5	10	25	40	60
Canadian equities	15	20	30	30	30
Global bonds	20	20	15	10	0
Canadian bonds	35	30	15	5	0
US high yield	5	10	10	10	10
Canadian cash	20	10	5	5	0

The information was prepared by CIBC Asset Management Inc. Data as at January 31, 2022.

Unsurprisingly, all these profiles experienced a capital drawdown during 2022, with a modest recovery since the middle of the year (Table 3). For the Capital Preservation and Income portfolios, the current drawdown is the worst on record in our 36-year historical sample. This reflects the relatively poor performance of fixed income, which in 2022 at least was driven primarily by an unexpected amount of interest rate policy tightening as central banks sought to put the inflation genie back in its bottle. Although it may not comfort investors, it's important to note the current drawdown for equity-centric profiles has so far been relatively mild compared with previous periods of capital loss.[1]

Table 3 – Historical performance of LTSAA investor profiles

	Capital preservation	Income	Income and growth	Growth	Aggressive growth
Jan - June 2022	-9.70%	-11.10%	-12.40%	-13.40%	-15.30%
Jan - Sept 2022	-9.50%	-10.70%	-12.30%	-13.30%	-15.20%
12 month rolling performance	-7.90%	-8.60%	-8.80%	-8.90%	-9.60%
Max Drawdown Sept 1986 - Sept 2022	-9.70%	-11.10%	-20.90%	-28.20%	-38.50%

The information was prepared by CIBC Asset Management Inc. using the following third-party service provider's data: Refinitiv Datastream. Sample is January 1986 – September 2022. Data as at September 30, 2022. Year-to-date defined as January-September inclusive. Data as at November 3, 2022.

Using these profiles, we simulate the potential recovery path for each of our investor portfolios.[2] This allows us to calculate how many months on average it takes each of our five portfolios to achieve a full recovery following a capital loss at least as big as the drawdown experienced by our LTSAA investor profiles in 2022. The answer is 18-23 months (Table 4), depending on the return/risk profile. This implies a full recovery of portfolio capital at some point close to the end of 2024 – provided investors remain fully invested.

This conclusion does not say anything about the path to full recovery. In the most optimistic outcome, the positive year-to-date performance seen in early 2023 could continue broadly unabated. Alternatively, we could first experience another correction before seeing a sustained recovery back to the previous market peak and beyond. This is an outcome we're currently tactically positioned for in our managed solution portfolios.

Either way, focusing on the longer-term outlook provides a relatively bright perspective and an opportunity for investors to consider putting any additional capital to work.

Table 4 – Our simulated portfolios show relatively quick recovery speeds

	Capital preservation	Income	Income and growth	Growth	Aggressive growth
Average # months to recover from drawdown equivalent to 2022	18	19	19	23	21
Longest recovery periods, # months	23	35	65	89	111

The information was prepared by CIBC Asset Management Inc. using the following third-party service provider's data: Refinitiv Datastream. Sample is January 1986 – September 2022. Year-to-date defined as January-September inclusive. Data as at November 3, 2022.

Equity markets tend to experience vigorous recoveries with particularly strong annualized returns in the initial phase of bull markets. According to Goldman Sachs, this phase—which they refer to as 'Hope'—typically begins during recessions when the economy is weak and news is poor. It is often associated with cheap valuations and a peak in the interest rate cycle; similar market conditions to those we expect to see by mid-year.[3] Our statistical analysis doesn't capture this facet. Instead, it assumes market recoveries occur at an even pace through all phases of a bull market. This suggests our simulated data may overstate the length of market recovery periods, and understate how quickly portfolios could recover lost ground. The opportunity to re-engage and put capital to work may be brighter than it seems.

We can also count the number of instances in our simulated dataset when drawdowns exceeded the loss realized in 2022 (Table 5). For the Capital Preservation profile, there were only three. This means the 2022 drawdown should be expected to happen only once every 278 years.[4] Truly exceptional and a function of how poorly fixed income performed in the past couple of years.

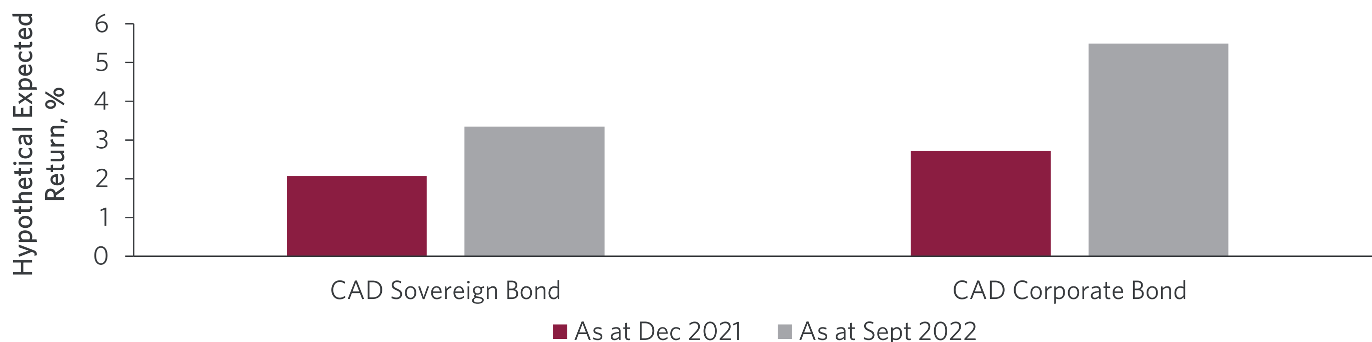
Table 5 – Our simulated portfolios' number of drawdowns greater than experienced in 2022

	Capital preservation	Income	Income and growth	Growth	Aggressive growth
Simulated Drawdowns Worse than 2022 Observed Drawdown	3	11	82	137	196

The information was prepared by CIBC Asset Management Inc. Data as at November 3, 2022.

Keeping with our themes of positivity, the silver lining here is that bonds—sovereign and corporate—are now in a much healthier position to contribute attractive performance to investor portfolios in coming years. This reflects the increase in yields seen in recent months that has improved long-term expected returns (Chart 3), and a widening in breakeven spreads.

Chart 3 – Sovereign and corporate bond hypothetical expected annualized returns



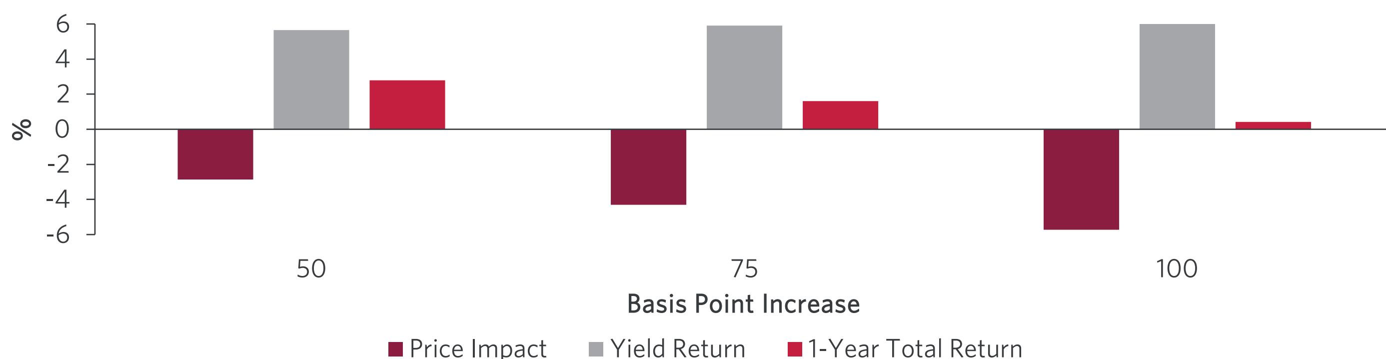
The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: Bloomberg LLC.; Refinitiv Datastream. Data as at September 30, 2022. Methodology for calculation of hypothetical returns available at Long-term Capital Markets Returns 2022.pdf.

Breakeven spreads help protect against losses in the event of a further move higher in yields (Chart 4). Even a yield increase of 100 basis points (bps) from current levels wouldn't lead to a loss on the FTSE Corporate IG Index on a 1-year horizon. Based upon our simulated data, conservative investors can be reasonably confident the magnitude of future drawdowns won't match 2022 losses for the foreseeable future.

By contrast, the drawdown experienced in 2022 by the Aggressive Growth portfolio wasn't exceptional and should be expected to occur every 4 years. This may appear overly frequent, but it's consistent with the risks equity-centric investors implicitly accept for receiving relatively higher expected returns than more conservative, bond-centric investors. Drawdown risk goes hand-in-hand with enhanced opportunity for investment returns.

Chart 4 – Corporate bonds help protect against losses, even if yields rise further

Breakeven impact of yield increase on investment-grade corporate bond 1-year total return



The information was prepared by CIBC Asset Management Inc. using the following third-party service provider's data: Bloomberg LLC. Investment-grade corporate bond breakeven analysis measured using FTSE Corporate IG Index. Data as at January 12, 2023.

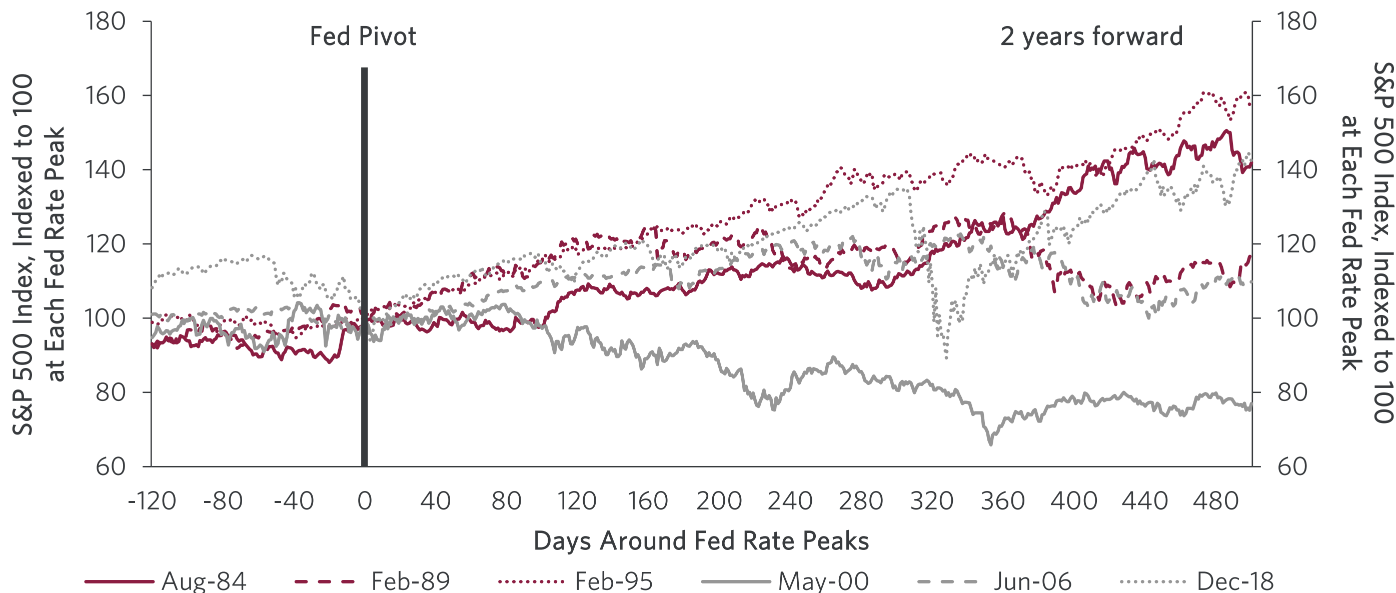
The frequency of drawdowns comparable in size to 2022 for other LTSAA investor profiles lies somewhere in between these two extremes.

Putting our analysis into economic context

Our statistical results need grounding in current economic reality. Equity and bond prices have often responded particularly positively once central banks start preparing markets for a sustained policy easing cycle. Reflecting relatively high and sticky service sector inflation, we don't see this happening for much of 2023, and do not envision actual cuts before 2024, at least for the major central banks.

Even so, evidence that central banks are at least set to end policy tightening cycles has also often provided support to asset returns (Chart 5). With 2023 under way, we appear to be closing in on this event, offering reason for guarded optimism to investors after such a difficult 2022.

Chart 5 – Behaviour of the S&P 500 index around Fed policy rate pivots



The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: Bloomberg, Goldman Sachs. Sample is February 1, 1984 – December 20, 2020. Data accessed as at January 11, 2023.

A long-term focus can help investors stay invested during market volatility

Last year's market correction and continued high economic uncertainty mean investor confidence in the prospective performance of traditional Balanced portfolios may be low. Our analysis highlights a more optimistic perspective. Portfolios often recover relatively quickly. And as markets are always forward looking, the healing process frequently starts well before gloomy economic indicators give way to more positive data trends. This suggests investors will continue to benefit by avoiding the temptation to find short-term performance fixes.

We suggest investors stay focused on their long-term goals and outcomes. Bond yields have reached levels that make fixed income an increasingly attractive proposition and equity valuations have started to reach healthier levels. For these reasons, we think there's an attractive opportunity for investors to stay invested during short-term volatility and begin to consider putting available capital to work.

Managed investment solutions are available through CIBC Managed Portfolio Services, the Renaissance Private Investment Program and through CIBC Wood Gundy Investment Consulting Service.

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[1] Our focus on positivity necessitates we don't draw any ominous conclusions from this observation.

[2] For the interested reader, we use Monte Carlo simulation techniques to construct a large database by repeatedly adding positive and negative random values to the average monthly return of each investor profile. To ensure our constructed dataset is statistically robust we calculate 10,000 new monthly observations, equivalent to 833 years of simulated data for each of our five profiles. The only constraint we impose is that all these simulated asset return series be normally distributed. This is a stylized assumption that allows us to present initial conclusions; we recognize actual return data for Balanced portfolios, particularly those with relatively high equity exposure, tend to exhibit more instances of large drawdowns than would occur if returns were truly normally distributed.

[3] Goldman Sachs (2022), Bear Repair: The Bumpy Road to Recovery. Global Strategy Paper #57.

[4] 833 years / 3 = 278 years.

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