2020 – A YEAR OF REVELATIONS AND SILVER LININGS

A year unlike any other, 2020 will forever be associated with the gloom and doom narrative brought about by the widespread impacts of the COVID-19 pandemic, which will stay with us for a very long time. The pandemic has resulted in the loss of lives, jobs, and the huge adjustment to the way we go about our daily activities, which were previously taken for granted. The investment world has experienced its own narrative resulting from the fall out of the pandemic.

This article highlights five revelations and silver linings stemming from what we learned in 2020.

1. Importance of Technological Innovation

It goes without saying that by far the biggest silver lining in 2020 was the appreciation of how far technology has advanced and how influential it is in our daily lives. Historically, humans have had complex relationships with technology due to machines eliminating and changing the role of human jobs. However, in 2020, all was forgiven.

For example, many of us would not have found the transition to working from home (WFH) during the pandemic so seamless if not for technological advances. The ability to order most goods online and have them expediently delivered straight to our homes made the restrictions and transition to lockdowns more manageable.

For Connor, Clark & Lunn Financial Group and affiliates, advances in technology allowed for a very quick and efficient response to managing the firm's over $80 billion of assets under management. Client portfolios continued to be managed with the same level of scrutiny and care, irrespective of the requirement to WFH. Other than some short-term liquidity challenges in fixed income, investment managers of public market portfolios were able to respond to the changing dynamics of the various markets.

Technology also facilitated our ability to stay in touch and host meetings in a more personal and collaborative way through various video conferencing solutions, which also gave rise to the statement of 2020 - "You are on mute".

2. Difficulty of Forecasting

The equity markets' reaction to the spread of the pandemic in the first quarter of 2020 was no surprise. Investors responded to the implications for the economy and the fate of individual companies, particularly those in the travel and tourism industry as the world entered various stages of lockdown. Equity markets were hit hardest, and despite low yields, traditional fixed income markets provided portfolios an important component of capital protection (Figure 1).

Equity returns reflected the typical outset of a recession with smaller capitalization stocks declining the most. Despite the second and third waves in the rise in COVID cases, the much needed vaccine breakthroughs gave the markets a timely boost, contributing to very strong returns for the balance of 2020. Both domestic and global small capitalization stocks recovered by the greatest amount, with the Canadian small cap index generating a return of over 80% for the last nine months of 2020.

Figure 1: Index Returns During 2020 (in CAD $)

Asset Class	Market Index	Q1 Return %	9 Months Ended December 31, 2020 %	Calendar Year 2020 %
Canadian Equities	S&P/TSX Composite	-20.9	33.5	5.6
Canadian Small Cap Equities	S&P/TSX Small Cap	-38.1	82.4	12.9
US Equities	S&P 500	-11.7	31.7	16.3
International Equities	MSCI EAFE	-15.2	25.5	6.4
Global Equities	MSCI World	-13.2	31.9	14.4
Global Small Cap Equities	MSCI World Small Cap	-23.1	48.1	13.9
Emerging Markets Equities	MSCI Emerging Markets	-16.1	38.5	16.2
Fixed Income	FTSE Canada Universe Bond	1.6	7.0	8.7
	FTSE Canada Long Term Overall Bond	0.2	11.7	11.9

Source: MSCI, FTSE Russell & Thomson Reuters.

Despite the volatile experience for equities, the full calendar year returns for Canadian and international equities were close to those forecasted at the start of the year, while other equity market returns for the most part exceeded expectations. However, most investment managers would not have predicted the strong fixed income returns experienced in 2020. Prior to the onslaught of the pandemic, typical conversations regarding fixed income focused on how to deal with the impact of low bond yields and implications for future returns. This past year was a further reminder of not only the difficulties of forecasting, but also that the benefit of diversification is not only about expected long-term returns.

The role of fixed income will continue to be a topic of conversation. It will likely include consideration of:

- Opportunities to improve returns, such as relaxing the constraints for traditional fixed income mandates, and allowing for overlay or less liquid fixed income strategies;
- Fixed income strategies focused on reducing the risk associated with low yields, higher duration and declining interest rates; and
- The replacement of a component of fixed income assets by investing in higher yielding assets, such as direct infrastructure and commercial real estate.

3. Asset Class Benefits Can Vary Significantly

This revelation may first appear as stating the obvious. The benefits of private market strategies, such as commercial real estate and infrastructure, have historically been positioned as applying to the overall asset class. Up until 2020 it was a reasonable generality, but the implications from the global pandemic have changed this view.

Within commercial real estate, the retail sector was one of the hardest impacted by the pandemic as social distancing effectively shut down a large segment of the retail market. It also served to accelerate the trend to more e-commerce, which will likely have longer-term implications for the sector as consumers embrace the convenience of online shopping and home delivery.

The long-term impact on the office sector is still being assessed. In major cities, most tenants were been forced into the WFH model during 2020. There is an expectation that there will be two general outcomes going forward. Some tenants will embrace WFH and implement it to a greater extent, leading to less long-term demand for office space. Conversely, for a variety of reasons such as fostering corporate culture, other tenants will remain committed to a physical office presence and will require larger space to incorporate safe social distancing for work stations and common areas, like kitchens.

A silver lining for commercial real estate was the industrial sector where most warehouses and distribution space tenants continued to function and operate efficiently through the crisis. Both local governments and companies will likely revisit their supply chains, which could see domestic repatriation of manufacturing and warehousing for essential supplies, maintaining the resilience of the sector.

Within infrastructure, the most affected areas were those sensitive to economic factors. For example, airlines witnessed significantly fewer travelers and given the second and third waves from the increase in COVID cases, travel continues to be muted. Toll roads have also been desolate during ‘rush hour’ due to the switch to WFH.

In contrast, projects not dependent on the economy, such as those with long-term availability based contracts with government counterparts, were generally insulated from volume declines. For example, contracted renewable power assets experienced limited negative impact.

While the general diversification merits for direct real estate and infrastructure should remain over the long term, 2020 highlighted that individual strategy differences can exist in the time of crisis. How well a particular strategy performed during 2020 depended on the extent to which it was exposed to sectors or economic factors that struggled compared to the areas that were more resilient. In the past, differences focused more on the merits of domestic versus global strategies, but there was nowhere to hide during the pandemic with the implications being felt globally.

As investors look to include or add to existing allocations, whether domestic or global, it will be important to assess the sensitivity of individual strategies to the different economic and risk factors in order to improve the odds of achieving the diversification qualities expected from private markets.

4. Equity Portfolio Concentration

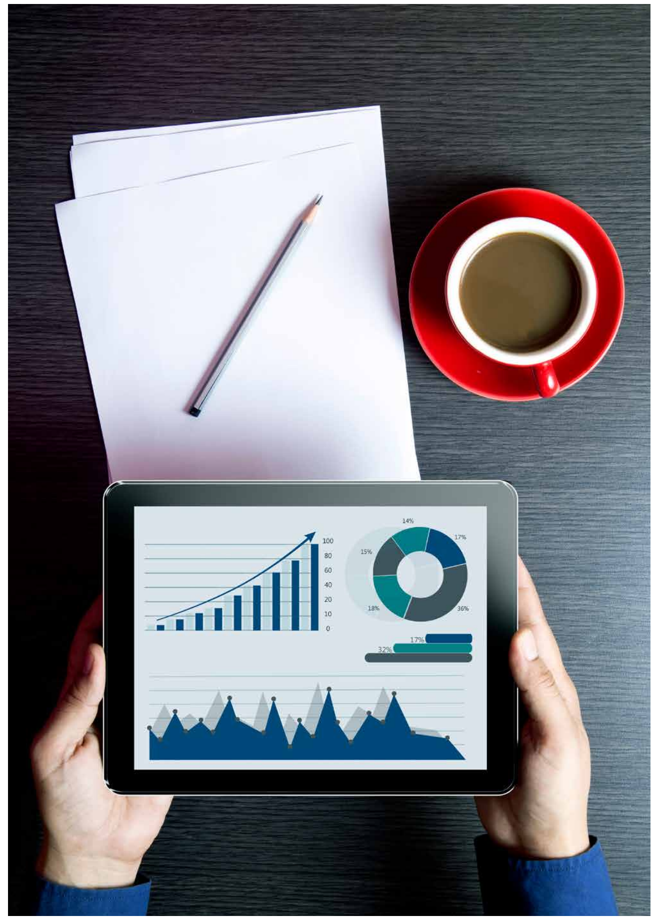
Some of the strongest performing stocks globally in 2020 were the technology stocks that benefitted from the implications of the pandemic, such as the increased reliance on e-commerce. The strong performance has led to further concentration in the major equity indices to the information technology sector and in a handful of names. For example, Apple, Microsoft, Amazon, Facebook and Alphabet Inc. comprise over 20% of the S&P500 Index[i]. Information technology companies were major sources of returns for the majority of developed and emerging market indices in 2020.

Technology stocks are typically favoured by growth style managers, which has contributed to the continued outperformance of growth versus value investing. In the fourth quarter of 2020, there was a hint of a potential change in market leadership with strong absolute and relative performance from value managers, but not enough to offset the outperformance of the growth style for the full calendar year.

Over the last number of years, low volatility funds have gained in popularity. Like value managers, they offer a portfolio less weighted to the growth-orientated sectors. Low volatility funds generally performed as expected in the first quarter of 2020, declining less than the main equity market indices. However, low volatility indices and funds significantly underperformed the main market indices in the balance of the year and for the calendar year as a whole.

While for most investors, the total equity portfolio return in 2020 would have been strong, it will be appropriate to review the level of stock and style concentration of portfolios. For example, while value style managers struggled over the past number of years, some have performed much better than others. Despite the strong growth style headwinds, there are examples of value managers who outperformed their respective broad index returns over the medium to long term.

Potential considerations to reduce equity portfolio concentration will depend on the unique circumstances of each investor. For those with a heavy bias to large capitalization developed markets, consideration of a global small cap and emerging market equity allocation may be appropriate, while those with a large growth bias may want to assess the merits of reducing the growth dependence.



5. Reinvigoration of Responsible Investing

According to governments around the world, responsible investing should be the bedrock of all investment decisions for the benefit of society as a whole. In 2015, United Nations (UN) member countries adopted 17 Sustainable Development Goals (SDGs) aimed at contributing to this cause with some specific targets to be achieved by 2030. The SDGs apply to developed and developing countries and represent a global plan of action for the planet, people and prosperity. Despite good intentions, the 2030 targets will fall well short based on current progress.

The global pandemic demonstrated that governments around the world can work together to manage important global issues and will hopefully lead to a reinvigoration of the commitment to the SDGs, and responsible investing in general.

Investors can do their part by fostering a stronger link between Environmental, Social and Governance (ESG) policies and the SDGs in their portfolios. The opportunities to support the SDGs run wide and deep from individual stocks to opportunities at an asset class level.

The pandemic refocused attention on all three areas of ESG leading to a re-examination of what is important in our personal and business lives and how they interact. For example, during the pandemic many companies promoted an increase in more direct communication between employees, with senior management recognizing the benefits of more resilient relationships. One potential outcome for many companies when the pandemic is over will be a willingness to allow greater flexibility for remote working.

The environmental aspect of ESG was already a big focus of investors with climate risk being at the forefront of discussions and actions. The pandemic has increased the awareness and the importance of the need to tackle such high impact and high probability risks, such as climate risk and biodiversity loss, and has globally reinvigorated the importance of responsible investing.

Take Time to Review

A common practice at the end of each calendar year is to take the time to review and reflect on how the assessment, response and monitoring of risk played out for the year. For many, 2020 has likely uncovered the emerged risk of a pandemic's impact on portfolios, and how such incidences should be measured and managed going forward.

When prioritizing risks and how to respond to them, David Hillson, internationally renowned risk consultant, suggests that key risks are uncertainties that matter. In other words, when reviewing the various investment uncertainties, understand how material the consequences could be if things do not go as expected.

If a particular risk has a low impact and low probability, then you may choose to accept the risk. However, for risks that are identified as material and have a higher probability of occurring, you will want to take action, such as controlling the risk exposure through better portfolio diversification, or avoiding the risk altogether, if at all possible.

As we enter into 2021, take the time to review your portfolio to determine uncertainties that could matter and that could elevate the risk of not delivering on your goals. Once identified, investigate how to best to manage the risk.

(i) As at 11 December 2020. Source: Thomson Reuters

Connor, Clark & Lunn Financial Group's Strategic Exchange is an initiative to promote dialogue, understanding and the development of solutions to the often complex investment challenges faced by institutional investors.

Under the direction of Peter Muldowney, SVP Institutional Strategy, we bring together investors and consultants in a variety of interactive, educational forums. We also produce thought pieces addressing issues that are top of mind to those involved in managing and overseeing various asset pools.

For more information, please contact:

Peter Muldowney
Senior Vice President, Institutional Strategy
Connor, Clark & Lunn Financial Group
pmuldowney@cclgroup.com
416-304-6810

CONNOR, CLARK & LUNN FINANCIAL GROUP