2022 Financial Year in Review and Looking Ahead for 2023

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Keith: Welcome to the Empowered Investor. My name is Keith Matthews and I'm joined by my co-host Marcelo Taboada. Marcelo, how are you today?

Marcelo: I'm doing great. It's great to be back. New year, new hope. 2022 was an odd year for a lot of reasons, but it was a good time for a lot of reasons as well.

Keith: I couldn't agree with you more. In today's show, it's really a focus on investments and what happened in the year 2022. We're going to be able to focus and pivot and also discuss how investors should think about 2023. Specifically, we're going to talk about 2022 asset class returns. What are the themes that were going on in the investment world last year? We'll also discuss the major events that occurred and then finally wrap it all up with how should investors think about 2023. So before we get into the numbers, Marcelo, let's just talk a little bit personally here. What does 2022 mean to you? When you reflect back a year ago and what happened over the past year, what do you think about?

Marcelo: I think about how great it's been. Obviously, we had a lot of pain in the world with the war in Ukraine, stock market returns weren't as good, but on a personal side, I think this was the first year since the pandemic that it really felt that, wow, we're really getting out of this. We had a full Christmas, we were able to meet our families during the holiday season, as opposed to the year before when we were completely locked down. And then summer was great. It's the same thing. You were able to meet people and I just felt like the general fear of people about COVID really was down and it really felt like normal life again.

Keith: Yeah, I agree. When I think of 2022 in my family, we had some health issues which my wife overcame during the lockdown period. You go back a year ago and we were pretty much across Canada in this mode where you couldn't go anywhere. And then the summer or early spring things start to open up. I'm happy to say my wife is doing incredibly well. She's a firecracker and she really overcame all the challenges. But then even on a personal basis, I look at the summer, I was able to reconnect and start coaching again. And I thought that was amazing for this young generation to be very active in the summer doing things. My rugby team, the girls that we coached, the young ladies, the women, they had an incredible summer. And it was a reopening. It was getting back to normal life. It was parties. It was family gatherings. And this past Christmas, I think resonated with just about everyone, and hopefully all of our listeners as well.

Marcelo: Yeah, another highlight for me was obviously the World Cup. I'm a huge soccer fan. I think everybody knows that in the office. And for us, like in my family, I'm half Argentinian. So the World Cup is always an event where it brings the family together. The fact that Argentina won the World Cup this year was a huge highlight for me.

Keith: Oh my God. I remember when Argentina was playing, I was like, Oh, Marcelo is going to be just out of control right now. But it was remarkable. And I think you look at, we were cheering on the teams in the office, there were some incredible quarterfinals and the final game was awesome. Unbelievable. I can't help but believe that no matter what sport you love, you really did enjoy the World Cup of soccer.

Marcelo: Yeah. And Canada making it to the World Cup was amazing. And then there is a golden generation of players coming in team Canada and people are going to be surprised. In 2026, we have the World Cup here in North America. Then in 2030, it's still undecided, but we have a lot of young players, early 20s, who are playing now in the biggest clubs in Europe. And it's going to be a great time for Canadian soccer, which is amazing to see.

Keith: Agreed. So let's transition now into those are some of the, I guess, the highlights for our listeners and for us. Let's talk about investing right now. Let's switch gears a little bit and start reviewing the year. Let's do it. So let's start with how did the markets do? How did equity markets and bond markets do last year in 2022?

Marcelo: So Keith, we saw red across the board. So bonds were down 11.6%, US equity was down 12.1%, international markets were down 8.2%, emerging markets 14.2%. Now we looked at a combination of international markets and emerging markets, so about 75% international and 25% emerging. That was down 10.1% and REITs, which is a nice proxy for real estate and commercial real estate, were down 18.8% across the globe. So tough year for markets, to say the least.

Keith: And I think what 2022 had that was a bit different is often when you have a tough year for equities, the fixed income side does okay. It holds up the portfolio. But ironically, fixed income, due to rising interest rates, had a tough year. And in many cases, tougher than equities, which was a bit of an unusual concept, but we'll talk about that a little bit more as we go along here. So let's refer to what we call the classic 60/40 portfolios. We'll use that as a bit of a benchmark. In Canada, Marcelo, what would the classic 60/40—60% equities, 40% fixed—what kind of numbers are we looking at here?

Marcelo: So when we look at that traditional portfolio using broad indices, we get that a 60/40 lost 10.3%. Those are big numbers for a 60/40 portfolio.

Keith: I remember in 2008, a 60/40 would have been significantly harder hit than that, but it is still nonetheless a negative number. In the U.S., the 60/40 portfolios are down even more. What are those down? I guess where I'm going with this is, listeners, if they're listening to U.S. commentary, U.S. market reports, they're going to hear things like, “Oh my God, it was an absolutely horrible year. Our 60/40s were down.” What were they down, Marcelo?

Marcelo: 17%.

Keith: So that's actually quite a bit worse than, let's say, a Canadian 60/40 that might be down 10-11%.

Marcelo: What's the major reason for that? The U.S. 60/40, there's the currency aspect, right? Some Canadian portfolios in their U.S. allocation will have some hedging. Then there is currency. And then there's the fact of diversification. If you're sitting here in Canada and you have a 60/40 portfolio, you may have more exposure to Canadian markets, international markets, and you'll have your U.S. slice, right? When you look at a 60/40 in the U.S., it's only normal you're going to have way more exposure to the U.S. markets, less exposure to international markets. Plus the currency aspect. I think that's the biggest driver of the difference.

Keith: Yeah, and following your comments, the Canadian balanced account will hold Canadian equity, and that did quite well relatively speaking last year, whereas the U.S. 60/40 will not own any Canadian equity and typically will have most of the money in something that proxies to an S&P 500, which had a more challenging year. And the Canadian holder, if he's holding S&P 500, he actually got about a 6% lift on the U.S. currency. So it's not as difficult. But clearly U.S. commentary is such that we're really talking about how challenging and how difficult the investment front was for American investors.

Marcelo: Yeah. And you're getting that here in Canada, right? So for a Canadian investor, you may feel like things are worse than they are because you're getting a U.S.-centric commentary, right?

Keith: Correct. Because in the grand scheme of things, as we're going to walk through here, what ended up happening last year, I think, was interesting because not one shoe fit all sizes. Did I get that expression correct? But essentially what I'm thinking of here is you had some people that had an incredibly challenging time in investing last year depending on what activities they did and where they invested. And then you had others that actually did remarkably well. And in the grand scheme of investing, their portfolio numbers did not get hit hard. Now, what are we going to start referring to here? Let's talk about areas within the market and how that...

Marcelo: When we look at the market, we break it down in different sectors. If you're looking at a matrix and you look at different components of the market, what really took the biggest hit was growth stocks, right? So when we open it up and lift up the hood, so to speak, we see that value stocks did way better than growth stocks on a relative basis across many markets, right? So when you look at that, that was one of the biggest drivers of the difference. So if you have a portfolio where you hold a broad index and you have another investor that has single stocks in that area of the market, that's a very different investing experience. So that's one of the biggest divergences that we saw in the market.

Keith: Yeah, absolutely. So growth stocks, explain what a growth stock is, Marcelo, versus a value stock.

Marcelo: Yeah. So growth stocks are typically, if you look at Amazon, for example, or a company like that, when you look at a particular industry, it's a stock that's growing higher than the industry itself. So you're going to pay a very top dollar for that extra unit of growth. And value stocks are typically stocks that have a lot of assets. They may not be valued accordingly in the market yet, and you're paying a cheaper price for that level of growth in the stock market.

Keith: Okay. And so last year, what ended up happening was it was growth stocks that really took a hit, and many argue that it was possibly because their valuations were too high. That would mean people were paying way too much money for company names. They were evaluating the assets or the prospects too high. And the other point that people discuss is that interest rates going up might have affected long-duration or growth companies more than value companies. But let's talk specifically here about some of these major growth companies. We've divided them into sort of two categories. We've divided them into large growth stocks and a lot of popular names that individuals will recognize. And then we divided a second group into what we call sort of the innovative companies that everybody was falling in love with 24 months ago. And those stocks had a particularly challenging year.

Marcelo: Yeah. So I think the first area is the mega stocks. When we think about mega stocks, those are the large-cap stocks that were in the news and everybody knows. The Shopifys, the Teslas, the Facebooks, which is now called Meta, the Microsofts, Amazon, Netflix, Google, which is also known as Alphabet now. And everybody knows Apple, right? So those companies, please remember during the pandemic, we were locked down. A lot of these companies, the one thing they have in common is that they provide people access to services where everything is locked down. Not all of them like Google and Apple, but generally speaking, these companies did really well during 2020. They had amazing returns. And you look at the dropdowns that they've seen in 2022. I'm just going to walk you through some of them, but I think people are familiar with them because we've heard in the media. Shopify is down 75% for the 2022 year. Tesla 65% down, Facebook down 64%, Microsoft 29% down, Amazon 50%, Netflix 51% down, Google minus 39%, Apple down 27%. Those are big numbers.

Keith: Yeah. Especially the first three that you mentioned, 70, 65, and 64. Those are very large numbers. You're absolutely right. And when you contrast that to value companies that actually had maybe even positive numbers, this is where you start seeing two different stories emerge in 2022.

Marcelo: Yeah. And we've alluded to this idea before that these are still great companies. You could argue that they're great businesses, right? But markets are truly a mirror of human psychology sometimes. And people tend to overpay and get hyped up about certain stocks. And there's a big divergence between the real business and what people are paying for that extra unit of earnings in a business. And I think that's exactly what happened here. The prices just became exuberant.

Keith: I think that you're 100% correct. And let's even switch gears a little bit and talk about innovative companies because those are the ones that people really fell in love with. When you look at the graphs, it's like you go 2017, 18, 19, and then you go 2021, a massive spike up like a mountain, and then 21, 22, a massive spike decline. It's almost like a mountain peak and then back to a flat value. So what are the kinds of stocks we're referring to here and what happened?

Marcelo: Yeah. So think about the stocks like Peloton, Lightspeed, Zoom, DocuSign, the Montreal company called Nuvei, Robinhood in the U.S. So these are small companies that are technology-driven. So innovation, but they have low profits and high valuations. So they may be great businesses, but they're still not profitable. And people were really hyped up about it. We were talking off mic about this two, three days ago. Think about how DocuSign and Zoom changed their business during the pandemic. It gave us access to our work and our clients during an environment where people are locked down in their homes. It is a remarkable thing to have when you're running a business, right? But on the return side, the returns were absolutely amazing during the 2020 period. So you see that peak and then complete collapse in the last year, right? So I'm going to walk you through some of the numbers, Keith. Peloton down 78%, Lightspeed down 65%, Zoom down 63%, DocuSign 64% down, Nuvei down 61%, Robinhood down 54%.

Keith: It is amazing because as you alluded to, there's two pieces of technology that have revolutionized our business. One is Zoom and everybody knows how to use it now and everybody can identify with that technology. And the other one is DocuSign. So we used to, Marcelo, three years ago, we would be running around getting clients to be signing physical documents. So with DocuSign now, it's so much more efficient. And so there are two examples of beautiful services, but at the end of the day, they were priced out outrageously. They were hyped up and they're still not making the profits they need to be making for investors to be comfortable. And so those two stocks are right back to where they were four years ago. To me, that's amazing. If I would go back and predict three years ago, this is what would happen. The world would become digitalized. Everybody would be working from home, would be running around in this brand new environment. You would say, I absolutely have to own these stocks. You would have done worse than if you bought a general market diversified portfolio and held onto that over the last three years. And so these are some of the big stories that you're alluding to. Growth really taking it on the chin in 2022. And it really started in November 2021 and it dragged on all the way through the last 13 months.

Marcelo: Yeah. Just to build on that, an investor may say, you know what, I don't want to invest in a particular name, right? I may not like DocuSign specifically or Peloton. I'm going to buy a bundle of these tech stocks and just ride through diversification in an ETF. So everybody knows and is familiar with Cathie Wood's ARK Innovation Fund, right? So that one, when you look at the peak returns, it started going down in November 2021. But if you look at the calendar year, so 2022, that fund was down 67%. And that is just a bundle of maybe 30, 40 stocks that invest in that category we just described, like tech company, high innovation, high valuation, low profit. So testament of what's going on in the industry. And we have a great chart here that we discussed last year during the annual review that we brought back in our discussions. But when you look at the behaviors of the people who were buying into the ARK fund, we realize and we have the evidence that people weren't buying at the beginning when it was starting to grow. They started to buy in once it started peaking and a lot of those investors ended up buying at the top. And when you're buying at the top, it's going to be tough to get back to those pre-pandemic levels where it was trading at way lower levels and you can still get your money back, which is tough.

Keith: Yeah. And what you're speaking to is the massive—so I guess the first topic is, okay, so you like innovation, you want to be in these types of stocks. Instead of trying to pick one, let me pick a basket. Let me pick a diversified—I'll go to Cathie Wood's strategy. You go to ARK, which was very popular, very well known. ARK's number one inflow year—they went from 6 billion to 25 billion—was right at the absolute peak. It was late 2021. So you're highlighting in a very nice fashion how people chase. It's this emotional, it's the hype, and they chase, and they buy at the absolute wrong time. So I'm looking at the price of ARK now, and its current price is $31.37. So if I go back in the last five years, 2018, so five years ago, it was $41. Wow. So I still, after five years, am still down almost 20% after five years. After one year, I'm down the 60 to 70% that you alluded to. So it's a great example. And what we're highlighting here is some of the biggest challenges that went on in 2022.

Marcelo: The one thing that sticks out for me is, if I were to have a lesson from 2022 when it comes to this type of stocks, is that profits matter. Valuations matter. And when you have interest rates at 0%, obviously that almost kills the idea of time value of money and the risk-free rate. And when you have zero interest rates, people throw money at crazy things and anything becomes really attractive when you have zero interest rates. But I think 2022 proved that valuations and profits do matter. I think about people who are CFAs and CAs looking at this and saying, it's crazy that people are just throwing money at companies who have no profits and all these valuations are just insane.

Keith: And those are what you're talking about are companies that are actually profitable, still producing and making products that are being used by lots of different people. There's a whole other element here about speculation. So we've spoken about this before. In 2020, that was a year that speculators seemed to be buying certain things. Remember GameStop and AMC and all these sort of meme stocks and crypto. And so all of a sudden, last year was the unraveling of the speculator because the speculator had a very challenging year. So crypto is, Marcelo, we don't and have never recommended it, do not include it in any client portfolios, period, had probably one of the most spectacular downfalls last year. Do you want to share a few comments on crypto or meme stocks?

Marcelo: Yeah, I think it was a horrible year for crypto in 2022. I think it's taking into that idea of valuations and profits matter. So I think people, when free money stops flowing, I think there's a lot of things that start falling back into place. But I think it was down for that reason. And also there were a few events in the industry. I think everybody knows about the FTX fraud and the different problems that the industry has been going through. There was a thing called stable coins, which were pegged like one-to-one to the dollar, but people couldn't really explain. So cryptocurrencies like Terra and Luna completely collapsed at the beginning of the year. Then you had the FTX fraud. But even when you look at the biggest names like Bitcoin and Ethereum, they're down 60-70% for the year. So it's been a bit of a crypto winter. They like to call it in the news for the space. And I'm just so glad that to me, the whole area never made sense. I tried to understand the technology behind it, and I think maybe it'll have a place in the future, but I think we did a good thing by not getting into the space and buying into the hype. I won't lie to you, Keith. I have a lot of friends in my age group who are investing in this stuff. And we also had clients asking us questions about, maybe I should put five, $10,000 in crypto. I'm assuming that's gone now or it hasn't been a very good experience, but yeah, I think those are my comments on crypto.

Keith: Thank you for that. You're absolutely right, Marcelo. We talked about these different areas in the market. Speculators had a very challenging year. Obviously, as we've never speculated, we don't think that's investing. It doesn't even come into the investment philosophy. So half of what ended up happening last year was, if you were successful, all you needed to do was actually make sure you stay away from all these explosions, bombs, and areas of the market that were getting individuals into trouble. And that gets back to the merits of a diversified portfolio. That gets back to the merit of staying, not chasing. We've created many podcasts in the past three years where we talk about don't chase, don't buy the hype.

Marcelo: Which is boring, right? Nobody wants to hear that when all these things—all my friends rolled their eyes when I explained how we invest and how boring it can be for a lack of a better term. But at the end of the day, it's sensible investing. And I think that's what pays off, and you need to be consistent as well. Because if you start shifting things around, it doesn't work.

Keith: Yeah, I agree 100%. And so let's just take a moment here. We don't usually speak about this that often, but let's talk about our portfolios. Let's talk about the portfolios we build and talk about some of the results. So let's just focus on equity for now, because we've spent the last little bit talking about how challenging some of the markets are and have been and how challenged speculators have been and how challenged it's been to be a growth investor. So we tilt portfolios. We manage diversified global portfolios—Canada, U.S., international, and emerging market stocks. We have a tilt and a bias towards heavier overweights to value companies and small value companies. So if we use a third as a benchmark—a third Canadian stocks, a third U.S. stocks, and a third international with its weighting of emerging in there as well.

Marcelo: If you look at that, our equity portfolio model was down 5.7%.

Keith: And that would be with the small tilts to value and small value. And that would be our dimensional core strategies.

Marcelo: Correct.

Keith: And if we were just invested in index, pure indexes that follow the world—Canada, U.S., international, and emerging—in exactly the same weightings, the result, if I'm not mistaken, would be somewhere around minus nine and a half to 10.

Marcelo: Correct.

Keith: So that difference between nine and a half and 5.7 is the tilts towards value and small.

Marcelo: Correct.

Keith: And we have some strategies that are included in some portfolios called vector, dimensional vector. If we did a third, a third, a third, what are those returns looking like?

Marcelo: Yeah, obviously the vector portfolio will have a stronger tilt towards small in value. So that portfolio of a third, a third, a third, lost 2.6%.

Keith: That's a big difference. Not only that, I think about all those returns we were talking about before, the speculators, the individuals chasing stocks, the growth stocks. You're talking in the minus 50s, 70s. Yes, they had run-ups prior to that, but I'm really proud of our portfolios and proud of our discipline and proud of our focus on the strategies. We know our clients will be happy, but it also, in this particular show, highlights what diversified portfolios did and how they did if they had some of the value tilt to them. Again, when you invest this way, we suggest that investors take very long-term views on it and hold the course not just for a year or two and flip back and forth, hold it for five to ten-year processes to make sure that they maintain their strategies.

Marcelo: Keith, you more than anybody know how the factors can go through bad periods in the market. How many times we had to sit in front of clients and we had lower performance at the broad benchmarks because the value tilts or the small cap tilts didn't do well. But again, this is like you said, long term and it's not to brag, but I cannot tell you, I know a lot of people in the industry, how different of an experience it is from what they went through in 2022 and what we went through in 2022. We didn't have any clients calling panicking about the markets. Whereas I know people in the industry who it is a very different experience because they're constantly stressed. They're trying to shift things around. It's very stressful every day and it's a very different experience for us and our clients.

Keith: Yeah, you absolutely, you're alluding to this sort of shifting and making bold moves. And we've always spoken about that just creating anxiety. So creating anxiety for no additional returns and all the research points to that very clearly. So let's pivot here a little bit. We've spoken about general markets. We've spoken about what did well, what had a very challenging year. What are the other major themes, Marcelo, in 2022? Let's slip into some other macro themes that are important for our listeners.

Marcelo: Yeah. So inflation continues to be the elephant in the room. It continues to be the main concern of the economy, the central banks, and a lot of Canadian families. They're struggling to buy groceries. It is tough for a lot of people. Continues to be high. But if there's a silver lining here is that we have two graphs here that show the progression of inflation in the last year. Both in Canada and the U.S., it peaked in June of 2022. So in the U.S., it peaked at 9.1% and in Canada peaked at 8.1%. And by the way, to clarify, this is the broad inflation number. It's not the core number that excludes food and energy. So I want to clarify that.

And we do see, Keith, that it is trending downward. So it's still stubbornly high. So in the U.S., you're still seeing inflation of 7.1%, in Canada 6.8%, but it is trending downward. I think as we go into 2023, the thing for central banks will be do we keep rates higher for how long? And I think we've spoken about this before. As long as inflation remains high, away from that target of 2-3%, it is going to be tough for central banks to say, you know what, let's stop the interest rate hikes and start bringing them down. So that was a big subject in 2022. It continued to be a big topic in 2023.

Keith: Yeah. And we did quite a few podcasts on inflation and interest rates. And I think on the positive end of this, if you're an investor, you went through the gut punch of negative returns on the bond side. But because the rates are higher, what that sets up investors for is higher expected future returns. As long as your duration of your bond portfolio, which means the maturity, the length of your bonds, is shorter than your horizon, your investment horizon. So most of our clients have durations between three and five years, but their investment horizons are longer than that. Then that bodes well because your breakevens are low. And that means after you pass your breakeven, you're into positive extra returns. So while inflation's not good for anybody, and we're not suggesting it is, the upside for individuals, if inflation can be tamed, is that interest rates will perhaps give us some better returns for investors.

Marcelo: Yeah. We don't have time to get into it too much in this episode, but I encourage all the listeners to go and listen to the podcast you did at the end of December of 2022 with Lawrence. That was an amazing show. Very simple, very easy to explain, and it really breaks them down in a very easy way for people to understand.

Keith: So Marcelo, we spoke about inflation. What was the other big theme that was discussed this year in 2022 and is still in discussion for 2023?

Marcelo: So when you talk about inflation, interest rates, obviously the big analogy the central banks use is can we land the plane softly? Can we have a soft landing? And what that means is that there's a lot of speculation still about, okay, you have high inflation, it's going to take interest rate hikes to slow down the economy. But a lot of economists are asking themselves, will we go into a recession? So I think that's a big subject going into 2023. 2022 didn't see an official recession. We had a podcast about it and there are different nuances about it's not only two negative quarters of growth, it also has to be declared to be an official recession. So we didn't see that in 2022, but in 2023 we are still expected to go through a recession. We just don't know how bad it will be, how long it will be, and how different it will be across different economies in the world. So I think it's not fair to say that we'll have the same recession in Canada than we will have in the U.S. that we'll have in Indonesia, right? So I think that's still a big concern globally when we think about the economy.

Keith: Yeah. And you can't also say we'll have a similar recession to the one we had in 2008 or 1991. Every economic cycle is going to come across with a different feel, a different experience. And one thing we do know is that stock markets and bond markets are forward thinking. So the implications for investors—I had a meeting this week and talking to a potential client and I think they fell into the traditional thinking, which is maybe I'll invest in stocks when I see things are getting better. And we went through this discussion that unfortunately when you see things are getting better, it's too late. The markets will have already appreciated. So this is part of this. The markets are forward thinking. So in the past, I'd say almost nine months now, the markets have been looking forward and pricing in a slowdown. Now can they get it perfect? No. And that's the problem with forecasting. So suffice it to say, as you've alluded to, it's still a discussion that's around. 2023 will probably mark something that might feel like a recession, possibly could be a recession. But from an investor's perspective, we're going to look at this and say, you must still continue to hold the line. Keep your diversified portfolios. We've gone possibly through the worst, although we don't know.

Marcelo: Yeah. We don't know.

Keith: And that's one of the biggest challenges about forecasting.

Marcelo: Oh, we're going to see a ton of it. You and I were talking about the Bill Gross story in 2009, right? When we were coming out of the great recession of 2008, the credit crisis. And yeah. So tell the listeners about that. I found that was like a fascinating story.

Keith: It speaks to this idea of forecasting and who can actually get it right. And even in today's market, you open up the newspaper and almost on a daily basis, somebody is forecasting better results on a go-forward basis. And on the very same page, another person, which appears to have the same credibility, is forecasting more doom and gloom. So how can you have all these different forecasts in the identical scenario? But it did remind me of 2008, 2009, and we just got out of a very difficult, very difficult—when stocks went down 50%. 50%, not the 10%. We're talking about geo-diversified across 50%. And we recovered. We were into 2009, 10. We recovered maybe 80% of that, 90%. And I remember vividly Bill Gross coming out and saying, now we, for the next five to ten years, we're in a very different world. And remember, he was on top of the world at this point, the most successful bond investor you had seen. And what he essentially said, we're going to have a new environment for returns. And he had suggested that all returns are going to be very low now. And even stock returns, very low single digits like twos and threes. And today we look back, for example, the U.S. market hasn't seen a better 10 years in a long time. We're talking returns in the high teens compounded for a decade.

Marcelo: Yeah, it's crazy.

Keith: And so it just goes to show you how that forecast was way off. And imagine if you're an investor listening to that forecast and you build a portfolio and you make moves based on those suggestions, you're just not going to have a successful investment experience. So I can't help but think in the last two years, there's been all sorts of people making all sorts of forecasts. And you know what? We look where we are today. And some of those forecasts just are not even close to coming to fruition.

Marcelo: No, we know it's a futile game. It doesn't work.

Keith: So Marcelo, we're talking about valuations and we know we've spoken about this before where we like the valuations in our portfolio. And we allude to the Vanguard reports and the Vanguard reports specifically talk about expected returns as do lots of investment management firms. Last year, with the markets were higher, expected returns were lower. Now the markets are lower, expected returns are higher. Can you give us just some summaries of what those expected return changes are? And then maybe we'll talk a little bit about this concept of undervalued, fairly valued and stretched.

Marcelo: So the report alludes to that. Now the 10-year expected returns across the board for equities and bonds has gone up about two to two and a half percent higher than it was a year ago.

Keith: So just stop here for a sec. So what that essentially means is that while all portfolios are down this year and we've got negative numbers, that has now increased expected returns. So we will catch up again in the future. So we lose now, but we get a chance to catch up in the future. And I think that's a really important part here. It's important to know that all these portfolios should produce better results in the next decade.

Marcelo: Correct. The other highlight that sticks to me is that you alluded to how the U.S. market has done in the last 10 years. It's done better than international markets, but the expected return for the U.S. is now lower than the U.S. than it is for international markets and emerging markets. So that is good for a diversified portfolio. It bodes well if you own diversified portfolios. And even for bonds, the expected returns have gone from 1 to 2 percent to 4 to 5 percent because of what you alluded to before that you took a big hit on the capital gain, on the capital aspect of the bond because interest rates went up. But if you stay in that bond, the expected return is now higher.

Keith: Yeah, absolutely. 100%, Marcelo. And then we're going to get a little technical here. And I don't want to suggest that we do any market timing based on any of this research that we're about to share with our listeners by moving things around from one asset class to another. But what I found fascinating and interesting inside that Vanguard report was they had a color scheme. And the color scheme identifies three different areas in terms of how they look at valuations. They got green for undervalued, which is a great time to buy. They've got yellow for fair market, fairly valued, and they got red for what they call stretched valuations, expensive valuations. So I'm assuming that at the end of the day, it was pretty clear that when you look at U.S. growth, those would be stretched valuations. But what are the areas that they are talking about that say are either undervalued or fairly valued?

Marcelo: Yeah. So when you look at the market overall, they still consider U.S. equities to be overvalued. And at the other spectrum, they consider global equities, so including Canada, international, and emerging, they still consider them to be fairly valued, but at the lower end of the spectrum. So almost very close to being undervalued. And then obviously bonds come at the fairly valued right in the middle. And they expect them to be fairly valued, but the expected return has gone up for the reasons we discussed. And on the second layer is just different areas of the market. So Vanguard group still sees the growth stocks very overstretched compared to a year ago, even though they've gone down this year. And they still see as a very attractive or undervalued areas of the market, like small cap emerging markets and that type of thing.

Keith: Yeah. And so we look at this and we really like the positioning of the portfolios that we're overseeing, which are globally diversified portfolios—Canada, U.S., international and emerging market. A good portion of the tilts that we have, whether they're value or small cap, the valuations don't appear stretched. And this bodes very well for expected returns. Add to that the fixed income, which will be higher expected returns. And this is what we tell our clients and our friends and contacts that if you stay in these diversified portfolios, we should be seeing reasonable returns in the next five to ten years. That's great news. So now we're going to get into the final wrap up here, Marcelo. So let's look at whether there are positive themes, final comments you have on 2022, lessons that we learned in 2022, what we want to look forward to in 2023.

Marcelo: I think from the market side, I think if you have excess cash, it's a great time to buy. We always say that valuations are attractive for diversified portfolios. Like you said, I think the second layer of that for me is having a robust evidence-based investment philosophy will continue to pay off because it tunes out the noise and prevents clients from falling for these major pitfalls that we saw in the market today, like chasing hot stocks on the tech side, cryptos and that type of thing, even market timing. So that's the two things that I see positive. On the economy side, I think inflation is trending downward. I'm fairly confident that we can get it under control. I just don't know the timing. I think nobody knows. Hopefully sooner than later. But those are the things that I see as positives for our clients and investors at large.

Keith: Thank you. Those are great takeaways. I would simply add that as we go into 2023, we want the world to continue to function, to continue to operate. Hopefully, we're going to get a resolution in Ukraine with Russia. That would be a major, that would be part of one of the best things that could happen in this year with regards to investment portfolios. I think as long as we're not chasing, as long as we're embracing a fundamentally sound investment philosophy, 2022 proved that the investment philosophy continues to resonate and work extremely well. Stay diversified, tune out the noise, don't chase, don't speculate, and keep on investing because there will be some really good returns in the next five to ten years. So with that, thank you very much to our listeners. And we look forward to hearing from you. And we look forward to our next episode.

Marcelo: Thank you for listening. See you next time.

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