



Di Iorio Family Wealth of RBC Dominion Securities

Think bigger. Act bolder. Invest better.

Predictions for 2022

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For the last several years, we have been trying our hand every January at making some predictions for the year ahead. We decided to do the same thing this year, but instead of focusing on predicting events, we decided to make predictions about behaviours. Events that do or do not happen in a given year have a high degree of unpredictability, but the broad behaviours of society as a whole is much more certain.

I recently re-read an excellent book, which I had first read when I started working as a portfolio manager over 20 years ago: *A Random Walk Down Wall Street*. The premise of this acclaimed investing book, written almost 50 years ago by Burton Malkiel, is that most investors would be better off buying and holding an index fund than attempting to buy and sell individual securities or actively managed funds. The basic thesis of the book is that the market largely prices stocks efficiently, and over time more than 2/3rds of professional portfolio managers are outperformed by the unmanaged S&P 500 Index. The premise has led us to evaluate certain aspects of our own strategy, and even though we have data to support our added value over time, we believe there are some aspects of our approach which could be simplified and made more efficient by taking these lessons to heart.

On that note, here are some of our behavioral predictions for 2022:

1. The Madness of Crowds will continue to push certain assets well above intrinsic value:

Having started my career in 1999, near the height of the internet bubble, I was able to see firsthand how the average investor made justifications for the asset prices at the time. The psychology behind this can be explained by cognitive biases like herd mentality or groupthink.

Looking back, the amount of speculation that occurred then may seem absurd, but at the time it was made to feel normal. To quote Malkiel, "Although the castle-in-the-air theory can well explain such speculative binges, outguessing the reactions of a fickle crowd is a most dangerous game". We

believe that there are certain instances of similar situations today, and one day we may look back on these with the same amount of disbelief as we do the dot-com bubble.

2. Investors will continue to focus their attentions to whatever draws the most clicks:

Lately, the market has clearly been most focused on the inflation narrative. While the data certainly bears monitoring, the way it is portrayed in the media can only be described as alarmist. While sustained levels of high inflation would undoubtedly be a negative, there is very little time devoted towards covering the various reasons this will unlikely be the case. For years, the greater concern has been that inflation is too-low, or even that there may be deflation. However, a myriad of temporary factors (supply chain issues, suppressed labour markets, etc.) combined to cause an inflationary spike – and suddenly the longer-term deflationary trends (slowing population growth, technological advancement, etc.) are ignored despite their much higher likelihood of persisting.

As always, we believe that investors' focus will shift towards whatever factors 2022 has in store for us which can be portrayed in the most alarming way. If this turns out to be something besides inflation, it will be as if 2021's inflationary concerns never occurred.

3. Markets will get more efficient as they have every year, for the last 100+ years:

We've talked about "secular growth" and what it means, as well as our belief that when you take an approach that involves investing in various secular growth themes via companies at different stages of maturity, you can create an active core portfolio that has both a stronger return potential, and a lower risk profile, than the overall market over time. More recently, we've been evaluating the benefits of complementing this with a more passive sleeve allocated to the broad market at a very low cost, and have been impressed with the results.

Though this may seem to contradict our theory on investing for secular growth, this is actually not the case. If we take the S&P 500 as an example, it is made up of 500 of the largest companies listed on US stock exchanges. It is also market-cap weighted, meaning the larger a company is, the greater its weight will be within the index. Over time, the companies that are achieving the most success within the secular growth themes of the generation (ie. the Generational Companies) tend to grow, and therefore will make up a larger portion of an index like the S&P 500.

4. Humans will continue to make suboptimal decisions

In 2022, we will make a concerted effort to focus on behavioral finance for our clients. Understanding the cognitive and behavioral biases of the average investor can help us to identify opportunities – and this applies both to the upside and the downside.

We may be seeing an example of this occurring now, with the recent downside seen in certain "growth" areas of the market. Many companies which are at the forefront of innovation in their spaces, have grown their businesses their revenues and earnings at consistently high levels, and

are projected to continue doing so, are trading well below their recent highs. This is occurring despite nothing changing about the outlook for these businesses over the longer-term.

By understanding that much of this current environment is being driven by short-term emotional thinking (ie. fears of inflation and rising interest rates), we can seek to take advantage of the opportunities this presents. Moreover, from our experience investing in “secular growth”, we know that as positive sentiment returns, investors will once again act in accordance with Malkiel’s “castle-in-the-air” theory. This is where our focus on process and procedures will allow us to once again benefit via profit taking and rebalancing (as seen during 2020 and early 2021).

While making predictions of what may happen over the next few weeks, or even months, is simply speculation, looking at longer-term trends and identifying opportunities for industries and companies that can be magnitudes larger over the coming years can be done with a higher degree of accuracy. The unfavorable market environment of 2021 (and so far in the first few days of 2022) will undoubtedly provide some extremely attractive entry points in what may become future generational companies.

As always, please feel free to reach out to us at any time for further discussion.

Sincerely,
Di Iorio Family Wealth

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