Four experts on investing risk and outlook for 2023

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Though inflation, interest rates and geopolitical risks concern investors, a silver lining of market turmoil is a sharp rise in bond yields

Clockwise, from left: Christine Poole at GlobeInvest Capital Management Inc., Claire Blessing at Gluskin Sheff, Leila Fiouzi at RBC PH&N Investment Counsel, and Kate Pal at Pal Insurance. Canadian Family Offices

As the volatile economic and geopolitical patterns of 2022 come home to roost in 2023, four experts discuss the risks and outlook for investors, especially high-net-worth individuals and family offices.

Claire Blessing, managing director, client wealth management at Toronto-based Gluskin Sheff

What are the major concerns of very high-net-worth clients or family offices, who tend to favour capital preservation and have a longer horizon?

"Defining and having a clear understanding of what risk means for clients is often missed by the broader industry. These discussions are crucial, since risk has different meanings for different people, which are often impacted by their unique situations and needs. As a result, risk tolerance, especially during times of prolonged volatility like we've recently experienced, ends up being a top concern.

Varying market conditions aside, what is important is the focus on planning and constructing an effective investment portfolio that addresses how clients define risk, is diversified and aims to meet their specific wealth goals and objectives, even during market downturns.

This plays into another concern we see in ultra-high-net-worth clients, which is legacy planning and wealth transfer to future generations. Very clearly, understanding each family's objectives and risk tolerance is critical to constructing bespoke investment portfolios that will help clients achieve their lifetime goals and preserve their legacy for generations to come."

What are major considerations for 2023?

"There are a number of key considerations … but the inflation outlook remains the key area of focus for the market.

In the U.S., inflation has remained higher for longer than the Federal Reserve originally expected, which has led to their increasingly hawkish stance. A worry is that, having seemingly moved too late to curb inflation in the face of massive fiscal spending, the Fed now faces keeping this hawkish stance into an economic slowdown or recession. A soft landing of sorts remains the market's wish, but the longer the Fed remains hawkish, the likelihood of achieving that outcome becomes increasingly uncertain.

Our approach has been one of caution since late [in 2021], when we began to see inflation as more structural than transitory. While we expect the current market volatility to continue until we begin to see more clarity on the path of inflation, our cautious approach is somewhat mitigated by the market moves we have already seen, which have led to extremely attractive pricing across certain assets. We are actively taking advantage of the opportunities that come out of this market environment across asset classes."

What factors should clients be taking into account in terms of risk management?

"While having trust in one's long-term mix is key, in times of volatility and dislocations being able to make tactical shifts as opportunities present themselves is also important.

A couple of factors come into play, such as having enough diversification in public and private assets, defining and understanding their own tolerance for risk when looking at things like participating versus missing out, time in the market versus trying to time the market and keeping long-term wealth goals in mind.

Another factor clients should be considering is taking advantage of the opportunity to move into a position to improve overall diversification if there is currently no or low exposure in the portfolio.

Another challenging feature of markets over the past year has been the extreme level of asset correlation, particularly between stock and fixed-income prices, as prices of both have declined sharply in 2022. This has dampened the value of fixed income in a traditional 60/40 portfolio as a tool to soften volatility and preserve capital.

Fortunately, the silver lining of this market turmoil has been a sharp rise in bond yields, which means new investments are able to provide substantially better returns than we have seen in the asset class in quite some time. Additionally, as the markets settle into a new reality of higher interest rates, we expect the traditionally negative correlation of equity and fixed income to return."

While each portfolio and circumstance is different, can you discuss strategies specific to HNW clientele concerning rising interest rates, especially regarding fixed income?

We have been relatively well positioned for inflation and rising rates in our clients' portfolios this year. We avoided traditional duration fixed-income exposure and instead focused on more floating rate exposure with senior lien loans on the public market side and collateral loan obligations (CLOs) on the opportunistic credit side.

Additionally, in our flagship investment-grade credit fund, we hedge out against interest-rate risk and focus on absolute returns. We are cautiously optimistic for returns given the back up in rates and widening in credit spreads."

What strategies take into account geopolitical considerations?

"The war in Ukraine continues to add a layer of uncertainty and volatility. While international equities are looking attractive from a valuation standpoint, they are currently lacking a near-term catalyst. For instance, in our international equity portfolio, we are taking advantage of this volatility, which will benefit our clients with a 2- to 3-year-plus view. Our European holdings by and large are multinationals that draw business from markets across the globe and are able to withstand the considerable volatility of domicile markets. Exporters in Europe are also significantly aided by weak currencies."

Does the current state of the market affect how clients should be looking at alternative and real assets?

"Clients need to do their research and ensure that they have access to the resources and talent of a well-capitalized, entrepreneurial firm, one that has the ability to apply specific expertise to less efficient or competitive markets, where the managers can generate strong returns and support them through all market cycles.

Personally, we're quite excited about the role of private market capabilities in our clients' portfolios. We're in a differentiated position to be able to provide our clients with direct access to an asset class typically reserved for institutional investors. Adding a private equity or private credit component to a portfolio allows accredited investors to participate in a segment that historically has exhibited higher returns and less volatility than are available in most public market funds. This is because of the multiple levers private equity teams have to generate growth from their investments, making it a terrific add for investors who qualify."

Christine Poole, CEO and managing director at Toronto-based GlobeInvest Capital Management Inc.

What are the major concerns of very high-net-worth clients or family offices, who tend to favour capital preservation and have a longer horizon?

"Concerns center around the persistence of the high inflation we are presently experiencing and its impact on capital preservation over the long term. Capital preservation does not mean "not losing money or absolute dollars" but making a real return on your portfolio, which is more difficult when inflation is high.

For clients with a long investment horizon, stocks remain the most durable asset class to preserve capital. According to renowned economist Jeremy Siegel (a finance professor at Wharton), the long-term real return (net of inflation) from investing in stocks from 1802 onward until June, 2022, is 6.7 per cent. Note that the 6.7 per cent real return was unchanged from his initial study period ranging from 1802 onward to the end of 1992. Returns from investing in stocks are remarkably volatile in the short run, but the equity premium (or the excess return from stocks over a risk-free rate like a Treasury bond) is quite durable.

Another area of concern is the geopolitical change over the past year with the outbreak of the Russia-Ukraine war and tenuous trade relations with China. Both have also contributed to rising prices in many commodities. The move to onshoring (or nearshoring or friend-shoring) may influence the future geographic mix within an investment portfolio."

What are major considerations for 2023?

"Major considerations … include: rising interest rates, elevated inflation, restrictive monetary policy by central banks around the world, economic uncertainty and global geopolitical turmoil. The decline in the broad equity indices this [past] year reflects many of these concerns. [In] 2023, we are likely closer to the end of the monetary tightening cycle than the beginning.

Economic cycles are inevitable, but the timing much less so. Macroeconomic forecasting is highly unreliable. We prefer to analyze incoming data, interpret their possible impacts on companies in our client portfolios, and respond only if we believe there will be long-term consequences.

On the positive side of things, volatility will create opportunities to invest in companies well-positioned to benefit from secular growth trends. We continue to adhere to a disciplined process of staying invested in financially strong, reasonably priced growth and income stocks. We believe that in the long term this will result in our clients continuing to build wealth through the power of compounding."

What factors should clients be taking into account in terms of risk management?

"Risk management in 2023: Reassess your liquidity and cash flow needs over the near-term (less than two years) and longer-term, as they will dictate portfolio asset mix and investment allocation within each asset class.

Higher interest rates, especially at the shorter end of the interest-rate yield curve, means clients that require liquidity over the next couple of years now have more attractive investment options that include guaranteed investment certificates (GICs), treasury bills, provincial strip bonds and investment grade bonds, laddered to meet cash needs.

Funds that have a three- to five-year investment horizon can be allocated to quality, high dividend-paying stocks or what we refer to as income stocks. They provide defensive, visible cash flow streams and reliable, growing dividends. Utilities and telecommunication companies are examples of income stocks. Our primary investment criteria for income stocks include an investment-grade balance sheet and a proven record of annual dividend growth.

Funds that have a longer-term investment horizon of over five years can be invested in a diversified portfolio of quality, financially strong, profitable growth and income stocks with resilient businesses that can weather periods of economic uncertainty."

While each portfolio and circumstance is different, can you discuss strategies specific to HNW clientele concerning rising interest rates, especially regarding fixed income?

"In an environment of rising interest rates, investors should seek to invest in profitable companies with a strong balance sheet, balanced debt maturity schedule, pricing power and a record of annual dividend growth.

The weighting of the fixed-income portion in the portfolio should be dictated by the client's liquidity needs and risk-tolerance level. Investment in high-yield non-investment-grade bonds is not recommended as debt servicing costs may increase (as debt is refinanced at higher rates) and the spread to investment grade bonds may widen (especially in an economic downturn) putting downward pressure on prices."

What strategies take into account geopolitical considerations, especially with regard to foreign or commodities investments?

"Given the volatile geopolitical environment in many parts of the world, we avoid investing in countries under autocratic leadership. The foreign (non-Canadian) portion of a portfolio is invested in U.S.- and European-based multinational companies. They have global operations, so investors can still benefit from having exposure to the faster rate of economic growth in emerging countries. There is also more transparency in their financial reporting, as they adhere to accounting standards set and enforced by independent regulatory bodies.

Companies in commodity industries generally do not have pricing power and are price takers for the commodity goods they produce. Therefore, we allocate a minimal amount of a portfolio to commodities. Investments in the commodity sector should be restricted to companies operating in politically stable or safe countries that are governed by the rule of law."

Does the current state of the market affect how clients should be looking at alternative and real assets?

"Allocation to alternative and real assets in a portfolio should be driven by a client's long-term investment objectives, liquidity needs and risk tolerance level. Current market conditions should not affect the asset mix allocation unless it causes a change in the aforementioned factors.

Our firm invests in large capitalization public securities and, while we do not have in-house investment expertise in alternative and real assets, there is justification for them in a diversified portfolio. I do not put cryptocurrencies in the same category. I view them as highly speculative due to their inherent high price volatility, lack of cash flow and assets to support their valuation and the lack of regulatory oversight over crypto exchanges."

Are there reasons for staying invested even during volatile markets?

"Equity markets will go through periods of volatility which are beyond our control. However, we (investors) can control how we react.

Stock markets rise and fall. History shows that, over the long term, they go up more than they go down. In fact, since the post-war period, the U.S. stock market has gone up in around 70 per cent of the years because the U.S. economy grows most of the time. 'Loss aversion,' our natural fear of losing money, leads investors to focus on the 30 per cent of the time stocks decline.

For Canadian stocks, the good far outweighs the bad. Over the past 60 years, 44 years (73 per cent) were positive and 16 years (27 per cent) negative.

Market timing is difficult. Since no market cycle is the same, it isn't easy to anticipate market movements. If your market timing is not precise, you could miss out on potential rallies. In the past 20 years, seven of the best trading days happened within 15 days of the 10 worst days.

But, staying invested does not mean buy-and-hold and doing nothing. Underlying strategies to employ include portfolio diversification across asset classes and sectors to meet your risk tolerance level and liquidity and cash-flow needs. Or, portfolio rebalancing, meaning selling assets that have gained in value and buying assets that have fallen in value, or keeping proceeds on hand to take advantage of market volatility and temporary mispricing of securities."

Leila Fiouzi, senior investment counsellor at RBC PH&N Investment Counsel

What are the major concerns of very high-net-worth clients or family offices, who tend to favour capital preservation and have a longer horizon?

"Our firm has increasingly seen inflation and its impact on long-term real capital preservation to be an immediate concern. Longer-term concerns tend to align with intergenerational wealth transfer and ensuring that the next generation is well-equipped with the skill, will, and trusted counsel to steward the family's wealth."

What are major considerations for 2023?

"Inflation remains a significant macro risk and the path forward for the economy and markets largely depends on if, and when, price stability will be restored. RBC Global Asset Management [in December] continues to anticipate a recession across much of the developed world in 2023 with varying regional severity, depending on the continued strength of the U.S labour market, global central banks' likelihood and timing of pausing or cutting interest rates, and the trajectory of the Ukraine war.

Ultimately, it is important to remember that recessions are inherently temporary and, in this case, potentially central to fixing the inflation problem."

What factors should clients be taking into account in terms of risk management?

"Long-term perspective requires an approach that aims to add incremental value while controlling risk and this is particularly important when the economic picture falters. In the short term, rising rates can stress stretched balance sheets and uncover unsustainable cost structures so it is important to focus on quality companies with balance sheet discipline, sustainable business models, and skilled management that can navigate an economic downturn and a potential hit to earnings.

In the long term, the ESG (environmental, social, and governance) merits of both private and public markets' investments are a strong driver of their long-term value and risk profile. With increasing public and media scrutiny of climate issues, social polarization, workers' rights, and corporate governance, a focus on ESG is instrumental in protecting investors from risks associated with contingent liabilities that can destroy future value. Ultimately, quality companies with a lower perceived risk can command a lower cost of capital and therefore a potentially higher return for their shareholders."

While each portfolio and circumstance is different, can you discuss strategies specific to HNW clientele concerning rising interest rates, especially regarding fixed income?

"Financial markets have suffered as problematic inflation levels have upended the classic counterbalancing of bonds and equities with a rapid and sharp revaluation of bonds alongside equities.

We [at RBC] acknowledge the futility of timing the market bottom, so instead we think about what an eventual stabilization in rates, and consequently equity valuations, could look like and how we can position portfolios to generate stable and consistent returns throughout a market cycle.

At this juncture, inflation is the main determinant of the path forward for interest rates and consequently fixed-income instruments. The low yields of the past couple of decades have led many investors to increasingly reach for yield in lower rated segments of the bond market, and this year's sharp and rapid rate hikes may have led some to question the wisdom of maintaining an investment-grade bond allocation.

Should inflation decline, however, as our firm expects it to, the stabilization in rates would be a nice tailwind for investment-grade bonds and a good reason to shore-up a potential under-allocation to this segment."

Does the current state of the market affect how clients should be looking at alternative and real assets?

"Over the past decade, investors with a long time horizon have increasingly looked to alternative strategies, and in particular private markets alternatives, as a good diversifier with low to no correlation to the public markets. The past year has really hit home the benefits of this diversification as private markets alternatives, and in particular real assets, have held up much better, with some posting positive returns in what has largely been a sea of red numbers for bonds and equities.

Our firm views manager skill as the key to long-term success in a well-diversified alternatives program, as there is a much wider dispersion of returns across alternatives managers compared to traditional bond and equity managers.

Over the past decade, alternatives managers' reliance on leverage to boost returns has led to phenomenal outcomes in an era of cheap money. As the cost of borrowing has increased, however, investors will do well to review their current manager roster and sharpen their pencils on due diligence of future managers, with a focus on the level and terms of the leverage embedded in these strategies. Going forward, higher borrowing costs can separate the wheat from the chaff with great returns primarily being driven by manager skill, rather than higher turns of leverage."

Kate Pal, president and estate planning advisor, Toronto-based Pal Insurance

What are the major concerns of very high-net-worth clients or family offices, who tend to favour capital preservation and have a longer horizon (if that is, in fact, what you are finding)?

"Most successful high-net-worth … families think longer in term than public companies run by an executive management that tend to think shorter in term, focusing on more immediate earning results, quarterly reports for analysts and stock price for shareholders. Privately held family businesses have less scrutiny or immediate pressure, providing them with the luxury to be able to think with a longer time horizon. They tend to develop plans with an outlook in terms of decades, with a focus on future generations. Their major concern is capital preservation and a proper succession plan for the next generation to be educated and aware of their role as custodians of the family capital."

What are major considerations for 2023?

"Major concerns for these high-net-worth private family businesses are educating the next generation, having the appropriate organizational structure, ensuring good open communication within the family, having a strong advisory team and an overall succession plan.

As the baby boomer generation ages, we are seeing an increase in transfers of family capital and family leadership. Families are focused on ensuring they have completed the required planning – both hard and soft aspects – to see the next generation continue to thrive and manage capital successfully."

What factors should clients be taking into account in terms of risk management?

"Management factors to mitigate risk will include: controlled use of debt and leverage; maintaining a strong balance sheet; continuing to build strong management teams with a focus on earning employee trust and loyalty and being prepared to take advantage of growth opportunities or unusual market opportunities that may arise.."

While each portfolio and circumstance is different, can you discuss strategies specific to HNW clientele concerning rising interest rates, especially regarding fixed income?

"For the first time in a long time, interest rates have risen and at a fast pace. Many of our client families approach life insurance as an asset class and treat it as their long-term fixed income. Life insurance cash values grow tax sheltered which enhances the yield policy holders would otherwise receive on fixed income. Higher interest-rate environments are unsettling for many investors but are good for many permanent life insurance funds and their policies' performance."

Responses have been lightly edited for clarity and length.