ECHELON WEALTH PARTNERS

Weekly Insights

Fast Markets

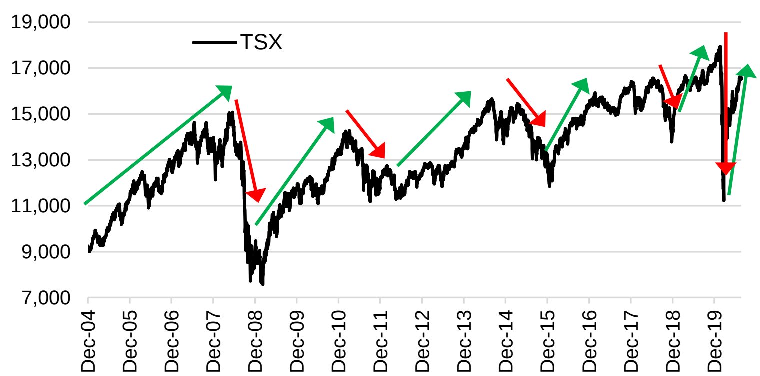
14 September 2020

For those paying attention to markets this year, most would agree that 2020 has not just been an eventful year but one of record speeds. The February correction that grew into a bear market set all-time record speeds for a correction (-10% decline) and bear market (-20% decline). It took eight days from the market high on February 20 to breach correction territory and only 21 days to reach bear market territory. The market then bottomed on March 23 and started its record speed ascent. All the while it managed to avoid, surprisingly, getting the bends by rising 55% over 142 days. Within that rise, there has been a 6% one-day decline and a 7% decline over 3 days. There have also been many pretty big up days.

We would not view the market gyrations of the past year as a new normal. It is a market wrestling with the massive uncertainties of a pandemic, a self-induced recession, an unprecedented stimulus, plus a "little" election, trade tussle, etc. However, compared with past years, the market appears to have moved faster than before and continues to enjoy/suffer bigger swings up/down. When we say "fast," we mean prices changing quickly.

Has something changed? The truth is markets always change and evolve over time. The makeup of equity ownership changes; the behaviour of investors changes; the composition of the market itself changes; technology clearly changes; and the different options on how to invest in the market is always changing. Things change and one of the by-products of many of these changes appears to be a market that moves faster.

Chart 1: Big market swings, both up and down



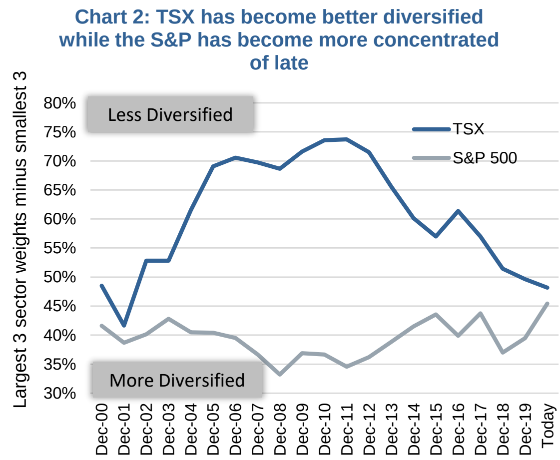
Market Participants - Decades ago, most equities were owned by a small subset of the population (the "rich") who often were entrepreneurs themselves. Today, equity ownership is very much more widespread across the population and includes many additional entities. The democratization of investing has come a long way, allowing broader participation without requiring a sizeable net worth to get started. This was started by the pooled fund (mutual funds) and has accelerated with Exchange Traded Funds (ETFs) and other vehicles. This broader participation likely provides better market stability, but of course it depends on how they behave.

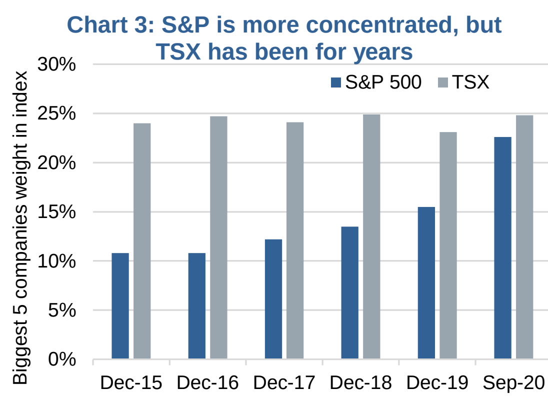
Investor behaviour has changed. In the 1950s, the average holding period for an investor in an individual stock was over 10 years. Now that was buy-and-hold!! This plummeted to less than 2 years in the early 2000s and now sits around 3 years. Time horizons have shrunk, which means that the shareholders of a company change faster now. This would contribute to faster-moving prices when these behaviours are tilted in one direction or another.

Market Composition – The equity markets used to be pretty small. With global equity markets near $90 trillion, this is triple what it was only 20 years ago. The size of the market is less important; but how it is diversified is the key for better price stability or faster-moving market prices. The good news is that $90 trillion is spread over many countries and even those with a hefty weight (U.S.), many of those companies are more multinational. This likely helps price stability.

Unfortunately, while the global markets may be well diversified geographically, many individual markets are not well diversified. When individual investment, or the overall market, becomes too concentrated, this can lead to faster market moves (in both directions). This concentration is evident in some markets today. Measuring the largest three sector weights, less the smallest three, provides a lens into how well diversified a market is from a sector perspective (Chart 2).

Concentration is a risk in today's market. At the company level, the top 5 biggest companies in the S&P 500 have risen from carrying a 10% weight to 24% over the past five years (Chart 3). This increases single company risk and can lead to bigger index moves (a faster market). That being said, the TSX has been living with high single-security exposures for years.





Technology & How to invest – This has been the big enabler of faster markets. This is not just from the perspective that an order to buy or sell is executed in milliseconds, but from an information and cost perspective. Information travels faster than ever, which means that news is disseminated quickly around the world. Regardless of whether the news is good or bad, this can cause many market participants to react at the same time and in the same direction, moving markets. Of course, the interpretation of information is the difficult part of making money, but that is a much bigger topic.

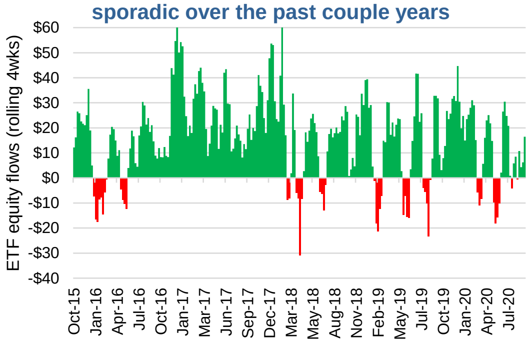
Lower costs, due to technology advancements, have enabled many different investment vehicles and strategies that likely contribute to faster-moving markets. "Robinhood" zero-cost trading is perhaps the latest example. Fees in the investment world have increasingly shifted from a fee to transact and more towards a fee for advice, whether overall portfolio/planning advice or portfolio management services. This has encouraged a new generation of speculators of late.

Frictional costs (i.e. the direct and indirect expenses associated with the execution of a financial transaction) have also come down, which is evident in the average Bid/Ask spread. There was a time this was material and now for many highly liquid securities, it is measured in pennies or even fractional pennies. All this enables different strategies, many of which fuel faster markets.

Then there are ETFs. The rise of ETFs has been a boon for investors, providing market exposure at a much-reduced cost measured by the management expense ratio (MER). This, along with the rising use of futures, has enabled both individual and institutional investors to add or reduce market exposure very quickly, if desired. It would appear that there are more and more investors engaging in this approach of adding or removing market exposure. All this, of course, feeds into a faster market.

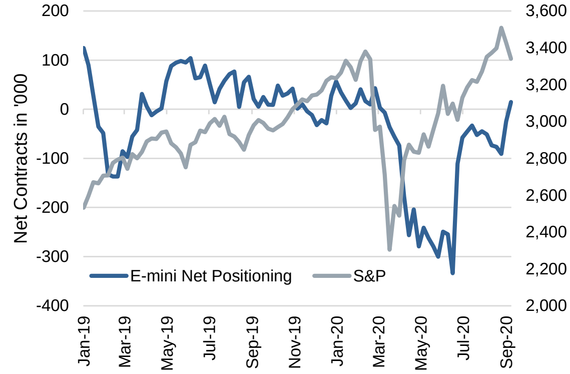
ETF Flows – The secular trend of greater ETF use has continued, but it would seem their usage has evolved beyond inexpensive passive market exposure. Chart 4 reveals that flows come in and out pretty quickly over time. And just look at the largest ETF, SPDR S&P 500 ETF. With 900 million shares outstanding, this ETF trades about 90 million shares a day. That means it would trade its outstanding volume ever 10 trading sessions. This is clearly used well beyond buy and hold investors.

Chart 4: ETF flows have become more sporadic over the past couple years



Futures – The use of futures to add and reduce market exposure has increased dramatically compared to the past decade. While some of this activity can be attributed to hedging, when these net exposures change quickly, there is a direct impact on the market. And since these moves occur quickly at times given the number and size of participants in this marketplace, the overall market moves. (Chart 5)

Chart 5: Futures are increasingly being used to add / remove market exposure



Part of the New Normal

It is unlikely that many of these trends will reverse in the years ahead, which means that faster-moving markets are likely here to stay. This is not necessarily a negative as larger market moves open the door to being tactical or more opportunistic. For buy-and-hold focused investors, managing the emotional toll of faster-moving markets will be key to avoid making behavioural mistakes. But keep in mind that by the time investors become comfortable with the new normal, the market is sure to change once again.

Charts are sourced to Bloomberg L.P. unless otherwise noted.

Forward Looking Statements

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