Five years ago the S&P 500 bottomed out at an index level of roughly 676. Since the March 2009 low, it’s gained almost 180% - not including dividends.

When we look back at the global stock market plunge following the collapse of the U.S. real estate market and the September 2008 bankruptcy of Lehman Brothers, perhaps the strength of the rebound makes perfect sense.

Consider it a kind of twisted lesson in physics, stock market style: what goes down must come up. In technical terms, we’re talking about mean reversion – the theory that prices and returns eventually move back to their historical average.

Of course the word “must” is an overstatement, and the theory of mean reversion is just that – a theory. A stock price that plunges on news of bankruptcy, corporate fraud, patent rejection, legal action, political interference, natural disaster, and any number of other reasons, may never go back up.

But in the case of the 2008-09 financial crisis, stepping into the fray when investors were running for the exits was clearly a good idea.

No one knows this better than Warren Buffett, who on October 16, 2008, declared: “Buy American. I am.” Keep in mind that when Buffett wrote his opinion piece for the New York Times, the S&P 500 still had another 29% left to fall before it hit bottom. On this matter of timing it’s worth quoting Buffett at length:

> I can’t predict the short-term movements of the stock market. I haven’t the faintest idea as to whether stocks will be higher or lower a month — or a year — from now. What is likely, however, is that the market will move higher, perhaps substantially so, well before either sentiment or the economy turns up. So if you wait for the robins, spring will be over.


At the time, I was also looking at some very compelling valuations. I saw that risk was “cheap,” and within my mandates, I was increasing my equity positions to take advantage of what I thought would eventually be a sizable rebound. I didn’t know when it would happen, and I certainly didn’t time everything perfectly. But I can say with confidence that I participated to the extent I felt appropriate under the circumstances, and that investors whose money I was managing participated right along with me.
While we might not go so far as to say it’s back to business as usual in the markets, the chart below paints a pretty clear picture of “then” and “now.”

STRESS RELIEF

The Federal Reserve Bank of St. Louis publishes the “Financial Stress Index” every week. It’s a composite index, made up of 18 weekly data series, measuring everything from interest rates to yield spreads to volatility. Index values below zero suggest “below-average” financial market stress, while values above zero suggest “above-average” stress.

Based on the chart, financial markets appear downright relaxed. Of course one can never be too complacent – a contrarian might point out that with values hovering around minus one, the index is in the same territory it was in right before the crisis of 2008.

Setting aside the potential for another black swan, the table below offers another potentially constructive physics lesson – that for every action, there’s an equal and opposite reaction.

A REVERSAL OF FORTUNE

<table>
<thead>
<tr>
<th>5-YEAR RETURN TO FEB. 28, 2009</th>
<th>5-YEAR RETURN TO FEB. 28, 2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canadian bonds</td>
<td>26.4%</td>
</tr>
<tr>
<td>Emerging market stocks</td>
<td>20.2%</td>
</tr>
<tr>
<td>Canadian stocks</td>
<td>3.9%</td>
</tr>
<tr>
<td>Global developed market real estate</td>
<td>-25.9%</td>
</tr>
<tr>
<td>Commodities</td>
<td>-27.6%</td>
</tr>
<tr>
<td>U.S. stocks</td>
<td>-29.0%</td>
</tr>
</tbody>
</table>


Two of the worst performers in the five-year period to March 2009 were U.S. stocks and global developed market real estate. In the five years since then, they jumped to the top of the list, with gains for those two asset classes exceeding the others by a substantial margin.
The best performer of the group in the pre-crisis period was Canadian bonds. In the post-crisis period, it was the second-worst performing asset class.

Note that despite some recent weakness, emerging market stocks were in the top half of the list in both periods. Commodities were near the bottom. Past performance is certainly no guarantee of future returns, and we like to think that history doesn’t repeat itself.

But any rearview perspective on market activity prompts the usual question: what now?

We would agree the so-called easy money has been made. The 12-month price-to-earnings ratio of the S&P 500 is hovering around its long-run average, and asset classes that saw correlations converge during the crisis have returned to more historically recognizable relationships.

In our view, current conditions – and what we see as the trend of current conditions – underscore the importance of active management today.

To get an idea of the change in correlation among U.S. stocks since the downturn, we can look at the CBOE S&P 500 Implied Correlation Index. The Chicago Board Options Exchange uses option prices to measure how stocks listed on the S&P 500 move in relation to each other.

Note the spike in correlation during the height of the crisis. Since late 2011, U.S. stocks have been growing increasingly uncorrelated – reverting back to a more medium-term average. Such an environment can provide active managers greater opportunity to beat the index through stock selection.

So for us, part of the answer to the question “What now?” means continuing to favour actively managed funds over passive funds within our managed solutions. The ability to shift emphasis between active and passive based on market conditions provides a flexible overlay to our long-term portfolio strategy.

Overall we continue to see value in equities, despite some hefty gains – especially in light of what we view as a very limited opportunity set in bonds. We’re favouring U.S. and international stocks, and we remain largely negative on Canada. We’ve been bullish on U.S. stocks for a few years now, and our overweight position has been a key contributor to the strength of our Sun Life Granite Managed Portfolios.

That history can be a great teacher is clear. It’s taught us time and again (and again, and again…) the importance of maintaining a portfolio that’s balanced between stocks and bonds – especially during financial market upheaval.

It’s also taught us – as it’s taught Warren Buffett and plenty of other investors – that in general, over the long term, stock markets rise.
Sun Life Granite Managed Portfolios invest in mutual funds and/or exchange traded funds (ETFs).

Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated.

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