Market Commentary
Fourth Quarter 2015

CI Investment Consulting

Portfolio Series and Portfolio Select Series

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Market performance

Monetary policy and oil prices were the two main factors driving the performance of capital markets in 2015. Quantitative easing in the Eurozone and Japan continued to fuel equity markets and support bond prices. In the United States, where the central bank began to tighten, equity markets produced a small positive total return in local currency terms. Meanwhile, lower crude oil prices continued to pressure Canadian equities and the dollar, with the decline in the dollar leading to impressive returns for Canadians investing in foreign securities. For example, the S&P 500 Index in Canadian dollar terms gained 20.8% in 2015, but 19.4% of the return was contributed by the currency conversion.

Returns in % at December 31, 2015	**3 mo**	**1 yr**	**3 yr**	**5 yr**	**10 yr**
S&P/TSX Composite Index	-1.4%	-8.3%	4.6%	2.3%	4.4%
S&P 500 Index (C$)	11.0%	20.8%	28.6%	20.2%	9.2%
MSCI World Index (C$)	9.5%	18.7%	23.1%	15.5%	7.4%
FTSE/TMX Canada Universe Bond Index	1.0%	3.5%	3.6%	4.8%	5.0%

Source: Bloomberg, FTSE/TMX

While the year-end results in the markets were generally attractive (with the exception of the Canadian stock market), investors faced significant volatility throughout the year. Chart 1 shows that capital markets had a very challenging second half. The Canadian stock market, as measured by the S&P/TSX Composite Index, peaked on April 15, 2015 with a 6.5% return for the first few months of the year. However, it lost 13.9% in the subsequent months to end the year with an 8.3% loss.

While some asset classes had positive returns for the year, they were still lower than their highs within the same period. For example, the domestic bond market, as represented by the FTSE/TMX Universe Bond Index, was up 3.5%. However, all of the gains came in January, as the index declined over the next 11 months. At one point, investors assumed that the worst was over for the oil sector. Oil prices (West Texas Intermediate) gained 15% in the first five months of the year, but then went on to lose 40% during the next seven months. Oil ended the year with a 30% loss.

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Chart 1: Performance of key markets in 2015

	Peak Date	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total 2015 Return
FTSE TMX Universe Bond Index	2/2/2015	4.8%	-1.2%											3.5%
Merrill Lynch High Yield Master II (USD)	5/29/2015	4.1%					-8.4%							-4.6%
S&P/TSX Composite Index	4/15/2015	6.5%				-13.9%								-8.3%
S&P/TSX Preferred Share Index	n/a	-15.0%												-15.0%
S&P500 Index (USD)	7/20/2015	4.5%							-3.0%					1.4%
MSCI World Index (Local currency)	5/21/2015	8.5%					-5.4%							2.6%
WTI Oil	6/10/2015	15.3%					-39.7%							-30.5%

Source: Bloomberg

Portfolio Series and Portfolio Select Series

Despite a challenging backdrop, 2015 was another rewarding year for our global multi-asset strategies. We are pleased to report that for the calendar year, all of our investment portfolios achieved positive returns for our clients. Portfolio Series Income Fund, which is a portfolio designed for investors with a short-term investment horizon, gained 4.5% for the year. Investors who can tolerate greater short-term volatility and plan to invest for at least five years would have gained 4.3% by investing in Portfolio Series Balanced Fund. The income fund benefited from a larger exposure to the global bond market, which was last year's best-performing major asset class.

We were able to navigate the remarkably high intra-year volatility by being defensively positioned going into the second half, having trimmed our equity holdings and having a low energy exposure. These tactics helped our portfolios retain gains. Portfolio Series Income Fund gave up just 0.3% and Portfolio Series Balanced Fund incurred a 2.3% decline from April 15 to the end of the year, while the S&P/TSX Composite Index incurred a double-digit loss over the same period.

Looking back at another successful year, we note that our performance could have been slightly higher had we been slower in taking profits from our foreign currency exposure. However, this would have involved taking more risks by maintaining significant exposures to the top-performing currencies, whose valuations had become less appealing. Instead, we stuck to our disciplined approach of buying low and selling high even though the highs, in some cases, went even higher. We believe that following a disciplined approach leads to consistent performance over an investor's time horizon and is the best way to ensure that clients' investment goals are achieved.

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Returns in % at December 31, 2015	3 mo	1 yr	3 yr	5 yr	10 yr	Life
Portfolio Series Income Fund	1.7	4.5	6.8	6.2	5.1	5.4 (Dec. 97)
Portfolio Series Conservative Fund	2.3	4.1	7.9	6.0	4.6	5.2 (Dec. 97)
Portfolio Series Conservative Balanced Fund	2.5	4.0	9.0	6.5	4.6	5.0 (Dec. 01)
Portfolio Series Balanced Fund	2.8	4.3	9.7	6.8	4.6	7.0 (Nov. 88)
Portfolio Series Balanced Growth Fund	3.3	4.4	10.6	7.1	4.5	4.8 (Dec. 01)
Portfolio Series Growth Fund	3.8	4.5	11.6	7.5	4.5	4.5 (Dec. 01)
Portfolio Series Maximum Growth Fund	4.4	5.2	13.4	8.1	4.4	4.2 (Dec. 01)
Select Income Managed Corporate Class	0.6	1.7	3.8	4.1	n/a	3.9 (Sept. 10)
Select 80i20e Managed Portfolio	1.1	1.9	5.5	4.9	n/a	3.8 (Nov. 06)
Select 70i30e Managed Portfolio	1.5	2.0	6.3	5.3	n/a	3.8 (Nov. 06)
Select 60i40e Managed Portfolio	1.8	2.0	7.2	5.7	n/a	3.8 (Nov. 06)
Select 50i50e Managed Portfolio	2.1	2.3	8.1	6.1	n/a	3.8 (Nov. 06)
Select 40i60e Managed Portfolio	2.5	2.4	9.1	6.6	n/a	3.8 (Nov. 06)
Select 30i70e Managed Portfolio	2.7	2.5	9.9	7.0	n/a	3.7 (Nov. 06)
Select 20i80e Managed Portfolio	3.1	2.7	10.9	7.4	n/a	3.7 (Nov. 06)
Select 100e Managed Portfolio	3.8	3.1	12.8	8.2	n/a	3.5 (Nov. 06)

All fund returns are for Class A units/shares

Select Income Managed Corporate Class

In the Select Income Managed portfolio, which is optimized for a short investment horizon, we are positioned to be a "credit lender" and less of a "shareholder" for 2016. We have 40% exposure to corporate bonds (investment grade and high yield), which yield 6% on aggregate. Unless P/E multiples expand, a 6% yield from income is competitive when compared to stocks that offer approximately 4% earnings growth and a 2% dividend yield. We expect our credit weighting to grow over the next six months.

We have been gradually reducing our equity exposure as valuations have gone from being undervalued to fairly valued over the past five years. Recognizing this is an income portfolio, we own only modest exposures to equities when they are undervalued and do not need to own them when they are at fair values or above. To manage the negative implications and growing risks of a global recession, we hold a sizeable government bond weighting (one-third Canada, two-thirds global) with a duration of 8.5 years. This component will grow in sync with the increasing credit weight. The majority of it is invested in U.S. Treasuries with the U.S. dollar exposure hedged. The government bond portion earns a positive carry from a yield of approximately 2%. This effectively means that we are getting paid to hedge.

We "stress test" this portfolio on an ongoing basis and position it for a net-of-MER downside of no more than 6% for any 12-month rolling period. This downside risk is more conservative than what investors should expect when investing in a bond fund or the bond index. The last time we approached something close to this was when we had a negative one-year return of 4.1% as of February 2009 (when the S&P/TSX Composite Index lost 38.2% over the same period). We recovered the "loss" within the following four months. Most importantly, investors who held the fund for two years from February 2008 to February 2010 earned a cumulative return of 9.9%. Since its inception, the fund, net of its Class A MER, has had more positive months than the Canadian bond index (91 of 121 months, versus 77 of 121), which reflects the high level of consistency.

Overall, the portfolio is generating a yield of 3.5% with a duration of five years. This compares to a 2.0% yield and 7.4 years duration for the FTSE TMX Universe Bond Index. We have been very active over the past few days and weeks in light of the heightened volatility. As correlations between asset classes continue to normalize, we will expect to deploy more cash.

Outlook and positioning

In a "lower for longer" setting, where earnings will likely fall short of the year's expectations, we see an increasing need to focus on high-quality businesses and avoid chasing past winners. Government bonds will continue to act as an attractive offset to equities in conservative and balanced portfolios, especially in the most stressed market environments. While oil has the potential to take the Canadian dollar lower, we note that the U.S. dollar is a highly crowded trade and we see limited benefits to having heavy exposure to it. Instead, we prefer to hold an underweight position in the energy equity sector and focus on foreign companies, while ensuring that the majority of our U.S. dollar exposure is hedged back to Canadian dollars.

Lower for longer, accompanied with increased short-term volatility, presents both challenges and opportunities. While we are patient investors, we do not hesitate to act when opportunities arise. For example, we have recently increased our high-yield bond exposure across the portfolios. The credit spread, which is a gauge of the premium investors receive for taking credit risk, has widened by over 350 basis points over the last year and a half. We believe downside risk is low at current valuations. However, to further hedge the downside risk of high-yield bond investments, we have been adding government bonds to our portfolios. The two asset classes are generally negatively correlated, making for an attractive pair in various economic environments. Consider a robust economic environment where default risks of high-yield issuers decline. This would be positive for high-yield bonds as credit spreads tighten, while negative for government bonds as investors would shun safe investments. In a recessionary setting, government bonds would be in favour while high-yield bonds would be out of favour. Owning the two together, at a 50-50 split, generates a yield of approximately 5.5% with little expected capital gain or loss in almost any economic scenario due to the negative correlation. This pair of investments is represented in all of our income and balanced portfolios.

Additionally, we are making enhancements to a number of the conservative and balanced portfolios inside our Portfolio Select Series program. Since the creation of Portfolio Select Series, we have typically used four multi-manager pools to construct each of the nine portfolios designed for a broad range of investors; we are now introducing a fifth component – Signature Global Bond Fund – to the following funds: Select 60i40e Corporate Class, Select 50i50e Corporate Class, Select 40i60e Corporate Class and Select 30i70e Corporate Class. With currently attractive bond valuations and improving correlations, this is an opportune time to modestly increase duration within the income components of the equity-centric portfolios without sacrificing total return potential. The most aggressive funds are designed for investors who can tolerate more risk while the most conservative portfolios already have sufficient duration exposures given their smaller equity exposures; as a result, the changes are not required in those funds.

Following a stretch of multi-year stock market expansion, the priority should be to preserve capital and retain gains for all but the most aggressive investors. Holding cash may be one option but it is far from the ideal solution given the undesirable effects of inflation. And with a lower dollar, Canadians should be prepared for higher prices for imports. We anticipate another busy year as we are looking forward to capitalizing on the opportunities that arise.

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