Portfolio Select Series Commentary

Third Quarter – 2019

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Market performance

Throughout the third quarter of 2019, risk appetite remained high as central banks delivered on their promise by cutting interest rates. The European Central Bank cut deposit rates to -0.5% and the U.S. Federal Reserve cut rates twice during the quarter, bringing the federal funds rate to a range of 1.75-2.00%. Investors seemed to have paid little attention to the risk of Brexit and global trades.

Fixed-income performance was above trend as investors pivoted from pricing in rate hikes to rate cuts. For example, the 10-year Government of Canada bond yield fell by over 100 basis points over the last year.

It is worthwhile to note that Canadian equities actually outperformed their U.S. and global counterparts during the last 12 months. Factors that contributed to outperformance included: the relative strength of the Canadian dollar as the Bank of Canada bucked the trend by not cutting interest rates; and very low expectations for Canadian companies a year ago, resulting in investors receiving a decent return and solid dividend, and not being disappointed even though earnings were not outstanding.

Benchmark returns in % at September 30, 2019	3 months	1 year	3 years	5 years	10 years
S&P/TSX Composite Index	2.5	7.0	7.4	5.3	7.9
S&P 500 Index (C$)	2.9	6.7	13.7	14.6	15.7
MSCI World Index (C$)	1.9	4.3	10.5	10.9	11.3
FTSE Canada Universe Bond Index	1.2	9.7	2.7	3.9	4.4

Source: Bloomberg Finance L.P., FTSE

Portfolio performance

Our portfolios delivered attractive returns as a result of strong market performance and our asset allocation decisions, despite the roller coaster ride markets went through during the last 12 months. In October of 2018, investors were expecting rate hikes, economies to slow, and Canada to disappoint, but the marijuana sector to boom. Sentiments changed quickly in early 2019 when central banks turned dovish following a large market correction in the fourth quarter of 2018. Investors began to price for rate cuts and economies globally were still slowing, but investors ignored this fact. Canada actually outperformed other markets, but not because of marijuana stocks. The value of marijuana stocks has been cut in half within the last year as prices were ahead of fundamentals and speculation eventually subsided with poor price momentum. It is fair to say that for a lot of Canadian investors, it was not that difficult to earn positive returns given the strength of the broader markets. However, the markets also exhibited unusual volatility that may have caused investors to change course. We received some criticism last year for our decision to hold government bonds and not allocate to marijuana stocks, but we adhered to our investment process and protected our investors' capital, keeping them out of trouble.

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Returns in % at September 30, 2019 (Class F)	3 months	1 year	3 years	5 years	10 years
Select Income Managed Corporate Class	1.5	8.2	2.3	3.3	n/a*
Select 80i20e Managed Portfolio Corporate Class	1.4	6.8	3.0	3.7	5.4
Select 70i30e Managed Portfolio Corporate Class	1.4	6.3	3.3	3.9	4.7
Select 60i40e Managed Portfolio Corporate Class	1.4	5.8	3.6	4.1	6.2
Select 50i50e Managed Portfolio Corporate Class	1.4	5.2	3.9	4.3	6.5
Select 40i60e Managed Portfolio Corporate Class	1.3	4.5	4.4	4.6	6.9
Select 30i70e Managed Portfolio Corporate Class	1.3	4.0	4.7	4.8	7.3
Select 20i80e Managed Portfolio Corporate Class	1.2	3.2	5.3	5.2	7.8
Select 100e Managed Portfolio Corporate Class	1.0	1.7	5.9	5.7	8.5

**Since inception return: 4.1% (Sept. 2010)*

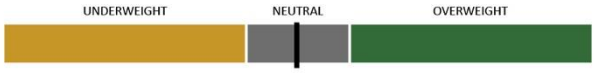
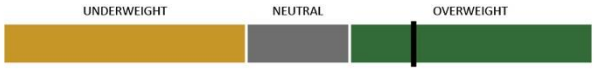
Select Income Managed Corporate Class

This portfolio is catered to capital protection. We understand both equity and fixed income have their own risk characteristics. Even though fixed income is regarded as low risk, being 100% invested in fixed income is a high-risk proposal as it requires economies to remain sluggish to justify the low yields investors are earning.

At one point this year, over US$17 trillion of debt carried negative yield globally, meaning borrowers were getting paid to borrow and lenders were the ones paying. It is definitely unusual, but it reflects the fact that interest rates as set by central banks have turned negative. We see value in investing in Canadian and U.S. bonds as they still offer positive yields. All else being equal, growing demand from investors tired of negative yields elsewhere should provide a floor to prices.

Given fixed income has already been aggressively repriced with large capital gains and lower yields, we have cut our exposure and are carrying a larger amount of cash instead. The cut is most noticeable in non-North American government bonds. Cash is generating more interest income than bonds as the yield curve is inverted. We are maintaining equity at the range of 18-22%, serving to offset some of the portfolio interest rate risk and capturing some equity premium. We still own some gold bullion as we see value building after the price of gold stalled in 2013. Both equity and gold bullion are non-benchmark asset classes that investors typically don't find in a fixed-income portfolio, but these asset classes make a fixed-income portfolio more stable due to their diversification benefit.

Outlook and positioning

Detailed asset mix (all local currency):	
Cash	
Government bonds	
Investment-grade bonds	
High-yield bonds	
Canadian equity	
U.S. equity	
International equity	
Real estate	

Neutral weight refers to the targeted strategic asset allocation for the portfolios.
Overweight/underweight is the amount the current asset allocation differs from the neutral weighting.

It is fair to expect global economies to continue to slow even if the U.S. and China eventually reach a trade deal and avoid further tariffs. What matters to investors in the next 12 to 18 months is central bank policy. It is widely expected that more rates cuts will come and money supply will rise. Even if consumption doesn't grow, it is possible for companies to grow earnings through share buybacks and lower interest expense. Demand for risky assets will also grow as money supply increases, a trend that we have seen in the last decade. We retain our position to strategically overweight stocks but adjust on a tactical basis for any dramatic shifts in policy or sentiment.

The risk of central banks changing their tone to become less dovish or outright hawkish is possible as we enter 2020. We believe economies must improve significantly for central banks to be comfortable in withdrawing the additional stimulus that has been in place since 2019. If that happens, stocks will do just fine but fixed income will likely have negative returns as capital losses from repricing yields tend to outsize the yield being generated. It is important to be nimble and realistic.

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