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Adapting to change is part of our life

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This month, I would like to start with a quote from naturalist Charles Darwin: *“It is not the strongest of the species that survives, nor the most intelligent, but the one most adaptable to change.”* Most people are only willing to change when things are not working. As investment managers, we continuously follow changes in market dynamics and the valuations of our investments so we can adapt our mix of investments accordingly.

Market dynamics change every day as investors go through bullish and bearish sentiment cycles. The changes are largely driven by company news, economic data, and unexpected political and natural events. Market dynamics affect investment performance over the short term and have very little impact over the long term. Valuations, on the other hand, matter less over the short term, but are an important driver of long-term performance. As investment managers, we focus on valuations but we are also mindful of changes in market dynamics.

We are currently monitoring three big-picture events: volatile oil prices, unconventional central bank policy and the growth slowdown in China.

Oil prices have spiked recently as a result of the weaker U.S. dollar and speculations that major oil-producing countries will cut or contain oil supply. Oil companies and the Canadian dollar have rallied even more to price in further growth. Even if oil prices continue to rally to US\$60 or higher, it is unlikely that we will see capital spending in the Canadian oil industry in the near term. The industry has high marginal costs and oil companies need steady and higher prices to commit to new projects. This means that Canadian GDP will not benefit fully from high oil prices and with the higher Canadian dollar, we are losing competitiveness in the manufacturing sector. The recent rally in the Canadian dollar has probably gone too far.

In terms of unconventional central bank policy, the U.S. Federal Reserve has finally compromised and provided more dovish guidance on interest rates as a result of 1) tight local credit market conditions; 2) weak global growth, including challenges in emerging countries that are being driven by lower commodity prices and high funding costs in U.S. dollars; and 3) the appreciation in the U.S. dollar, which has reduced the competitiveness of U.S. companies and the earnings of multinational companies that report their earnings in U.S. dollars. The change in tone moved the markets, to say the least. The high-yield credit spread tightened 200 basis points over the last three months, stocks rallied 10% from their low in February

2016 and the U.S. dollar depreciated. Elsewhere, the Bank of Japan is trying out negative interest rates and the European Central Bank has expanded its quantitative easing.

In China, there are more problems than just low growth. The country is targeting growth at 6.5-7.0%, which is great, if it is achievable. However, there are many factors that can influence China's growth. They include, at the least, capital flows and pollution. Although pollution is not on the radar for many investors, it does limit how much manufacturing and infrastructure can grow.

We recognize that any new developments in these areas can affect investor sentiment and short-term investment performance. These developments can be somewhat unpredictable. Fortunately, over the investment horizon of our investors, valuations and quality matter more, and are also more predictable for those who do their research and due diligence.

We are probably not the first to tell you that stocks are not as attractive as they were five years ago when investors were skeptical about growth and central bank policies. In terms of valuation, we are at the middle of the range between the trough in 2009, during the global financial crisis, and the peak in 1999 during the technology bubble. Market returns going forward will likely be positive, but unlikely to be in the double digits.

The risk and potential of government bonds is misunderstood by the markets and we believe the downside risk is low in certain countries. We have overweight exposure to U.S. Treasury bonds as we do not expect the Fed to deliver the interest rate hikes that the markets have priced in. In addition, U.S. Treasuries also offer an interest premium to other G7 countries. For example, a 10-year U.S. treasury has a yield of 1.75%; this compares to 1.32% in Canada, 0.15% in Germany and -0.11% in Japan.

We have made adjustments to our portfolios as a result of current market dynamics and valuations. The following is a summary:

1. We increased the duration of both Canadian fixed-income and global fixed-income investments. Generally, higher duration rewards investors with greater interest income, and in difficult economic times, it produces strong performance to offset equity risk.

	March 2016	December 2015
Canadian fixed income	6.0	5.5
Global fixed income	8.5	7.7

2. We increased U.S. dollar exposure across all portfolios. We hedged as much as 80% in our U.S. equity pools when the U.S. dollar traded at C\$1.46. Recently, when it traded at \$1.26, we brought the hedge ratio down to 47%. This means that for every dollar of U.S.-dollar-denominated investment, our actual

exposure was as little as 20 cents. Currently, the exposure is at 53%. At the portfolio level, U.S.-dollar exposure has increased in a range of 2.4% to 7.7% as shown below.

	80i20e	70i30e	60i40e	50i50e	40i60e	30i70e	20i80e	100e
Change in U.S. dollar exposure	2.4%	3.2%	4.2%	4.6%	5.5%	6.4%	6.7%	7.7%

3. We decreased equity exposure through an asset mix change in the enhanced income mandate and simultaneously added exposure to government bonds.

	March 2016	December 2015
Stocks and real estate income trusts	21.3%	36.0%
High-yield bonds	29.8%	30.5%
Government and investment-grade bonds	30.3%	19.8%
Cash	18.6%	13.7%

As a result of the change to the enhanced income mandate, our portfolios now have lower equity exposure.

	100i	80i20e	70i30e	60i40e	50i50e	40i60e	30i70e	20i80e
Change in equity exposure	-6.0%	-3.2%	-2.7%	-2.1%	-1.5%	-0.9%	-0.6%	-0.5%

The changes are smaller in the portfolios where investors are expected to hold investments for a longer term as time allows performance to normalize. We expect that in the long term, equities will deliver a premium to bonds.

It is important to remember that these changes are not static. We will continue to apply a disciplined process to adjust the asset mix in our portfolios to meet investors' objective of attractive risk-adjusted returns.

Combined top 15 equity holdings as of April 30, 2016 of the Evolution 40i60e Standard portfolio with Alpha-style exposure:

1. Microsoft	6. Alphabet – Class C	11. Thermo Fisher Scientific
2. Atco	7. Toronto-Dominion Bank	12. Simon Property Group
3. Manitoba Telecom Services	8. Chubb	13. UnitedHealth
4. Altagas	9. CIBC	14. PrairieSky Royalty
5. Tourmaline Oil	10. Synchrony Financial	15. Brookfield Infrastructure

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