Insights & Strategies

PRIVATE CLIENT SOLUTIONS

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Inside this Issue

What's Your Allocation?

In our 2018 Outlook (published on January 12), we outlined the reasons why we remain fundamentally bullish on the market, and explained that we are late in the equity market cycle. Late market cycles characteristically exhibit some of the best equity market returns, which is one of the reasons from an asset allocation perspective why we remain overweight equities and underweight bonds. Another characteristic of late market cycles is the tendency for equity market volatility to increase, which may surprise many investors due to the subdued volatility over the past couple of years. In this light, the volatility experienced in February is a precursor for investors as we transition from a period of relative calm to a period of higher market volatility. Investors need to recognize this transition and ensure they are adequately prepared for significant market swings, both up and down, as the market cycle continues to mature. In this publication, we discuss ways to mitigate volatility through diversification and provide a few simple steps investors can take today to move closer to the "efficient frontier".

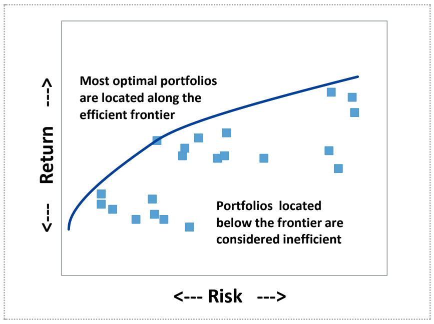
Achieving a properly diversified portfolio can be a daunting task given the myriad of investment options available to investors. The investment world has become increasingly complex with products like derivatives, hedge funds, and smart beta ETFs, but as Warren Buffett wrote in Berkshire's annual letter, investors should "focus on a few simple fundamentals" rather than looking for complicated, exotic solutions. Keeping it simple, there are three things we can do to achieve an appropriately diversified portfolio:

- Determine an appropriate asset allocation
- Diversify within your equity holdings
- Diversify within your fixed income holdings

Asset Allocation

The first step an investor can take is to determine an appropriate asset allocation. A proper asset allocation can range from 90% equities for an aggressive growth profile to 90% fixed income for a capital preservation strategy. The profile depends on an investor's long-term return objectives and risk tolerance. In theory, the optimal asset mix can be guided using the "efficient frontier", which is the set of optimal portfolios that can be constructed using a variety of asset classes and securities. The optimal combination offers the highest expected return for a defined level of risk. In practice, achieving the optimal portfolio is a little more difficult as asset returns are asymmetrical and human elements, such as home country bias, can skew allocations to particular assets and/or regions. Nonetheless, the efficient frontier provides us with a goal to strive towards.

The Efficient Frontier



Source: Raymond James Ltd.

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Current rates of return on most fixed income products pale in comparison to equity returns, but regardless we believe investors should have some element of fixed income within their portfolio. The importance of including an asset class that will exhibit a negative correlation to equities will be realized during periods of stress. As such, we view fixed income more like an insurance policy that offers protection and optionality. By owning fixed income, the cost is giving up participation in further equity market returns (this is similar to the premium you pay to the insurance company) in order to have protection during periods of stress. In theory, the fixed income components of a portfolio will not experience the same level of loss during periods of equity market volatility, which will allow investors the option to rebalance when equities are more attractive while still earning a modest return.

Equity Holdings

Investors tend to display a home bias, regardless of domicile, which is often in conflict with the benefits gained from global diversification. Home bias is the tendency to invest in domestic companies because there is a sense of familiarity and comfort. This bias is a particularly acute issue for Canadian investors given the sector concentration issues our market faces – financials, energy and materials represent 65% of the S&P/TSX, while the remaining 8 sectors represent 35%; the top 10 Canadian companies by market capitalization represent about 40% of the market. When compared to a global benchmark the concentration issues are very apparent. In a global benchmark, financials, energy and materials represent 28% and the top 10 companies in the MSCI World Index represent under 10% of the benchmark.

The first step a Canadian investor can take to diversify within equities is to ensure representation across a variety of domestic sectors. The most heavily weighted sectors in Canada are cyclical in nature, so adding defensive sectors that exhibit a lower correlation can help mitigate volatility. However, increasing exposure to non-domestic equities is an essential step to achieving more consistent returns and lowering overall portfolio volatility. Investors can add non-domestic equities, either through direct purchase, active management or a passive ETF. Taking this one simple step can enhance returns while lowering the overall risk profile of the portfolio.

Let's look at a simple example by pairing two passive ETFs, iShares S&P/TSX 60 index (XIU-T) and SPDR S&P 500 (SPY-US). From a Canadian investor's perspective with an extreme home bias of 100%, as of the end of 2017 XIU produced a 5 and 10 year annualized return of 6.1% and 3.6%, respectively. Over the same periods, the ETF experienced annual swings of 10.4% and 17.3%. The average Canadian allocates about 60% of their portfolio to domestic equity, so if we simply take the average and include a 40% allocation to SPY, the 5 and 10 year annualized numbers improve to 9.0% and 7.3%, respectively, while the volatility remains almost unchanged at 10.8% and 17.9%, over the same period. While we recommend an allocation significantly lower than 60% to Canadian equities, we know in reality Canadian investors are unlikely to allocate only 5% to Canada which is the percentage a globally diversified portfolio would suggest. Within our allocation framework, we recommend anywhere from a 20% to 28% weighting to Canadian equities, depending on your profile.

	10-yr Price Return	10-yr Standard Deviation
iShares Canada ETF (XIU-T)	3.6%	17.3%
SPDR S&P 500 (SPY-US)	12.8%	18.8%
60/40 (XIU/SPY)	7.3%	17.9%

Source: Bloomberg, Raymond James Ltd. As at December 31, 2017

Fixed Income

Similar to equities, there are many decisions one can make within one's fixed income investments. The most important decision is determining the level of interest rate sensitivity, or duration. Duration is a term that describes the sensitivity of a bond to changes in interest rates. If you're long duration, this means you have greater sensitivity to changes in interest rates and vice versa. Typically, when interest rates are rising, like they are today, investors want to be short duration (have less sensitivity to changes in interest rates). When interest rates are falling, we want to extend duration.

The next major decision is to determine the weighting to corporate or government bonds. Corporate bonds tend to do well when the economy is performing well, while government bonds tend to perform well during economic slowdowns. Within our asset allocation framework, we currently recommend investors be short duration with an overweight in corporate bonds and an underweight in government bonds.

As many investors may be unfamiliar with many of the decisions needed to build a fixed income solution, we recommend active management. Alternatively, investors can employ a simple laddered bond portfolio, which we discuss in more detail later.

Jason Castelli, CFA
VP, Portfolio Manager

Global Diversification

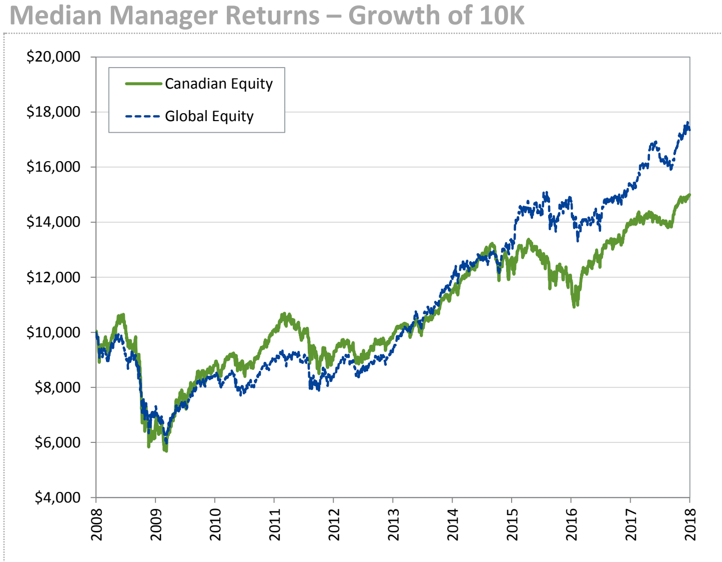
As the saying goes, "there is no better time than the present" and that couldn't be truer today for diversifying your portfolio. For Canadians, it can be tough to take a critical look at the geographic exposures in your portfolio, particularly when the S&P/TSX's 2017 total return was 9.1%, and we remain bullish on the Canadian market. However, this doesn't mean we should place all of our eggs in one basket. There are many investment opportunities that exist outside our borders, which when added to a portfolio can potentially boost return and lower the overall risk. Canada represents about 5% of the global index, but Canadian investors typically have an allocation to Canada in the range of from 20-30% to the extreme of 60-100%. Is that wrong? Well, not exactly but there could be a smoother ride out there. The Canadian economy is made up of primarily energy and financials (those sectors representing about 50%). When both of those sectors are rocking and rolling Canada is too, and the TSX will provide some excellent returns. However, when those sectors underperform, like in 2015, our market can produce lackluster returns.

The median global manager in 2015 had a return of 11.9%, while the S&P/TSX fell -8.3%. In the following year, the global manager only did 3.3% and the S&P/TSX outperformed with a 21.1% return. As one can see, owning just the S&P/TSX could create a rather volatile ride for investors. But over a long term, when you diversify globally, you can avoid the cyclical nature and volatility of Canada only holdings, ideally protecting from the major swings, both up and down (see charts). Sometimes it is hard to look at your portfolio and see that you're only up 3.3% while the S&P/TSX Composite is up 21.1% such as in 2016-17. Yet at those points just remember what 2015 felt like. Slow and steady wins the race.

There are many options to help diversify a portfolio, from passive low cost ETFs to more meaningful oversight from an active manager. Our view is grounded in the market efficiency argument. What indices can managers consistently beat over the long term (active) and where are you better off owning a cheaper beta alternative (passive)? The answer is complicated but simply put, it's hard to beat the S&P 500 and the US market in general. However, active management is much more effective internationally (and that includes segments of the Canadian market). Market efficiency and sector diversification are critical to whether an active manager can consistently add value. Active managers have historically outperformed their benchmark in less efficient segments of the market like small caps or preferred shares. From an international perspective, there are over 8,500 companies in the MSCI ACWI IMI (All Country World Index Investable Market Index). Active managers often have global resources in these local economies that can filter through the noise and identify good companies rather than holding them all.

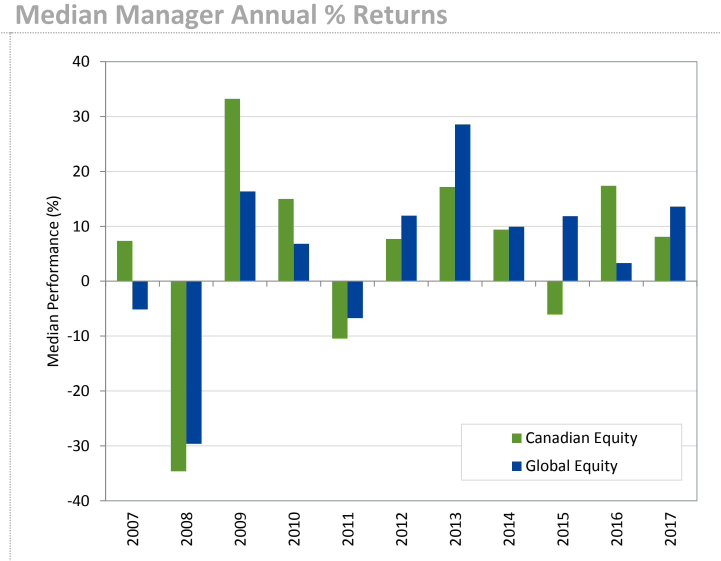
From an active management perspective, there are some excellent contenders. There is **Edgepoint Global Portfolio**, a fund run by bottom-up stock pickers from the very heart of things, and an approach that has paid off. There is the technical and critical edge provided by Guardian Capital in their **Global Dividend Growth Fund** that uses a system-

Median Manager Returns – Growth of 10K



Source: Morningstar. Raymond James Ltd.

Median Manager Annual % Returns



Source: Morningstar. Raymond James Ltd.

driven, bottom-up approach of quantitative and qualitative factors to narrow down the global universe. In the world of small caps, the **Global Alpha – Global Small Cap** fund is run by business owners at heart. They consistently deliver alpha by focusing in on only the companies and areas of the market that draw to their strengths and they are interested in.

However, for investors who prefer using a passive approach, you can either go with a pure index ETF such as **XEF-T (iShares Core MSCI ACWI ex-Canada)**. Or you can apply a screen for quality companies with strong balance sheets and competitive advantages; an approach we think continues to make sense. From an ETF perspective, two that follow this strategy are **Wisdomtree's Quality Dividend Growth ETF (IQD-T)** or the **RBC Quant EAFE Dividend Leaders (RID-T)**.

We also believe investors can benefit from active management in the fixed income space. We like **Manulife Strategic Income** as a way to gain both active management and geographic diversification. The fund is a global multi-sector fixed income product that can access any fixed income asset class from any area of the world. With discretionary portfolio managers based in Hong Kong, London and Boston, this global multi-sector fixed income fund is managed 24 hours a day, 6 days a week, and prudent risk management is the primary focus in all investment decisions. The team focuses on the management of 4 key risks to the portfolio: credit, liquidity, interest rate and currency.

At the end of the day, Canada has an excellent economy that when firing on all cylinders can produce spectacular returns. But when you're planning for retirement, it is prudent to look beyond the borders of our fair land and embrace the global capital markets.

Spencer Barnes, MSc.
Mutual Fund & ETF Specialist

Walking Safely Under a (Bond) Ladder

With the first two months of 2018 now in our rear view mirror, it's time to reevaluate the road ahead for Canadian fixed-income markets. Much like what we saw in 2017, a Bloomberg survey (see below table) shows that economists are again calling for higher yields in 2018 across the Canadian yield curve. This outlook is supported by expectations for the Bank of Canada to continue normalizing monetary policy, with two additional hikes to the overnight lending rate expected by year end.

Canada Bond Yield	Current (%)	Consensus Forecast (%)			
		Q1 18	Q2 18	Q3 18	Q4 18
30-Year	2.34	2.54	2.76	2.89	2.97
10-Year	2.18	2.33	2.42	2.54	2.66
2-Year	1.77	1.80	1.94	2.08	2.20
3-Month BA	1.68	1.66	1.75	1.92	2.06

Source: Bloomberg. As of March 2, 2018

With the prospect of rising yields on the horizon, we recommend fixed-income investors utilize shorter maturity portfolios, which would take advantage of rising rates when reinvesting proceeds from those shorter maturities. In particular, conservative investors are recommended to employ one of the three below strategies.

1) Invest in money market products or GICs with a maturity of 6-months to 1-year.

The risk/reward tradeoff of this strategy is quite appealing at this time given that the yield curve remains relatively flat, demonstrated by the fact that the spread between yields on 1-year and 5-year Canada bonds is a mere 41 basis points.

2) Creating your own ladder with positions that mature annually.

This popular strategy is one where you are always in the market though positioned in such a way that every year you have the opportunity to re-invest at prevailing market rates. This is shown in the below 1-5 year laddered portfolio. Each year an issue matures which allows you to use the proceeds to buy a 5-year bond as a replacement, thus re-activating the 5-year ladder. This approach is efficient given that every year you are putting your money back to work whether markets are trending higher or lower. However, investors should recognize that softening yields result in re-investing at lower rates as well as betting on a 5-year rate that is better than a shorter term issue.

The below sample portfolio currently yields 2.50% and has an average duration of 3.15, which equates to 3.36 years-to-maturity. Therefore, building out a 1-5 year ladder such as this is akin to investing in a 3 ½ year bond with less overall duration risk.

3) Invest in a Managed Portfolio or Guided Portfolio of bonds.

This takes the guess work out of yearly reinvestments and allows the Portfolio Manager to navigate the continuously evolving fixed-income markets. If this interests you or you are worried about diversification in your portfolio, talk with your Financial/Investment Advisor today about your alternatives.

Harvey Libby
Fixed Income & Foreign Exchange

Sample 1-5 year Laddered Bond Portfolio

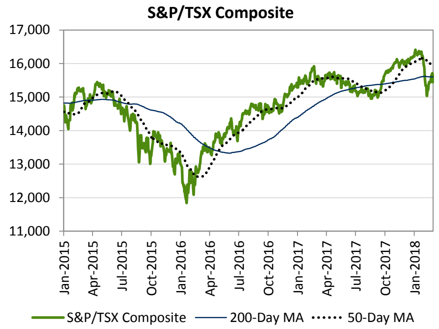
Pricing Date		Portfolio Parameters							Portfolio Value *(rounded values)*		
ISSUE PRICES AS OF:	28-Feb-18	*Weighted Rating	Total Maturity Value	Total Premium (Discount)	Weighted Yield to Maturity	Weighted Annual Equiv.	Weighted Term (years)	Weighted Duration (Mod.)	Total Accrued Interest	Total Principal Cost	Total Portfolio Investment
BOND SETTLEMENT:	Standard Conventions										
		A low	$100,000	-1.03%	2.50%	2.51%	3.36	3.15	$491	$98,970	$99,461

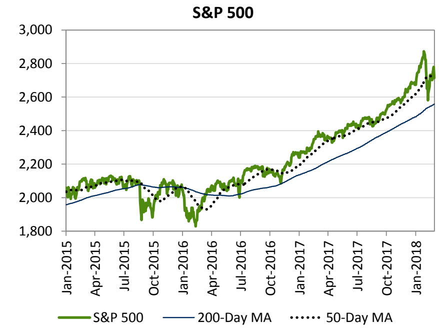
Issuer	Coupon Rate	Maturity Date	Debt Rating	Maturity (Par) Value	Offering Price	Yield to Maturity	Annual Equiv.	Term (years)	Duration (Mod.)	Accrued Interest	Principal Cost	Total Cost
Coast Capital GIC	2.350%	1-Mar-19	Not rated	$20,000	$100.000	2.35%	2.35%	1.00	0.98	$0	$20,000	$20,000
National Bank	1.742%	3-Mar-20	AA low	$20,000	$99.250	2.13%	2.14%	2.01	1.94	$172	$19,850	$20,022
Bank of Nova Scotia	1.900%	2-Dec-21	AA	$20,000	$98.100	2.43%	2.45%	3.76	3.58	$94	$19,620	$19,714
Canadian Western Bank	2.737%	16-Jun-22	A low	$20,000	$99.500	2.86%	2.88%	4.29	4.00	$114	$19,900	$20,014
Royal Bank	2.333%	5-Dec-23	AA	$20,000	$98.000	2.71%	2.73%	5.76	5.32	$111	$19,600	$19,711

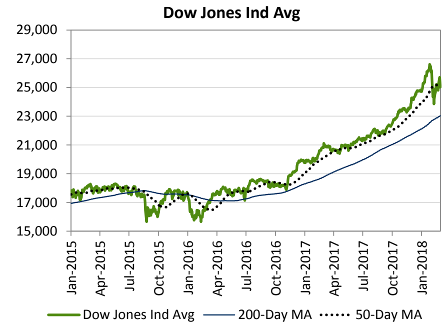
Source: Bloomberg, Raymond James Ltd. Priced on February 28, 2018

Charts of Interest

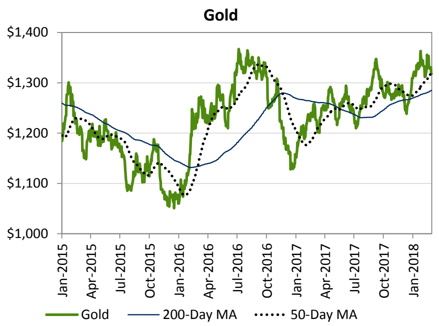
Markets

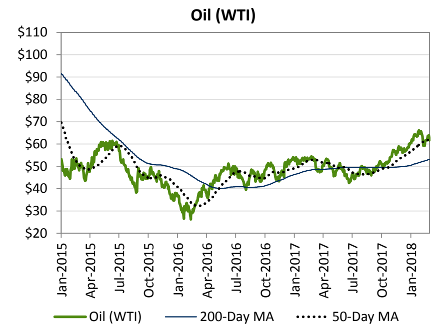


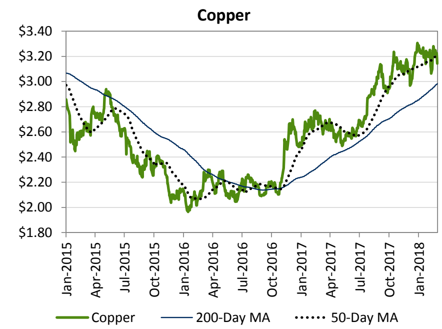




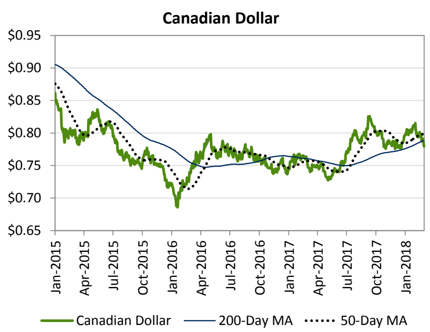
Commodities

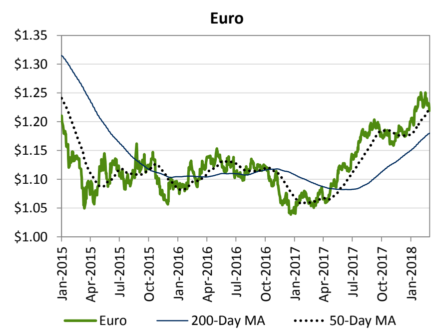


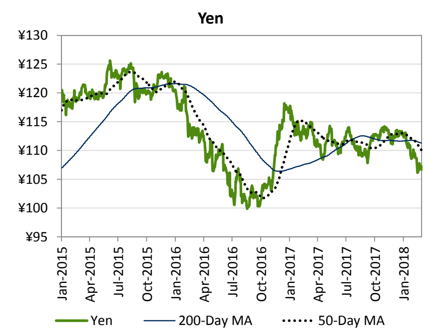




Currencies





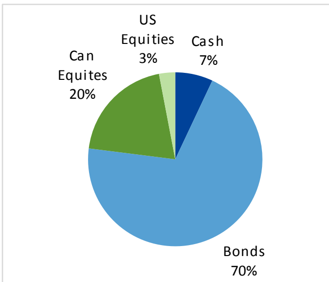


Source: Bloomberg, Raymond James Ltd. Performance as at February 28, 2018.

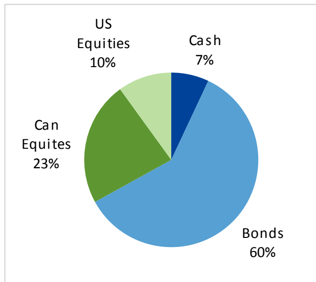
Investor Profiles and Asset Class Weightings

Recommended Asset Allocation

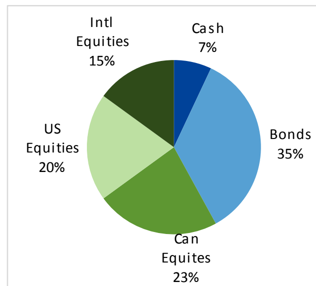
Capital Preservation



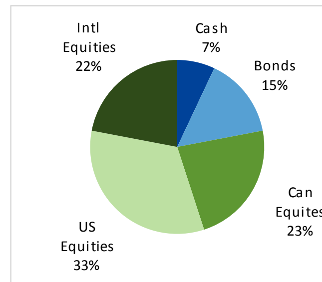
Conservative



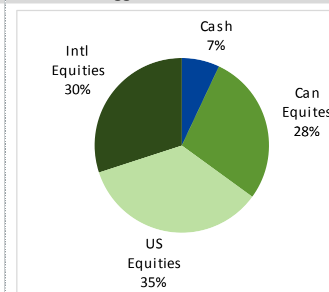
Moderate



Growth



Aggressive Growth



	Capital Preservation	Conservative	Moderate	Growth	Aggressive Growth
Cash	7%	7%	7%	7%	7%
Bonds	70%	60%	35%	15%	0%
Can Equities	20%	23%	23%	23%	28%
US Equities	3%	10%	20%	33%	35%
Intl Equities	0%	0%	15%	22%	30%
Tactical Asset Mix (Bonds include cash)					
Bonds | Equities	77 | 23	67 | 33	42 | 58	22 | 78	7 | 93
Strategic Asset Mix (Bonds include cash)					
Bonds | Equities	80 | 20	70 | 30	50 | 50	30 | 70	10 | 90
Asset Ranges					
Cash	0-20	0-20	0-20	0-20	0-20
Bonds	60-100	50-90	20-70	10-50	0-30
Equities	0-30	10-50	30-75	50-90	70-100

Description

Capital Preservation	Conservative	Moderate	Growth	Aggressive Growth
May be appropriate for investors with long-term income distribution needs who are sensitive to short-term losses. The equity portion of this portfolio generates capital appreciation, which is appropriate for investors who are sensitive to the effects of market fluctuation but need to sustain purchasing power. This portfolio, which invests primarily in fixed-income securities, seeks to keep investors ahead of the effects of inflation with an eye toward maintaining principal stability.	May be appropriate for investors with intermediate-term time horizons who are sensitive to short-term losses yet want to participate in the long-term growth of financial markets. The portfolio, which fixed-income securities tend to make up the largest proportion of holdings, seeks to keep investors well ahead of the effects of inflation with an eye toward maintaining principal stability. The portfolio has characteristics that may deliver returns lower than that of the broader market with lower levels of risk and volatility.	May be appropriate for investors seeking a balance between capital preservation and capital growth. This portfolio, which is a split between fixed-income securities and equities, seeks to keep investors well ahead of the effects of inflation with an eye toward maintaining principal stability. With roughly half of the portfolio invested in a diversified mix of Canadian and international equities, investors should be comfortable with moderate fluctuations in the portfolios.	May be appropriate for investors with long-term time horizons who are not sensitive to short-term losses and want to participate in the long-term growth of the financial markets. This portfolio, which has a higher weighting in equities, seeks to keep investors well ahead of the effects of inflation with principal stability as a secondary consideration.	May be appropriate for investors with long-term time horizons who are not sensitive to short-term losses and want to participate in the long-term growth of the financial markets. This portfolio, which is primarily invested in equities, seeks to keep investors well ahead of the effects of inflation with little regard for maintaining principal stability. The portfolio may deliver returns comparable to those of the broader equity market with similar levels of risk and volatility.

Important Investor Disclosures

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