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Capital Markets & Portfolio Update

Markets Continued to Focus on the Positives in July

July followed a similar path as the previous few months, with the global economy continuing to recover from the COVID-induced shutdown and equity markets celebrating the re-opening of the global economy, albeit with its challenges.

Evidence of the recovery was supported by solid second quarter corporate earnings; that coupled with continued fiscal and monetary stimulus from central banks and governments around the world gave investors what they needed to continue buying equities.

Deviating a little from previous months, and a bit surprising given the current U.S./China tensions, global equity returns in July were led by emerging markets; as the Chinese economy returned to growth in Q2, largely the result of relatively successful containment of the virus and government support policies. The MSCI Emerging Markets Index gained 9.0% for the month. Here at home, the S&P/TSX index gained 4.5%, and the S&P500 climbed 5.6% (4.1% in CAD) and Europe 2.4% (0.8% in CAD).

After a long hiatus, gold has been hitting new highs lately and broke through the $2,000/oz level in early August. Near-zero interest rates and unprecedented money supply has laid the foundation for a potentially sustained gold rally.

Bond prices, again, moved in tandem with equities in July and recorded another positive month. This is in an environment where the overwhelming consensus for bonds is for prices to drop. The Canadian Bond Universe gained 1.3% for the month, and is now up 8.9% year-to-date.

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Our Balanced Growth Model Portfolio, even though we continue to maintain a relatively defensive posture, participated nicely in the gains and had another solid month of returns as well, appreciating 2.4% for the month.

Although the GP&A model portfolio is doing well given the volatility this year, our defensiveness has led to us slightly underperforming our benchmark year-to-date. We're not used to this, but we feel it's been the right thing to do as the downside risks have far outweighed the upside potential since the March sell-off; and if we're going to get anything wrong as we manage your money, we'd rather it be earning a little less during times like this than risk losing a lot. Also, as global economies open up over the next year or so, and we get a rotation out of the expensive stay-at-home stocks and into the more traditional blue-chip companies, we believe our positioning will allow us to outperform once again. In the meantime, we have much better protection in case the situation worsens before it gets better and earn a fairly high amount of dividend income .

Here's how the key indexes performed for the month:

Bellwether Indices	Source: CIBC Wood Gundy				
As at July 31st, 2020	Price Performance % Change				
	1 mo	**3 mo**	**6 mo**	**12 mo**	**YTD**
S&P/TSX Composite Index	4.5	10.3	-5.0	1.9	-3.3
S&P 500 US Index	5.6	12.9	2.4	12.0	2.4
MSCI EAFE (Europe & Japan)	2.4	10.6	-7.0	-1.2	-9.0
FTSE Canada Bond Universe Index	1.3	3.3	5.8	9.1	8.9
Canadian vs. U.S. Dollar	1.2	4.0	-1.3	-1.6	-3.1
Morningstar CDN Neutral Balanced[1]	2.8	5.8	-2.1	2.6	-0.3
GP&A Balanced Growth Model	**2.4**	**5.6**	**-3.4**	**2.1**	**-1.8**

[1] The Morningstar Canadian Neutral Balanced benchmark is an industry regulated benchmark that reflects the performance of all Funds in Canada that invest at least 70% of total assets in a combination of equity securities domiciled in Canada and Canadian dollar-denominated fixed income securities. In addition, they must invest greater than or equal to 40% but less than or equal to 60% of their total assets in equity securities.

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Investment Strategy & Portfolio Positioning

Managing Risk in a New Normal Interest Rate Environment

The Art of War author Sun Tzu, as well as the likes of George Washington and Machiavelli, have all suggested in one manner or another that "defense is for planning an attack". In other words, to be successful in an endeavor that contains risk, defense is for the purpose of eventually becoming more aggressive.

Applied to investing, this means that when risks are high (expensive markets and elevated uncertainty), protect your position (portfolio) and wait for the enemy to weaken (markets to sell-off). Then mount your attack by buying into the weakness and establishing good long-term investments. This strategy may mean losing some short-term battles, for example not participating fully in the tail-end of a strong bull market, but winning the war by achieving attractive long-term returns with minimal causalities (i.e. volatility) along the way.

I've been thinking a lot about this analogy lately as *the war* on COVID-19 continues, as well as a U.S./China trade spat, but markets continue to shrug it off and move higher. A situation where we may feel like jumping into equities with both feet, so we don't miss out, but where prudence is warranted in order to avoid the risk of a large loss. The question is, however, how prudent should we be, and what is the best way to apply defense in an environment where cash and bonds are more likely to lose money than equities.

As with any plan, investment or otherwise, striking the right balance between aggressiveness and caution is paramount to success. Too defensive, and you'll likely lose slowly to inflation as it eats away your savings. Too aggressive, and you run the risk of large losses (think tech bubble, housing bubble and resource bubble). History suggests a measured approach, with thoughtful execution, provides the best outcomes (and the best long-term returns).

A measured approach traditionally means a balanced portfolio of stocks and bonds. Pension funds have typically invested with a strategic plan of 60% stocks and 40% bonds to strike an acceptable risk/return posture. For the last forty years, that's worked well. But in an environment where equity markets are expensive (increasing the risks) and the go-to defensive investment, fixed-income, is almost guaranteed to lose money for

the foreseeable future (as inflation runs higher than the interest being earned on the bonds), how do we achieve the right balance to control risk while still being able to earn our target return?

That's the question on every investor and portfolio manager's mind, and where we've been allocating a lot of our research time. On the one hand, recovering economies, encouraging comments regarding a vaccine, and (by far the primary driver) negative inflation-adjusted interest rates are driving equity and commodity prices higher. On the other hand, all of these assets are expensive and there are still substantial pandemic-induced economic risks. So the need for defense, i.e. portfolio protection, against a substantial sell-off is as important as ever.

The "New" Safety Portfolio

For each of our clients, we have a long-term return objective. That's based on your needs, wants, and comfort with volatility. The return target dictates the balance between our growth portfolio and our safety portfolio. For example, a client with a moderate growth profile, and thus a 4.5% above inflation target return, would have a typical pension plan strategy of 60% growth and 40% safety. Whereas an aggressive client may be 100% growth (and vice-versa). Most clients fall into the moderate growth profile; it's a good comfortable balance of long-term growth with very low long-term risk (this strategy has never had a negative five year return).

Based on various economic and market indicators, and our specific holdings, we feel quite good and comfortable with the growth portfolio today. It's positioned and performing well as we maintain a barbell strategy with financially strong, high-quality, profitable leadership businesses on one end (which look cheap and should outperform as economies reopen), and growth companies that are being positively impacted by accelerating trends, caused by the pandemic, on the other (and broad-based global equity indexes in the middle). For the safety portfolio, however, we have had to do a lot of work to get it properly invested so that it can provide the defense we want but also achieve the expected return.

Based on our research, and current market dynamics, we have made adjustments to the safety portfolio so that it's well positioned to continue to accomplish its dual mandate of providing protection while also being able to make positive after-inflation returns.

Without going into too much painstaking detail, here's a snapshot of the investments and allocations that currently make up the safety portfolio (approximately):

- 27.5% Canadian Bond Universe Index: high-quality bonds ranging from short-term to long-term. Traditionally this would have been the entire safety portfolio

- 12.5% Global Unconstrained Fixed-Income Fund: a conservative mandate with one of Canada's top fixed-income teams that can invest in any type of fixed income investment globally, including mortgages, foreign sovereign bonds, high-yield debt, options, default swaps, etc.

- 12.5% Global Corporate Bond Fund: a conservative corporate bond specialist team (one of the highest regarded bond hedge fund managers in Canada)

- 12.5% Multi-Strategy Hedge Fund: a conservative hedge fund manager designed to produce returns independent of interest rates and stock markets. They have a 20-year track record and are up over 10.0% year-to-date with very low volatility

- 12.5% Long Duration High-Quality Bond indexes (U.S. and Canada): these provide the ultimate portfolio insurance as they tend to gain substantially during large equity market corrections. They are a hedge against negative interest rates.

- 12.5% Gold Bullion Index: inflation, geopolitical and economic unrest hedge

- 10.0% Fixed-Rate Preferred Shares: investment grade high dividend paying (6.0%+) preferred shares that rise if interest rates go up. They are very cheap currently and provide a strong hedge against rising interest rates

Strong Returns in a Unique Time

As we work our way through this very unique period of weak economies, unprecedented debt, expensive equity markets and near-zero interest rates, we'll maintain our focus on owning a diversified group of investments that can provide attractive risk-adjusted returns each on their own, but also complement one another well to reduce total portfolio volatility; while not reducing total returns — which is referred to as

noncorrelated diversification, what Nobel Prize laureate Harry Markowitz called “the only free lunch in investing”.

Thank you for reading, and for the confidence you place in us to look after your savings. Stay safe and healthy and don’t hesitate to ask if you have any questions or comments.

Sincerely,

Daniel E. Girard

Data Sources: CIBC World Markets, Thomson ONE.

Daniel Girard is a Portfolio Manager and Investment Advisor with CIBC Wood Gundy in Waterloo. The views of Daniel do not necessarily reflect those of CIBC World Markets Inc. This information, including any opinion, is based on various sources believed to be reliable, but its accuracy cannot be guaranteed and is subject to change.

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