Select Income Managed Corporate Class
Update September 2018

Select Income Managed Corporate Class: Positioned for the late cycle
Alfred Lam, SVP and Chief Investment Officer
CI Multi-Asset Management

Following the second-longest economic recovery since the Second World War, we are now in the late stage of the economic cycle. At its peak, this expansionary phase has included bloated asset valuations, investor exuberance and risk-taking at any price. Inevitably, this phase has also created the conditions that could fuel inflation, prompting central banks to instigate measures that “cool” the economy; this includes raising rates and shrinking the money supply. So far in 2018, the Bank of Canada and the U.S. Federal Reserve have each raised rates twice, with the Fed signaling that additional increases are likely.

What does a mature business cycle potentially mean for the current and future positioning of Select Income Managed Corporate Class? The following commentary discusses recent economic conditions and the implications for the fund’s performance; our ongoing effort to actively manage the fund amid these late-cycle dynamics; and our rigorous commitment to risk management moving forward.

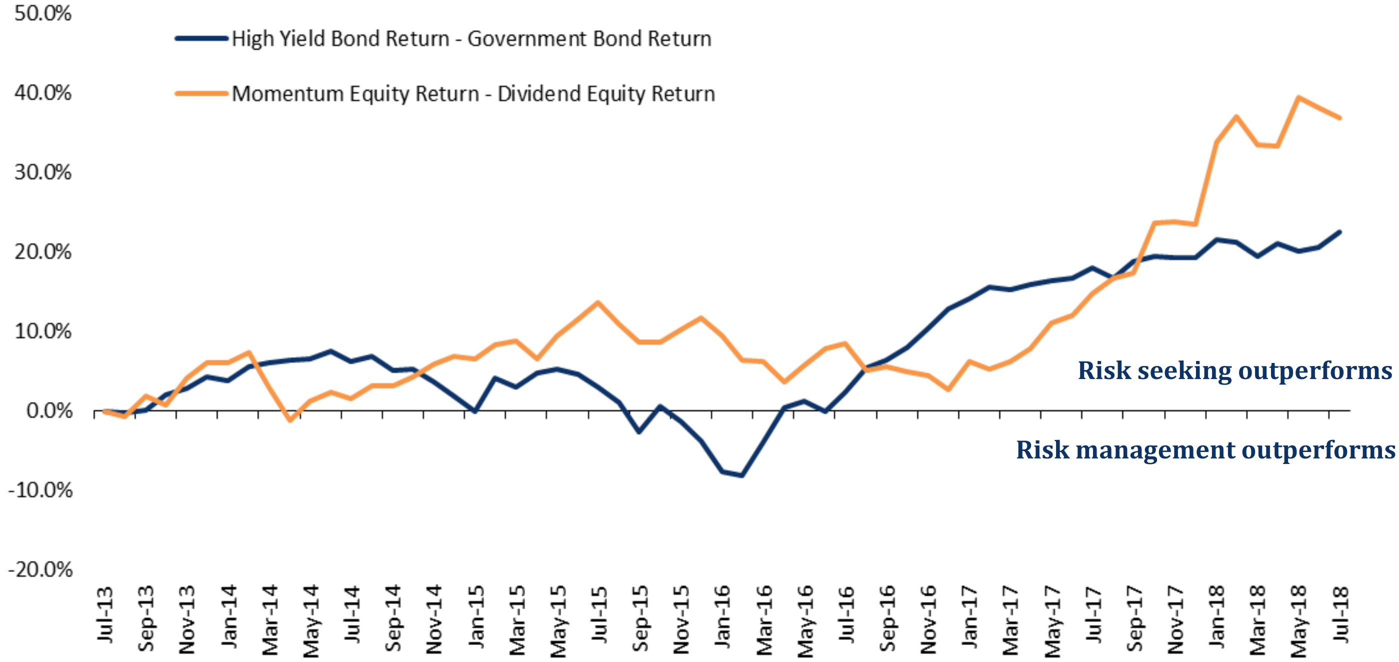
Protecting your capital amid excessive risk-taking

Select Income Managed Corporate Class is designed for conservative investors seeking exposure to a diversified portfolio of income-generating securities with a short-term time horizon. As a result, the fund aims to generate returns while ensuring that client capital is protected by diligently managing risk within the portfolio.

In recent years, risk-seeking has been rewarded over risk management, and conservative positioning has underperformed as a result. In fixed income, faster-than-expected rate hikes in the U.S. and Canada have led to relatively weak performance in government bonds. Government bonds have low default risk and provide strong returns during periods of financial stress when investors flee to safety. In credit, high-yield (or “junk”) bonds – which carry the highest probability of default – have produced the strongest performance. Lenders in the high-yield market typically demand higher rates of interest from companies as compensation for higher risk. Currently, the interest rates that lenders are demanding over government bonds are at their narrowest level since just prior to the financial crisis, indicating a heightened risk appetite and a reach for yield.

Also in recent times, overweight allocations to equities have been rewarded as stock markets have continued to drive higher. In our view, much of this growth can be attributed to higher valuations and momentum from a narrow group of market leaders in the technology sector that are “priced for perfection” (i.e. based on optimistic expectations for future earnings). In the equities portion of Select Income Managed Corporate

Class, we focus on high-quality, dividend-paying stocks, consistent with the mandate of generating income and protecting client capital. These companies have underperformed the market rally.



Source: Morningstar; Based on monthly return data from August 1, 2013 to July 31, 2018.
High-yield bond return is based on ICE BofAML U.S. high Yield TR USD; Government bond return is based on ICE U.S. Treasury Core TR USD; Momentum equity return is based on MSCI World Momentum GR LCL; and Dividend equity return is based on MSCI World High Dividend Yield GR LCL.

Effective positioning for the late cycle

The Select Income Managed Corporate Class portfolio is actively managed to succeed in a late-cycle environment. Here's a summary of our current positioning:

- **Overweight cash.** Maintaining a cash buffer is important in the late cycle because it doesn't have downside risk and provides more flexibility to reinvest at lower prices if markets correct.
- **Overweight government bonds.** Government bonds are an important portfolio construction tool because they tend to have negative correlation to equity (in other words, bond prices rise when equities fall). While recent performance has lagged, we are adding to our positions because of the stability they offer.
- **Underweight equities.** This position is due to high valuations, narrowing market breadth (i.e. a decrease in the number of companies making gains) and a lack of value opportunities. We prefer companies with low market beta (or volatility), a strong balance sheet and resilience to the economic cycle.

- **Adding quality.** We are upgrading the quality of the portfolio. In the investment-grade portion, this means lending to companies with a lower debt load and better credit ratings. As higher interest rates trickle through the economy, the probability of default on debt of lower-quality companies increases.
- **Shortening duration** (*NB. Duration measures a bond price's sensitivity to interest rate changes*). In the credit portion of the portfolio, we want our money back sooner based on the higher level of interest rate risk. Corporate bonds with shorter duration tend to be more resilient during an economic downturn.
- **Reducing exposure to cyclical asset classes.** We are underweight high-yield corporate bonds in the portfolio. High yield tends to correlate with equities during periods of financial stress, and valuations are close to all-time highs. Sub-investment-grade companies are more exposed to rising interest rates and economic downturns.
- **Adding inflation protection.** We have been building a position in gold, which protects against inflation shock and behaves as a safe haven asset in risk-off markets.

Risk management moving forward
We believe the expected returns on fixed income are increasing while the expected returns on equity are decreasing.

Fixed income. These returns are driven by current yield, expectations for yield and credit spreads on corporate debt (i.e. the yield premium over government bonds). As central banks raise rates, the current yield component provides more return because we are earning higher interest rates on new positions in fixed income. In addition, we believe that rate hikes have already been aggressively priced into current bond prices and, as a result, there is a higher probability that the rate of hikes will have to decelerate causing bond prices to rise in our view. As such, we are overweight government bonds. In credit, we believe that spreads are too tight, especially on high-yield bonds, and so hold an underweight position as well as short duration in that portion.

Outlook: Positive

Rationale: Higher reinvestment rates

Outlook: Negative

Rationale: Cyclical tights

Fixed Income Return = Current Yield + Change in expected yield + Credit spread

Outlook: Positive

Rationale: High expectations priced in

Equities. Return expectations for stocks have decreased. We assess the expected total returns to equity based on three underlying components: earnings growth, dividends and change in valuation. The recent surge in valuation metrics such as the price-earnings ratio indicates that valuations are more likely to detract from performance when prices revert to historical averages. Earnings growth has been a contributor to returns; however, we believe that much of the impact from tax cuts and federal stimulus in the U.S. have already been realized.

Outlook: Neutral

Rationale: Earnings are starting to peak

Outlook: Negative

Rationale: Valuations above historical average

Equity Return = EPS Growth + Dividends + P/E Expansion

Outlook: Neutral

Rationale: Close to long term average

Maintaining discipline for best results

In investing, it is easy to succumb to “action bias”, which is the tendency to do anything instead of nothing. There is a certain satisfaction to taking action – say, by trying a shortcut while stuck in traffic, even if it ends up taking longer to get to your destination. CI Multi Asset Management is determined to stick to our risk budgeting process and philosophy that has worked for our investors in the past, and to continue to approach investment management with a forward-looking mindset.

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