# Market Commentary

# Second Quarter 2014

CI Investment Consulting

**Portfolio Series and Portfolio Select Series**

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## Market performance

Investors who were looking for bargains were once again disappointed during the second quarter as both bond and stock markets recorded gains. The domestic stock market, as represented by the S&P/TSX Composite Index, rallied 6.4%, while global markets, as measured by the MSCI World Index, gained 1.4% in Canadian dollars. The Canadian market benefited from its significant weighting in the energy sector, which was boosted by higher energy prices. Weaker foreign currencies also presented a drag on the performance of foreign markets for Canadian investors. The U.S. dollar, euro, yen and sterling depreciated 3%, 4%, 2% and 1%, respectively, against the Canadian dollar.

Bond investors have effectively changed their minds since September from pricing in interest rate increases to expecting an extended period of stagnant or even declining interest rates. For example, the yield of five-year Government of Canada bonds fell 60 basis points (or 0.60%) since last fall – a significant decline from starting yield of 2.15%. Due to a supply and demand imbalance, corporate bonds continued to rally. The spread on high-yield bonds (which is the difference between the yields of the corporate bonds relative to those of government bonds and measures the premium that investors receive to take on the greater credit risk in corporate bonds) ended the quarter at just 350 basis points, approximately two-thirds of what it was a year ago.

| Returns in % at June 30, 2014 | 3 mth | 1 yr | 3 yr | 5 yr | 10 yr |
|---|---|---|---|---|---|
| S&P/TSX Composite Index | 6.4 | 28.7 | 7.6 | 11.0 | 8.8 |
| S&P 500 Index (C$) | 1.6 | 26.4 | 20.6 | 16.8 | 5.4 |
| MSCI World Index (C$) | 1.4 | 26.5 | 16.3 | 13.6 | 5.4 |
| FTSE TMX Canada Universe Bond Index | 2.0 | 5.3 | 4.8 | 5.2 | 5.6 |

*Source: Bloomberg, PC Bond*

## Portfolio Series and Portfolio Select Series

All Portfolio Series and Portfolio Select Series funds earned a positive return during the second quarter, and achieved attractive gains for the first half of the year. Our diversified income positioning provided better risk-return metrics than the domestic bond markets. In general, we were able to keep up with the performance of the domestic bond markets but earned our returns with less exposure to changing interest rate expectations, which have been very volatile. Having a large weighting in U.S. stocks has worked out well over the last three years but this positioning has been less favourable recently. However, investors should note that the depth and breadth of the American marketplace cannot be found locally, as our economy is

concentrated in financial and resource sectors. Hedging some of our portfolios' foreign currency exposure enhanced our foreign holdings' results.

| Returns in % at June 30, 2014 | 3 mo | 1 yr | 3 yr | 5 yr | 10 yr | Life |
|---|---|---|---|---|---|---|
| Portfolio Series Income Fund | 1.1 | 10.1 | 6.9 | 8.3 | 5.6 | 5.4 (Dec. 97) |
| Portfolio Series Balanced Fund | 1.6 | 15.2 | 8.3 | 8.9 | 5.6 | 7.1 (Nov. 98) |
| Portfolio Series Growth Fund | 1.9 | 19.9 | 10.0 | 10.2 | 5.0 | 4.5 (Dec. 01) |
| Select Income Managed Corp. Class | 0.8 | 6.4 | 5.1 | n/a | n/a | 4.5 (Sept. 10) |
| Select 70i30e Managed Portfolio | 1.1 | 10.5 | 7.0 | 7.6 | n/a | 4.0 (Nov. 06) |
| Select 50i50e Managed Portfolio | 1.5 | 13.3 | 8.3 | 8.8 | n/a | 3.9 (Nov. 06) |
| Select 30i70e Managed Portfolio | 1.7 | 16.1 | 9.5 | 10.0 | n/a | 3.8 (Nov. 06) |

*All fund returns are for Class A units/shares.*

**Select Income Managed Corporate Class**

Our decision to add government and corporate bonds in summer 2013 has paid off faster than we had anticipated. Bond markets have rallied, with the yield on five-year Government of Canada bonds falling steadily from 2.15% to 1.5%.

As a result of this change in risk-return metric, we have reduced government bond weightings and duration (which is a measure of interest rate risk). We have used the freed-up room in our "risk budget" in other areas that we expect to produce better returns. The portfolio continues to hold approximately 20% stocks and we have increased our exposure to the U.S. dollar to above 20%. Overall, the credit exposure has been tilted to higher quality. The ratio of investment-grade credit to high-yield credit ratio has been increased to two-to-one.

The fund currently earns a yield of 2.7% from a mix of income and dividends and we expect to earn an annualized total return of 3% to 4% after fees with some capital gains driven by stocks and asset allocation. Select Income represents a conservative offering designed for investors who want inflation protection but are reluctant to take on too much risk and/or have a shorter-term investment horizon.

**Outlook and positioning**

Stock markets appear to have normalized following their dramatic decline in 2008-2009 and the subsequent rally. Valuations seem reasonable compared to historical averages, and can be considered very attractive as long as interest rates stay at low levels. Investors generally demand a return premium of 4% to 5% from stocks over bonds to compensate for the risks. At a bond interest rate of 1% to 2% today, stocks need to generate 5% to 7% to meet that objective. This hurdle seems easily achievable for many companies today, especially the large firms that have steady cash flows from existing pipelines of products and services. Most companies are cash-rich and are capable of producing a 4% return through share buybacks and dividends alone. The largest non-financial companies as tracked by the Standard and Poor's had an aggregate cash balance of $2 trillion at the end of 2013.



In order to meet the 5% to 7% total return objective, the underlying business needs to grow only an additional 2% to 3%. This is a much lower benchmark than in periods when interest rates were much higher. For example, when interest rates were 5%, the total return objective on equities was close to 10% (5% plus an equity premium of 4% to 5%). This implies that the underlying business needed to grow 6% to 7% annually to satisfy investors – more than twice the requirement today.

Low interest rates have effectively taken global economies out of recession, but their impact now is limited because this situation has become the "new normal." Having low rates for an extended period will have the following implications: 1) economies in general will grow at a slower rate because businesses are not aggressively pursuing growth; 2) employment will grow at a less robust pace due to the prior point; 3) the average wage will grow slowly as competition for labour is less severe, also due to the first point; and 4) equity market volatility will be subdued because companies are not relying on strong growth to drive performance. Instead, they are buying back shares, paying dividends and investing in the baseline business.

The million-dollar question is how long this will last. Our expectation is that it will be quite a while. In order for the current scenario to change, the main variable – interest rates – has to rise. However, in the current environment in which government and household debt are at elevated levels, it is unrealistic to see a change on the horizon because higher rates would be a significant burden to both governments and households and lead to a significant reduction in spending.

Even under this scenario, investor expectations may turn unrealistic from time to time. We expect a continuing tug-of-war between expectations for interest declines and increases. We invest realistically in the bond markets, ignoring the noise and managing the risks. We expect the five-year yield to fluctuate between 1.50% and 2.50% for the foreseeable future and we will adjust our bond exposure within this range. With our prudent fixed-income positioning and a backdrop of continued low volatility for the stock markets, we expect to achieve reasonably attractive, stable returns for our investors. However, should conditions change, we are well prepared to adjust the portfolios on your behalf.