# Market Commentary

# Third Quarter 2014

CI Investment Consulting

**Portfolio Series and Portfolio Select Series**

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## Market performance

Capital markets held up well in the third quarter although there were growing concerns about the slow pace of growth in Europe and Japan and the conflicts in both Eastern Europe and the Middle East. Bonds rallied on a pledge by the European Central Bank to provide further stimulus for the region's struggling economy and on the view that the U.S. Federal Reserve may hold off on raising interest rates. The Canadian bond markets as represented by the FTSE TMX Universe Bond Index gained 1.1% during the third quarter.

Results from stocks were mixed. Commodity prices dropped on the news of weaker growth in Europe, Japan and China, which affected the value of resource equities globally. The Canadian market, with its large resource component, felt the pain more than others. The S&P/TSX Composite Index lost 0.6% during the quarter, even though seven of the index's 10 sectors recorded gains during the period. Foreign markets had better performance, but not by a wide margin. The foreign stock markets, as measured by the MSCI World Index, gained 0.9% in local currency terms but rose 2.7% in Canadian dollars, reflecting the decline in the Canadian dollar against the U.S. dollar and other currencies.

Investors in general avoided high-risk investments during the third quarter. Small caps under-performed large caps by 9% in Canada and 8% in U.S. In contrast to the gains in investment-grade bonds, high-yield bond markets declined. The benchmark Bank of America Merrill Lynch High Yield Master II Index lost 1.9% while the yield spread of high-yield bonds relative to government bonds (which measures the premium investors receive to compensate for the higher credit risk) expanded 90 basis points to end the quarter at 4.4%.

| Returns in % at September 30, 2014 | 3 mth | 1 yr | 3 yr | 5 yr | 10 yr |
|---|---|---|---|---|---|
| S&P/TSX Composite Index | -0.6 | 20.4 | 12.1 | 8.7 | 8.5 |
| S&P 500 Index (C$) | 6.2 | 30.2 | 25.7 | 16.7 | 6.8 |
| MSCI World Index (C$) | 2.7 | 22.6 | 21.2 | 12.5 | 6.4 |
| FTSE TMX Canada Universe Bond Index | 1.1 | 6.3 | 3.5 | 4.9 | 5.4 |

*Source: Bloomberg, FTSE*

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## Portfolio Series and Portfolio Select Series

Most Portfolio Series and Portfolio Select Series funds earned a positive return during the third quarter despite some challenges in the markets. The funds benefited from their overall positioning, which was comprised of an underweight position in high-yield bonds, overweight the U.S. dollar, overweight U.S. equity and underweight Canada and the resource sector. Holding extra cash in both income and equity mandates detracted value. However, there is no doubt that holding cash is a reliable way to reduce volatility and this added stability to our portfolios as volatility increased in late September in the stock and bond markets.

In general, our three to five-year outlook on the stock markets is constructive and we plan to re-invest our cash holdings should we find compelling opportunities and/or the volatility eases. We expect to maintain a structural underweight in Canadian government bonds given the low yields. For example, bond investors currently collect only 71 basis points of extra yield by extending the term to five years.

| Returns in % at September 30, 2014 | 3 mo | 1 yr | 3 yr | 5 yr | 10 yr | Life |
|---|---|---|---|---|---|---|
| Portfolio Series Income Fund | 0.9 | 9.5 | 7.8 | 7.2 | 5.6 | 5.4 (Dec. 99) |
| Portfolio Series Balanced Fund | 0.7 | 12.4 | 11.5 | 7.7 | 5.7 | 7.1 (Nov. 98) |
| Portfolio Series Growth Fund | -0.1 | 14.2 | 14.1 | 8.7 | 5.3 | 4.4 (Dec. 01) |
| Select Income Managed | 0.6 | 6.1 | 5.7 | N/A | N/A | 4.4 (Sept. 10) |
| Select 70i30e Managed Portfolio | 0.7 | 9.0 | 8.9 | 6.6 | N/A | 4.0 (Nov. 06) |
| Select 50i50e Managed Portfolio | 0.7 | 10.8 | 11.1 | 7.6 | N/A | 3.9 (Nov. 06) |
| Select 30i70e Managed Portfolio | 0.8 | 12.8 | 13.3 | 8.7 | N/A | 3.7 (Nov. 06) |

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

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**Select Income Managed Corporate Class**

Liquidity in fixed-income markets has become a topic of concern recently. (Liquidity reflects how quickly a security can be sold without a significant impact on its price.) Liquidity is particularly tight in markets such as mortgages and high-yield bonds where there are fewer investors than in the government bond and stock markets. The concern focuses on the fact that many billions of dollars have flowed into fixed-income markets in recent years and what would happen when those flows reverse.

Liquidity is a risk that we monitor and manage. Our view is that investors in Select Income Managed Corporate Class wish to avoid excessive liquidity risk as well as price risk. The fund benefits from a mandate that is not constrained but which allows for wide diversification within the broad universe of income-producing securities. The portfolio is invested into multiple strategies that include the Canadian dollar, U.S. dollar, short-duration investment-grade bonds, core Canadian bonds, global bonds, high-yield bonds, real estate investment trusts, publicly listed infrastructure and other income securities, dividend-producing Canadian and global equities. The weighting of each strategy is determined by our team based largely on valuations and the downside risk after considering each strategy's volatility and how it interacts with other strategies.

Approximately 80% of the portfolio is invested in very liquid investments such as U.S. dollars, government bonds, investment-grade corporate bonds and stocks. The term to maturity of the income portion is approximately half that of the index. This means we can get paid back two times faster than a typical bond portfolio or the index. This decision was made not only for liquidity reasons but because we find longer-term bonds unattractive.

It is important to us that liquidity is not a constraint on our ability to own more or less of any of the above strategies. With flexibility and a large amount of cash currently held in our portfolio, we are positioned to take advantage of opportunities as they arise. In stable markets, the portfolio is well positioned to generate stable returns for our very conservative investors.

Select Income Managed Class A units have earned a return of 4.3% for the nine months ending September 30, 2014. The fund has been underweight bonds for a while due to our concerns that they are overvalued. The switch from bonds to holding U.S. dollars has added value in terms of generating better performance and reducing the overall volatility of the fund. The volatility of the fund as measured by standard deviation is approximately two-thirds that of the benchmark.

September was a volatile month as both stock and bond markets recorded losses. The U.S. dollar was the only bright spot with a 2.9% gain. We adjusted the portfolio by adding bonds and stocks and reducing our exposure to the U.S. dollar.

**Outlook and positioning**

We continue to research and invest realistically. The global economy has not yet returned to full capacity and as a result, central banks are still pursuing unconventional policies to stimulate growth and boost

employment. While the U.S. Federal Reserve is reducing the stimulus by winding down its quantitative easing program, Europe has just started a new round of expansion. The effect of stimulus is felt more in the capital markets than the real economy, which is why the prices for stocks have grown much faster than the real economy. Central banks' commitment to both quantitative easing and low (effectively zero) interest rates continue to put a floor under asset prices.

Bond valuations are at an extreme as interest rates have been set below inflation for an extended period. However, this seems likely to persist because interest rate policies are not changing soon. To manage the downside risk and volatility, we adjust our bond weighting frequently and maintain a structural underweight in this asset class. Stocks, on the other hand, are more attractive. Even though this bull market has already run for more than five years, valuations have been only at the high end of the normal range and not at the euphoria level seen at previous market peaks.

The "side effects" of continued stimulus and low interest rates – beneficial for those who own assets such as equities and negative for those who rely on interest income – are likely to continue. However, companies are largely doing well, with solid balance sheets and reasonable earnings growth. Low interest rates mean that companies can finance their projects, including share buybacks and increasing dividends, at a very low cost. With a constructive longer-term view on the stock markets, we expect to add stocks to the portfolio whenever we see value.