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11 January 2021

Investor Strategy

2021 optimistic start

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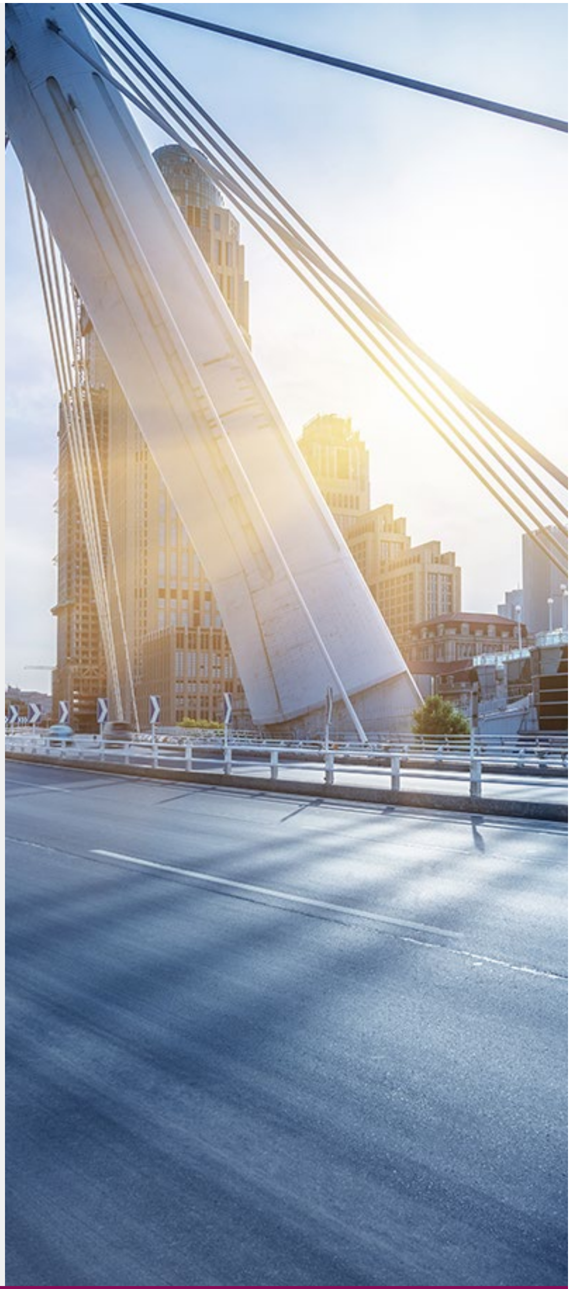


Executive Summary

- **Part 1: Market recap – Pretty much only capitulators lost money in 2020**
  - A graphical look back at 2020
  - The bulls head into 2021 full of vim and vigor
- **Part 2: Asset Allocation – Is this an early or a late cycle?**
  - We have been through a bear market and a recession, yet markets are behaving like it's a late cycle
- **Part 3: Equities – Emerging markets have started to catch up**
  - EM has been on the mend with optimism for the global economy and a lower U.S. dollar
- **Part 4: Fixed Income – Fishing beyond the traditional 60/40**
  - Long/short credit as a partial solution for the current low-yield (albeit rising), low-credit spread environment
- **Part 5: Managed Portfolios – Turning ideas into action**
  - Recent transactions to align with the Team's outlook for 2021

Market Recap – Pretty much only capitulators lost money in 2020

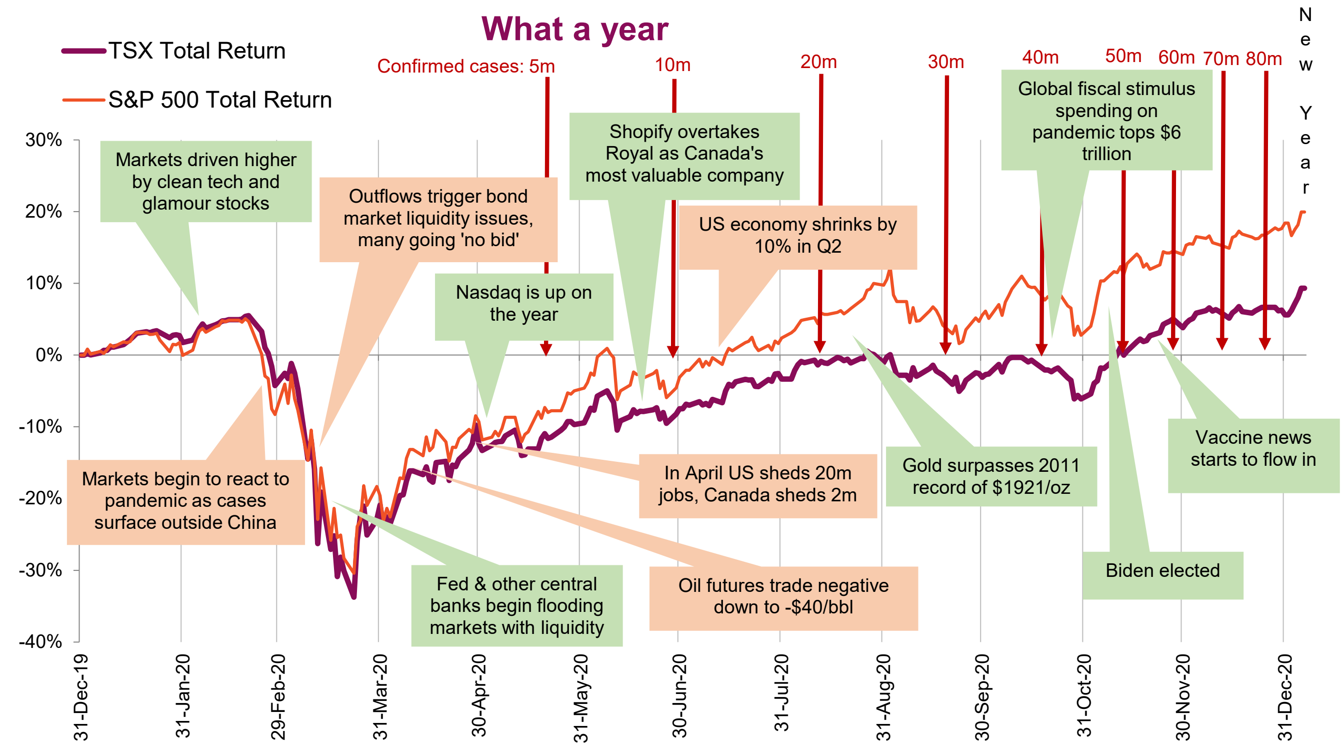
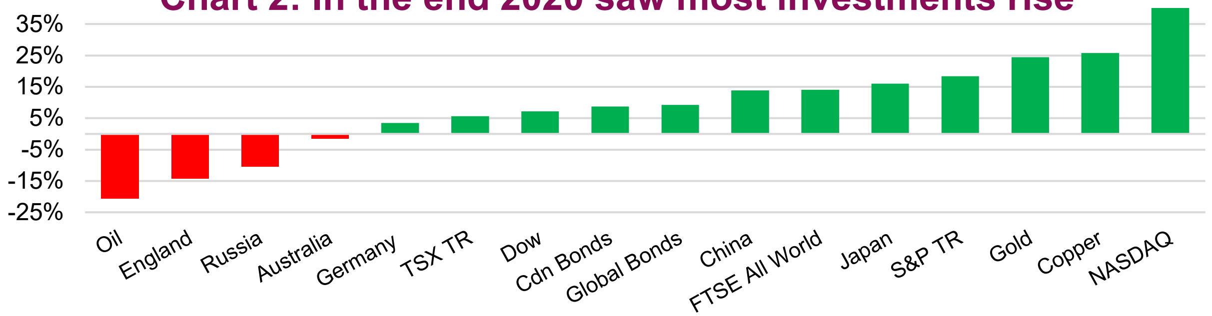


Chart 2: In the end 2020 saw most investments rise



Alexander Tjiang

- Despite a terrible year for humanity and the global economy, the prices of most asset classes finished the year in the green. While we can explain this divergence due to perhaps the most unequal recession in history, it still rattles the sense and sensibilities: A pandemic that is still accelerating, millions without jobs and the market at an all-time high.
- December is always a slow month for most years, with more muted trading volume. Still, North American equity indices managed to squeeze out one last month of gains with the S&P 500 and TSX rising +3.7% and +1.4%, respectively, in local currency terms.
- The optimists clearly rode into 2021 and have continued to carry the day. IPOs are off to a booming start and speculation has driven bitcoin to double over the past month. The bulls are in such control that even the storming of the U.S. Capitol building barely registered a wobble in the equity markets' ascent.
- Optimism of the vaccine rollout continues to eclipse the rising case count and death toll. Equity markets, commodity markets and, now with 10-year U.S. Treasury yielding over 1.0%, bond markets are pricing in a continued strong recovery.
- The global economy appears to have adjusted to a pandemic world quicker than expected. While still in a recession, the pain is very concentrated in several industries while others are feeling little or no pain. Again, a very "unfair" recession (not that any of them are fair).
- 2020 was replete with lessons, and it's certainly worth reflecting on them before looking forward. The set-up for 2021 appears especially challenging given the mismatch between the severity of the pandemic and historically high valuations. With global markets and economies enveloped in clouds of uncertainty, we reiterate that being able to quickly adapt to the unexpected has never been more important.

The only question – Is this an early or a late cycle?

Craig Basinger, CFA

Chart 3: Developed economic growth

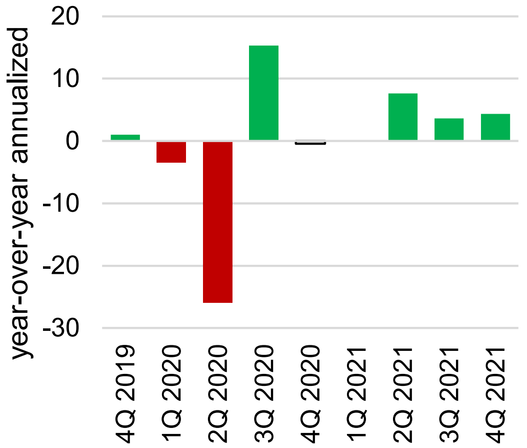
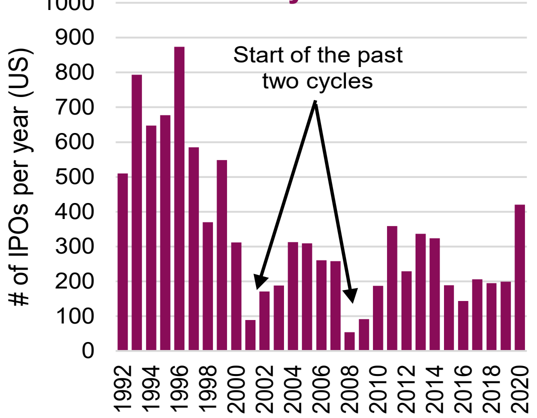


Chart 4: IPO activity is indicative of the start of a new cycle



Ok, every cycle is different so there is no simple road map to follow. However, the biggest question that will differentiate between investment success and failure (on a relative basis of course) is whether this is the start of a new cycle or if we are still in the late stages of the cycle that began in 2009. Spoiler alert: nobody knows.

Early in a new cycle

- 2020 does check several important boxes for the end of a cycle. There was a bear market, with global equities falling about 35%. There was, and still is, a recession with the global economy expected to have posted a -3.8% growth rate for 2020 (developed economies). This included negative GDP in Q1 (-3%) and Q2 (-26%) with a snap back in Q3 (+15%). Q4 and Q1 of 2021 are expected to be flat.
- The U.S. economy saw unemployment peak at 15%, Canada at 14%. These have subsequently recovered to 7% and 9%, respectively.
- No question this was a very different recession that really impacted services and didn't have to burn through any excesses such as housing (2008) or tech spending (2000). With aggressive 'proactive' stimulus on both the fiscal and monetary front, the economic damage has been limited. And the recovery will gain even more speed when the vaccine enables industries negatively impacted by social distancing to return closer to pre-pandemic levels of activity.
- It is this scenario that the equity markets appear to be increasingly pricing in.

Late cycle still

- The pandemic was an exogenous shock that triggered a technical bear market and recession but did not end the current cycle. From a market perspective, some similarities can be drawn to 1987 or 1998.
- Before the pandemic, the global economy did not appear to have any excesses, the economy was not running too hot, central banks were not tightening.
- There did not appear to be widespread speculation or silly individual investor behaviour during the bull run from 2009 until the pandemic. However, over the past year the silly behaviour has come, big time. There were 480 IPOs in 2020, and retail option trading increased 8x 2019 levels.
- Monetary policy and high liquidity have lifted asset prices. If the economic recovery isn't a sure thing, there could be an air-pocket ahead. Perhaps when things do get back to more normal thanks to vaccines, the market may realize how much economic damage has been done.

We are not convinced one way or the other. However, there are more bubbles today than a year or two ago which is concerning and not indicative of a new cycle. That doesn't mean it won't keep going. From our perspective, the strategy is to trade into some of the lagging or less expansive assets or markets. This should help protect on the downside, and if this is the start of a new cycle, this approach should also benefit from the steady global economic recovery back to 'normal'.

Equities – Has EM started the long road back?

Derek Benedet

Chart 5: Emerging markets playing catch-up

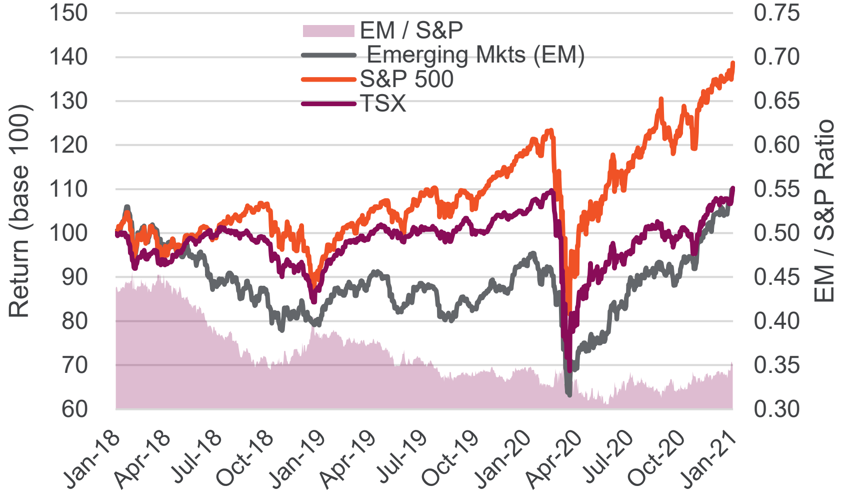
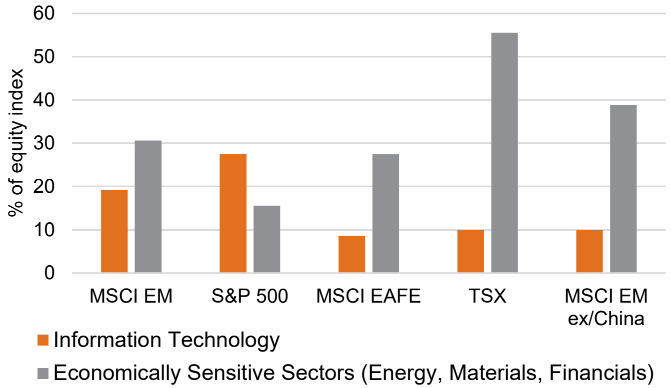


Chart 5b: U.S. market is much less economically sensitive



- The final puzzle piece has fallen in place for International & Emerging Markets (EM). In our 2021 outlook we detailed why we believe in overweighting international equity exposure, including emerging markets (EM), over U.S. equities. Now that control of the U.S. Senate has flipped, we find it probable that President Joe Biden will be able to push through some of his additional fiscal spending plans. The dominant drivers of the ongoing risk rally will include stimulative monetary and fiscal policies as well as the prospects of mass vaccinations. These themes will be paramount for the continued economic recovery, but they likely will also mean that the ensuing growth rebound could also be a detriment to U.S. equites from a relative basis.
- The mega-cap tech rally of 2020 will likely be hard to replicate over the year ahead, especially with threats of potential regulations coming from Washington. Amazingly, Technology contributed more than half of the S&P 500's return last year. While the clean-tech bubble continues to grow, it simply does not have the market-cap clout to drive index outperformance the same way. As you can see in **Chart 5**, EM have been underperforming for the past few years but have begun to outperform even U.S. equities. A lot of emerging economies have stronger secular growth rates and yet their valuations are cheap relative to the U.S. Investors have been hesitant to tilt towards EM as we were late cycle, but now the state of the cycle seems rather irrelevant. Developed international markets are also attractive from a valuation standpoint. Valuations on the S&P 500 are significantly above their five-year average, less so for international markets.
- The predominant trend of the lower U.S. dollar, as investors bet on a continued economic rebound, will be a boon to EM and a headwind to domestic U.S companies and foreign investors. The U.S. dollar tends to serve as a risk haven, and while we continue to believe it will benefit from further episodes of volatility, overall we expect the current downward trend to continue with brief periods of counter-cyclical bounces.
- European market lagged in 2020, but with Brexit now behind them there is also less of a distraction. The European market is dominated by cyclical shares, whereas the U.S. has grown increasingly tech-heavy. EM might have less industrial exposure, but many are still heavily exposed to commodities, which will benefit from the reflationary trade, as will Canada. **Chart 5b** details the index weight of economically sensitive sectors versus technology across various indices. The U.S. has by far the lowest economically sensitive exposure. With rates rising, and the yield curve steepening, the S&P 500 also has relatively low exposure to bank stocks, which could benefit during an economic recovery. Financials make up 18% of the MSCI emerging-markets index and nearly 16% of its Europe gauge, compared with 10% of the U.S. benchmark
- Stocks and other risky assets outside the U.S. remain attractive, bolstered by cheaper valuations, solid growth prospects and aided by what we view as the end of the cyclical U.S. dollar bull market. There has been lots of interest in EM, but we continue to believe there is still more room to run.

Fishing beyond the traditional 60/40

Chris Kerlow, CFA

Chart 6: XSB vs. PFIA Performance

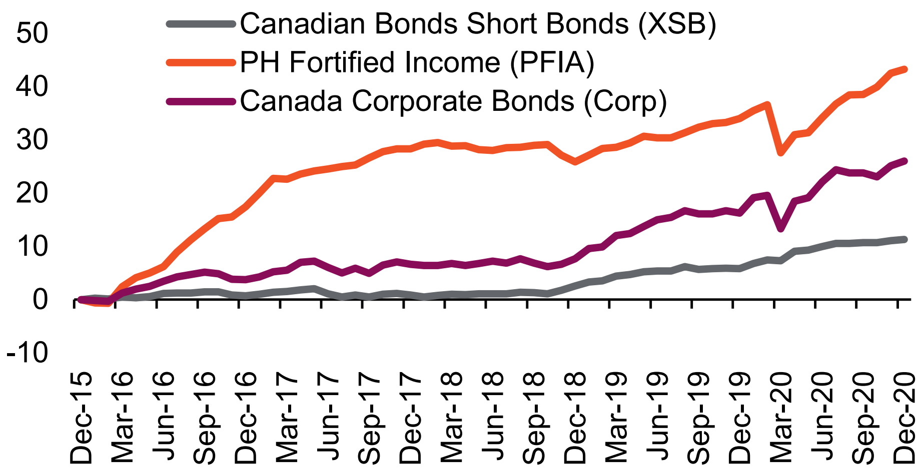


Chart 7: 5-Year Risk / Reward Analysis

	XSB	PFIA	Corp
Annualized Compound Return	2.17%	7.45%	4.73%
Annualized Standard Deviation	1.45%	4.57%	4.30%
Upside Capture	0.38	0.85	1.00
Downside Capture	0.25	-0.28	1.00
Beta	0.25	0.70	1.00

- The evolution of the balanced portfolio is leading to the implementation of alternative strategies to replace a portion of traditional fixed income components. The purpose of many of these strategies is to replicate fixed income characteristics – overall portfolio volatility reduction, increased diversification, and overall portfolio drawdown minimization – while also generating more income than traditional fixed income sources.
- Equity markets are heading into 2021 at historically high valuations and bond yields have doubled off the summer lows. The latter may continue to do so if the reflation trade continues into next year. Add to that the fact that credit spreads have fallen to 14-year lows, and it seems that the risk does not appear to be symmetrical but instead more tilted to the downside for credit.
- While we do not believe a complete abandonment of fixed income is warranted, shifting part of client portfolios to alternative credit strategies could be a solution for tackling this particular investment landscape. Bonds are not dead and traditional long government bonds still serve a strong point in portfolio diversification.
- Long/short credit strategies are of particular interest in this environment. Managers typically have the opportunity to short bonds and futures contracts. Shorting bonds is an interesting proposition because the credit at maturity settles at par, so downside is limited. The long/short nature of the fund also reduces the risk from rising rates.
- In our Managed Portfolios program, we recently shifted part of our traditional short-term fixed income (XSB) into the Picton Mahony Fortified Income Fund. The duration of the fund is 1.8, less than half of the benchmark (4.5) and even less than the XSB (2.8) position we are trimming.
- While also offering a significantly higher yield than both the benchmark and XSB, of course there is a trade-off: the strategy deploys leverage and that does add a different risk component. The key is to balance all the potential risks in this low yield environment.

Turning ideas into action

An Nguyen, CFA

Chart 8: Emerging Markets Exposure by Fund/ETF

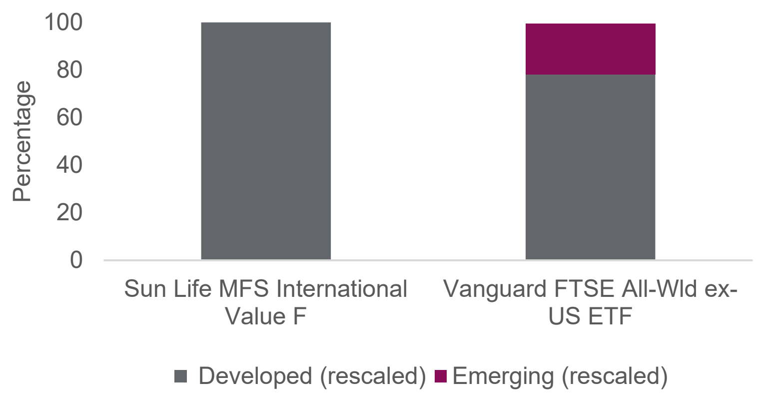


Chart 9: Top 10 Country Exposure by Fund/ETF

Country	Sun Life MFS Intl Value F (rescaled)
Japan	24.9%
France	15.4%
Switzerland	14.1%
United States	11.5%
UK	10.8%
Germany	9.6%
Taiwan	4.0%
Spain	2.1%
South Korea	1.9%
Denmark	1.6%

Country	Vanguard FTSE All-Wld ex-US ETF (rescaled)
Japan	17.1%
China	11.9%
UK	8.7%
Switzerland	6.2%
France	6.0%
Germany	5.8%
Canada	5.6%
Australia	4.7%
Taiwan	3.9%
South Korea	3.7%

- **Managed Portfolios** is the portfolio implementation tool for our investment ideas and our outlook. It captures our recommended asset mix tilts, style tilts, geographic allocations, and bond allocations all in one portfolio. Designed as a core investment solution, Managed Portfolios invest in a combination of actively managed funds and passive ETFs. The portfolios are therefore very cost efficient and provide daily liquidity. In our most recent trade, we focused on the following three key themes: (1) Dividends back in vogue, (2) International and Emerging Markets (EM), and (3) the “evolution” of the 60/40.

- **Dividends back in vogue:** The past few months may have just been the start of the pendulum swinging back from growth to value. This would be beneficial for dividend strategies which tend to have more exposure to value names than growth. To increase the portfolio’s exposure to dividend-payers, we added to the portfolio’s holding in the Purpose Core Equity Income fund, the core Canadian equity holding in Managed Portfolios. The fund has a cyclical/value tilt and provides up to 35% U.S. equity exposure. The investment process incorporates a balanced approach to dividends, combining cyclical yield names with more interest-rate sensitive ones.

- **International and Emerging Markets:** We believe Global ex-U.S. markets should benefit from an economic rebound. The Global ex-U.S. markets’ higher exposure to economically sensitive sectors (energy, materials, financials), compelling valuations, and virus containment (notably in Asia) should bode well for these regions. While the portfolio is already overweight international equity, we added to the portfolio’s holding in the Vanguard FTSE All World ex-U.S. ETF (VEU) and trimmed our holding in the Sun Life MFS International Value fund (Sun Life). VEU invests in International equity and EM while Sun Life is focused largely on developed International equity only (see **Chart 8** and **Chart 9** for the breakdown). The net effect of this trade therefore increased the portfolio’s exposure to EM and reduced the portfolio’s exposure to developed International markets. We believe EM will benefit from the reflationary trade, as well as the ongoing weakness of the U.S. dollar.

- **The “evolution” of the 60/40:** The evolution of the balanced portfolio is leading to the implementation of alternative strategies to replace a portion of more traditional fixed income investments. Some of these alternative strategies share many of the same characteristics as their traditional fixed income counterparts such as: to improve portfolio diversification, minimize equity drawdown, and reduce overall portfolio volatility. While we do not believe a complete abandonment of traditional fixed income is warranted, we shifted a portion of our passive short-term fixed income ETF (XSB) and initiated a new position in the Picton Mahony Fortified Income Fund, an actively managed long/short bond fund. The Picton Mahoney Fortified Income fund is focused on total returns and invests in three main areas; defensive corporate bonds (40-60%), event-driven credit (20-40%), and shorting challenged credits (20%). The fund is designed to provide regular income, have a lower correlation to traditional long-only credit, and mitigate interest-rate risks (options overlay).

Disclaimer

Source: Charts are sourced to Bloomberg L.P. and Richardson Wealth unless otherwise noted.

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