



iA Wealth Monthly Investment Call

Summary Notes: October 2019

October 16, 2019

On the third Tuesday of every month, the iA Wealth Product Research & Oversight team hosts a conference call featuring some of the most prominent names from the worlds of portfolio management, investment strategy and economics. This piece is a summary of the October 15th call on which James Gauthier spoke with Eric Bushell of Signature Global Asset Management and Marc-André Gaudreau of Dynamic Funds. The discussion covered an array of topics, including a 30,000 foot take on the economy, equity and fixed income markets, and ideas on opportunities in North American fixed income.

Eric Bushell

Senior VP and CIO, Signature Global Asset Management

JG: Your team's asset allocation mandates, such as the First Asset Global Asset Allocation ETF (CGAA) and the Signature Income and Growth funds, are the purest expression of your team's take on the markets. What are the asset allocations in these strategies telling us about where the team sees things today?

- The current positioning of the Global Income and Growth mandate is as follows: approximately 5% cash, 4% gold, 50% equities, 30% investment grade/rates (full duration 7.5 years), and a 10% allocation to high yield. The portfolio is slightly de-risked.
- The team moved to these allocation levels a year ago. Signature has expectations for a global growth slowdown that will unfold from geo-political trade turbulence and de-globalization with no quick fixes. Trust is broken and there are more headwinds to growth going forward. The ability to respond from a policy space perspective is not as robust as it was in 2015. Monetary policy also has less potency. On the fiscal policy side, China has amassed a substantial amount non-performing assets due to past stimulation. There is reluctance for China to rescue the world.
- Investors now have to adapt their asset mixes to a low interest rate world.

JG: Based on your underweight position to cyclicals, when you look at areas such as utilities, and real estate infrastructure (bond proxies), they have been strong performers this year due to falling long-bond yields and investors getting defensive. Is there more to it than that? Are you focusing on these areas?

- Look at European, Japanese and North American investors, where rates are low, financial plans are broken and there is a need for alternative assets.

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- Global pensions are choosing to allocate up to 40% to global alternative managers (Apollo, Blackstone, Brookfield, etc.) as clients are searching for predictable yield.
- Clients are willing to buy real estate portfolios at 4.5-5% yields with embedded cashflow and rental growth. If you believe the rate environment stays in the 1.5-2% corridor, which is likely based on Signature's low growth view, these real estate portfolios provide good relative value.

JG: CI has delved into this space with the CI Global Private Real Estate product? In terms of what Signature is doing, can clients access to true alternative (non-market listed) in a plain vanilla 81-102 fund? Are there any new liquid alternative products that you are investigating currently?

- Signature can look at pre-IPOs of up to a 10% illiquid threshold. Signature is not doing anything on private market side.
- Signature is finding better value, quality assets and quality management teams on in liquid markets.
- Alternative managers will have to look at liquid market.

JG: The Canadian energy complex has lost about half its value in the last five years. Some more value oriented managers are seeing good opportunities here but others are see significant structural issues for the space. What's Signature's view?

- Foreign investors have vacated the Canadian oil patch. Producers in the Permian can grow at 20%/year for multiple years. Canada is constrained due to exports, so growth is hindered. This has hurt Canadian early stage juniors.
- While senior producers will be owned by Canadian investors, juniors are less needed in the entire ecosystem. Inventories of oil and gas and reserves due to shale technology is pushing them out. Junior players are getting stranded. Boards and management will have to continue to amalgamate in the junior space.
- So far Canadian energy has been a value trap, so stay away from it. If we get a Democratic President, environmental challenges in the U.S. would help Canadian producers. The Canadian election will also impact for these companies.

JG: It looks like the outcome of the Canadian election could be a minority government? Is this good for the energy patch?

- This will not be a good outcome for the oil patch.
- The Bloc Quebecois has been outspoken about oil patch (pipelines in Quebec).

- There is a lot of pressure to restrain future development. Canada needs to understand the ramifications. It is a tough balance between sustained growth and being responsible to the environment.

JG: Considering financials, the flattened yield curve seems to be a significant headwind. What is your outlook for the space?

- For Canadian banks, if you look at activity in their capital markets business, it is going to stay weak. You are going to see cost cuts roll through Bay Street, until we get something exciting in capital markets (e.g. cannabis).
- More importantly look at the real estate market and the U.S. economy. As long as the U.S. economy is rolling along, Canadian consumers can carry debt burden. If the U.S. has a downturn, that could hurt heavily indebted Canadian consumers. A lot of Canadians have never witnessed a downturn in Canada employment.
- Bushell prefers insurance companies over banks at this time.

JG: I know the team pays very close attention to credit conditions, and things there appear to be very benign. Is all clear on that front from your perspective?

- In Q4/18 there was a massive credit hit, leveraged finance markets shut-down for months. BBB and high-yield credit needed to clean up their balance sheets before next downturn. That was great for credit as it reset prices.
- This year credit has been a homerun, massive returns.
- The market has squeezed last drop out of that rally. Now there are stresses on edges.
- Going into the end of the year, Bushell is not positive on credit.
- He feels loans will perform better than high-yield in next downturn as they are secured.

Audience Question: Will the improving U.S. consumer situation make a difference for U.S. markets?

- No doubt that the single strongest force in the global economy is the U.S. consumer. Things are fairly positive on the U.S. consumer front with wage gains, low unemployment, decent confidence, and home values trending upwards. Are we going to break services and consumer from global industrial slowdown? The stock market in the end will make the call, setting sentiment.
- If the market has issues – if credit flares up, earnings revisions down, insurance cuts from CEO in the U.S. (job cuts for a coming slowdown – Ford, Charles Schwab, etc.), it is too soon to say if this situation holds or tips U.S. markets. The situation has to be watched.



Marc-André Gaudreau **Vice President and Senior PM, Dynamic Funds**

JG: I wanted to begin by discussing the high-yield space. Spreads remain in the 400 bps range, which I suppose is reasonable. What is your view on where we are in the credit cycle, and how does a high-yield manager protect capital going into a period of increasing spreads and defaults?

- Our top-down view that we are later in the credit cycle. Usually cycles end when the cost of capital goes up. Last year, Fed Chairman Powell told the market that they were going to increase rates and was far from done. When you do this, you increase the odds of recession. Access to capital became scarce. We saw financial contagion. Central bankers did a 180, and started lowering rates. Now risky assets are pricing in an extended cycle, like 1998.
- Conviction in the risk on trade is a bit weaker. The distress ratio, bonds trading below 80 cents on dollar, have gone up. Names in pharma or retail could see increased defaults.
- We are late cycle. This cycle, investors are overweight credit. Life insurance companies, pensions and retail mutual funds have moved out the risk spectrum in search for yield. This may pose some risk.
- As an active portfolio manager looking to provide protection, Gaudreau and team do the following: 1) strong credit work on names they want to own, 2) a lot of hedging tools (buying protection on investment grade market in U.S.) and 3) some mandates (liquid alternatives) can short credit, shorting companies and bonds that offer a poor risk return profile. Overall, that is how the top-down view gets into their portfolios.

JG: For balanced investors 60/40, what would you recommend on the fixed income side?

- Gaudreau does not manage balanced funds. Within fixed income, you can be in core mandates (8-year duration, running yield 2% before fees). You either need to set your expectations lower or go out risk spectrum.
- Gaudreau thinks for investors who can, should look at alternative strategies which provide diversification and do not necessarily increase your risk profile.

JG: Dynamic Credit Absolute Return Fund II is a liquid alternative version of the original Dynamic Credit Absolute Return Fund strategy. It is a long/short fund. What is the positioning of this portfolio currently?

- This is a mandate which allows the team to have two additional flexibilities. Selling short credit, with the size of the corporate credit market, there are opportunities to short in this space. If risk/return profile is attractive, they

can add leverage to short-term investment grade bonds. This generates a mid-single digit return, with zero duration risk and zero foreign exchange exposure, while maintaining investment grade quality.

- This strategy has shown over the past six years to have low correlation to other asset classes, while remaining liquid.
- Current positioning – Have not used leveraged in the past two years, but have instead increased shorts in credit.

JG: What are your observations in private credit?

- Gaudreau does not manage private credit mandates.
- The team does manage \$1.5 billion for large pension plans, which have increased their allocations to private debt, private equity, infrastructure, real estate, etc.
- There were opportunities when European banks were scaling down their risk exposure in 2012-13. Same in the U.S. which had to recapitalize. There is lack of supply of credit. There is a bigger pool of capital looking for opportunities, however, the return profile is not as attractive.
- Gaudreau believes if or when we have the next recession, losses will be higher on the private side.

JG: Those who follow the Canadian preferred share market are likely keenly aware of its trials and tribulations. The 1-year return for the Canadian preferred share market is -11% and the 5-year number is -1.3%. What sort of opportunities are you seeing in this space today?

- Unlike most risk assets within fixed income, preferred shares are really cheap. If clients are not expecting a recession, they provide an opportunity.
- Pipelines are being priced as if rates are going to 50 bps. Spreads should be significantly wider. This is an attractive sector.
- Shorter term, we may see tax-loss selling in 2018, similar to 2015. Energy stocks and preferred were down significantly.
- There are more gains on equities in 2018, so tax-loss selling could be a tactical opportunity for preferred shares.
- If there is a recession, the asset class will go down. If there is no recession, the margin of safety is attractive now.
- What is the current yield environment?
 - Current yield it is 5.75%.
 - You can buy securities below par without having an impact to your return profile. It is a very cheap asset class.
 - Some Canadian banks have been issuing preferred shares in the U.S., at the margin this should support Canadian preferred share market.

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Recommended List: The list presents a selection of funds that we believe are among the best of their peers and offer unique characteristics that can add value when used in a well-diversified investment portfolio tailored to a client's investment objectives.

- Hold: The fund remains on the Recommended List, but is not recommended for adding to or selling from client's portfolios.
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