PORTFOLIO UPDATE: **EMPIRE LIFE BALANCED FUND**

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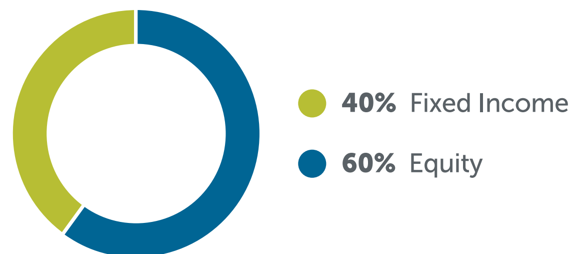
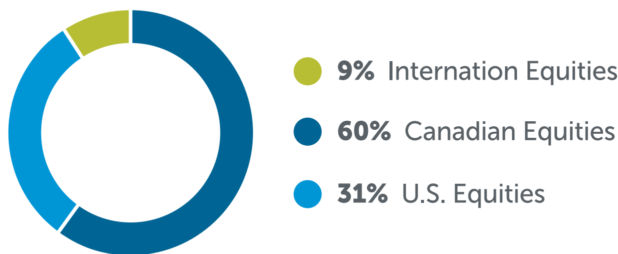
Our thoughts on the fund



A bit of a high level overview on how we think about the fund. This is a strategic balanced fund versus our tactical asset allocation fund, therefore the fund will typically be managed as a 60/40 (equity/fixed income) fund with some deviations around that level. Since taking over the management of the fund about seven months ago, I have reduced the fixed income weight given expectations for inflation and hence rising interest rates at the time. (Ian Fung provides a more detailed view on this below). Today the fixed income weight of the fund is about 40% which is the lower limit for funds in its category (Canadian Neutral Balanced).The US equity weight was also reduced as the continued reopening of market economies was expected to be supportive of cyclical equities which dominate the Canadian market. We have since modestly reduced the cyclicality within the Canadian equity allocation of the portfolio.

Current geographical positioning



Today, roughly 60% of the fund is in equities of which 60% is in Canadian, 31% in US and 9% is in international securities. We believe that over the long-term the US provides the highest investment opportunities and want to ensure we have significant exposure to the region. However, given current relative valuations as well as a supportive backdrop as economies continue to reopen, we are maintaining our overweight position in Canada. Our US and international equity allocations are managed internally by Ashley Misquitta and David Mann, respectively.

Our Team Approach

In order to make asset allocation as well as geographic allocation decisions, we leverage insights from both our internal as well as select external experts. During our monthly meetings, portfolio managers from each geography as well as the fixed income investment team share their views on their particular area of focus. We then debate and discuss the various views as a team. Those views are then incorporated into asset class/ geographic allocation decisions within the fund. While the primary focus is bottom-up fundamental analysis, we are very much aware of the impact of overall macro trends on individual equities. Furthermore, the asset allocation component does rely - at least to some degree - on overall macro level views.

Investment philosophy

Before we continue, I want to share a few words about my personal investment philosophy. Similar to my colleagues, my primary focus is balancing capital preservation with the right amount of risk to ensure maximum return. This is achieved by investing in companies with a sustainable competitive advantage with a unique product/service offering allowing for pricing power particularly during times of inflationary pressures. These attributes, coupled with a strong management team with proven capital allocation abilities often results in a stable and predictable FCF/ share (free cash flow per share) growth over time. It is my belief that while such companies may look relatively expensive in the near-term, they will "grow into multiples" over time – (i.e. their underlying cash generation power is greater than the implied multiple).

Canadian equity update

With that in mind, I have increased the fund's weights in names such as Waste Connections which is a great waste management company. Waste Connections' contracts and business model allow for pricing above inflation resulting in mid-single-digit organic growth while maintaining or growing margins. The company also has a similar level of potential in M&A opportunities which together result in solid double-digit FCF/share growth for the foreseeable future.

Another example is Granite REIT which is an Industrials REIT company and our largest real estate position. Industrial REIT fundamentals continue to be robust with strong demand resulting once again in pricing power. In my view, Granite has the best balance sheet in the sector which coupled with a strong CEO has led to accretive allocation of capital. This accretive allocation of capital has resulted in above-expectation NAV/ share growth which in turn has resulted in the analyst community continuing to increase their target prices (i.e. the stock continues to grow into its multiple).

Notwithstanding my comments regarding great businesses and great management teams growing into their multiple, I am very mindful of valuation and the FCF/share growth implied in current share prices. As I am sure you have heard from others (market commentators), our world of low interest rates has led to elevated valuations in many cases. To that end I maintain a watch list and am ready to take advantage of opportunities as they arise.

Changes to Canadian equity

The most significant changes that I have made since taking over the management of the fund on April 1, 2021 would be adding to/introducing new industrials names such as Waste Connections, Thomson Reuters, WSP Global, CP Rail all of which meet the criteria of sustainable FCF/share growth I described above. Today, industrials are my largest overweight at 17.5% (vs TSX at 11.8%).

I have selectively trimmed our Shaw position at higher levels. However, I continue to maintain an overweight in Shaw at 3% as I believe that despite the Rogers family drama, this transaction will close. Given that this is an all-cash transaction, the risk to Shaw shareholders is considerably reduced.

I have also increased the technology weight by introducing names such as Constellation Software. At 6.5% I continue to be underweight (TSX at 11.5%), however, as noted above I am not opposed to adding more technology names if I see opportunities. As a side note, I would highlight that although opportunities may be limited in Canada, we are fortunate to gain exposure to the sector through our U.S. equity allocation.

As an investment team, we are aware that not owning Shopify has detracted from the performance of the fund. We have no issues with owning Shopify and believe that a percentage of the fund should be allocated to higher growth technology names. However, Shopify's valuation today at 28x revenue – about 10x more than its peers – makes it hard to invest in the name at this time, even after we adjust for its growth. Shopify continues to be on the watch list.

I am very confident in the positioning of the fund today. We are seeing stretched valuations in some cases and will be looking to rotate capital in names with more favourable risk/reward offering. I continue to be a fan of quality businesses and will continue to look to add to our positions and/or introduce new names to the portfolio as the opportunities arise.

Fixed income update

We've currently been in the midst of headlines relating to the recent surge in inflation, and the global tightening of monetary policy. Fixed income markets have been very volatile over the last few months, particularly in interest rates, as market participants are increasingly pricing the likelihood of rate hikes in the coming years as the debate related to the persistence of inflation continues to heat up.

Duration exposure has been a tough one this year, particularly with the changes in central bank messaging and positioning around the world. Globally, central banks have begun shifting their policy stances away from the extraordinary accommodative policies put in place during the pandemic to that of tighter monetary policy. The removal of pandemic-related accommodation is necessary as economies have either recovered to pre-pandemic levels or are approaching those levels, but tighter policy is also a response to combat the recent surge in inflation that economies have experienced.

The persistence of inflation remains a battleground for debate. Central bankers are taking a more tolerant approach to inflation, as in past years, they have generally undershot their inflation targets. Last fall, the US Federal Reserve recently changed their approach to inflation targeting to "Flexible Average Inflation Targeting", targeting an average level of 2%, and the Bank of Canada appears to be following a similar playbook. Central banks continue to view inflationary pressures as transitory, and driven by factors like supply chain interruptions, which should resolve themselves in due time. Longer term inflation expectations appear to support that, as they have remained relatively restrained over the last year, but the debate remains as to whether inflation remains a more structural phenomenon as inflation numbers continue to surprise to the upside.

We continue to monitor a wide range of economic indicators and surveys to gain insights into the state of the inflation picture. Interest rates have currently priced in an aggressive level of tightening - with markets in interest rate futures pricing about six 25 basis point hikes in the overnight rate in Canada by the end of 2022. This may prove to be too aggressive, but in the near term, yield curves have steepened in the very front

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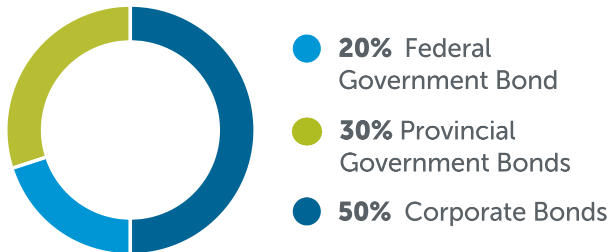
end out to 2 years, and have flattened from 5s/10s and 5s/30s. 10-year and 30-year bonds have rallied, implying that the market believes that the number of hikes priced into the market would slow the growth profile of the economy.

Fixed income positioning



The fund's fixed income allocation is currently positioned with 50% in corporate investment grade credit, and 50% government bonds (with 20% in Federal government bonds, and 30% in provincial government bonds). In terms of duration (the price sensitivity with regard to moves in interest rates), the fund has a duration of 7.8 years, which is about 0.3 years less than that of the index.

We have tended to favour corporate bonds due to the positive backdrop for the economy as we continue the recovery from the depths of the pandemic, and they provide the fund with incremental yield relative to government bonds. Corporate fundamentals have been solid through the pandemic, and balance sheets are in good shape as we begin to re-open economies. Corporations were able to pre-fund earlier in the year in the debt markets, have kept debt maturities manageable, and in some cases, are carrying even less debt than prior to the pandemic.

Similar to our equity colleagues, we believe in looking for competitive businesses that are able to generate strong free cash flows in a disciplined manner with competitive advantages. It is crucially important that businesses are able to generate cash flows to both grow the company and continue to support their debt payments, and those with stronger balance sheets are ultimately afforded the most flexibility in times of stress.

Personally, I like thinking about corporate bonds with a thematic lens, which I find helps to see where things are going and what areas to avoid as well. Valuations are also important in credit, and I have kept a close eye on credit spreads as we've progressed out of the pandemic. Credit spreads have yet to eclipse pre-pandemic levels, but we are beginning to approach those levels.

Corporate bond sectors

Since taking over the management of the fixed income component of the fund in April, I have added exposure to the Real Estate, Industrials and Energy sectors, and maintained an overweight position in financials. Financials and Industrials are the largest overweight sectors relative to the index (FTSE Canada Universe Bond Index), with a 14% overweight in Financials, and 11% overweight in Industrials.

However, around 7% of the overweight position in Financials is in 1.5 to 2 year bank bonds, which provide a decent short term pickup in yield, particularly after interest rates have backed up in the front end. I continue to like these shorter term bonds as a place to pick up yield in a product with greater liquidity, particularly as we continue into a period with rising rates, and credit spreads that could be nearing pre-pandemic levels. These shorter-term high quality bonds provide yield while we wait for better opportunities at more attractive levels.

The Industrials sector allows for exposure to names that have great businesses that are poised to do well even in an inflationary environment. For instance, we own Brookfield Infrastructure Partners debt, which is an asset manager that owns infrastructure projects globally. They are phenomenal capital allocators/ recyclers, with a multi-year track record of buying assets cheaply, improving their operations, selling them when valuations become rich, and redeploying into other opportunities. However, one of the under-appreciated aspects of the company is that many of their infrastructure contracts have pricing contracts tied to inflation rates in their respective markets. Other notable companies include WSP Global, Thomson Reuters, and CGI Group.

Within Real Estate, our largest exposures are to the industrial sector, through names like Granite REIT and Dream Industrial REIT, and to the office sector through Allied Properties. All three are leaders in their respective industries, and are extremely well managed. The backdrop for industrial REITS continues to be positive, as they are in a position where they have best in class assets, and strong demand, which gives them great pricing power. Within Office, Allied Properties is a beneficiary of the post-pandemic return to work, and despite the headlines relating to the "death of the office", has continued to successfully lease out their upcoming projects, and should be poised for success once office workers begin to return to the office.

We are currently underweight Telecommunications, because though they were a beneficiary during the pandemic due to increased usage in an almost utility like business, the sector is needing to issue debt to pay for their acquisition of spectrum for 5G connectivity in the near term, pressuring leverage ratios, and remains an overhang on the sector.

Fixed income performance

From a performance standpoint, the fixed income component has been close to the performance of the index over the past 7 months. Our shorter duration than the index helped, as did our larger weight in corporate bonds relative to the index, particularly as government bonds sold off in the last few weeks of October. The comparative performance report hasn't been run yet for October, but for the 6 month period ending September 30, the fixed income portion of the portfolio returned 1.317% net vs the index of 1.14%. I have continued to keep some powder dry for opportunities as they come up, but am continuing to manage the portfolio with some conservatism.

Thank you for your continued support.

Sara & Ian

Contact us to find out more about the Empire Life Balanced Fund!

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