Morningstar Conservative Portfolio

Fund Commentary

The recovery in stock prices continued in 2020's third quarter as many parts of the global economy rebounded faster than expected from the COVID-19 pandemic.

Massive fiscal stimulus from governments and monetary policy of central banks offset income lost to unemployment and kept retail sales chugging along.

Companies brought workers back as lockdowns eased, bringing down Canadian unemployment rates to 9% in September from a high of 13.7% in May, with rates still elevated from the 5.5% level at the start of the year. While travel, hotel and other leisure services continued to deal with severe conditions, many manufacturers scrambled to meet demand for new orders from merchants needing to rebuild inventory levels.

The stock market's dramatic recovery has done more than reflect investors' perception of the current economic conditions, as companies in certain industries have thrived in this new environment. Firms with strong e-commerce efforts and those helping enable the suddenly larger work-from-home labour force have seen accelerated demand for their services. At the same time, the recession caused by the pandemic left cyclical sectors far below their highs.

Energy performed the worst among sectors in the quarter even though oil prices were flat. Gasoline demand rose, but demand for jet fuel remained weak, and supply constraints promised by Russia and OPEC may prove tenuous. Financials were also under scrutiny as banks prepared for an increase in bad loans and weak profits.

International stocks largely mirrored U.S. markets, though they have generally underperformed the U.S. and the divide between growth and value hasn't been as pronounced overseas.

With central bankers moving quickly early in the crisis to push rates lower and provide liquidity to credit markets, bond markets were relatively quiet in the period.

As the COVID-19-induced crisis hit global equity prices in the first quarter, we (Morningstar) repositioned the portfolios to move close to benchmark equity levels as the reward for risk had become meaningfully more attractive in our view.

While we thought almost all risk assets were more attractive, we continued to find particular opportunities within value stocks, non-U.S. equities and emerging-markets bonds. Even with the market rally, we remain constructive on these areas, though we marginally pared down some of our exposures to risk assets in the third quarter. We believe our portfolios are set up well to capture returns in the eventual pandemic economic recovery, and we hope to see stronger returns from our non-U.S. equity and value positions.

However, given that valuations have recovered meaningfully, we believe the reward for risk has deteriorated and the portfolios are positioned for a variety of scenarios.

Domestic fixed income indices were modestly positive in the third quarter, with the FTSE Canada Universe Bond Index up about 0.44% and the FTSE Canada Short Term Bond Index up about 0.73%. Returns in global fixed income were comparable, with the FTSE World Government Bond Index up 0.72% in local terms, and 0.95% in Canadian dollars in the period. Canadian Real Return Bonds continued strong performance with a 4.43% return in the period.

Domestic stocks, as represented by the S&P/TSX Composite, rose about 4.7% in the quarter, moderating the tumultuous pace of the previous quarter. Industrials and Utilities both clocked in returns above 10%, with most other sectors broadly positive, except for the tiny health care sector down 14%, and the volatile energy sector down about 14.1%. Canadian Small-cap stocks had a relatively good showing, with the S&P/TSX Small Cap Index up about 6.6%.

The S&P 500 gained 6.8% in the quarter.

The MSCI EAFE Index of foreign developed markets rose 2.8%. Germany and Japan led the recent rally, while the United Kingdom lagged. In emerging markets, Asian countries such as China, India and Korea powered higher, while Russia and Brazil suffered small losses. The MSCI Emerging Markets Index gained 7.4%.

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The Morningstar Conservative Portfolio outperformed its blended benchmark[1] during the quarter.

Positive Contributors

The BMO Real Return Bond ETF rose about 4.1% in the quarter, eclipsing returns in the rest of the domestic fixed income market. Yields on Real Return Bonds became even more negative in the period, ending up at -0.18% for the 30 year by the end of September.

Capital Group Global Equity Fund (Canada) rose about 8.6% in the quarter, continuing a strong showing from Q2. Holdings in consumer discretionary and utilities sectors outperformed, with an underweight to Energy, as well as security selection within the sector making a positive contribution. TSMC, the world's largest contract chip contractor, U.S. chip-maker Advanced Micro Devices and Mercari, a Japan-based second-hand marketplace, were stocks contributing positively. Three new stocks were added and three eliminated during the quarter, holdings were increased in emerging markets and consumer discretionary stocks and cash sits at 4.8%.

The Galibier Canadian Equity Pool rose 11.6% in Q3, outperforming the Canadian equity market. Strong performance from firms like West Fraser Timber, Intertape Polymer, Gildan Activewear and Park Lawn drove returns. The Pool continues to be focused, with 25 holdings, and the cash position increased to 3% in the quarter.

Performance Detractors

The iShares MSCI EAFE Value ETF languished in the quarter, dropping about 0.8% while global equity markets continued to rally. The Value style, characterized by selecting stocks based on higher book value to price, forward earnings estimates and dividend yield continued to trail the more growth-oriented parts of the market.

The Global X MLP & Energy Infrastructure ETF gave back the gains of the second quarter and more, with a drop of about 11.3%. Midstream MLPs and energy infrastructure companies benefit from the volume of oil and natural gas they transport and store and suffered amid fears that energy production would continue to decline. Free cash flow yields in midstream started the year just under 4% but rose to almost 10% at the end of Q3.

Valuation-Driven Asset Allocation Positioning:

Overall, the portfolios are slightly below a neutral weight in equities versus our benchmarks, having modestly trimmed from domestic equities to domestic bonds in several portfolios during the period. Intra-equity, we continue to remain overweight non-U.S. equities, specifically value-leaning securities, and sectors such as energy and financials, and countries such as Japan, the U.K., Germany, South Korea and Mexico as they remain among the more attractive areas in the equity market by our analysis.

In fixed income, we remain slightly underweight duration and overweight emerging-markets debt. We have maintained our high yield bond position introduced in the previous quarter and our overweight to credit, but are watchful as spreads and the reward for risk proposition narrows. Even with the continued rally in government bonds, they still hold some downside protection value in the event of another risk-off event, notwithstanding their meagre yields. Despite the low probabilities of inflation rising in the short term, we remain overweight Real Return Bonds as a form of insurance policy against unexpected future inflation.

During the quarter, we took the opportunity to move a portion of our U.S. equity exposure to a currency-hedged ETF as we believe the U.S. dollar is modestly overvalued versus the Canadian dollar at this time.

Oakmark, one of the active international managers we have been using in the Portfolios, was merged into another mandate, the Canoe Defensive International Equity Fund. This new mandate was familiar and attractive to us, and we like both the quality-

[1]The Morningstar Conservative Portfolio's benchmark comprises 54% FTSE TMX Canada Universe Bond Index, 16% FTSE World Government Bond Index in Canadian dollars, 6% S&P/TSX Composite Index, 14% MSCI All Country World Index ex Canada IMI Index in Canadian dollars and 10% FTSE TMX 91 Day T-Bill Index.

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focused approach of the manager and the risk management overlay. Nonetheless, we also took the opportunity to redeploy some of the allocation from the continuing mandate to a EAFE value ETF to get the split of value focused equities back to where we desired.

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