Building robust portfolios in rocky markets

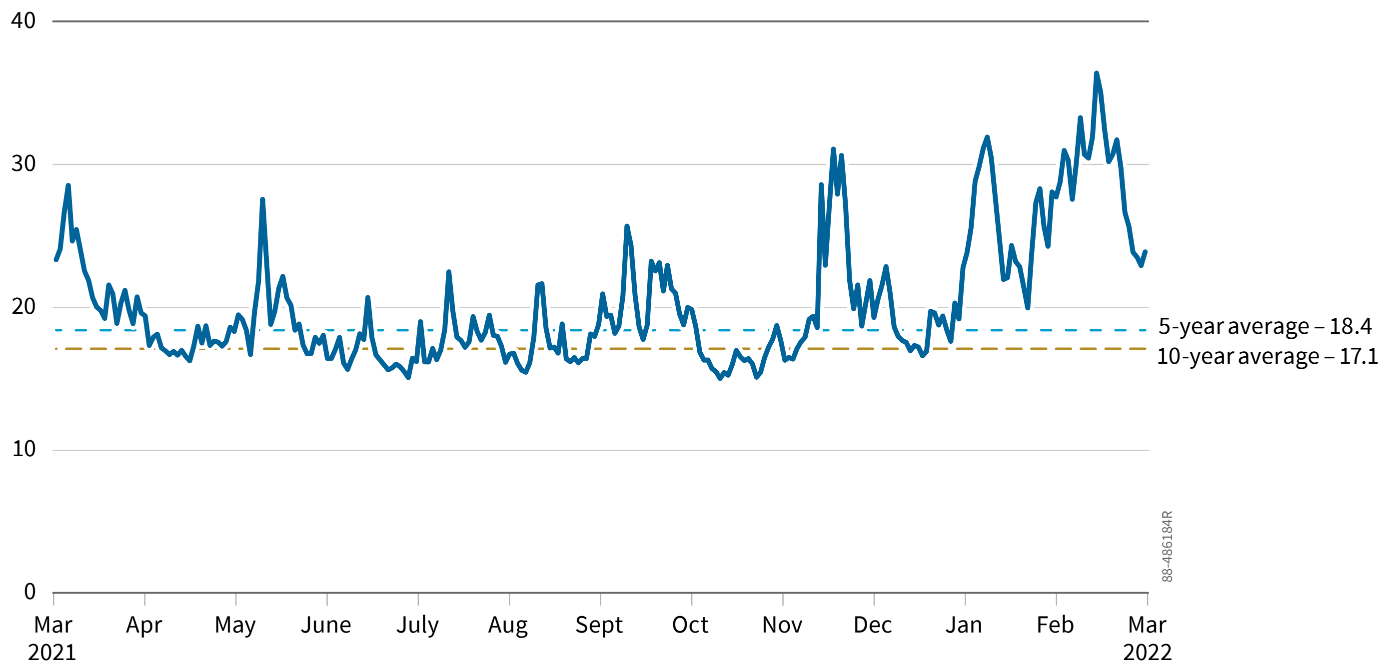
Asset allocation in a complex macroeconomic environment

The current market environment

In our 2022 Market Outlook, Navigating the new normal, we highlighted some of the key macroeconomic factors to consider as the global economy slowly works its way from pandemic conditions towards a "new normal." Since we published that piece, global markets have been roiled by the Russia-Ukraine conflict, which has sharply impacted capital flows and particularly affected sectors such as energy and commodities. According to Bloomberg's U.S. EQ:FI 60:40 Index, the traditional 60/40 portfolio was down more than 8% (in $US) as of April 15, 2022, its worst year-to-date performance ever recorded for the index, which began in April 2007.

> Since the start of 2022, we have experienced a period of heightened uncertainty, with the CBOE Volatility Index (VIX) peaking at 36.4, well above the five and 10-year averages of 18.4 and 17.1, respectively.

CBOE Volatility Index (VIX)



Source: Bloomberg LP as of March 23, 2022.

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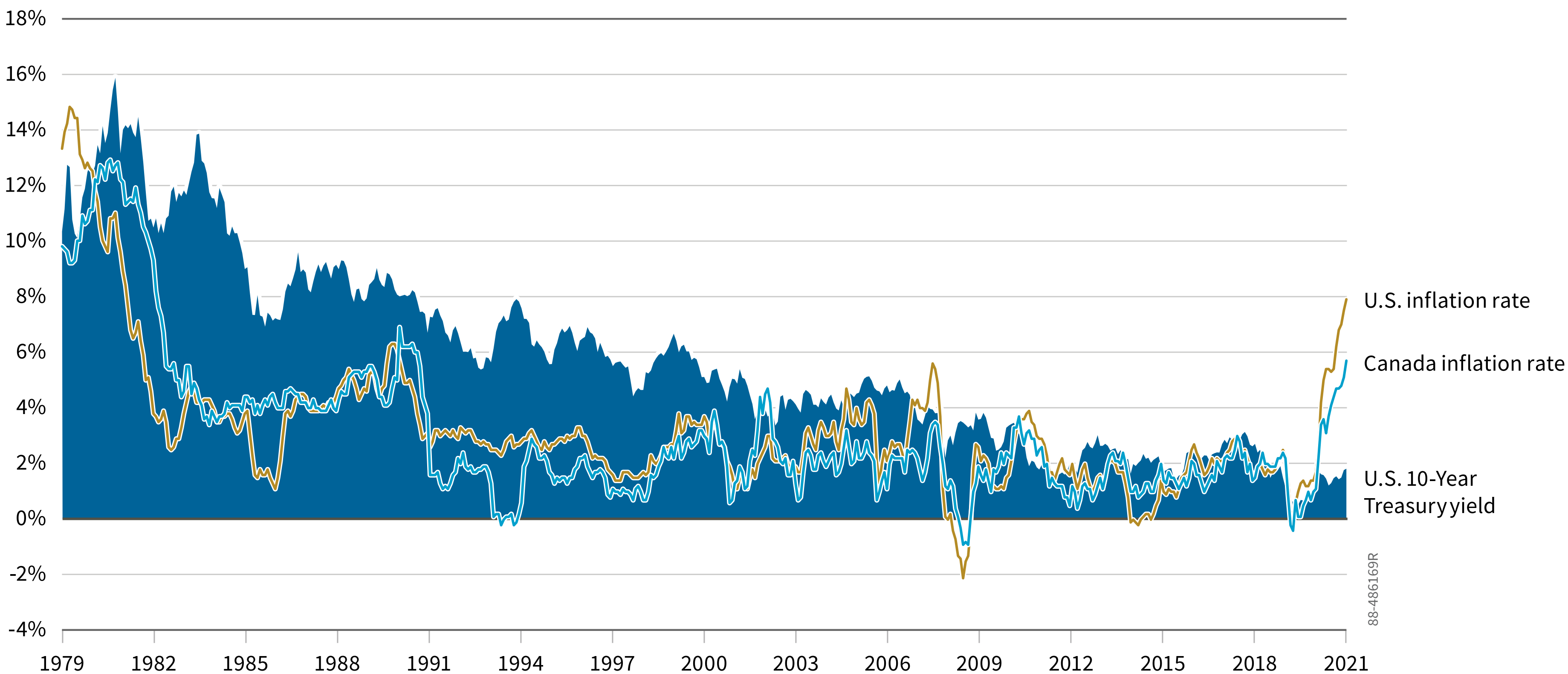
The current market environment – continued

Even prior to the conflict in Ukraine, investors were facing a more challenging investment environment with several headwinds, inflation being one of the most visible. The inflation rate in the U.S. and Canada rose to 7.9% and 5.7%, respectively, as of February 2022, their highest levels in decades. However, the high inflation of the 1980s was accompanied by even higher interest rates, which allowed bond investors to still earn positive returns after the effect of inflation. Today, the opposite is true and investors face negative real rates of return as bond yields remain well below inflation.

Inflation rate (year-over-year)



Source: Bloomberg LP as of February 28, 2022.

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The current market environment – continued

As a consequence, the world's major central banks have signaled that the cost of borrowing will be going up, as they attempt to rein in these rising cost pressures. In March 2022, the U.S. Federal Reserve Board raised its federal funds rate range to 0.25%-0.50%, the Bank of Canada increased its benchmark rate to 0.50% and the Bank of England announced its third rate hike in a row to 0.75%.

> While the ultimate pace and magnitude of rate increases is unclear, the upward direction seems certain. As the risk of runaway inflation weighs on investors' minds, central banks will continue to pay attention to the data in their quest to combat inflation while protecting growth and jobs.

"We have to take into consideration the fact that rates will rise this year. Central banks are moving towards normalization and there are a lot of moving parts. Right now, the name of the game is balance."

Jack Manley, Global Market Strategist
J.P. Morgan Asset Management,
sub-advisor to Canada Life

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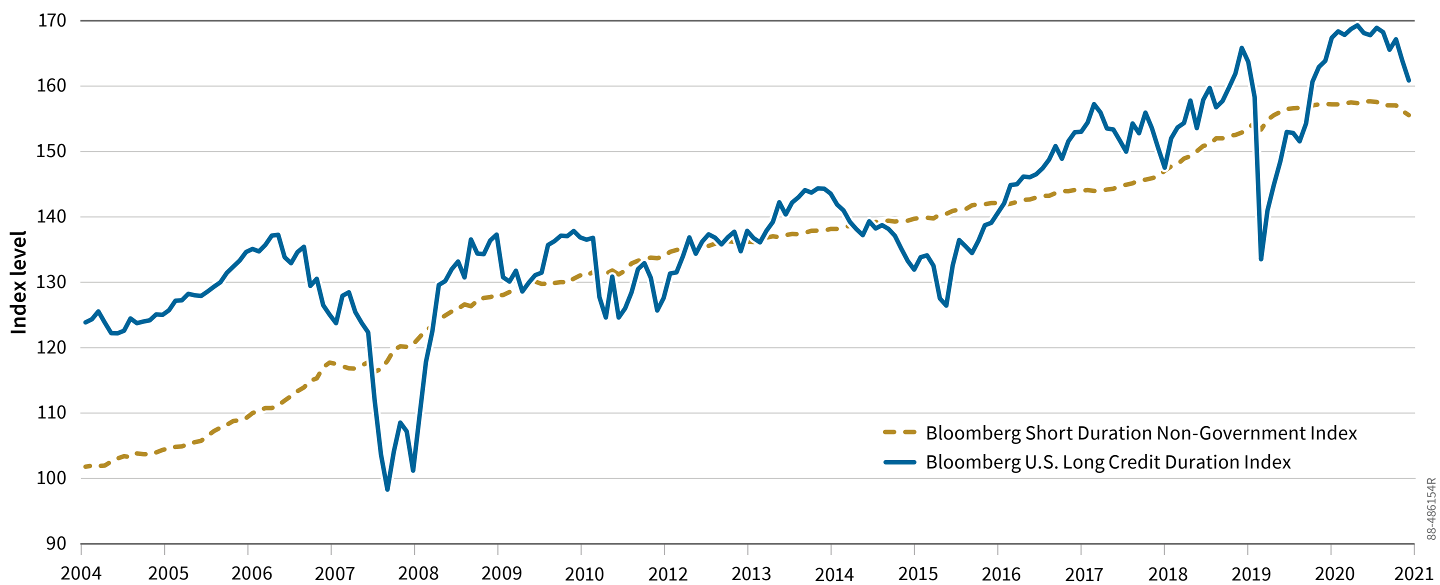
Asset class outlook

At Canada Life, we rely on world-class sub-advisors and portfolio managers to help design robust portfolios. We asked two experts who specialize in Managed Solutions at Irish Life Investment Managers (ILIM) and J.P. Morgan Asset Management (JPMAM) for their views on a variety of asset classes, with the following results.

Fixed income

With inflationary expectations high and rate increases generally expected, it is time to lighten up on duration (a bond's sensitivity to interest rate changes), which in turn reduces interest rate risk. Historically, as interest rates rise, bond prices decline. In addition to focusing on shorter-term issuances, consider creative ways to achieve yield without overly compromising safety. For example, look lower on the investment-grade credit spectrum. Emerging market debt, which requires a significant level of due diligence, and inflation-linked notes are additional potential sources of attractively priced fixed income and current cash flow. The graph below highlights how shorter duration bonds can minimize price volatility during periods of changing interest rates.

Long vs. short duration fixed income



Source: Bloomberg LP as of February 28, 2022.

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Asset class outlook – continued

Equities

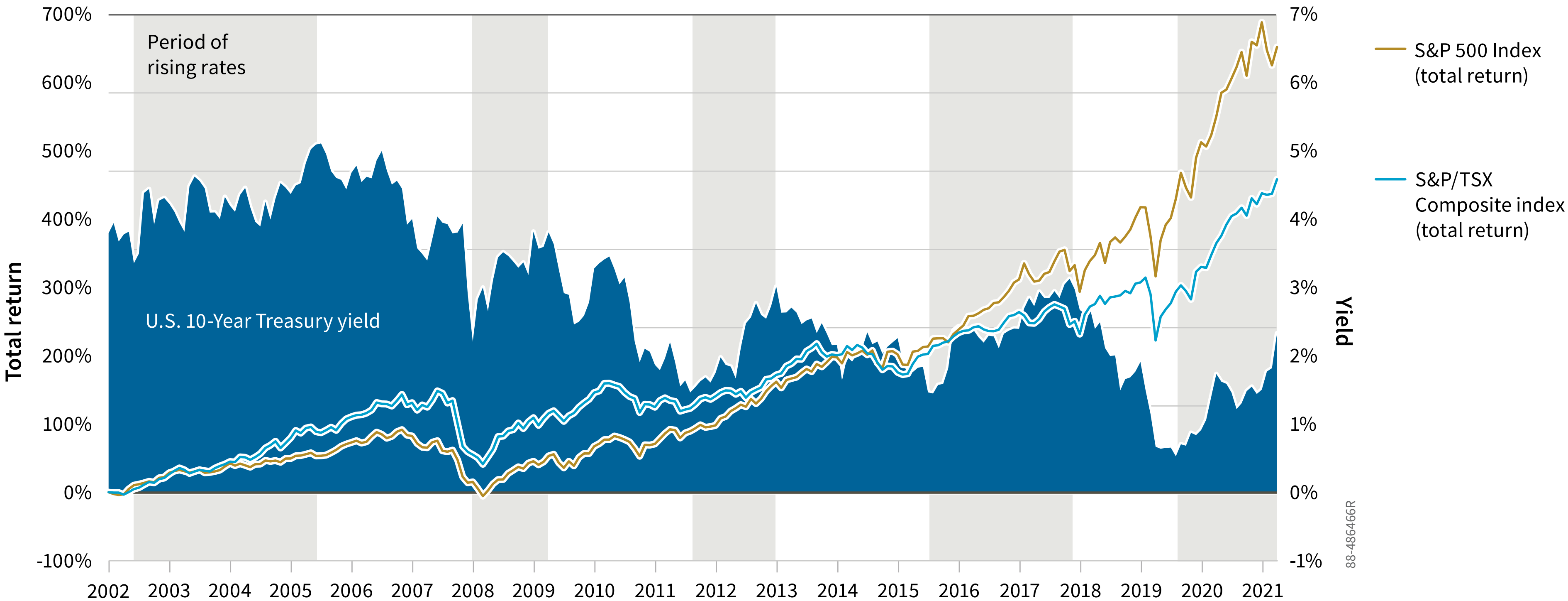
The impact of rising rates on equities is not as straightforward as it is with bonds. Nevertheless, history has shown that rising rates lead to increased borrowing costs and weaker consumer demand. Companies that are significantly indebted and rely on strong consumer demand may, therefore, be at a disadvantage. As such, our experts still have a generally positive outlook — with some caveats. While somewhat expensive versus historic valuations, corporate earnings have remained strong heading into the year. Many analysts still expect global growth to remain positive in 2022, but the outlook is clouded by uncertain macro conditions and conflict in Europe. Accordingly, the experts at ILIM and JPMAM recommend a focus on more defensive equity strategies and those with dividend paying abilities. Value-oriented equities are trading at an approximate 40% discount to growth equities, with more than double the dividend yield, making them the more attractive opportunity. So far this year, we've seen defensive equities such as consumer staples and value stocks outperform more recent winners such as technology stocks, which are likely to remain under pressure from a combination of rising rates and already high valuations.

Asset class outlook – continued

Rising rates and equity market performance

The following chart shows the impact of changes in the 10-year treasury on different equity indices. Even with increased borrowing costs and weaker consumer demand, equity markets have typically been resilient during times of rising rates.

Returns in rising rate environment



Source: Bloomberg LP as of March 31, 2022. Total returns.

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Asset class outlook – continued

Industry breakdown

The pandemic and its related supply chain disruptions have laid bare the fact that many industries have distribution constraints, some of which will take years of investment and increased capacity to fully resolve. This bodes well for the “veins and arteries” of the global economy – transportation, shipping, containers, etc. Commodities remain another attractive way to hedge inflation and, while more volatile on average, offer a degree of protection from rising input prices. Industrials, materials and energy may do well in this environment, which bodes well for Canada’s resource-based economy and by extension, Canadian equities.

Vibrant portfolios for volatile markets

Building and managing portfolios in this kind of environment poses unique challenges. As a result, markets like this present an opportunity to get back to basics. What are the keys to building well-crafted portfolios in uncertain markets? We believe it is important to consider asset allocation, active management and alternative investments.

Strategic and tactical asset allocation

Asset allocation is the process of investing in a range of asset classes to achieve preferred long-term outcomes. It is a critical component of portfolio construction that if done correctly, can enhance returns, mitigate volatility and provide downside protection – the latter being critical in the current market environment. Studies have indicated that asset allocation is a prime contributor to a fund's performance. One oft-cited study by Roger G. Ibbotson and Paul D. Kaplan found that asset allocation explains about 90% of the variability of a fund's returns over time. On top of strong overall strategic asset allocation, portfolios with the ability to make tactical changes (small, short-term tweaks to asset allocation) have the advantage of being nimble during times of heightened market volatility.

Stay active and stay flexible

Passive management gained in popularity in the low-rate, higher-growth environment that we may be exiting. In that environment, investors tend to be less discriminating as a rising tide carries all ships. However, with today's increased volatility and rising rates, we believe now is a good time to consider utilising a blend of both passive and active approaches. Advisors can help clients navigate the uncertainty by allocating more assets to best-in-class active managers with a track record of finding value in choppy or uncertain markets.

Active managers can be more dynamic in terms of security selection and sector allocation. And when managing fixed income, managers can also make tactical changes to duration and other attributes. In practice, active managers can tilt assets away from economically sensitive, or cyclical, sectors to more defensive sectors when markets are volatile. This tactical advantage allows for a nimbler approach, which could provide stability and success in a more difficult and volatile environment.

Time for alternative thinking

Alternative investments represent another attractive and rapidly-growing asset class that has a place in many modern portfolios. Most alternative strategies focus on delivering a diversified return stream that has less dependence on market direction and may come with lower volatility when compared to a traditional balanced portfolio. The goal is to maintain low correlations or low beta to global stock and fixed income markets. This allows these strategies to act as a stabilizer when implemented within a traditional portfolio. At Canada Life, Canada Life™ Risk-Managed Portfolios incorporate select alternatives into their overall asset allocation in an effort to deliver an uncorrelated source of returns.

"When designing portfolios, it is critical to ensure you're getting exposure to a broad range of diverse risk premia. Having a long-term view and using sound principles of diversification and risk management helps to deliver a smoother journey for investors."

Leonie MacCann, Senior Multi-Asset Portfolio Manager
Irish Life Investment Managers, sub-advisor to Canada Life

Time for caution, not capitulation

For many people, investing can be an emotional experience. When markets are volatile, it can lead to worry or even panic that drives some clients to withdraw their investments, often at the worst possible time. This is one of many areas where you add value as an advisor. You can help your clients develop and adhere to a solid financial plan and provide the education and expertise they need in a rapidly changing investment world.

Paired with well-crafted managed portfolios from Canada Life, such as Canada Life Risk-Managed Portfolios and Canada Life Sustainable Portfolios, you can help protect your clients' hard-earned savings by managing the impacts of uncertain markets.

To learn more about Canada Life's wealth offering, please contact your Canada Life wealth wholesaler today.

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