Striking a Balance

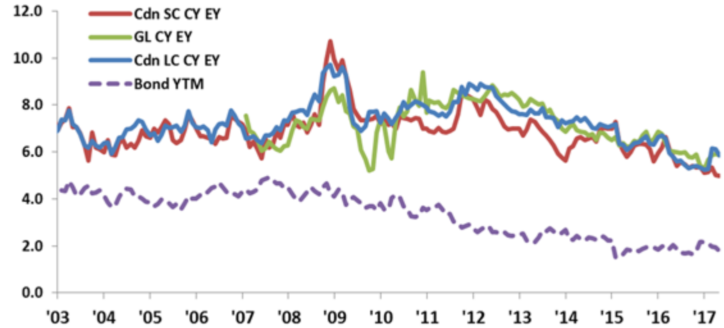
In setting our asset mix for our balanced strategies, we consider many different factors that influence our target weights for bonds and equities. We consider the state of the Canadian and global economies, and the policies that may affect their trajectory. At the same time, we look at many different economic indicators to assess inflation pressures, and with that, the expected path of interest rates. We also review valuations and expected returns for each asset class in determining the appropriate exposures.

Our review of economic indicators is important in assessing the relative strengths and risks in our economy. For example, Canadian real GDP growth continues to recover from the oil price shock in 2014, recently reaching long-term median levels of 2.5%, as shown in the chart below.

Source: Bloomberg

These improved growth measures must be considered in the context of high consumer debt levels in Canada, which pose a risk to our economy if borrowing rates or unemployment rates rise quickly. From our perspective, this current level of household indebtedness moderates the pace of growth and potential interest rate increases. It does not, however, prevent the Bank of Canada from raising rates, which should be expected given the improvement in key economic indicators.

An improving economy can be supportive of higher corporate revenue, earnings and market sentiment. This view, coupled with the prospect of rising interest rates, may lend itself to increased equity exposure in a balanced strategy. However, what is missing from this analysis is the price we are paying today for those future earnings.



Source: Capital IQ & Bloomberg

The above chart depicts the earnings yield for each of our three equity strategies (Canadian large cap, Canadian small cap, and global equity) and the yield to maturity of the QV Canadian Bond Fund over the last 15 years. The earnings yield provides a gauge of equity returns, while the yield to maturity is the comparative return of the bond portfolio assuming all bonds were held to maturity. We note that expected returns from all asset classes are currently lower than their long-term averages.

Given the yield advantage of equities over bonds, one could easily make the argument to always own a higher percentage of equities over bonds, especially since 2009. However, risk must be considered in this decision. Our own worst-case scenario analysis suggests a potential downside of 20% in our equity strategies compared to a potential loss of 1.5% in our bonds if yields (valuations) were to normalise quickly. While we are not expecting this type of adjustment, we must consider this possibility in our asset mix decision.

As above-average valuations in both stock and bond markets continue to offer a lower safety margin, we are maintaining our asset mix of 50% cash and bonds, and 50% equities in our balanced strategies. To increase equity exposure, we would require a higher earnings yield to offset the greater potential for capital loss. Conversely, further declines in earnings yields may prompt a more conservative asset mix.

Ultimately, our investment objective for our balanced strategy is to achieve above-average long-term growth while minimizing the risk of capital loss. At this juncture, we err on the side of caution, trying to strike a balance between risk and reward as high valuations across asset classes support a defensive positioning.