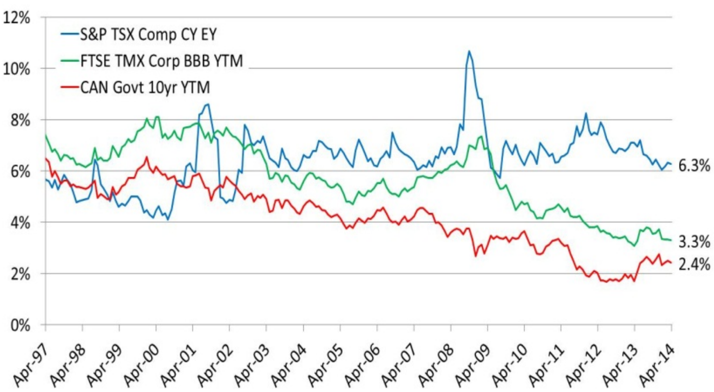
Reducing Risk

Relative yield comparisons provide the context for which we assess the opportunity between bonds and equities. This is an important consideration in determining the appropriate asset mix in our Canadian Balanced Fund and our global balanced mandates. Relative yields between government and corporate bonds, small cap stocks and large cap, and Canadian versus global equities are also evaluated in setting the appropriate investment allocation within each class. Relative yield comparisons may signal an opportunity in the higher yield class. They may also signal rising valuation risks.

The chart below illustrates the relative yields offered by Canadian stocks on the Toronto Stock Exchange (blue line), compared to BBB- rated Canadian corporate bonds (green line) and the 10-year Canadian government bond yield (red line) over the past 17 years. A widening gap between the yield on expected earnings of Canadian companies and current bond income yields is readily apparent. Replacing the TSX earnings yield with other



Source: Bloomberg, FTSE TMX, QV Investors Inc.

global indices would produce a similar result. An asset mix decision based purely on this yield relationship would likely lead to a large overweight in equities. And why not? A strategy to overweight equities in 2009, the last time the gap was so wide, led to strong double digit returns in most equity-weighted balanced funds, including our balanced mandates.

Following the financial crisis in 2008, the price decline in all risk assets resulted in double digit earnings yields for most equity indices, and large yield spreads between equities and bonds, and between corporate and government bonds. For investors who were willing to take on risk while the world was fearful, the returns have been extremely rewarding. Today, equity earnings yields have returned to their long-term averages. Yield spreads between corporate and government bonds have also narrowed to their historical norms. Investors are no longer fearful. In 2009, the deep valuation discount applied to all risk assets provided an opportunity. Today, the yield gap is a reflection of the continued suppression of bond yields by central banks in their attempts to support economic growth. We do not believe it presents an opportunity to increase our equity allocation. It is not just about the spread. Absolute valuations are not compelling.

Central banks' low interest rate policies have served to bid up the price of all risk assets. Now, after an extended equity market rally, we are at a turning point. Earnings growth must pick up in many sectors of the market to justify valuations. Inflation must stay low to justify these low bond yields.

To counter rising valuation risks for both bonds and equities, we are reducing our total equity target in our global balanced mandates to 60%. This may be reduced even further if equity valuations continue to rise. Our security level analysis still suggests small cap stocks are expensive relative to their potential reward. Cash remains elevated in our small cap portfolios in response. Canadian large cap stocks offer better value in comparison, though we are more tempered in our return expectations. We are finding attractive investment opportunities in global stocks, as indicative of our lower cash position in our global portfolios. For this reason, we are reducing our Canadian equity allocation to meet our lowered equity target. Our bonds remain short in term to mitigate volatility from changing interest rate expectations. They offer a future buying reserve.

We know we may be early in making this move. Equity markets may rally further given their relative yield advantage to bonds. To protect capital, we would rather be early in positioning the portfolios to withstand a potential correction, and provide a buying opportunity for more attractive and sustainable returns in the future.