RICHARDSON GMP

OUR PARTNERS

Jefferson | Steele

FIXED INCOME IN A RISING RATE ENVIRONMENT

DECEMBER 2015

INTRODUCTION

This is the fifth update we have provided since we published the report “Fixed Income in a Rising Rate Environment” in February 2011. The purpose of these updates is to provide our clients with an overview of the fixed income landscape and to discuss the current positioning of the fixed income component of client portfolios. So far, 2015 (to the end of October) has been a year of modest gains for fixed income. The returns were all realized in the first half of 2015 as interest rates fell. In the second half, expectations of a 0.25% rate increase from the US Federal Reserve and widening corporate bond spreads have dampened bond returns. Bonds, as represented by the Canadian Universe Bond Index exchange traded fund or ETF (ticker XBB on Toronto), have realized a total return (price appreciation plus reinvested interest payments) of 1.94% year-to-date to October 31, 2015.

The increase in bond prices in 2015 increases the potential that traditional bond portfolios will have negative returns in the short to medium term if central banks begin to raise interest rates as the global economy improves. Real interest rates (the nominal rate minus CPI), have reached all-time lows, with negative central bank rates in some countries, and acknowledgement of the possibility of negative rates from Bank of Canada governor Stephen Poloz.

Despite the risk of rising rates, we believe that fixed income needs to be a core component of client portfolios. When properly constructed, fixed income portfolios provide consistent income, act as a store of value, and are a hedge against equity market down-turns and the risks of systemic crises such as the one experienced in 2008-2009.

PERFORMANCE

In the past seven years, our fixed income portfolio has provided clients with higher returns than the benchmark with similar volatility. In addition, as demonstrated in 2013, we feel our portfolio is in a better position to protect capital in times of rising interest rates.

Please see performance table on next page.

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	2008	2009	2010	2011	2012	2013	2014	2015 YTD
Portfolio Returns **	6.74%	10.92%	10.64%	6.02%	6.90%	3.51%	5.92%	3.26%
iShares Canadian Universe Bond Index ETF Return *	6.10%	5.00%	6.40%	9.40%	3.30%	-1.50%	8.46%	1.94%
Alpha (portfolio return less index return)	0.64%	5.92%	4.24%	-3.38%	3.60%	5.01%	-2.54%	1.55%
Portfolio Compound Annual Return ***	7.20%							
iShares Canadian Universe Bond Index ETF Compound Annual Return***	5.21%							
CUMULATIVE OUTPERFORMANCE****	14.05%							
ANNUALIZED OUTPERFORMANCE****	2.64%							

* Source: iShares Canadian Universe Bond Index ETF (ticker XBB – TO) October 31, 2015. Distributions are re-invested.
** Source, Factsheets of constituent investments as of October 31, 2015. Performance is NET of fees.
*** Compound Annual Return Jan 1, 2008 to Dec 31, 2014
**** Percentage by which our portfolio has outperformed Benchmark over 7 years, and annualized over 7 years.

HOW ARE WE DIFFERENT?

Our Approach versus Traditional "Bond Ladders"

It is common for investors in Canada to own a 1 – 10 year government and investment grade bond ladder, a ladder of GICs, or an ETF to represent the Government and investment grade Canadian bond asset class.

The Jefferson|Steele team takes a broader approach to fixed income investing. We feel that investing only in Canadian government and investment grade bonds would be analogous to investing only in Canadian large capitalization equity for an equity investor. Thus, Canadian government and investment grade bonds are one of several components to our strategy.

We maintain a core position in Canadian government and investment grade corporate debt for the following reasons:

- We see these components as a key store of value and a hedge against equity market downside risk and the risk of systemic crises.
- Consistent income.
- Interest rates do not have to fall very far for a long duration bond portfolio to provide high single digit returns.
- Real Return Bonds, whose principal value and coupon adjust based on changes in the Consumer Price Index (CPI), can protect against inflation.

In addition to Canadian government and investment grade bonds, we add the following components to client portfolios:

- Global Bonds: Yields in certain parts of global bond markets are materially higher than in Canada. We believe the risk / return profile of parts of the global bond market, such as select emerging markets, is excellent. Currency hedging is a key skill of global bond managers and analysis of this skill is a key component of our due diligence process.
- High Yield Bonds: We prefer to use hedged high yield bond managers over using "long only" managers, picking individual bonds, or high yield bond ETFs. This approach can result in lower returns in a bull market for high yield bonds but has demonstrated, in periods such as 2008, the ability to protect capital. We believe that this capital protection element is of paramount importance. Hedged high yield has demonstrated that it can protect capital and make money in a rising rate environment, because it can profit from interest rate volatility as well as interest rate direction.

- Canadian Commercial Mortgages: Investors in this asset class receive a liquidity premium and an interest rate spread over investment grade bonds of similar credit quality. We feel that the security given by a first or second charge on a commercial building is better than a “promise to pay” given by corporate bond issuers. The short duration and demonstrated positive returns in rising rate environments in the past 5 years also make portfolios of commercial mortgages attractive.

The above components have demonstrated correlations from below one to slightly negative over the last 5 years which increases diversification and reduces portfolio volatility.

CURRENT POSITIONING

Our current portfolio addresses the current risks facing fixed income investors by having: lower duration and higher yield than the benchmark, inflation protection components, credit hedging and global diversification.

FIXED INCOME ASSET CLASS	TRADITIONAL WEIGHTS *	PORTFOLIO CORE WEIGHTS	PORTFOLIO CURRENT WEIGHTS
CDN Government & Investment Grade	100%	30%	23%
Global Government & Investment Grade	0%	10%	20%
CDN Mortgages and Mortgage Securities	0%	30%	33%
Hedged High Yield & Floating Rate Loans	0%	30%	24%

* As represented by iShares Canadian Universe Bond Index ETF (Ticker XBB – TO) October 31, 2015.

PORTFOLIO RISK METRICS	DEX UNIVERSE BOND INDEX ETF *	CURRENT PORTFOLIO **
Duration	7.25 years	3.71 years
Weighted Average Term to Maturity	10.18 years	6.8 years
12 month Trailing Yield	3.25%	4.28%
Standard Deviation (3 year) ***	4.21%	3.39%
Weighted Average Yield to Maturity	2.10%	4.08%

* Source: iShares Canadian Universe Bond Index ETF (Ticker XBB – TO) October 31, 2015. Distributions are re-invested.
** Source: Factsheets of constituent investments as of October 31, 2015.
*** Summed standard deviations of portfolio constituents. Correlations between portfolio constituents assumed to be 1.

Please feel free to contact us if you would like to discuss this update in further detail or if you have any questions.