FROM THE DESK OF

Ian Hardacre , MBA, CFA

SVP and Chief Investment Officer, Empire Life

Chief Investment Officer, Empire Life Investments Inc.

OUR TAKE ON MARKET VOLATILITY

November 2, 2018

The month of October historically has been one of the most volatile months for the stock market, and this year has turned out to be no different. Not surprisingly, I have been receiving more questions recently on whether this is just a normal correction or the start of the next major bear market. While one can never be entirely sure I would lean to the former, given the strong macroeconomic environment and consistent growth in corporate earnings. While we are well aware of the risks in the market such as rising interest rates, trade wars etc., the largest risk is likely the one no one has yet anticipated. However predicting the length of this correction is not the intent of this article. Instead, I want to take a step back and look at volatility from the perspective of our overall investment philosophy.

In the previous edition of this publication, I described our investment philosophy and process. In it, three tenets were described: Business, Management, Valuation. Over the last decade valuation is often the most challenging of the three tenets of investing. In a nutshell, often the best businesses with the strongest management teams have traded at valuations that we deem far from acceptable. However, valuation is the tenet that is likely most impacted by market volatility, but in a good way for the long term investor.

Negative market sentiment often does not discriminate – it impacts shares in both good and bad companies. From a bottom-up investment manager's perspective, this makes high quality companies more attractive and allows us to invest more in opportunities that were previously too rich for our liking. It allows the investment team to purchase companies that we have followed, in some cases for years, at a valuation that we find acceptable. Volatility also allows company management teams to buy back shares in their own stock at discounted values, thereby increasing the intrinsic value per share of the remaining shares outstanding. As difficult as it is to endure, market volatility should be interpreted as an opportunity for the disciplined long term investor focusing on value and quality.

High quality company management teams are discerning allocators of capital. They focus on opportunities that are likely to contribute to returns on invested capital over a longer time period. We value our investors' capital with similar regard and prudence. We focus on the best longer term opportunities at the best price, and market volatility can broaden this opportunity set.

Another question I usually get in times of heightened market volatility is – are you raising cash to protect the portfolios? As you've probably guessed, the answer will likely be no. We generally manage with marginal cash (approximately 3-5%). Raising large amounts of cash and then attempting to deploy the cash before the market recovers is an almost impossible task. We prefer to reallocate the funds between our different companies based on the risk reward spectrum. Again, we treat market volatility as an opportunity to invest in companies that were previously too expensive We do not run away and hide. We are more likely to raise cash in frothy markets when value opportunities are harder to come by.

Empire Life Investments

Lastly, I'd like to address my definition of downside protection. Downside protection means avoiding a permanent loss of capital. This means we want exposure to companies whose intrinsic value is stable or growing, and avoiding companies whose intrinsic values are declining or at risk of declining. It does not necessarily mean minimizing price volatility, as volatility can lead to better opportunities. Market volatility has a direct impact on a stock's price, but its effect on the company's intrinsic value is much less direct, and that's what we focus more on.

On a side note, I'd like to provide an update on our new global oriented Funds launched back in May. I'm very happy with the progress made on these Funds in terms of how they're positioned for the current environment and the investor interest we've received in them. Our Strategic Corporate Bond Fund was created to provide an option with lower interest rate sensitivity in a rising rate environment, and that's exactly how it's performed. Our Global Asset Allocation Fund and our global-oriented options in our Emblem Portfolios were created to provide more options in U.S. and international markets. With U.S. markets faring better than all other major equity markets so far in the year, these products couldn't have come at a better time.

Ian Hardacre, MBA, CFA,SVP, CIO, Empire Life

For more information on products visit empire.ca.

INV-2297-EN-11/18

Empire Life Investments®