INVESTMENT INSIGHT

An interview with Paul Holba

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How would you describe the 2022 investment environment?

Last year was a challenging one for most asset classes. Stocks took a significant hit, and bonds had one of their worst selloffs in history. Global stocks and bonds lost more than $30 trillion in 2022. The losses came after the central banks, led by the U.S. Federal Reserve, raised interest rates more aggressively than they have since the 1980s to combat the worst inflation in decades. The combination of rising inflation, higher interest rates, the conflict in Ukraine, and worries of an impending recession triggered the heaviest losses in the global equity markets since the 2008 global financial crisis.

Did markets in 2022 favour a particular investment style?

With central banks tightening the money supply and raising interest rates, effectively ending the cheap money era, investors shifted towards investments that generated high dividends and steady earnings. Rising inflation led investors to safety plays, such as stocks in the utility, consumer staples, and healthcare sectors, all of which outperformed the overall market. Value stocks in markets worldwide, specifically in Canada, and the U.S., all posted positive returns (in Canadian dollars) in 2022.

How did Empire Life's investment managers cope with the environment?

Depending on the investment mandate, the investment team made several tactical allocation decisions on asset classes, geographic locations, and sectors. This is vital to managing investment portfolios such as the Empire Life Emblem Portfolios and Empire Asset Allocation GIF, helping the latter fund earn an A+ FundGrade award[1] for performance in 2022 and ending the year with a 5-star Morningstar rating.[2]

Was geographic and/or sector asset allocation important, and did it change during the year?

At the beginning of the year, the investment team de-risked Emblem portfolios by tactically increasing fixed-income and decreasing equity exposure, specifically in the international markets, to address a range of concerns, including ongoing inflationary pressures, geopolitical uncertainty and certain pockets of elevated valuation.

Managers of the Empire Life Asset Allocation GIF also made a series of incremental tactical asset allocation decisions last year, including shifting some geographic exposure from international equities to Canadian equities right after Russia's invasion of Ukraine that sent energy prices soaring. The fund also gradually increased fixed income duration when the managers saw the signs of inflation peaking and a slowdown in economic activities in the fall of last year.

What kind of a year was 2022 for stock picking?

Heightened volatility last year wasn't bad for everybody. Significant market swings allowed the investment team to buy shares in some high-quality companies "on-sale" because their valuations had dropped to levels we haven't seen for many years.

Were your managers able to pick up good stocks at reasonable prices to set the stage for future gains?

One example held across a wide range of funds is Maxar Technologies. Maxar is a leader in space intelligence and earth observation — they are a leading provider of detailed satellite imagery to U.S. agencies and recently won extensions on their contracts.

The company is nearing the launch of its next-generation satellites, which will enhance capabilities and enable an array of new products. The investment team's view has long been that Maxar is a fantastic and grossly underappreciated asset and would fit very nicely into some of the larger defence primes focusing on space.

The investment team added to their position during the second quarter of 2022. We weren't the only one to realize its value. On December 16, 2022, Maxar announced that Advent International would acquire it at a substantial premium (more than double) to its previous day's close.

Another example is Ross Stores. Our managers have owned and liked Ross for a long time. It's an off-price retailer in the U.S. Their business model is to buy at massive discounts, inventories that department stores purchased but couldn't sell. Ross then sells those inventories, and their customers get crazy deals on name-brand apparel while Ross still earns good margins. This is a business has exhibited solid profitability, great returns, and ample store growth opportunities ahead of them. They have been able to generate meaningful free cash flow, and have consistently bought back their stock (share count down 15% since 2016). So that's the quick snapshot of the business itself. Lots to like there.

Then last year, as everyone was worried about supply chain, inflation and consumer spending, especially the lower-end consumer (where Ross customers skew to), Ross sold off. The general market sentiment made this worse. Seemingly the market ignored the fact that economic distress leads to Ross getting even better inventory from department stores and fire sales from stores that are shuttered. The investment managers expected Ross to come out of this period strongly and continue to prosper.

The investment managers were delighted to take advantage of that and added to the position in the low $70 in the U.S. fund.

How did you cope with your fixed-income exposure as interest rates rose?

Overall, we were underweight longer duration bonds throughout the year, and overweight corporate credit in our fixed income portfolios. We also tactically adjusted yield curve exposures throughout the year, and began adding duration again opportunistically through the second half of the year.

As yield curves inverted due to the accelerated tightening of monetary policy, the investment team was able to take advantage to find opportunities to pick up yield in shorter-term bonds issued by companies with resilient balance sheets. The managers tactically positioned Empire Life's core fixed income portfolio with a "barbell" strategy with overweight positions in short-term bonds issued by companies with resilient balance sheets, and in longer dated government bonds, while remaining underweight in the belly of the yield curve.

These short-term corporate bonds provided meaningful yield pick up (or spread) over comparable government bonds and some of the highest all-in yields since the financial crisis. At the same time, their resilient balance sheets and shorter-duration limited their default and mark-to-market risks.

At the other end of the spectrum, longer-dated government bonds were likely to benefit should economic risks heighten due to restrictive monetary policy.

What investment environment are you anticipating in 2023?

2023 has started as we expected with inflation concerns and market volatility. As we move through the year, we expect to deal with high (but easing) inflation and a global slowdown that could lead to a mild recession. We believe we're closer to the end of the current interest rate hike cycle than the beginning, especially in Canada. So, some challenges might ease up in the year's second half if inflation calms down and monetary policies loosen up as we expect. But the significant challenges of nationalism, de-globalization, and geo-political divisions will probably continue to cause volatility in financial markets.

How are your funds positioned?

Empire Life's investment strategies reflect a cautious view of the environment. We're taking a defensive stance by keeping more cash and diversifying our investments across different asset classes, sectors, and regions. The investment team will keep focusing on picking the right companies to invest in that can handle the slowing global economy.

The investment team will also use market volatility to buy shares in some high-quality companies "on-sale" because their valuations have dropped to levels we haven't seen for many years.

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[1] Source: Morningstar Research Inc. as of December 31, 2022. Morningstar is an independent organization that groups funds with generally similar investment objectives for comparison purposes and ranks them on a historical basis. Morningstar Ratings reflect performance as of December 31, 2022 for Class A and G units and are subject to change monthly. The ratings are calculated from a fund's 3, 5 and 10-year returns measured against 91-day Treasury bill and peer group returns. For each time period the top 10% of the funds in a category get five stars, the next 22.5% four stars; the following 35% three stars; the next 22.5% two stars, and the bottom 10% one star. The Overall Rating is a weighted combination of the 3, 5 and 10-year ratings. The CIFSC categories and number of funds in each category for the standard periods are: Morningstar Rating is for Class A units only; other classes may have different performance characteristics. Class A units only available to existing clients. For Empire Life Asset Allocation Fund-A the number of Tactical Balanced funds for each period is as follows: 3-year: 180 funds, 5-year: 161 funds, 10-year: 58 funds.

[2] FundGrade A+® is used with permission from Fundata Canada Inc., all rights reserved. The annual FundGrade A+® Awards are presented by Fundata Canada Inc. to recognize the "best of the best" among Canadian investment funds. The FundGrade A+® calculation is supplemental to the monthly FundGrade ratings and is calculated at the end of each calendar year. The FundGrade rating system evaluates funds based on their risk-adjusted performance, measured by Sharpe Ratio, Sortino Ratio, and Information Ratio. The score for each ratio is calculated individually, covering all time periods from 2 to 10 years. The scores are then weighted equally in calculating a monthly FundGrade. The top 10% of funds earn an A Grade; the next 20% of funds earn a B Grade; the next 40% of funds earn a C Grade; the next 20% of funds receive a D Grade; and the lowest 10% of funds receive an E Grade. To be eligible, a fund must have received a FundGrade rating every month in the previous year. The FundGrade A+® uses a GPA-style calculation, where each monthly FundGrade from "A" to "E" receives a score from 4 to 0, respectively. A fund's average score for the year determines its GPA. Any fund with a GPA of 3.5 or greater is awarded a FundGrade A+® Award. For more information, see www.FundGradeAwards.com. Although Fundata makes every effort to ensure the accuracy and reliability of the data contained herein, the accuracy is not guaranteed by Fundata.

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