ASK ME ANYTHING
with the Empire Life Investments team

Transcript for Ask me anything webinar on March 28, 2023
Albert Ngo, Senior Portfolio Manager

Good morning, everyone and good afternoon. Welcome and thank you for joining us today. My name's Rob Popazzi, I'm the Vice President of retail distribution for Empire Life, and I'll be your host for our session this morning. On behalf of my sales team colleagues, I want to welcome you to the return of our AMA or Ask Me Anything webinar series. We'll host several of these throughout the course of the year to provide you with the opportunity to have your questions answered by members of our investment team. So, today's date is March 28th, 2023, and we're excited to have Albert Ngo, our Senior Portfolio Manager with the Fixed income team. But before we get to Albert, let's begin with a few updates.

I'd like to take the opportunity to thank and congratulate our investment team for their hard work last year. Based on the results posted in the recent Investment Executive article, "*Stock Picking Supports Segs in 2022*",[1] published this month, Empire Life ranked second in the industry based on overall segregated fund performance in the 2022 year. As of December 31st, we had over 84% of our assets under administration in the top two quartiles. And this comes fast on the heels of both Empire Life Asset Allocation GIF and the Empire Life Short Term High Income GIF being awarded a FundGrade A+® Award.[1] And over 12 funds achieving a 4-Star Morningstar Rating™,[2] or higher, which is a fantastic job.

Additionally, we're excited to announce that we are continuing both the GIF Growth Commission Bonus campaign as well as the CI Concentric GIF Commission Bonus campaign for 2023. So be sure to ask your local sales team for more details on those programs.

Now before we move on, I do have to get to some of the legalese. And I want to remind everyone that this presentation reflects the views of Empire Life as of the date published and is subject to change without notice. The information in this presentation is for general information purposes only, is not to be construed as providing legal, tax, financial, or professional advice. The Empire Life Insurance Company and its affiliates assume no responsibility or any reliance on or misuse or omissions of the information contained in this document. Information obtained from and based on third-party resources are believed to be reliable, but accuracy cannot be guaranteed. So please seek professional advice before making any decisions.

So now, with that behind us, let's get our webinar underway. There are many factors affecting markets around the world, concerns about inflation, banking instability, fears of a growing recession, are just to name a few. So, we've reached out in advance for questions, and we'll address them directly with Albert. If you have any additional questions, please put them into the chat and we'll address them as time permits. If we run out of

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[1] Source: Investment Executive, 2023, *Stock Picking Supports Segs in 2022*, accessed April 13, 2023, < https://www.investmentexecutive.com/newspaper_/news-newspaper/stock-picking-supports-segs-in-2022/ >

minutes, we'll make sure we have someone respond to you following the webinar. So, to help us answer some of these questions we've asked Albert Ngo to join us. Welcome Albert.

In your recent Off the Cuff video, you outlined several potential scenarios for financial markets. And in light of the recent events, I'm wondering what impact they've had on interest rates, credit spreads, and what indicators you're looking for to help inform where we land?

- That's a great question, Rob. I'll start by just reminding everyone some of what I mentioned in the Off the Cuff. I outlined a few scenarios. One was for a no landing scenario where inflation comes down and growth stays strong. Another scenario would be a soft landing where inflation comes down, while growth slows but is still positive. Continued high growth and sticky inflation is another scenario. A fourth scenario would be a hard landing where inflation comes down, but unfortunately, we enter into a recession. And in my opinion the worst-case scenario would be a scenario of stagflation where inflation stays high while we enter into a recession.

- I also mentioned in the Off the Cuff that it's very difficult, if not impossible to predict where we're going to land. If you think about the beginning of the year before these recent bank failures, we had very optimistic markets. And the market was actually pricing in a decent probability of a no landing scenario. But as you know, after the recent bank turmoil, interest rates have moved lower, credit spreads have widened significantly. Which suggests an increased probability of a soft landing or maybe even a small probability of a hard landing. But as I said, it's impossible to predict and only time will tell.

- If we look at the moment, to me it doesn't appear there's a broad banking crisis. But I do believe in the near-term financial conditions are going to get tighter, which is going to put pressure on growth. Inflation, my long-term view is that it eventually will abate. But in the near term it's definitely the wild card here. We have components such as goods which have come down, there's deflationary pressure in shelter. There's been very sticky components of inflation, primarily in services. So, in terms of what we are monitoring, we're focused on employment and consumer data to give us insights on the health of the consumer. And in particular, inflation data. And we're paying particular focus to important categories such as used autos, shelter. And now it's been sort of a sticky component, which is airfare.

With the failure of the Silicon Valley Bank and the sale of Credit Suisse, can you help us understand what's happened there and what the broader implications are for the global financial system?

- There's a lot to unpack there. So, I'll do my best to address the core issues. Broadly speaking, I think the issues to these recent bank failures come down to risk management. In the case of Silicon Valley Bank (SVB), you had a big mismatch of assets and liabilities. So SVB’s assets were heavily skewed towards long duration bonds that had really large mark to market losses. And in fact, these mark to market losses were actually greater than the company's equity value on their balance sheet. So that gives you a sense of the magnitude, which is very different than other banks in the system. At the same time, they also held almost entirely uninsured deposits that could be withdrawn at any given time, which also exacerbates this mismatch.

- Another component was their client base was very much concentrated amongst start-ups that needed the cash and needed to withdraw the cash. And that was further exacerbated by a number of large accounts. To meet those withdrawals, SVB had to sell a significant amount of bonds at a loss and crystallize these losses just to cover the withdrawals. And then once, like any sort of bank run, once fear gets to a point, plus with the losses on the balance sheet, there was just no recovering here. So that really speaks to the specific issues at SVB.

- As far as Credit Suisse is concerned, I would say its demise was linked to two big scandals over the past couple years, which have really dented the trust in Credit Suisse. I'm sure people will recall the collapse of Greensill funds, which Credit Suisse distributed. And at one point 10 billion dollars of client money was frozen, which is not a great way to build trust long-term, obviously. And at the end of the day, Credit Suisse ultimately realized a 2 billion dollar loss, which is quite significant.

- And then the other was the collapse of the Archegos Family Office. This made a lot of headlines. Archegos was a client of Credit Suisse, and after Archegos collapsed, Credit Suisse, which was a significant lender to Archegos, ultimately lost 5 billion dollars. You combine these events that lack some risk management, an erosion of trust, an over-leveraged balance sheet. And then the announcement that their largest shareholder would not continue to support it with additional equity infusions. And you had sort of the quick demise of Credit Suisse.

- The main takeaway here is, I think these were unique circumstances. I don't think these bank failures were indicative of broader systemic issues, but obviously only time will tell. If you think about what has happened since the financial crisis, these global systemically important banks have become better capitalized due to higher regulatory requirements. And they've also become more resilient to face financial shocks as they're stress tested every year. That being said, there are pressures in the banking system. SVB definitely brought to everyone's attention that the rapid increase in rates has led to pretty significant, unrealized losses in bank bond portfolios, now some have larger than others. And in isolation this is not an issue, but it's more of a risk when you combine that with the risk of deposit outflows. And so that being said, there are some pressures on deposits. In this environment they don't pay savers very much interest, and they're not sticky. So, banks are going to maintain extra liquidity in the system, on their balance sheets, rather. And then we've also seen spreads, even on healthy banks, widen. The cost of capital for banks is increasing. At the same time, lending rates are already quite high for borrowers. So, I think this will ultimately put some pressure on bank margins. If you put all of this together, I think you will see banks will be less willing to lend. And I think that overall, this will be a headwind for growth.

Okay. So not necessarily global systemic issues that when you look at SVB and Credit Suisse, but certainly some caution around some of the other elements at a macro level.

- I think that's well summarized.

We often hear about how sound the Canadian banking system is, how well its faired during the financial crisis. What risks do you see for our banking system? Are they the same as what you just spoke about or are they slightly different?

- I think the risks to the Canadian bank system are similar, but they are definitely mitigated, based on how well the Canadian banks are positioned to absorb these shocks that I talked about. Look, they're very well capitalized, they have high capital ratios well above their regulatory minimums. And they're generally pretty good businesses in that they generate very high return on equity, especially compared to some other global banks. Another feature is just given the large market share of the large Canadian banks, they tend to have much more deposit stability. And even if they do face some increased deposit withdrawals, they maintain very high liquidity ratios. And then the last piece is if you dig into their balance sheets, they have relatively low unrealized losses on their balance sheets stemming from their bond portfolio. So yes, the risks are similar, but I think for all those reasons the risk is far mitigated.

Would you say the financial controls as well would be another element, the risk aversion I guess, maybe, perhaps?

- I think part of that is the by-product stemming from having larger players in the marketplace and not having as many players. I think that all these sort of competitive market structures as well as regulatory regime really help here.

In Canada, we often get questions about the investment team's currency views. What's your view on the Canadian dollar?

- As everybody knows, currency can be very volatile and very extreme. In fact, currency moves can distort and sometimes even outweigh the returns of foreign holdings. And this is especially true for fixed income. I will admit that I'm not a currency expert, so I don't have a strong view on the Canadian dollar. And the funds that I manage, the two fixed income funds I manage, which are global mandates, my objective really is to deliver to the unit holder fixed income returns that come from our process of selecting good or mispriced corporate issuers. And so, in order to deliver that fixed income like return, I end up hedging the currency exposure in the funds I manage. So, in a way, given the nature of how I manage currency risk in the funds, since I manage almost all of that risk, I don't really have to take a strong view. So that's our approach to currency and the funds that I manage.

Speaking of the banking system there is a question. Is Empire investing in the Schedule B bank debts with these banks, the higher risk, less regulatory attention, higher risk versus higher interest rate? What's our strategy in this space?

- I can only speak to the funds that I manage. The funds that I manage, I do own some notes that are issued by Schedule B banks. Those tend to be very highly rated, A or higher, and very, very short in duration. So, I sort of use those more as money market type instruments of, call it a year or so or less. And then in terms of the approach to banking, and I can touch on this a little bit later as well, the US regional banks. There are a handful of regional banks that aren't quite regional, they're super regional, very large, very diversified businesses with significant scale. And there's been a couple opportunities that have come up that we started to take small positions in. Under the view that these banks are very different, well-capitalized. We've had to dig through deep into balance sheets and look for banks that have managed their duration better, who have less exposure to long-term treasury bonds and less exposure to corporate real estate. There have been some babies thrown out with the bathwater that's made us really have to dig into the balance sheet. So, we've seen a couple opportunities there.

There's a bit of a follow-up question as well, talking a bit about market volatility, which we've kind of been alluding to. The directional rates are really sending these very mixed messages. Would it be better to leave client funds in a tactically managed asset allocation fund versus some other choices?

- Yeah, so I think I've said before, a lot of these movements are impossible to predict. And so, my view is that it's always best to have some form of diversification and to sort of be able to manage different risks that may occur at any given time. So, I do think something that's tactically managed or a balanced fund is by nature inherently diversified. I do think diversification is key here. So, without getting in too much detail, I think the more diversification the better. That's what I'd have to say with respect to that.

One of the questions, and maybe you could spend a bit of time on this piece, would be around this volatility and uncertainty. What opportunities are you seeing in the market? You talked a little bit, you're seeing some opportunities in regional banking. What are some of the opportunities you're seeing and how are you positioned?

- So let me just step back first and maybe talk a little bit about the goal of the two fixed income funds I manage, and then that will help explain opportunities we're seeing and positioning. So just a reminder, the two fixed income funds I manage, in general, the goal is to provide extra yield by taking on selective measured credit risk, while keeping duration low. And keeping that sensitivity to rapid and big movements and interest rates low and mitigated. So, both funds at a high-level yield around six and a half percent, give or take. Which is around 260 basis points more than their equivalent treasury bond. But to do so, to get there, I do it in different ways depending on a unit holder's risk tolerance. Whether they want to take on a little bit more interest rate risk or credit risk. So, the first GIF is the Short Term High Income GIF. It takes on very little interest rate risk with the duration of only about two years. And picks up that incremental yield that I talked about by taking on what I'd say is a moderate amount of credit risk. And it has an average rating of BB or so. The second is the Strategic Corporate Bond GIF. This achieves sort of the same yield but in reverse. By taking on a little bit more interest rate risk with a duration of four years but taking less credit risk with an average rating of BBB.
- That's how the funds are set up and that's the goals of the fund and how they're positioned. So, the key thing is no matter what happens in markets, no matter what happens with volatility, no matter what happens out there, I think the key is to really stick to your process. And so, for me, in terms of the two funds that I manage, the key for me is to stick to my process. Which is primarily investing in corporate issuers who I believe will either pay us back in full or whose risk is mispriced, while at the same time maintaining that low duration, low interest rate risk. So again, stick to my process, stick to the sort of key tenants here, and not sort of swing wildly around on duration or credit risk. And sort of stay within a band to deliver these types of returns.
- So that being said, since early last year I increased the overall credit quality of both funds while maintaining that consistent and low duration in both funds. Inflation has proven to be stickier than everyone believed, and again it's still very difficult to predict. So that lower duration positioning has really helped reduce the volatility in the funds. In addition, in terms of positioning, I've selectively and tactically increased small exposure to government bonds. And these are useful as they really act as a buffer for the portfolios during periods of market stress that we've just had. And then the last point, just to expand on what I said earlier, with the recent volatility, spreads have widened across the board, but I would say mostly in the financial sector. So we've dived into balance sheets, tried to find which are some of the more resilient sort of super regional banks, and where can we pick up a higher incremental spread for that sort of resilient balance sheet. So those have been a couple situations. And then I would also say just given the economic sensitivity of the resource sectors, just given with the recent volatility, we've added to a couple short-term bonds of resource companies that are going to mature in a year or two, whose near-term prospects and near-term fundamentals are very strong. So those are the types of examples of opportunities that have risen that we've tried to take advantage of, while sticking to our process and sticking to the core positioning of the funds.

That's fantastic. And again, some great results from that approach so far and we're looking forward to more continued results. Albert, is there anything from a final perspective that you wanted to make sure that the attendees are aware of? Just from a philosophy or sort of perspective for your funds on the Fixed income team?

- In past communications, in our memos and in our discussions, we always want to take a very diversified approach to fixed income. I'd like to reiterate, so much of what impacts fixed income returns is the movement of interest rates. Which I think are very hard to predict with some degree of accuracy. And so, the key with your fixed income portfolio and positioning is to have that diversification. Have some of that portion allocated to government bonds, which work very well as insurance during market stress. And then add to that, such as what I do and what we do, opportunities in corporate credit and other areas of credit. Where you can pick up that spread and that yield relative to treasuries. And so, we offer the three GIFs. We have the Short Term High Income GIF, we have the Strategic Corporate Bond GIF and we have the Bond GIF. And each of those plays a role within your diversified fixed income portfolio. You have the sort of lower duration, higher yielding, you have the middle duration with higher yielding, and then you have a long

duration, but extremely high credit quality to help offset that risk that we take in the other funds. So, I always try to reiterate diversification. But every investor has different priorities, has different risk tolerances, so we've parsed them into three broader buckets to meet those needs. For anyone who really doesn't want to take that interest rate risk, we have an option. For someone who really doesn't want to take that credit risk, we have that option. And then we have something in the middle. So, I think that's sort of the big takeaway that I'd want to reiterate.

We have had some questions come in aligned with that, actually. One of them is, what are the returns you're expecting from these funds after the MERs?

- That's a good question. That requires a little bit of crystal ball work, which is very challenging. So, the way that I always think about it is if you step back, you start with what the fund yields, and then you take away the MER. And that's what the return profile should look like in an environment where rates don't move and credit spreads don't move. That is what your core earning potential is in that portfolio. Now the impossible thing is that we've never existed in a world where interest rates don't move and credit spreads don't move. And that's the part that's most difficult to predict. I will say that to get back into that, you can sort of say what's the yield, and then how much duration risk has the fund taken and how much credit risk has the fund taken, to think about potential upside or downside swings. But very difficult to predict where rates and spreads are going to be at any point in time in the future.

And again, a similar question along the same lines. Since interest rates in Canada, that sort of increase feels paused for now. Is it time to focus more on the long-term investments more than on our traditional bond fund?

- In terms of the potential for fixed income returns, I will say that in this environment, the yield on the 10-year Canada is 3%, that's the highest it's been in a decade. If we also look at corporate bonds, corporate bond yields are the highest they've been in more than a decade. So just looking at history, in terms of relative to history, the higher the yield suggests this is a relatively more attractive entry point into fixed income, more so than we've seen in the past 10, 12 years. The other thing I would also remind is, we've come out of this environment where interest rates were near zero. And at that point buying a bond with the near zero yield, not only was there a low yield, but it did not really provide a lot of defense during periods of market stress.
- But if you look at this past period, we entered the year with yields closer to 4%, highest we've seen in a long time. Last year I saw lots of articles about the death of the 60/40 portfolio. And then this year I've sort of seen a lot of articles regarding the return of the 60/40 portfolio. So, I do think in the long-term, fixed income plays an important part. Last year was sort of a one in a 40-year anomaly where both equities and bonds were down. But given where the yields are now, given how high they are relative to the past 10, 12 years, they are doing what they're supposed to be doing in a diversified portfolio.

So changing gears a little bit, this question's more about the offering size. So, does your group have access to smaller offerings as opposed to the very large entities that are out there?

- Yes, our size enables us to be fairly nimble in the fixed income market. If you think about very, very large players who manage a trillion dollars, for example. For any position or security to buy, to have some meaningful impact to a trillion dollars of total investments, it has to have a certain amount of size and it has to be big enough. And so right there, that eliminates a large universe of smaller issuers that in general provide a little extra yield for their small size. So, I think of our size as being a sweet spot. We can be nimble enough to participate, and buy, and sell smaller bond issues, issued by smaller companies. But at the same time, we do have enough scale that we still maintain, we still have good relationships with the street. We

have access to multitude of dealers and access to a multitude of research. So, I think we're in this sort of useful sweet spot.

I do have one additional question in the chat. I'm going to assume on this particular topic, can you give us some examples of some of those issuers or some of the types of holdings? I know we talked a bit about being cautious around that. So, do you want to speak to that a little bit?

- With specific examples, I think a great example I've talked about in the past, and this is a good case study for a number of reasons. One of my favorite investments in my funds and on the credit side has been a company, at a very high level, what they do is they manage fleets on behalf of their clients. They're one of the largest buyers of cars in North America. And they're the largest, one of the largest buyers of insurance, of auto repair services and gasoline. So, what they do is they sort of take that immense scale and purchasing power that they do have, and in turn they take over the responsibility of managing a fleet on behalf of their clients.
- So, think about a pharmaceutical salesperson who's got a company car, think about a truck of a cable company. This company takes that cost savings, they pass it on to their customers, they take out the complexity of managing a fleet. And I think it's a great business. And it's a great example because it was also a company in which we've also been invested in the equity in our balanced funds and in some of our Canadian mandates. And so, I think it's a good example for a number of reasons. One great example of the collaboration that we have between the equity and credit teams. And when we can work together on the same company, but invest in the different parts of the company that have different risk reward attributes depending on our mandate. I think that's a very powerful synergy that we have with the team.
- And then in terms of speaking specifically to the size and scale issue, they are issuers of senior notes, convertible bonds, preferred shares, and obviously common equity. Some of these position sizes, some of these bond issues and preferred issues, are fairly small that some of the larger players just can't buy enough of. And so given our sort of nimbleness, we were able to invest in senior notes, convertible bonds, and the various series of preferred shares. So yeah, I think that example illustrates a handful of things, a handful of ways that we can take advantage of these opportunities.

Fabulous. And final question that's come in that I'm not sure you can speak to but I'm going to ask it anyway is, where you're expecting returns in 2023, what is your expectation of the funds?

- Great question. Also, a bit of a crystal ball question. The starting point to think about the return potential for a fixed income fund is look at where that yield is. And then any sort of capital gain or loss is going to come from either rising or declining rates, or wider or tighter credit spreads. Again, really hard to predict where those are going to be, I guess, nine months out now.

It's a great question but it's very difficult to respond to. So, I lobbed it out there just to see what you would say. Kind of thought that might be your response. So, thank you. We've had a bit of a flurry in the chat, so thank you for the participation. Thank you for the questions. I'll do a final call because we've got a couple of minutes left. And otherwise we'll wrap up and give everyone a few minutes back in their day. And the question is, with the yuan seeming to want to be a major reserve currency, how would that impact the US debt and further favor the short term?

- Great question. In the short term, I don't see that being a meaningful risk in terms of the yuan displacing the US dollar as the world's currency of choice. In the short term, I don't think it's a risk. Longer term, one of the large main reasons why the US dollar is the global currency of choice is really the sort of faith and belief in the US treasury bond market. This is a multi-trillion dollar asset class. The US Treasury is a frequent issuer of

US treasury bonds. Those are where the US dollar reserves are held. And part of that belief of the credit of the US Government is built on many years of having some of the most open and transparent financial markets. Having some of the best regulatory environment for business and competition. And so, these are things that I think take a long time to build faith and trust in. Yeah, I just think it's probably more of a long-term risk. And I think I'd have to see more evidence of the type of depth, and breadth, and transparency of capital markets that the US has.

One final question's come in, is around your investment philosophy in terms of private equity. So, are you investing in private equity?

- No. Within the segregated funds that I manage, I'm only able to buy sort of liquid securities. So, bonds, preferreds that are tradable. That being said, obviously most people are aware of the large Canadian and US private equity players who are publicly traded, and who are also issuers of notes and equity. If I had a view on a particular private equity player and their sort of investment acumen, and their ability to generate strong returns, I would consider looking at securities that they issue. But in terms of direct private equity investing, that is not a tool that I have in the toolkit.

Right. It's not in the mandate.

- Exactly.

And so, what we'll do is we'll conclude our session with Albert today. So, thank you Albert for taking the time and for joining us. And again, I'd encourage people to check out the Off the Cuff video that's available. Thank you for taking the time to join us today. I would say that the investment team really does continue to find investment opportunities in all market cycles. And you can stay informed on the investment team's activities through the investments blog, where you'll find the Off the Cuff video, and you'll find a whole lot more.

So, if you have any questions on today's webinar or our industry leading product choices, please reach out to our sales team, we'd love to talk to you. Watch your inbox in the next few days for an e-blast that will include a replay of today's webinar you can share with your colleagues who have missed it. And in addition, there's many great fund resources on the newly enhanced and updated advisor site, empire.ca/advisor. And so, with that, I'll wish all of you a wonderful day and thank you very much for joining us. And that'll conclude our session.

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