

# Morningstar Balanced Portfolio

## Fund Commentary

The unprecedented scale of the global fiscal and monetary policy response helped ease financial conditions during the second quarter of 2020. This provided firms and consumers with a vital lifeline to help weather the worst economic contraction since the Great Depression, and propelled a recovery in risky assets. Yet, the path to economic normality remains highly uncertain, with a vaccine not expected to be available until 2021 and the virus spread not under control in the U.S., hindering the recovery of economic activity in the near-term. Thus, we (Morningstar) expect fiscal and monetary policymakers to continue to be accommodative which we believe will be effective in averting a spill-over of the global recession into a financial crisis.

Given the swift recovery in asset prices and the sharp improvement in investor sentiment over the quarter, we are reviewing risk levels in some of our multi-asset portfolios, even as we are looking at an opportunity set that offers a markedly better reward for risk profile than at the beginning of the year.

As long-term valuation-driven investors, we attempt to look beyond the near-term and try to assess the impact of the current economic downturn on the long-term valuation of an asset. From that vantage point, we see value in cyclical sectors such as financials and energy, as well as export-oriented markets such as Germany and South Korea.

Banks today are much better capitalized than during the previous crisis and should be able to withstand even a severe economic downturn without needing additional capital. Also, while banks were the cause of the global financial crisis of 2008-09, the current crisis originated in the real economy and policymakers recognize that banks are to be part of the solution of an eventual economic recovery.

We expect lower oil prices will lead to the typical capital cycle response, whereby energy firms will cut capital expenditures, reducing supply and leading to a rebalancing of oil prices. Lower oil prices also tend to enforce better capital allocation discipline,

<sup>1</sup>The Morningstar Balanced Portfolio's benchmark comprises 30% FTSE TMX Canada Universe Bond Index, 8% FTSE World Government Bond Index in Canadian dollars, 18% S&P/TSX Composite Index, 42% MSCI

sowing the seeds for higher profits in the future. We believe that integrated oil companies continue to offer attractive value at today's prices.

Even as the short-term news continues to be negative and uncertainty is elevated, we remain committed to finding assets that trade at a discount to their fair value.

The Morningstar Balanced Portfolio outperformed its blended benchmark<sup>1</sup> during the quarter.

Domestic fixed income indices continued their positive run in the second quarter of 2020, as investors continued to pile into the bond market, with the FTSE Canada Universe Bond Index up about 5.9% and the FTSE Canada Short Term Bond Index up about 2.1%. Returns in global fixed income were more muted, with the FTSE World Government Bond Index up not quite 1% in local terms, and down about 2.4% in Canadian dollars in the period. In Canada, long-term bonds were the biggest winners, particularly corporate bonds, as spreads narrowed on abating concerns about the financial health of borrowers.

Domestic stocks, as represented by the S&P/TSX Composite rose almost 17% in the quarter. Information Technology stocks soared, with the sector up almost 50%, and the materials sector also rebounding strongly with a 42% return. Not all sectors were so fortunate. Financials lagged the market with a comparatively anemic 6.2% return, Utilities were also off the pace at 3.8%, and Communication Services stocks were the lone sector continuing the downturn, posting a small loss in the period.

The S&P 500 rose 20.5% in local terms in the quarter, leaving it with a 3.1% loss for the year to date. Despite the improved outlook for some cyclical value sectors, continued strength among technology and internet giants translated into another quarter of outperformance for growth stocks. Many parts of the market remained well off their highs. The Morningstar US Energy Sector Capped Index gained 34.7% in the quarter, but still was down 35% year to date. While oil markets remained oversupplied, OPEC agreed to cut production, and car traffic started to return,

All Country World Index ex Canada IMI Index in Canadian dollars and 2% FTSE TMX 91 Day T-Bill Index.

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which should stoke demand. Small-cap stocks had a similar path of falling more than large caps to start the year, and rebounding more recently, yet the Morningstar US Small Cap Index was down 14.2% year to date.

International markets participated in the rally, but generally underperformed the United States. The MSCI EAFE Index of developed-market stocks gained 9.9%, while the MSCI Emerging Markets Index rose 13.0%, leaving those indexes down 6.9% and 5.2% respectively for the year to date. German stocks were one of the leaders while United Kingdom equities lagged.

## Positive Contributors

Capital Group Global Equity Fund (Canada) rose almost 21% in the quarter, contributing strong positive performance in absolute and relative terms. Financials, communication services and consumer staples were standout sectors. Stock picks such as Apollo, EQT, Autodesk and ASML were highlighted as strong performers. The Fund redeployed a portion of the higher cash weight from earlier in the year, with new holdings domiciled in emerging markets, Europe ex-U.K. and the U.S.

The Galibier Canadian Equity Pool rebounded 19.8% in Q2, outperforming the Canadian equity market. Strong performance from firms like Spin Master, West Fraser Timber, AG Growth International and Cargojet drove returns. The portfolio was active in the quarter, adding new positions in Kirkland Lake Gold, Canadian Tire and Restaurant Brands International, eliminating Alcanna, Canadian National Resources and Dollarama, while adding to and trimming several other names.

The Global X MLP & Energy Infrastructure ETF soared in the second quarter, with gains of almost 32%. Energy assets began a recovery during the quarter after a painful March and early April. OPEC+ production cuts helped curb a freefall in oil prices. Going forward, the most important factors for MLP and midstream energy prices are COVID-19's impact on oil demand, OPEC+ supply agreements and the resilience of MLP customers: The E&P companies.

## Performance Detractors

The Mackenzie Ivy Canadian Fund rose about 9.4% in the period, underperforming its blended benchmark. Underweight exposure and stock selection in Information Technology and Materials, as well as stock selection in Communication Services, detracted from relative performance. The Fund remains cautiously positioned, seeing elevated valuations and risks. Positions are focused on stable cash flows and long-term growth, further supported by a moderate level of cash and a small amount of gold.

The JPMorgan BetaBuilders Japan ETF rose approximately 7.6%, as Japanese equities lagged the broader global equity markets recovery in the quarter, after previously being a relative outperformer in the first quarter downturn. International trade issues weighed on electronic component suppliers and other Japanese firms that are part the global supply chain.

The Franklin Bissett Canadian Equity Fund recovered approximately 9% in the quarter, lagging the bigger rally of almost 17% in the Canadian market. Overweights to consumer staples stocks such as Loblaw Companies and Metro Inc. hurt, as did underweight exposure to surging information technology and materials stocks. The Fund is currently positioned for a balance of risks to the downside, citing the massive stimulus propping up global markets, valuation excesses and speculation.

## Valuation-Driven Asset Allocation Positioning:

As the COVID-19-induced crisis hit global equity prices in Q1, we repositioned the portfolios to move close to benchmark equity levels as the reward for risk had become meaningfully more attractive in our view.

While we thought almost all risk assets were more attractive, we continued to find particular value within value stocks, non-U.S. equities and emerging-markets bonds. Even with the market rally, we remain constructive on these areas, and we have further tilted our portfolio toward what we think are the more attractive parts of the markets, including the financials and energy stock sectors, and emerging-markets debt.

While tech/growth companies led the charge forward in the second quarter, there is much ground yet to be made up by

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cyclical value companies. We believe our portfolios are set up well to capture returns in the eventual pandemic economic recovery, and we hope to see stronger returns from our non-U.S. equity and value positions. Within equities, at the headline level we are close to benchmark levels.

Intra-equity, we remain overweight non-U.S. equities, specifically value-leaning securities as they remain one of the cheapest areas in the equity market by our analysis. Further, we have targeted U.K., Japanese and South Korean equity exposure. We continue to see better risk-adjusted return potential in emerging-markets stocks and maintain a small overweight in this area. Additionally, within our sector positioning we hold diversified energy and financial overweights, with additional dedicated positions in consumer staples.

While we are very constructive on these beaten-down asset classes (energy/financials), we are mindful of the extra drawdown potential and want to make sure we balance the risks properly.

Among bonds, we remain slightly underweight duration and overweight emerging-markets debt. Government bonds have performed exceptionally well in recent periods and still hold some downside protection value in the event of another risk-off event. With the large returns from long-term governments during the sell-off, we continue to believe there is little benefit to further extending our overall duration.

We have initiated a high yield bond position in the quarter, and remain overweight Real Return Bonds as a hedge against future inflation.

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