Managed Money Report

PRIVATE CLIENT SOLUTIONS

2020 – Spring

Mutual Funds & ETF Strategy

Inside this Report

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Currency Exposure: To Hedge, Or Not To Hedge

What Is Happening in FX Land?

Since the market began to unravel at the beginning of March, we have seen monumental shifts in both volatility and liquidity in every major asset class. Currency markets, trading the most liquid financial assets in the world, were not immune to this volatility. The US dollar is considered by many as a safe haven currency that typically is bought during times of stress. In risk-off scenarios, people look for safe assets; US treasuries are some of the safest you can buy but you first need US dollars to purchase them. Given this prominence, one instrument often cited is the US dollar currency index, known by its symbol, "DXY". This index tracks the US dollar against a basket of major currencies and since March 9, it has seen average daily movements that are roughly three times as large as the daily average over the last 20 years. This has come largely as the Coronavirus pandemic continues to tighten its grip across Europe and North America, which has driven a surge in the need for cash by businesses across the globe. With lockdowns and supply-chain disruptions expected to trigger corporate defaults, questions remain about the length of the impending global recession. Central banks have been quick to pump liquidity into the global economy; this liquidity paired with massive fiscal stimulus from governments has eased some of the financial vulnerabilities stemming from the Coronavirus pandemic and thus volatility in the global FX space has somewhat subsided.

Shifting our attention homeward, the loonie was hit with a double whammy, first by the pandemic, and second by plummeting oil prices. As people raced to safety in the US dollar, the USDCAD pair reached its highest intra-day level since January 2016. The CAD has been considered a petrocurrency for many years and as domestic and global benchmarks for crude oil reached near-historic lows, so too did our currency. On the supply side, at the beginning of March it become known that global oil producer heavyweights Russia and Saudi Arabia could not reach an agreement to extend global production curtailments, thus setting expectations for a swath of new oil supply to an already glut market. On the demand side of the equation, signs are pointing to reduced expectations for oil needs on the back of a looming recession. Canada's dependence on oil production is well known, with nearly 10% of GDP tied to the energy sector, and as such weak dynamics in the oil patch have weighed on Canada's outlook. Volatility in USDCAD has been impressive to say the least; similar to the DXY and over the same time period, we've seen average daily price movements of $0.015 versus the $0.004 average since 1999. For short term investors with assets abroad, the extreme volatility has been challenging to stomach depending on whether you were hedged or unhedged. However, taking a longer-term perspective the picture may not be so bleak.

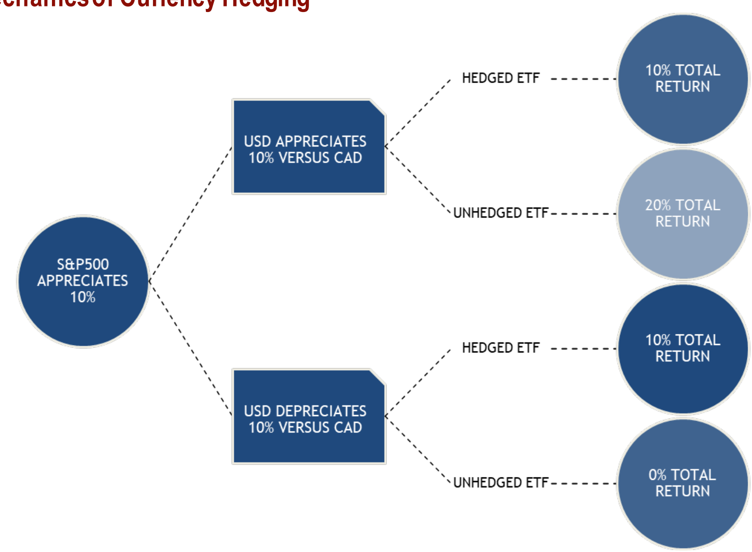
How can Currency Returns Impact Portfolio Assets?

Currency exposure can be an overlooked variable when investors map their strategic asset allocation and risk/return profile. Remaining exposed to foreign currency can either add or detract from returns depending on the relative performance of the Canadian dollar versus the currency of your asset. Hedging currency exposure protects your portfolio from volatility in currency markets ensuring you enjoy the pure return profile of the foreign-denominated assets invested in. Considering the Canadian market, investors must be cognizant of that fact that limitations, especially in key sectors like health care and information technology, or the desire to hold a fully diversified portfolio, requires one to consider currency relationships. However, as we will discuss later, the decision whether to hedge or not hedge currency comes down to more than one variable.

How Do Funds Adjust for Currency?

Mutual Fund and ETF providers in Canada have long produced products that come in both a hedged or unhedged wrapper for passive mandates, and active managers investing in foreign denominated assets often have the decision to leave their assets unhedged, fully hedged, or partially hedged. In order to remove the currency exposure, a portfolio manager (PM) will employ the use of derivative instruments. For example, a Canadian-based PM trying to hedge $US exposure in their portfolio will sell $US forward contracts with the underlying amount equal to the portfolio's $US exposure. Here, parties would agree to pay the performance difference of two currencies for an agreed amount of time, removing the effect of currency gains/losses that could have resulted from holding an asset in a foreign currency. For example, let us say that US dollar appreciates by 10% and our stocks appreciate by 10% as well. The portfolio is now up 20% but our forward contract is down 10%. The net result for the fund is 10% positive returns minus the cost of the forward. Currency returns can also be hedged with the use of option contracts.

The Mechanics of Currency Hedging



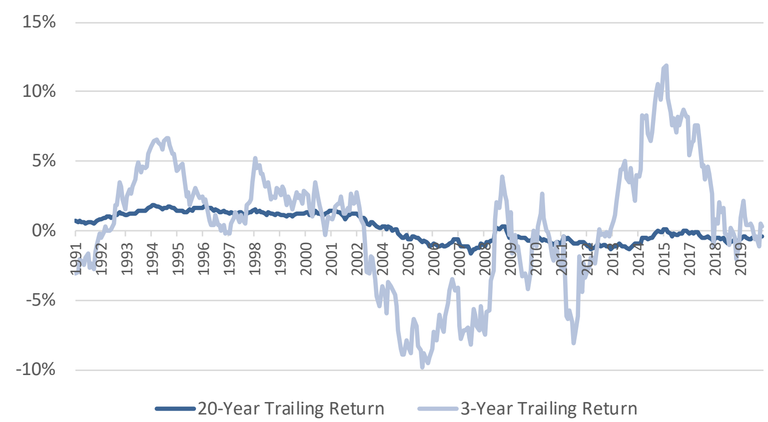
Hedged vs. Unhedged - What is right for me?

Taking a closer look, we can see there are situations where hedging currency exposure is recommended as well as others where it may not be necessary. There is always a cost to hedging currency exposure and therefore it is prudent to do a cost-benefit analysis. While the added cost of hedged products versus unhedged is typically small, roughly 5-10 basis points, over time this cost could eat into longer-term returns if it is deemed unnecessary. Two particularly important variables to consider when making this decision is time horizon and portfolio concentration.

Time Horizon

Taking a closer look at currency movements over time, we note that the impact of currency returns typically diminish over longer periods of time. For longer-term investors (i.e. 10-20 years) that can tolerate short-term fluctuations, hedging your currency exposure may not add value. However, for those with shorter time horizons the expected addition of volatility increases the need to hedge currency. The below charts show 20-year and 3-year monthly rolling returns for the DXY and USDCAD. As we can see, over a longer time horizon the return and volatility derived from currency is typically muted. However, over a shorter period it is quite clear that the opposite is true.

USDCAD Trailing Returns



Source: FactSet

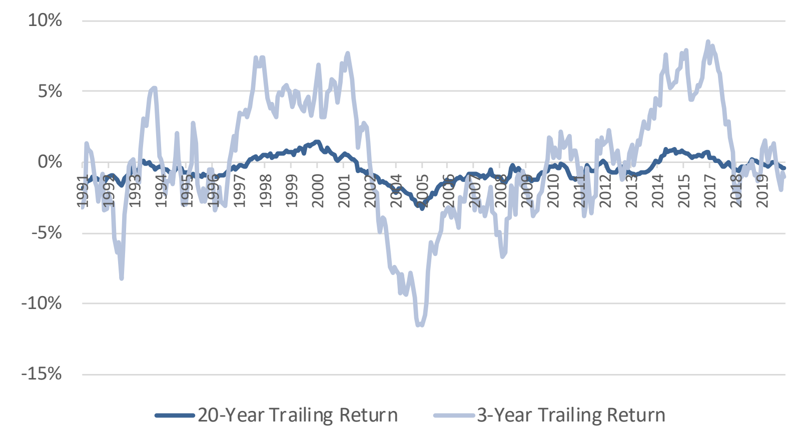
Portfolio Concentration

A portfolio that is broadly diversified by geographic exposure will naturally have exposure to several different currency pairs. Given that currencies trade in relative terms to one another, it is expected that over time the net impact from FX can act as a natural hedge. The recent market pull back has demonstrated exactly this. US equity markets were down while USD relative to CAD was up materially. The net result was Canadian investors with unhedged exposure were down less than the market was, based on the month-end results of Vanguard's S&P 500 ETFs (-8.29% unhedged vs -13.26% hedged).

Conclusion

A common view shared amongst PMs is that it is very difficult to consistently add value through currency; we share this view. However, the relationship between a strengthening USD in periods of stress means we could potentially see USD begin to lose steam as the global pandemic unfolds. That means there could be an opportunity for those investors that were unhedged going into this crisis to hedge their positions in the short term to lock in gains they've received from the USD. We would stress again however, that this is short term positioning to capture alpha, and a trade that would need to be monitored closely for when to revert back to unhedged positioning. The US dollar could continue to run, and perhaps levels do not revert back for some

US Dollar Index (DXY) Trailing Returns



Source: FactSet

time. In the long term however, we continue to believe that currency exposure can add diversification and some level of protection for Canadian investors in a global portfolio of equities.

Managed Money Flows – March Madness Edition

On a quarterly basis, we review notable trends of asset flows into managed money products and the past quarter was certainly one for the record books. Canadian-domiciled ETFs and mutual funds (funds) provide the basis for our holistic look at where investors put their money to work this quarter, with a focus specifically on the month of March 2020 given the rise of the global pandemic.

Overall Trends

The first quarter was a period of exceptional change and volatile market conditions with investors moving their money faster than ever before. Drawdowns of the past—think 2008-09—typically took many months to reach the levels we hit in a matter of days. Funds were not immune to investor movements and saw significant redemptions with almost $16 billion net outflows from the space in March 2020 alone. While a large number no doubt, it is only a small fraction of overall fund assets in Canada; for context, the mutual fund industry in Canada is still over $1.1 trillion. The quarter-to-date number of $12 billion net outflows indicates there was some buying activity earlier in the year. On the flipside, ETFs saw significant net new inflows to begin 2020 but did not capture all of fund outflows, particularly in March. The likely reason was investors increasing their cash to wait out the storm or purchasing individual equity names that appeared to provide value from a long-term perspective.

Product Type	Net Flows ($M) March 2020	Net Flows ($M) Q1 2020	Net Flows ($M) 1 Year
ETFs	$2,941	$13,940	$38,003
Mutual Funds	($15,990)	($12,010)	($4,265)
Sum	($13,050)	$1,928	$33,758

Source: Morningstar. As at March 31, 2020

Sell Bonds, Buy Equities!

Based on asset flows in the managed money space, investors sold fixed income across the board and rotated into equities and cash. Fixed income categories saw over $16 billion in net outflows with equity based categories seeing $7.5 billion of new inflows. While almost every fixed income category was in net redemptions, high yield received significant net new assets. Given the nature of high yield fixed income, it is not surprising that these bonds were the hardest hit area of credit markets. In turn, it is also not surprising to see some buying interest in this space given these securities traded at such substantial discounts to normal levels. Many active managers are coining this the opportunity of a decade in the high yield space. Time will tell, but if history repeats itself, there certainly are some long-term opportunities out there.

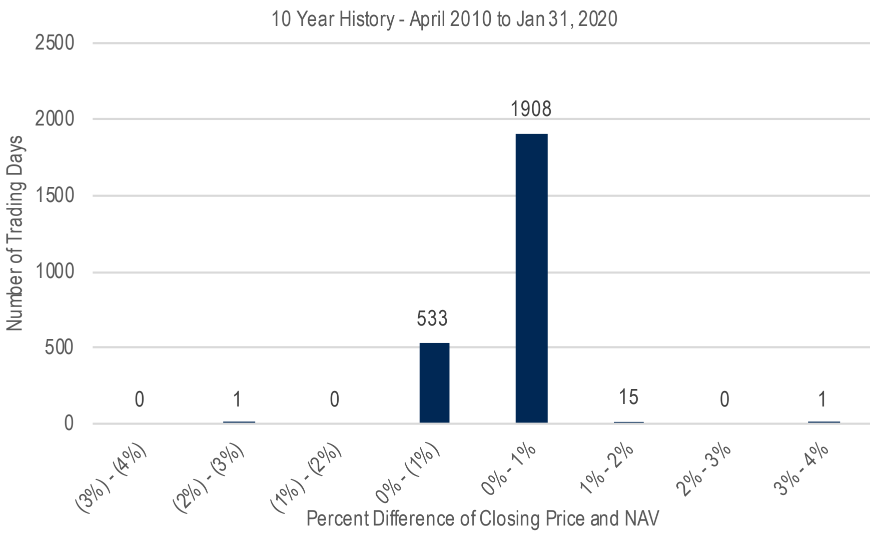
Volatile fixed income markets in March also tested the daily and intraday liquidity offered by funds and ETFs with overall positive results. Fixed Income ETFs continued to trade while the underlying markets essentially froze up. The result was meaningful intraday swings in prices, and significantly wider bid-ask spreads. In essence, fixed income ETFs started to provide a clearing price for bonds and the swings are simply the cost of liquidity in an illiquid market. The important take away for investors is that for those who did not require the intra-day liquidity, they were unaffected by massive risk off trade. The table to the right highlights for three major fixed income index ETFs that performance was in line or beat the index on a month-end basis.

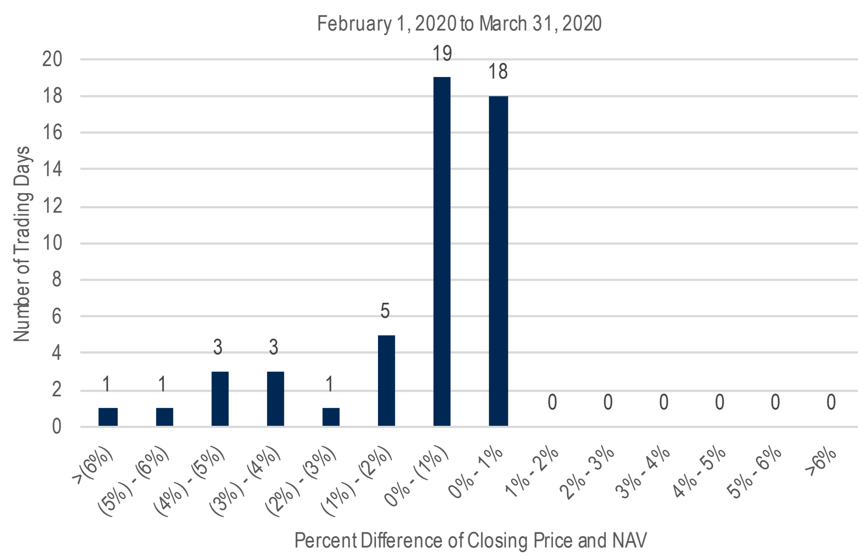
ETF	March 2020 Return	+/- Benchmark Return
ZAG – BMO Aggregate Bond	-2.15%	-0.15%
ZCB – BMO Corporate Bond	-5.40%	0.01%
ZSB – BMO Short-Term Bond	0.34%	0.20%

Source: Morningstar. As at March 31, 2020

Dislocations can happen between the Net Asset Value (NAV) and the closing price of the ETF due to how an ETF's NAV is calculated. Normally, a third party agent determines NAV by looking at recent transactions of a basket of bond prices, and they provide an estimate for any bonds that have not traded. Canadian agents are unable to include real-time trade information, so estimating bond prices for indices is common practice here. However, this means that during periods of stress, the estimated prices are stale, and can inflate the ETF's NAV. To illustrate this cost of liquidity, we compared historical closing price to NAV for **BMO Aggregate Canadian Bond Index – ZAG,** one of the largest and most liquid fixed income ETFs in Canada. Our sample period was 10-years ending January 2020 which we compared to February and March of this year. Over this 10-year period, ZAG closed within +- 1% of its NAV 99.31% of the time. In contrast, during the February and March sell off, **ZAGs** closing price was off by more than +-1% of NAV almost a third of the time (see chart). Put differently, ZAG has closed at a premium or discount almost the same number of times in the last two months as it has in the last 10 years.

ZAG – Frequency of Daily Closing Price Deviations From Net Asset Value (NAV)





Source: FactSet; As at April 15, 2020

Deep Dive - What People Sold

Fixed income represented the top three funds and one of the top ETFs in net redemption as the table below highlights. Interestingly, PIMCO Monthly Income Fund was the third most redeemed fund for the month of March, but experienced net inflows for the first quarter as a whole. On the ETF front, the top redeemed ETF was **Purpose High Interest Savings – PSA,** with people looking to put some cash to work in the market turmoil. While there was some speculation to the liquidity of these cash based ETFs, they seemed to have weathered a 25% fund redemption with no impact to the NAV or remaining investors - a good test in a period of historical stress and volatility. Rounding out ETF redemptions in March was **BMO Aggregate Bond Index – ZAG**, and **BMO Long Federal Bond ETF – ZFL**. With these bonds protecting on the downside for the month of March, **ZAG** (2.15%) and **ZFL** 0.59%, it appears that investors were selling their winners and increasing their risk appetite by moving into more opportunistic areas of the market.

Deep Dive - What People Bought

The top purchased investment for both funds and ETFs was high yield fixed income. On the fund side it was the recently and only temporarily uncapped, **PH&N High Yield Bond Fund**, and for ETFs the **NBI High Yield Bond Fund – NHYB.** Such a large move into lower quality credit could be seen as risky; however, historical analysis conducted by JPMorgan suggests that when high yield spreads widen to the extent they did, from +350 basis points (bps) in late February to nearly 1100bps in late March, a strong positive one year return has historically always occurred. We are reminded, however, that past performance is no guarantee of future performance.

Rounding out the top purchases in March for ETFs were, unsurprisingly, large cap indices for Canada, **iShares Core S&P/TSX Capped Composite Index ETF** – **XIC**, and the United States, **iShares Core S&P 500 ETF CAD-HEDGED – XSP**. In the fund space, **RBC European Equity** came in second and **PH&N US-Multi-Style All-cap Equity** rounded out the pack in third.

Mutual Fund and ETF Flows – March 2020

Largest Redemptions by Asset Class

Funds

	Net Flows ($M)	
Morningstar Broad Category	Mar-20	Q1 2020
Canadian Fixed Income	($7,845)	($6,465)
Global Fixed Income	($4,470)	($2,240)
Canadian Short Term Fixed Income	($2,076)	($2,000)
Sub-total	($14,391)	($10,704)

ETFs

	Net Flows ($M)	
Morningstar Broad Category	Mar-20	Q1 2020
Canadian Short Term Fixed Income	($563)	($419)
Canadian Fixed Income	($410)	$1,344
Canadian Long Term Fixed Income	($276)	($9)
Sub-total	($1,249)	$916

Largest Net New Fund Flows

Funds

	Net Flows ($M)	
Morningstar Broad Category	Mar-20	Q1 2020
Canadian Equity	$1,731	$1,284
US Equity	$1,182	$132
European Equity	$832	$869
Sub-total	$3,745	$2,285

ETFs

	Net Flows ($M)	
Morningstar Broad Category	Mar-20	Q1 2020
US Equity	$1,547	$3,907
High Yield Fixed Income	$769	$877
Canadian Equity	$721	$1,652
Sub-total	$3,037	$6,437

Largest Redemptions by Individual Security

Funds

	Net Flows ($M)	
Mutual Funds	Mar-20	Q1 2020
RBC Bond Fund	($2,469)	($2,468)
RBC Global Bond Fund	($1,437)	($1,165)
PIMCO Monthly Income Fund (Canada)	($993)	$124
Sub-total	($4,899)	($3,509)

ETFs

	Net Flows ($M)	
ETFs	Mar-20	Q1 2020
Purpose High Interest Savings ETF	($490)	($400)
BMO Aggregate Bond ETF	($457)	($133)
BMO Long Federal Bond ETF	($253)	($138)
Sub-total	($1,200)	($671)

Largest Net New Flows by Individual Security

Funds

	Net Flows ($M)	
Mutual Funds	Mar-20	Q1 2020
PH&N High Yield Bond Fund	$638	$691
RBC European Equity Fund	$554	$534
PH&N U.S. Multi-Style All-Cap Equity Fund	$504	$508
Sub-total	$1,696	$1,733

ETFs

	Net Flows ($M)	
ETFs	Mar-20	Q1 2020
NBI High Yield Bond ETF	$825	$825
iShares Core S&P 500 ETF (CAD-Hedged)	$767	$795
iShares Core S&P/TSX Capped Comp ETF	$602	$421
Sub-total	$2,195	$2,042

Source: Morningstar. As at March 31, 2020

The Bottom Line

The tide continues to shift towards ETFs in favour of traditional funds. ETFs provide investors two major benefits in times of stress but come with their own cautions. The first major benefit is intra-day liquidity. Investors are able to buy and sell ETFs at any given point during the day, but this is also the first major drawback. During periods of increased volatility, there can be a meaningful discount in your sale price in the form of wider bid-ask spreads and substantially discounted underlying markets, as was the case of fixed income markets toward the end of March.

The second benefit of ETFs versus mutual funds in stressed periods is greater transparency of transaction costs, and in turn, clearer protection for unit holders who remain invested in the ETF. Potentially inflated transaction costs and volatile intraday swings are borne by those wishing to transact, not the remaining unit holders. In essence, only those who sell their ETFs during this period of stress see a discount in the value of their investment, and only they bear the increased trading costs. Funds still protect remaining unit holders from these transaction costs, but it can be more work to do so. It is fair to say that most funds are actively managed in Canada; this fact gives portfolio managers the discretion on how they use cash in the portfolio including implementing new ideas and providing cash for redemptions. For funds that are seeing significant net redemptions, they might need to start changing the composition of the investment pool to have the necessary cash on hand. For example, funds may need to sell their most liquid assets to meet an immediate surge in redemptions.

Significant drawdowns in markets provide an important time to review positions in our portfolio and reflect on our long-term strategic asset allocation. March 2020 reminded us all of the power of global diversification in terms of asset-type and geography. Following our asset allocation for a globally balanced portfolio, a moderate investor in the Freedom Enhanced Income program outperformed the Canadian equity market by 10.4% and outperformed a 50/50 balanced Canadian portfolio by 2.11%. It is important to reflect on these numbers because going forward, there will be countless funds and ETFs that will "shoot the lights out" from March lows. When we see those returns, it will be prudent of us to remember the protection offered by diversification and ensure the changes we implement serve to enhance our future requirements, based on our needs. Some positions provide income, some stability, others growth opportunities. It has never been more important to stay focused on what is important to you, and try to avoid the noise out there that only seems to be growing louder.

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