Market Cycle Asset Allocation

This report is a primer that introduces the framework behind our approach to asset allocation. Asset allocation is one of the most important decisions in reaching your investment goals from a return, income and risk perspective. But it is only one of the steps. Having been involved in researching, authoring and implementing asset allocation services for over 15 years, the Market Cycle Asset Allocation (MCAA) approach is the culmination of all we have learned and experienced along the way.

Why Use the Connected Wealth Market Cycle Asset Allocation:

- **Continuous Tactical Advice** – Sometimes a static asset allocation does not fit all markets. The MCAA is a dynamic process that changes depending on the markets and the outlook from the Richardson GMP asset management team. This outlook is used to tilt baseline investor profiles to better position given where we are in the market cycle.
- **Transparent** – This framework is completely open and transparent. If you own something, you should be able to see exactly what you own, it's your money. The output of our asset allocation models and portfolio holdings are available upon request down to the individual holding.
- **Cost Conscious** – Costs must be clear, transparent and commensurate with value. MCAA incorporates both active funds and passive ETFs as we believe certain markets are better for different strategies. We also believe ETFs offer an effective tool for reducing costs.
- **Client First** – We have created and offer MCAA as a product agnostic platform for continuously sharing our views and advice. Any of the recommended products can be swapped for other products. We do manage money and have included two of our funds/mandates based on our expertise while incorporating transparency and fee conscious aspects. But we strongly believe in a multi manage approach of trying to find and select the best strategies.

Connected Wealth is Richardson GMP's asset management service that provides client centric, transparent and objective asset allocation and investment advice. We strive to help investors better understand and connect with their wealth.

Market Cycle Asset Allocation (MCAA) is a continuously updated and open framework incorporating the asset management team's research and analytics across various asset classes. MCAA incorporates key themes, tilting and adjusting traditional asset allocation investor profiles. We also incorporate many other asset classes and investment strategies.

Craig Basinger, CFA
Chief Investment Officer
416.607.5221
Craig.Basinger@RichardsonGMP.com

Chris Kerlow, CFA
Analyst
416.943-6156
Chris.Kerlow@RichardsonGMP.com

Derek Benedet, CMT
Analyst
416.943-6156
Derek.Benedet@RichardsonGMP.com

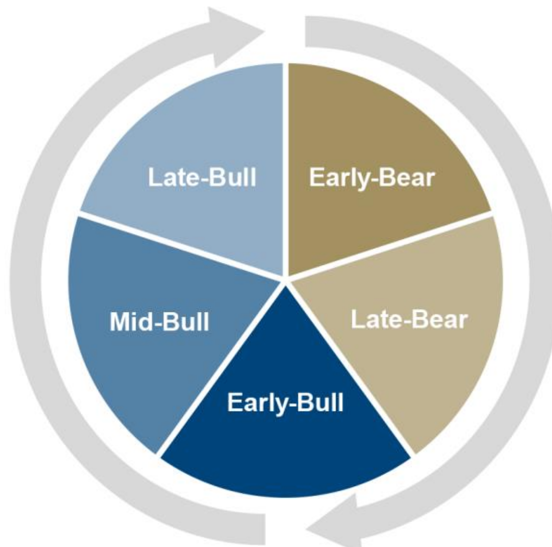
RICHARDSON GMP

Similar to seasons, the market tends to move in cycles while traditional asset allocation ignores the market cycle and is based on a static approach. We believe sometimes seasons warrant change. The Market Cycle approach is based on the foundation of traditional asset allocation but incorporates tactical tilts to take advantage of different phases of the market cycle. While this is not an exact science as every cycle is different, there are often more similarities than differences and we believe this creates an opportunity to add value to the asset allocation process.

The Market Cycle Asset Allocation (MCAA) framework breaks the cycle into five phases – Early Bear, Late Bear, Early Bull, Mid Bull and Late Bull. The duration of the cycle varies from one to the next, there are a number of commonalities that impact the performance of different asset classes at different cycle phases. There are also a number of sector implications from this model as different industries perform well during some phases and poorly during others.

Market Cycle – providing a tactical tilt to your asset allocation

The traditional approach to an asset allocation has some key benefits. The fact that it's easy to implement with limited maintenance is certainly high on the list. A great framework for contrasting the risk/return trade-off. It is an open framework that can be implemented with various investment vehicles and managers. Using 65+ years of data to develop an allocation provides confidence in the allocation that is based on the average experience over an extensive timeframe. However, there are some shortcomings as well; one of the more obvious is it does not take into account the current market environment, economy, valuations, interest rates, etc. The MCAA provides a transparent framework to help guide decision making related to traditional allocations and incorporates positioning for the current or upcoming environment.



There are many factors that constantly impact asset prices. Some are short term, like single pieces of economic data, geopolitical shocks or changes in overall market risk aversion. History shows, that tying to time these proves fruitless. Others are longer term; these include the trend in economic data, the trend of the market itself or aggregates of fundamental company data. Often these do not turn on a dime and can be used to provide a better picture of where we are in the cycle. This is the area on which the MCAA focuses.

Below, we outline the five phases and their respective characteristics, general in nature, as each cycle certainly has its own nuances that may not fit perfectly. However, if the majority of the factors fit in a certain phase this certainly has investment strategy and tactical implications.

Early Bear – This is likely the most important phase in which portfolio construction is critical and also one of the more difficult to time as it emerges following a peak market. After all, corrections during a bull market phase are buying opportunities while corrections that turn into bear markets are not. Early Bear phases certainly have equity market weakness which is further confirmed by a loss of economic momentum. Most often we see earnings growth and sales growth momentum losing steam. There is often a policy response, but this tends to be well into the phase.

Late Bear – Equity markets are still weak or falling during this phase, but much less violently. This is the phase during which we typically witness "trough valuations" that if you ignored all the other bad news at the time would appear too good to pass up. A policy response is well underway and the economic data continues to worsen. Equities may begin to recover late in this phase.

Early Bull – This is a rapid rebound phase where equities typically perform very well recovering from oversold levels. Some improvements on the economic data side appear but there remains a high level of scepticism as to the sustainability. Leading economic indicators to either stabilize or begin to improve. Low quality equities tend to perform the best as they have been the most beaten up during the bear market.

Mid Bull - The transition from Early to Mid Bull is typically accompanied by more sustainable economic data improvements. Monetary policy remains accommodative but has stabilized. Credit growth resumes along with steadily improving earnings and sales growth. Disparity of returns among sectors tends to be low during this phase as the market moves as one.

Late Bull - Economic data continues to improve and some inflationary pressures may emerge. Monetary policy begins to tighten or become less accommodative. This phase witnesses strong leadership in a few sectors or industries, the leaders of this cycle. Market volatility increases.

Early Bear	Late Bear	Early Bull	Mid Bull	Late Bull
Equity market and economic weakness	Equity market and economic weakness	Economic rebound	Continued economic momentum	Economic data losing momentum
Profits and sales decline	Profit declines begin to lessen	Rapid profit rebound	Profit growth normalizes, sales growth	Leadership narrows
Reduced credit	Trough valuations	Limited sales growth	Strong credit growth	Volatility increases
Policy easing	Policy easing	Leading indicators improve	Flat policy	Policy tightening

Market Cycle Asset Allocation Model

This model is used to identify the current market phase, this approach relies upon a tactical multi-factor model designed to outperform relative to both the markets and a static asset allocation model, with less volatility. The model incorporates technical analysis of the markets, along with economic inputs and valuations. Acknowledging no model is perfect and different models work better at different times, this blended approach attempts to find the most optimized allocation for the ensuing market environment.

We fully acknowledge there is no magic bullet. In fact, each cycle has differences, which is why we incorporate a large number of inputs from various disciplines. Below, we have grouped the inputs into three buckets and highlighted what we are looking at. This all contributes to an average or consensus view as to which phase of the cycle we are in, which in turn helps drive our asset class strategy and sector tilts.

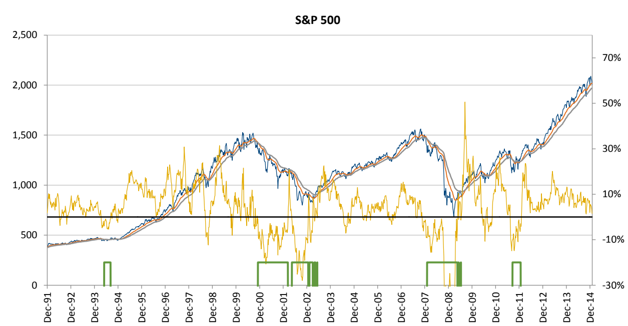
1) Market Trender

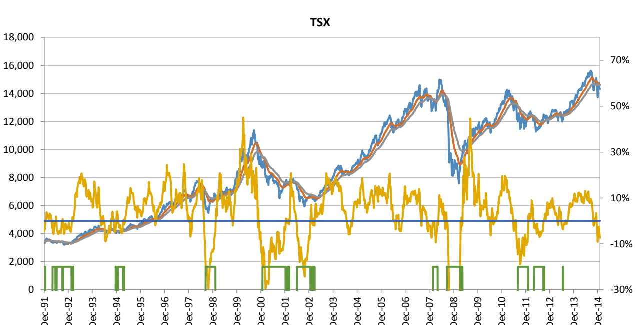
It may seem like circular logic, but we do use the equity markets as a signal to determine the phase of the cycle, which in turn drives our equity investment markets strategy. The fact is the equity markets provide predictive signals for the overall economy, noting that occasionally these are false signals. Reinforcing the point as to why we incorporate multiple inputs. When the market corrects and the economic data has softened, a recession is very often on the horizon.

Our Market Trender model incorporates moving averages and rate of change. For those so inclined, it uses the 100 and 200 exponential moving averages (EMA) along with the 6-month rate of change. The green areas along the bottom denote periods this model was negative.

The Market Trender models only break the Market Cycle into Bear or Bull markets. Currently the U.S. market remains solidly in the bull market camp while the TSX is on less stable ground.

Market Trender





Source: Bloomberg, Richardson GMP Limited

2) Economic

Gauging which cycle we are in certainly incorporates a number of economic inputs, but our approach goes beyond the published data. The reason being, economic data is often backward looking and suffers from time lags. The market reflects the current environment. In fact, the governing economic body in the U.S. is not usually able to call the economy in recession until up to a year after it has started. We break the economic models into three sub-buckets:

- **Rates** – This incorporates central bank overnight rates, yield curve steepness and yield curve steepness changes over a trailing 3-month period.
- **U.S. Economy** – This incorporates leading indicators (3 & 6 months changes), PMI and PMI new orders. Additional inputs include capacity utilization, consumer confidence, car sales, home starts and credit expansion/contraction.
- **Global Economy** – More germane to Canadian markets, this area of analysis focuses on metrics including a number of price changes: CRB, Oil, Copper, KOSPI and Emerging markets. We also track Global PMI levels and the Baltic Dry Index, which is becoming relevant again.

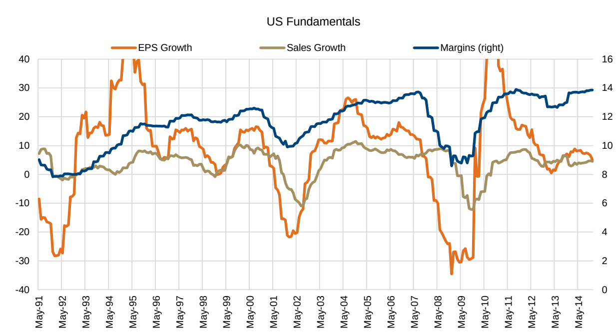
In aggregate, this helps paint a picture as to which phase of the market we are most likely in between Early Bear, Late Bear, Early Bull, Mid Bull or Late Bull. They never all point to one phase but provide a weighted average probability of which phase we are in.

3) Fundamentals

Valuations don't help to precisely identify market tops or bottoms, but certainly overpaying for assets can be a detriment to performance. Our Fundamental models incorporate aggregate market valuations, earnings growth, sales growth and profit margins.

All of these inputs are reviewed on a continuous basis to assess which phase of the cycle we are most likely in. We should point out that certain inputs provide better signals for different phase transitions. For example, capacity utilization and central bank rates are best for delineating between Mid Bull and Late Bull. Earnings growth is a good indicator for the transition from Late Bear to Early Bull.

U.S. Fundamentals including margins, earnings and sales growth point to continued bull phase



Today – Welcome to the Late Bull phase of the cycle

At the beginning of 2015, we have come to the conclusion the market has either progressed into the Late Bull phase or are about to do so. Capacity utilization in the U.S. has broken the 80% level, the Fed is expected to begin raising rates sometime this year. Plus we are starting to see greater divergence in economic data and asset performance.

There is little debate the current bull cycle appears elongated given the continued deleveraging impact of the credit driven recession of 2008/09. That is good news as even the last bull phase could last for a considerable amount of time.

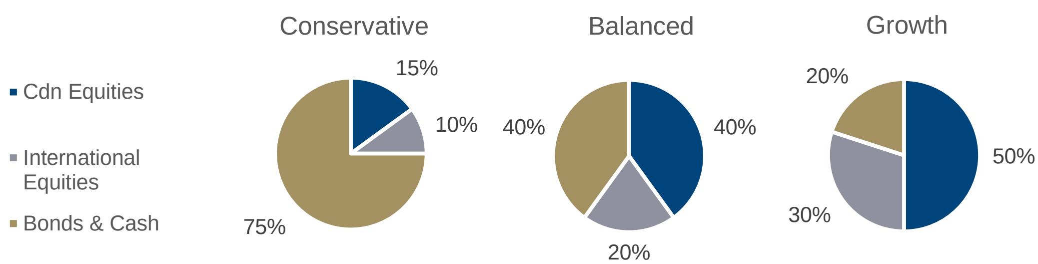
Investment Consequences of the Market Cycle

Each market phase has a number of investment implications and resulting recommended tilts. This is a general overview, as in many cases other factors weigh upon the Macro Investment Management Committee's (Macro IMC) decisions on tilts. These may include current valuations, secular trends, interest rates, spreads and conviction to mention a few. These types of factors customize the tilts further given the current environment. Still, this does provide a baseline for guiding decision making and implementing tactical tils to an asset allocation strategy.

	Early Bear	Late Bear	Early Bull	Mid Bull	Late Bull
Broad Asset Classes	- Equities + Bonds, Alts & Cash	- Equities + Bonds, Alts & Cash	+ Equities - Bonds	+ Equities - Bonds	+ Equities - Bonds
Bonds	Quality, long duration	Begin adding lower quality, shortening duration	More low quality, lower duration	No changes	Begin trading up quality, extending duration
Equities	Low beta, quality	Begin increasing beta	Low quality, lots of beta	No changes	Begin reducing beta, increasing quality
Best Sectors	Staples, Utilities, Telecom, Health	Staples, Utilities, Telecom, Health	Cons Disc, Materials, Industrials, Tech	Technology, Industrials	Energy, Materials, Health, Staples
Worse Sectors	Tech, Industrials, Consumer Disc	Tech, Industrials, Consumer Disc	Telecom, Utilities, Health Care, Energy	Utilities, Staples	Cons Disc, Telecom, Tech, Industrials

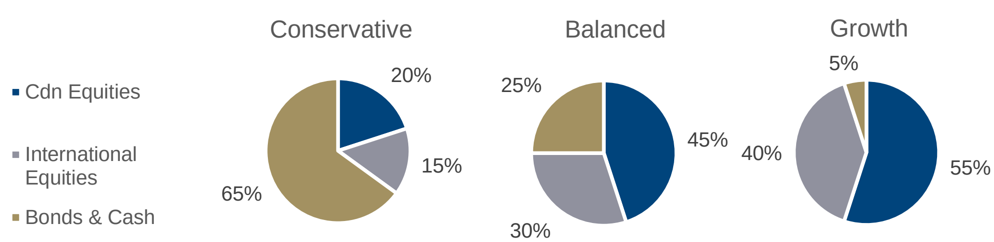
Implementation

Combining the Market Cycle Asset Allocation framework with individual investor profiles is where the rubber hits the road. We have broken this implementation stage into two approaches, the first focused on asset allocation and general strategy while the second provides a more comprehensive solution. Of course all of these remain flexible depending on individual investor objectives. To articulate this strategy overlay we begin with three baseline investor mandates – Conservative, Balanced and Growth. These baseline allocations are based on a traditional modern portfolio theory approach.



Implementation – High Level

Our market cycle analysis supports the view we have just entered or will do so shortly into the 'Late Bull' phase of the cycle. The late bull phase tends to see higher volatility and greater divergence. This phase can also see greater gains before all is played out. As we believe we are in the early stages of this phase, we remain comfortable with our current asset allocations. The table below outlines the tilts and provides some additional guidance for each asset class.



Conservative	Baseline	Tilt	Allocation	Notes
Cdn Equity	15%	+5%	20%	Dividend focused
International Equity	10%	+5%	15%	All developed market
Bonds & Cash	75%	-10%	65%	Prefer credit exposure over duration risk.

Balanced	Baseline	Tilt	Allocation	Notes
Cdn Equity	40%	+5%	45%	Balanced between dividend focus and broad Cdn market
International Equity	20%	+10%	30%	All developed market
Bonds & Cash	40%	-15%	25%	Prefer credit exposure over duration risk

Growth	Baseline	Tilt	Allocation	Notes
Cdn Equity	50%	+5%	55%	Balanced between dividend focus and broad Cdn market
International Equity	30%	+10%	40%	Developed market focused, small underweight emerging markets
Bonds & Cash	20%	-15%	5%	Increased credit exposure

Conclusion

While much of the MCAA framework requires careful inspection of numerous inputs and factors, it still requires experienced “operators” to interpret the results in aggregate, and, moreover, hardened resolve is needed to implement the strategy in accordance with its continued guidance. All stewards of wealth need to be able to clearly articulate their investment discipline from top to bottom in order to have a clearly defined approach that guides behaviours through good and challenging times. We feel that MCAA provides that guiding light, and consider it to be a fundamentally important part of our investment approach. Additionally, having familiarized themselves with the principle at work, client expectations can be effectively managed as portfolio changes are made over time – helping them to connect more meaningfully to their wealth, and instill confidence in their source of advice.