Empire Life Investments

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"Plan for Volatility"

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PRESENTATION

Operator

Good day, ladies and gentlemen. Welcome to the Empire Life Investments Inc. Conference Call.

Today's discussion may include forward-looking information based on the opinion and views of Empire Life Investments Inc., or the individual presenting. These views are subject to change and are not investment advice.

I would now like to turn the meeting over to Mr. Paul Holba. Please go ahead, Mr. Holba.

Paul Holba, Vice President, Retail Distribution

Thank you, Maude. Good day everyone. I am your host, I am Paul Holba, Vice President of Retail Distribution at Empire Life. I'd like to welcome you to our conference call. We've given it a title: Plan for Volatility.

Before we begin, on behalf of the entire Empire Life Sales team, we really would like to thank you for your business. We appreciate the trust and confidence that you've shown by placing your client's money with us, not just last year but also in the past. I also want to thank our investment team for their hard work. As of December 31, 2018, we have six funds that received a four-star overall Morningstar* rating. This includes our Empire Asset Allocation Fund, Empire Bond Fund, Empire Elite Balanced Fund, Empire Elite Equity Fund, Empire Global Dividend Growth Fund and Empire Global Equity Fund.

2018 was a very busy year for Empire Life. We made a number of very significant product enhancements. If you're not familiar with those then I really do encourage you to speak to your sales team and find out what's new.

As I mentioned, the topic for today's call is Plan for Volatility. This is very timely given that market volatility certainly made a comeback in 2018, as both positive and negative factors garnered the attention of investors. What impact will these factors have on the Canadian investment landscape and the overall global economy? Well, that's the topic for today, and to answer this question I'm going to introduce our panel.

First up, we have Ian Hardacre, our Senior Vice President and Chief Investment Officer. He is joined today by Ashley Misquitta who is our Senior Portfolio Manager in U.S. Equities, and Albert Ngo, who is our Portfolio Manager, Fixed Income. Albert is not in the room with us today; he's elsewhere conducting business.

They will be discussing how markets performed in 2018 and also plan to achieve sustainable future returns in 2019 by focusing on quality, value and managing risk. Following their comments, we'll open up the line to take your questions, so please, get your questions ready.

Ian, I'm going to start with you. Two thousand and eighteen was a difficult year for equities across the world. Many developed in emerging markets posted double-digit losses and Canada was no exception. Can you walk us through the Canadian equity market, Ian?

Ian Hardacre, Senior Vice President and Chief Investment Officer

Great, thanks, Paul, and good morning and good afternoon to everybody on the line.

On the equity side, it was a very challenging year for Canadian equities as a whole. The S&P/TSX Composite was down approximately 9% on a total return basis. Investor concerns, not just in Canada but also globally, came early in the year with rapidly rising government bond yields and the impact this might have on corporate borrowing costs.

For Canada specifically, ongoing NAFTA negotiations and the threat of a 'no new deal' also weighed on sentiment. The TSX was, at one point in February, down about 7 percent on a year-to-date basis, but as investor concerns eased over the spring and early summer, the Canadian equity market recovered and actually saw year-to-date gains of almost 4 percent by the summer. However, the second half of the year was much more challenging; concerns over higher bond yields were overshadowed by concerns over a trade war between the world's two largest economies, the U.S. and China. For Canada, some reprieve did come when an agreement on a revised NAFTA came through in September, but shortly after, Canada's energy patch was hit not only by lower global oil prices due to global demand concerns, but also the discounting Canadian oil hit record levels.

The market really could have used a December Santa Claus rally, but unfortunately, that didn't happen. In fact, with a decline of over 5 percent, about half the year's total losses came in December. This was the first December since 1980 that the TSX lost more than 5 percent.

Out of the big three sectors in the Canadian stock market – financials, energy and materials – all three were down more than the market for the year. Energy had the steepest decline, not surprisingly, given the volatile pricing environment.

We're definitely looking forward to a more positive 2019. The good news is that valuations have come down significantly and they're at attractive levels.

Lastly, we've had a lot of questions on the performance of some of our Canadian-focused funds. Firstly, I am very confident on how we're positioned with high quality companies within the context of Canada. However, just because you own high quality companies does not mean they will not have a bad quarter or a bad year, which was the case with a handful of our companies. For example, Prairie Sky Royalty, a Western Canadian based oil and gas royalty company, which is a large position, it was a significant detractor in the portfolio, as was Jeld-Wen (phon) Holdings, a large maker of doors and windows. However, both of them rebounded significantly in 2019 and are both up over 20 percent. In addition, all the Canadian banks had negative returns last year; almost every Canadian energy company was negative.

The real distinguishing factor in performance versus any group of competitive funds was the amount of cash one held in the fund. Cash was king last year and really determined the performance of the portfolio. We held a very small amount of cash in the portfolios, which was a competitive disadvantage, especially in the fourth quarter. We're not happy about the year, but it is one year. Our investment timeframe is not one year. We invest with a three- to five-year timeframe. We do not try and predict stock prices over one or two quarters.

I know many people on the line have been through bad markets and volatile markets before. We all know from history that sticking to one's convictions in a bad market is the key to long-term investment success.

Our portfolios are well positioned with high quality, well managed companies that generate significant amounts of free cash, and they're trading at very cheap valuation. For example, the Canadian banks and insurance companies are all trading at single-digit earnings multiples, which we have not seen in over 10 years. In a nutshell, high quality companies are very cheap. I'm really very confident in the position in the portfolios. I couldn't be more excited.

While predicting the timing of the recovery in stock prices is difficult, it is worth noting we've seen a significant recovery in early January in the majority of our stocks.

Paul Holba, Vice President, Retail Distribution

Great. Thank you, Ian. Ashley, this is a question for you. Economic expansion of the U.S. far outstripped the rest of the world in 2018, but the U.S. equities themselves had the worst annual decline since 2008. Can you talk to us about the movement of the U.S. equity markets last year?

Ashley Misquitta, Senior Portfolio Manager, U.S. Equities

Sure. Thanks, Paul. The strong momentum from '17 continued at the beginning of '18. U.S. equities surged in January before falling into a correction for the first time in two years in February. The upward fund trend then resumed in the summer when the U.S. economy surprised to the upside as businesses responded forcefully to tax reforms and deregulation, and earnings were strong.

After three years of essentially flat earnings, earnings growth rebounded strongly, as I mentioned. The S&P 500 earnings expansion reached 21 percent in 2018. U.S. GDP growth hit 4.2 percent in the second quarter and 3.5 percent in the third. The S&P set a record high on September 20th and added almost 10 percent year-to-date at that point.

While the strong economic growth helped stocks, bond prices tumbled; sending yields higher on expectations the Federal Reserve continue to raise rates. The market sentiment turned on October 3rd, when U.S. chairman Jerome Powell made a comment that U.S. rates were still a long way from the neutral level. The market started to worry the Fed may run the risk of

stalling the economy by raising rates too fast and too high. The 10-year bond yield hit the highest level since 2011 in early November, and the equity market was down solidly, of course, in the fourth quarter.

Worries about rising interest rates, a trade war with China, geopolitical tensions and a sharp drop in oil prices curbed risk appetite somewhat. The S&P 500 gave up all those gains, as I mentioned earlier, and tumbled within striking distance of a bear market. On a very un-merry Christmas Eve, that was down 19.8 from September high, 19.8 percent. U.S. stocks had their worst December since 1981 and the S&P 500 Index ended the year down 6.2 percent or 4.4 percent if you include the Dividend. This is in U.S. dollar terms. That was its weakest performance since ’08.

Defensive sectors – staples, utilities, healthcare – outperformed in the year. The lagging sectors were typically, and were actually the economically sensitive ones with energy being the worst performer.

Paul Holba, Vice President, Retail Distribution

Thanks for that great news. Albert, the economy remains reasonably strong in North America. Last year, the Fed raised rates four times while the Bank of Canada raised rates three times. Albert, can you give us a quick recap on the performance of fixed income markets in environments such as this?

Albert Ngo, Portfolio Manager, Fixed Income

Yes, definitely, Paul. For fixed income markets I would say 2018 was really a tale of two parts. For the first three quarters we saw a synchronization of global growth. Looking here at North America, the U.S. economy grew the highest since 2014, while here in Canada growth improved to as high as 2.9 percent in Q2. In addition, unemployment in both countries declined to the lowest in two decades.

In response to this strong economy, the Fed and Bank of Canada hiked rates to more normalized levels. In addition, the Fed began to shrink its balance sheet which further reduced monetary stimulus, so as a result we saw government bond yields rise in the U.S. and Canada. By October/November—just to paraphrase, just to reiterate what Ashley mentioned, reached 3.2 percent or the highest level since 2011.

Remember, when yields rise, the prices of bonds falls. Rising yields make it a really tough environment for government bond investors. If you look through the first three quarters of the year, government bonds actually had generated losses.

For high yield, where I focus, the strong economy was supportive and high yield generated a 3 percent return through the first three quarters, and as we would expect, they outperformed government bonds in a rising rate environment.

Now, the latter part of the year, the last quarter, is a dramatically different story from the first three quarters. There were—concerns around global trade, increased, global growth expectations declined and investors became more skeptical of earnings growth projections. This really caused a dramatic sell-off in all risk assets, including equities, credit and commodities, which all ended the year in negative territory.

In this kind of environment, investors sought a safe haven in government bonds, and so they bid up prices to the point that they rebounded from their earlier losses and actually ended up positive for the year. When bond prices rise, yields fall, so after peaking at 3-plus percent in October/November, the U.S. 10-year ended the year at around 2.7 percent.

Paul Holba, Vice President, Retail Distribution

Great. Thanks for that. Ian, oil was absolutely hammered in the last quarter. What happened? What’s the short-term impact on Canadian energy companies? Ashley and I are heading to Calgary today. We better have some good answers for people tomorrow. Does this change your long-term view on the energy sector?

Ian Hardacre, Senior Vice President and Chief Investment Officer

Thanks, Paul. First, let’s take a step back and look at the bigger oil picture, in particular pricing for WTI oil, West Texas Intermediate, which is the North American benchmark.

It wasn’t all bad news for oil prices in 2018. WTI saw choppy but gradual rise in price starting at about $60 a barrel at the start of the year to about $75 to start the fourth quarter. However, in September a lot of oil analysts were calling for $100 by the end of the year. But, the heightened tensions around global trade reached a tipping point in regards to oil demand risk, additional headwinds came in from stronger U.S. dollar and perhaps too many exemptions around Iranian oil sanctions. In the space of three months WTI oil prices dropped from $75 to about $45 a barrel.

For most Canadian oil companies what matters more is the price of Canadian oil, not WTI. Western Canadian Select, WCS, is the benchmark for Canadian oil prices compared to WTI. Canadian oil tends to be heavier in nature and requires more refining to produce consumables such as gasoline and heating oil, and therefore, it tends to trade at a discount.

This discount, however, widened to extreme levels last quarter due to the shortage of pipeline capacity moving Canadian crude oil to U.S. refineries, and pessimism by the market that any longer-term solutions are on the table. At one point, a barrel of WCS oil was trading for less than $12 a barrel, while a barrel of WTI was trading at $53. This prompted, as we know, the Alberta government to take extreme measures to stem some of the supply, imposing a production decrease of 325,000 barrels per day starting in January 2019. Today, that discount stands at about $10 a barrel. Increased crude by rail supply is likely to further help alleviate the situation, as will the completion of Enbridge's Line 3 replacement pipeline project which is due in the latter half of this year.

Our medium- to longer-term view towards our energy investments is positive and we believe market sentiment towards these stocks is very pessimistic. We've taken a conservative view towards this sector by investing in the higher quality names. We've added two positions that have come off, especially in the fourth quarter, as their longer-term fundamentals remain intact, such as Prairie Sky Royalty. We've also added a new name, Vermillion Energy, as negative sentiment on Canadian oil companies took down its stock price, even though most of its production is more sensitive to WTI and Brent pricing.

Even though short-term market sentiment is challenging for this sector, it's often in most cases in these contrarian situations where you will find the best opportunities.

Paul Holba, Vice President, Retail Distribution

Ashley, with a decline in stock price and expansion on earnings, the valuation of the U.S. equities must have become a lot more attractive. Is this yet another opportunity to buy on the dip, or is this the start of a lengthy decline? What's your strategy for this year?

Ashley Misquitta, Senior Portfolio Manager, U.S. Equities

Yes, Paul, you're absolutely right. Their valuations indeed become more attractive. If we look back to '18, even though we saw strong earnings growth, the multiple on the S&P 500 fell from its peak in late '17. The S&P 500 trading sort of give or take around 14 times forward earnings, that's three full turns below the high of 17 times about a year ago.

Twelve months ago when I was meeting people and I think maybe even on this call, I described my perspective as cautiously optimistic. I find myself having a similar view today but maybe a shade more cautious. We find ourselves at something of a fork in the road. On one side of the fork I can paint a pretty positive scenario that I find entirely believable, but at the same time there's certainly a number of concerns that we see on the other side of that fork. Many of these issues, the resolution of the trade disputes, the Federal Reserve's decisions and others, they're pretty opaque from where we sit today but they could be quite impactful. Where does that leave us?

Well, at present, the U.S. economic fundamentals are actually pretty strong. The economic expansion is solid. We continue to see the longer-term underlying structural benefits of deregulation. The second effects of the tax reform bill, things like more efficiency in corporate decision-making from a territorial tax system, more projects which will get a green light because more projects are passing the after-tax hurdle rate, right? Companies makes decisions on should we do the project or not based on forward projections of free cash flow after tax. Lower tax rates, more projects meet that hurdle rate so we get more economic activity.

We see the lowest unemployment rate in nearly half a century. Wage growth data is still generally positive.

Finally, the U.S. leading indicator index is firmly positive, but this has ticked down a little bit of late and that certainly bears some paying attention to.

Having said that, there are some risks I alluded to earlier that we need to pay attention to: accommodating of central bank policies have dampened volatility over the course of the cycle, and as stimulative policies recede, we're starting to see a return of volatility to more normalized level. Trade and global macro issues are all cited as a concern.

While I am cautiously optimistic over the short term, I remain really optimistic on the opportunity for the U.S. over longer periods of time. There are a bunch of reasons for this, three I would highlight as being particularly important. First, the U.S. is a global innovation engine; second, demographic tailwinds are going to be supportive. By that I mean that working age population in the U.S., 15 to 64 years old, is going to be growing in the U.S. over the coming decades. Decades, that's a plural. Finally, the energy renaissance we've seen in the U.S. over the past decade is a huge but generally unremarked on boon to the U.S. It's something we kind of take for granted, but natural gas prices were about $15 a BTU in 2008; they struggle to pass $3 today. They may tick up above that, but the quantity and the supply brings them back down. That's a huge tailwind for the U.S.

Regardless of market volatility, we continue to use the same processes we all used, the fundamental bottom-up approach, trying to find outstanding business that we can purchase for a price well below their intrinsic value. Essentially, we want high quality businesses with sustainable competitive advantages, attractive industry structure, strong and well-incentivized

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management. We want those in an industry with an environment of secular tailwinds and we want them at attractive valuations. We enforce this discipline on ourselves as we believe it has the greatest chance of producing superior long-term returns for investors.

When it comes to the economic cycle, we certainly seem to be in the second half of the match, even if it's not completely clear if we're in the third or fourth quarter. Given that, the ongoing portfolio construction process of the American Value Fund, where we are today, there is somewhat more emphasis on businesses that have a very robust balance sheet, and sustainable free cash flow. Even if they would go down if we hit an economic tough spot, they're sustainable in those environments.

Essentially, we're positioned with businesses that have strong defensive characteristics for one of those forks in the road, but the offensive potential to try and capture some of the upside in case we end up following that other fork.

Paul Holba, Vice President, Retail Distribution

Great. Thanks, Ashley. You can't really talk about the Canadian market without talking about the banks. They posted record earnings last year but the financial sector did not do well in the equity market. The banks became dislocated from their business fundamentals. Where do you foresee the attractive investment opportunities from other industries?

Ian Hardacre, Senior Vice President and Chief Investment Officer

That's great. Thanks, Paul. We still think there are very attractive opportunities in the Canadian equity market, particularly after December's pullback. Let's first talk about financials, which continues to be the largest sector by far in the Canadian marketplace.

Canada's big banks extended their record earnings streak in 2018 with a 7.5 percent surge in annual profits. A large factor behind that came from various operations outside Canada. For example, TD and the Bank of Montreal profited from their U.S. Consumer Lending divisions, while Bank of Nova Scotia's Latin American focus helped in a year when Canadian companies saw more muted results in domestic banking. At Royal Bank's Wealth Management was boosted by its Los Angeles based City National, and CIBC benefited from its takeover of a private bank in Chicago last year.

Although bank earnings were generally strong, stock performance did not align with these results. As investors seemed to gravitate towards weaker domestic loan growth figures and perhaps didn't believe in the forward guidance provided by the banks. The S&P/TSX equal-weighted Diversified Bank Index was down about 8 percent last year. We believe that banks generally offer good value as the market is underappreciating their ability to generate profit through multiple channels.

Although we have positions in the Big 5 banks within various funds, our largest weights are Royal, TD and Scotia.

It is worth noting that the only stock in the financial sector that was positive for 2018 was Thompson Reuters, and this really just speaks to how difficult it was to generate positive returns in 2018.

In other sectors of the market, the opportunities are really more on a stock-by-stock basis with a focus on high quality companies. For example, in the industrial sector we have positions in the rails, both CP and CN, as well as Toromont Industries; all these are very well managed companies. Valuations have become more attractive and we've been able to selectively add to certain positions. This was especially true in Q4 last year when we were actively adding to our position.

Paul Holba, Vice President, Retail Distribution

Thanks, Ian. Active management in motion.

Albert, fixed income demonstrated its ability to preserve capital during last year's equity volatility. Given the low-rate environment, how should investors be thinking about their fixed income allocations today?

Albert Ngo, Portfolio Manager, Fixed Income

I always like to remind investors what the objectives of their fixed income allocation are, and that is to, one, preserve capital either in a rising rate environment or in a volatile equity market; and two, earn a meaningful return above inflation in order to grow purchasing power. I want to focus on the second objective, which is to earn a meaningful return above inflation.

In Canada, inflation has been running around 2 percent, so investors should want to earn a return that beats that. An important question to ask is what kind of return can we expect from government bonds in this environment? Currently, government bonds yield around 2.5 percent and if interest rates stay flat the annualized return would be 2.5 percent before fees. But once you factor in fees and taxes, which, remember, our tax is ordinary income, the net return would only be around 1 percent, depending on what kind of fee and fee structure and tax bracket you're in. That 1 percent is less than inflation, so that means that these government bond investors are actually losing purchasing power over time. Worse yet, if interest rates

rise, they would actually lose money, so in this environment I don't think fixed income investors will meet their objectives if they invest all of their fixed income into government bonds.

To meet their return objectives, I believe investors have to be flexible and diversify into other fixed income securities that provide additional yield and a potential for returns meaningfully higher than inflation.

Paul Holba, Vice President, Retail Distribution

Right. That's exactly why we launched the Strategic Corporate Bond Fund last year, to provide another option for fixed income investors, has proven to be very popular. Can you explain how different the strategy is for Strategic Corporate Bond?

Albert Ngo, Portfolio Manager, Fixed Income

Definitely, Paul. To generate additional yield our approach is to invest in fixed income securities issued by companies. What that means is we can go anywhere and invest in any company that issues investment grade corporate bonds, floating rate loans, high yield bonds, preferred shares and/or convertible bonds, and we really adhere to the same investment philosophy. We're looking for good businesses or assets that provide an attractive yield relative to the downside protection.

Typically, the best ideas are found in high yield, and as a result that is where about 80 percent of the Fund is invested.

I think there is a general negative perception about high yield, but if you look at the facts, I believe it provides a very attractive investment opportunity.

First, if you look over the last 25 years, high yield bonds have actually generated an annualized return of around 7 percent, which is about three-quarters of the return of the S&P 500 but with half the volatility. On a risk adjusted basis, high yield has actually outperformed the S&P 500, and despite concerns about default risk, the historical average default rate is only 4 percent, and so what that means is the other 96 percent continue to pay you back, which is a key reason the asset class has performed so well.

Second, this is a large and deep market worth $2 trillion. That's bigger than our Canadian government and investment grade universe. It's a capital market where companies raise capital to invest in their businesses and create jobs. There are very large high yield companies with scale that everyone will know, including Netflix, Sirius Radio, Air Canada, and Restaurant Brands which owns our beloved Tim Hortons. The list goes on and on.

Lastly, I'd like to say Warren Buffett has been very successful investing in high quality companies. If you look at Berkshire Hathaway's portfolio, about one-third of the 40 or so companies are high yield issuers, so clearly, they have a level of comfort with high yield companies. But, Paul, like any investment universe or asset class, there are opportunities across the risk spectrum and it's really important to have a research process to identify the ideas that provide the most attractive risk versus reward, and to really manage downside risk.

Paul Holba, Vice President, Retail Distribution

Thanks, Albert. It's not just the Strategic Corporate Bond Fund itself, but we've sprinkled it into a number of our other holdings like Global Asset Allocation, for example; really helped to improve the performance there as well.

Ashley, talking about research and risk management, you mentioned there are risks and uncertainties that you like to pay attention to. Can you be a little bit more specific on what those are?

Ashley Misquitta, Senior Portfolio Manager, U.S. Equities

Yes. Sure, Paul. There's three that I'd highlight. The first is of course the U.S./China trade dispute. I'm not sure that's going to be a surprise to anyone. A year ago, I told many of you that I viewed NAFTA, EU trade and Korea trade as being generally solvable because the issues, they were relatively manageable. There were relatively evident solutions on how we could get to a finish line on them, and things have generally evolved in that direction.

My long view of the China/U.S. trade dispute is much more complicated and less easily solved because the issues are just much less tractable. The key issues in this dispute are related to IT theft, forced technology transfer from western companies through Chinese joint ventures, and government support for national technology champions. The U.S. argument is essentially that free trade is fine but what's happening now is not free trade, and that that generally works in the early stages of an emerging economy when it's principally labour-intensive industries where there's a relative comparative advantage, but it's a much bigger issue when you're talking about higher value industries as we've been seeing of late.

What happened? The U.S. placed tariffs on about $50 billion of Chinese imports over the summer. China responded with its own taxes on American goods and so on it went. Currently, there's a 10 percent tariff on an additional $250 billion of Chinese goods, and that may go up to 25 percent in March if the two countries

don't reach an agreement. There's another approximately $250 billion or so, give or take, of U.S. imports from China that could also become subject to tariffs that are not sort of currently on the table.

Tariffs create uncertainty in global supply chains, and we're in the early stages of seeing manufacturers and tech companies moving some aspects of their global supply chain out of China to diversify in case the current dispute is not resolved, or, even if it is resolved, diversify their supply chains in case more similar disputes flare up in the future.

While the impact to the U.S. has been relatively minor so far, further deterioration in trade could have an impact, so it's something we're paying attention to, particularly because when you step back and think about it, the past 20 or so years western companies have been outsourcing production to low-cost locales, China being one of them, and they've been reaping higher margins, and higher and grower free cash flow as a result. Any rollback of that, any diversification of supply chain would presumably lend themselves towards some pressure on margins and free cash flow, so obviously it's something we're paying attention to.

The second thing—and I'll be brief on this—is a sort of a softening global macroeconomic environment we're seeing. The U.S./China trade dispute happening at the same time as we're also seeing weakening in Chinese economic data, so weaker sales of iPhones, cars, new houses, they all point to a slowdown to some degree in the Chinese economy. Pretty much every indicator we've seen of economic activity in the last few months has been below expectations.

Europe is struggling with political disunity, right? We've got Brexit going on, which is an unclear resolution in front of us. We've got French yellow vest protests. We've seen a German political transition, not completely clear how that goes; Italian populism, and we've got European parliamentary elections in May. Layer on top of that we've got an economy that's sensitive to global trade, and we've seen some softening in Germany and Italy and France in their industrial production.

Eurozone growth forecasts for '19 have been dropping to fresh lows, so it's certainly something else we're paying attention to, and they just have less room for stimulus than they have in the past. China also has less room for stimulus, but we're expecting to see—we think they probably have a little bit greater latitude, so they've already offered some monetary stimulus and we're expecting to see more on the fiscal side shortly.

The U.S. is bordered on two oceans—on two sides by vast oceans, but it's not an island, certainly, when it comes to the macro economy. The risk is a global economic slowdown could put some pressure on the U.S. economy.

Finally, very briefly, the U.S. Federal Reserve, it looks like is on a tightening path; we've seen rates going up. We've seen the U.S. Federal Reserve reducing the size of their balance sheet. They sent some mixed signals over the last few months about both of those. Clearly the Fed wants to—just like the ECB, the Fed wants to regain some dry powder to be able to stimulate the economy in case we, or when rather, we get a recession, because it's going to happen at some point and they want to be able to provide some stimulus to the economy.

All that being said, they've got a pretty narrow path to tread, so we're watching real carefully. Historically, recessions have been preceded by the Fed raising rates above a neutral level and pushing the economy into a recession, so we're keeping a close eye on it. It's not my base case but it's something we're paying attention to.

Paul Holba, Vice President, Retail Distribution

Paying attention, right. Thanks, Ashley.

Albert, let's get back to how you manage risk on fixed income. How do you manage it and how important is active management when investing in corporate fixed income, including high yield?

Albert Ngo, Portfolio Manager, Fixed Income

I think active management, which includes risk management, is absolutely critical, and it's what we do every day.

From a risk management perspective, if you look at fixed income there are two primary risks: one, interest rate risk, and two, credit or issuer specific risks. We generally manage interest rate risk by mostly investing in fixed income securities that will mature into cash within five years, or in securities that have floating rate coupons that fluctuate as—where the coupon fluctuates as interest rates do.

To manage credit risk, as I mentioned earlier, we adhere to our philosophy, invest in good businesses or assets with downside protection, and we also maintain a sufficient amount of diversification and ideas.

On the importance of active management, I'd like to highlight two points. First, the top picks in Strategic Corporate Bond are the companies that through our research we believe provide the best risk versus reward. In contrast, the top picks in a passive index or ETF are the most indebted companies in the universe. We're really using different criteria when we're making our investments here.

Second, a passive index or ETF does not have the flexibility or capability to invest across multiple asset classes to find the best ideas, and to move around and invest where the value is, which is our investment approach for Strategic Corporate Bond.

Paul Holba, Vice President, Retail Distribution

Right on. Thank you. Ian, I'm going to talk about Emblem now. The Asset Allocation Committee normally would make four to five calls a year on reallocating the assets, but 2018 we only saw three. Has it become less active? What is Emblem's current portfolio positioning, and can you share the asset allocation strategy for this year, for 2019?

Ian Hardacre, Senior Vice President and Chief Investment Officer

Sure. Thanks, Paul. The Emblem portfolios have generally maintained an overweight position in equities and underweight position in bonds throughout '18, and remain so today. The team feels that global growth, while perhaps slowing a bit in 2019 is still set to deliver growth numbers in 2019 that are supportive of equities. Monetary conditions have been tightening but are not at the level that we would consider to be putting on the brakes. Remember, central banks are attempting to normalize interest rates back to levels that are appropriate for a healthy economy.

The last tactical move we made was back in early November following a volatile October which brought valuations down to more reasonable levels, and with the result of the U.S. midterm elections known, we thought it was a good opportunity to deploy cash that had accumulated in the portfolios over the summer months.

Proceeds from the cash were deployed into the U.S. and international equity mandates. I really like how those portfolios are positioned; very, very high quality stock with very attractive valuations at that point.

Although our Canadian equity mandates are also very high quality, the Canadian market in general tends to be more cyclical. Additionally, the portfolios already had a meaningful weight in Canadian equities to begin with.

In all of 2018 we made three tactical moves, which is somewhat lower, as Paul mentioned, than the number of moves we've made in past years, but we only make a tactical move when there's a good reason for the move in the portfolios. We don't make changes for the sake of making changes, but that does not mean they are not actively managed on a regular basis as we are always monitoring the portfolios. Remember, within each asset class mandate that comprise the portfolios, individual security level transactions are being made on a much more frequent basis.

Paul Holba, Vice President, Retail Distribution

Yes, can't forget about that. That's active.

That is going to wrap up our comments, so thank you, gentlemen, for your thoughts and insights. We'll now open up the call to questions from those on the line. If you could please instruct people on how to ask a question.

QUESTION AND ANSWER SESSION

Operator

Certainly, thank you. We will now take questions from the telephone lines. If you have a question and you are using a speakerphone, please lift your handset before making your selection. If you have a question, please press star, one on your telephone keypad, and if at any time you wish to cancel your question, please press the pound sign. Please press star, one at this time if you have a question. There will be a brief pause while participants register for questions. We thank you for your patience.

Paul Holba, Vice President, Retail Distribution

During that brief pause, Ian, I'm going to ask you a question that I've had asked several times, which is with the central bank policies being somewhat accommodative and dampening volatility in recent years and then all of a sudden we get this explosion of—not really explosion but back to normal volatility last year, what's your strategy to handle the heightened volatility and probably likely to stay in coming years?

Ian Hardacre, Senior Vice President and Chief Investment Officer

Thanks, Paul. So, '18 was a weird year in Canada because we were very volatile in the beginning of the year, the market was down; recovered, and then over the summer there was no volatility at all, and then we hit Q4 and we haven't seen the volatility in Q4 of last year since the financial crisis, and nowhere do I feel that we're anywhere near the financial crisis but that did come up a few times when people asked questions. For those of you who remember those days, they were completely different from what happened in fourth quarter last year other than the volatility.

The volatility provides a lot of opportunity for us. I know, especially when you have extreme volatility, it's

not great when clients are phoning, etc., but that's really how you outperform over time. We take advantage of dislocations and markets, take advantage of dislocation in stock prices to add to your positions, to initiate new positions, and it's really about doing your homework. The team is constantly travelling, constantly seeing companies, constantly doing their analysis to the point where when the day comes that a certain stock gets to a price that we can buy it, and sometimes you'll follow a company for multi years before you actually initiate a position because price matters.

That opportunity existed in Q4 last year. We made a number of changes in the Canadian funds. Even though we had low levels of cash, we could sell stocks that had done well to initiate positions in other companies.

The volatility for an active manager and the way we invest is in our favour. I completely understand that that does cause issues, again, with clients because they're reading the headlines every day, but it adds to the long-term performance over time.

Paul Holba, Vice President, Retail Distribution

Volatility is a good thing.

Ian Hardacre, Senior Vice President and Chief Investment Office

It is.

Paul Holba, Vice President, Retail Distribution

Awesome. Do we have any questions on the lines, Maud?

Operator

We do have a question from Franco di Stasio. Please go ahead.

Paul Holba, Vice President, Retail Distribution

Hello Franco.

Franco Di Stasio

Hi guys. Happy New Year to everyone.

Paul Holba, Vice President, Retail Distribution

Happy New Year.

Franco Di Stasio

I just wanted to say hello, and my question is really regarding the U.S. government shutdown. If this thing keeps going for weeks and months, how is that going to impact overall all the strategies that we're trying to put in place for our clients?

Paul Holba, Vice President, Retail Distribution

U.S. government shutdown, I think that might go to Ashley.

Ashley Misquitta, Senior Portfolio Manager, U.S. Equities

All right, thank you very much. Yes, it's a very good question actually. This is—we're now I think at the longest shutdown we've ever seen from the U.S. government. Just to be clear, it's a partial shutdown, right? Certain aspects of the government continue to function. Essential activities, military, FDA, food and health surveillance, there are some aspects of it that continue, but to your point, correctly, the consumer and the impact to the economy.

I think that as we—if we start getting to another two to three weeks, it's going to start to become an issue in a few different ways. Subtleties, right? Like all of the government employees who are not getting a paycheque, those people don't have as much disposable income to spend money, right? That will have an impact on the consumer sector, one.

Satya Nadella from Microsoft made some reference to this too in the sense that the government is a big customer of theirs, so while they haven't seen anything that will substantially impair—while it's not going to cause a problem for them yet, if we start getting into—if we start talking about this in terms of months as opposed to weeks, that's going to be something that's going to have an impact.

All that being said, two things I would say. One—or three things. One: the IRS will continue to be issuing tax—money back to people who have paid too much in taxes. This matters this year, particularly because with the tax reform bill last year by and large people don't usually go to their HR department and say, "Reduce my withholding tax." As such, the IRS actually has a lot of tax payments that are going to be made to people in the first quarter of this year. While that was originally thought to be stimulative to the first quarter, now, if we see the shutdown go longer, it will provide some offset

to that. The numbers I've seen—and we can't know this exactly. The numbers I've seen suggest in the range of 0.5 percent of GDP is of stimulus from that, so that's an encouraging thing. That's one.

Two is we're starting to see the early signs of—whether it's a fall or not, but we've seen an offer from the Trump administration that it has something for everyone. No one gets everything they want, but it's something that is sort of a step back from the edge, which I think is encouraging, and suggests that maybe there's a recognition that we've got to get things sorted out here. The longer it goes, I would agree with you. I think the base becomes somewhat more complicated.

Then the final thing I would say before we move on to the next question is this. Markets have a funny way of handling these things. Back when there was a government shutdown back in 2013, '14, somewhere in that era—I think it was '13 went Obamacare launched. If you had known that was going to happen ahead of time, intuitive reaction would have been I'm going to sell because the markets aren't going to like it, when in fact stocks were up through it. Everyone looked through it and viewed it as a temporary thing. As long as this is viewed as a temporary thing it will be, I suspect, viewed as a blip and markets will look past it. That pivot point will be when we start to think, I think as I said, in terms of months and not weeks.

Paul Holba, Vice President, Retail Distribution

Thanks, Ashley. Thank you, Franco.

Franco Di Stasio

Thank you, guys.

Operator

Thank you.

Paul Holba, Vice President, Retail Distribution

Happy New Year.

Operator

Thank you. The following question is from Jules. Please go ahead.

Jules

Yes, hi. I just had a question in regards to this year in Canada. There's a federal election that's coming up. Polls are kind of all over the place. There's no guarantees. Does any of that sort of factor into things? Certain parties might be more predisposed for massive deficits, those sort of things. Does that play at all a factor in your risk assessments, or if perhaps like we've seen in Europe and other places where very non-mainstream parties are getting more power, does that also play a factor?

Ian Hardacre, Senior Vice President and Chief Investment Officer

Thanks for the question. We are bottom-up so we're looking at stocks first and the fundamentals of the stocks, but you cannot operate in a vacuum so you do have to, even as a bottom-up manager, be cognizant of what's going on in the environment.

We do follow that, and really, when it comes to Canada it's more about a certain individual's or party's view on certain sectors, whether it be energy or other sectors, or environmental regulation, etc. It's something we do follow and are conscious of, but it doesn't really play a part because you don't really—we won't really know the outcome of any election, etc., it doesn't really play a large part in the actual stock selection unless we have an event that's way off the parameter.

We do follow it. We do follow it, and obviously—and watch what's going on, especially really when it comes to energy, but as bottom-up managers we're more focused on the companies than we are on sort of the macro.

Jules

Thanks.

Paul Holba, Vice President, Retail Distribution

Thanks, Jules.

Operator

Thank you. Our following question is from John Quigley. Please go ahead.

John Quigley

Yes, I have a number of clients, including myself, that have gotten into the American Value Fund. It has a

rather large MER, but could you just give me an idea of what the portfolio turnover rate is in that fund for the year 2018 as compared to, say, the Dividend Fund? Because I think last year, 2017, that portfolio turnover rate was around 25 percent.

Ashley Misquitta, Senior Portfolio Manager, U.S. Equities

Yes. Okay, I think I see where we're going here. I don't have tremendous insight into the turnover on other funds, but what I can tell you is that the turnover was higher in '17. I think that's the year you were referring where it was 25 percent, than sort of is typical for a fund that I manage. It's a result of I arrived in 2017 here and I was making changes to the Fund to position it in the way that I intended it to be.

My long-term approach has been buy great businesses, own them for a long time, and watch our wealth compound for investors. That's sort of my modus operandi. That is what I would—I don't know the number break even off the top of my head. I would expect analytically that we would discover for '18, and you should expect that to continue into the future.

There will be instances where a company we buy crystallizes its value faster than we would anticipate, and we want to make sure that—and this is part of the valuation aspect of it. We want to make sure that if all the good news is encapsulated in the stock price today, that doesn't give us a lot of upside longer term. Even with great businesses that happens sometimes and we're going to use our sell discipline to apply that.

I would say to you, you should expect over time that this fund will have a relatively modest turnover.

Ian Hardacre, Senior Vice President and Chief Investment Officer

Thanks, Ashley. On the Dividend Fund, in the majority of the Canadian mandates, my historical turnover in my career has been about 25 percent. You have to keep in mind the Canadian market is more cyclical so there's probably—there's more of a sense of setting a buy price and setting a sell price around that.

More importantly, to think about turnover is really we can go through a particular year only adding three or four new Canadian companies in the portfolio, but we'll make adjustments around the other names such that if a stock becomes more expensive we'll trim it back, reallocate that capital to another name, but in that year we may only own four new companies out of a group of 45 companies.

Our turnover in all our funds is low. It's definitely low and I would think a lot lower than—I know a lot lower than our competitor funds out there because we really are more of a buy and hold manager.

Paul Holba, Vice President, Retail Distribution

Great. Thank you, gentlemen.

A reminder, Maud, you can just remind people how to ask questions.

Operator

Certainly, certainly. Once again, please press star, one at this time for any questions or comments.

Paul Holba, Vice President, Retail Distribution

Okay, great. Since we're waiting for perhaps another question, I do have one that got emailed to me. This is for Albert.

One of the things that was interesting last year is the yield curve, which became very flat. The question is, when the U.S. yield curve inverted, that was the first time that's happened this cycle. Is that something we should be worried about?

Albert Ngo, Portfolio Manager, Fixed Income

Sure, Paul. Let me answer this in a few parts. First, historically, a flattening yield curve has been a reliable indicator for recessions, and I hate to use the saying, 'but this time is different,' but remember, we're in a bit of uncharted waters here which distorts our ability to rely on history. We're coming out of a 10-year period of unprecedented monetary stimulus. We've had abnormally low rates, even negative rates in Europe. We've had quantitative easing where the Fed and the ECB have gone and bought bonds in the open market. We're just in the early stages of unwinding this stimulus. Remember, all this monetary policy has a big impact on the shape of the yield curve, so there's all these drivers of the yield curve that we've never seen before, which makes it a little harder to use history as a predictor of the future.

Then the second part to answer this is when we think about what's driving the flattening of the curve, we don't believe this signals an imminent recession. Most of the flattening has come from the increase in the front end of the curve as the Fed has been hiking to get to more normalized levels and wanting to get to a place where they can have more dry powder. If you look at the two-year bond yield, it's actually the highest since 2008, and that's where most of the flattening has been coming from and what you would expect given what the Fed has been doing.

The long end of the curve has been kept in check by low inflation and some other structural issues, mainly global savers seeking safety and strong demand from insurance companies and pension funds that have to match their longer-term liabilities.

But having said all that, we can't entirely rule out what the yield curve is saying, and it may be foreshadowing a slowdown. Even though we don't believe a recession is imminent, the flattening yield curve is telling us to be cautious rather than complacent.

Paul Holba, Vice President, Retail Distribution

Ah, so another cautiously optimistic individual.

Albert Ngo, Portfolio Manager, Fixed Income

Yes.

Paul Holba, Vice President, Retail Distribution

Do we have one more question?

Operator

We do have a question from John Quigley. Please go ahead.

Paul Holba, Vice President, Retail Distribution

Welcome back.

John Quigley

Sorry to bother you again with this. We really wanted to know what your portfolio turnover rate for the last number of years on that American Value Fund, because it's been hot. I would have thought it would have had a lot higher turnover rate than the Dividend Fund. If you can answer. Thank you.

Ian Hardacre, Senior Vice President and Chief Investment Officer

I would think if you went back historically before the existing investment team was here, I think you would have found that the American Value Fund, if you went back maybe four years or so, had a very high turnover rate. I don't have those numbers in front of me but I feel very comfortable saying that.

Now our turnover rate in all our funds, and especially American Value, is quite low. I would think Ashley can talk about it, but again, in a normal year there would be a handful of new companies in and new companies out.

I'd say the turnover rate for all the funds is I would say, as I said earlier, well below industry norm.

Ashley Misquitta, Senior Portfolio Manager, U.S. Equities

Let me jump in with just one more quick point there. One of the things, as Ian alluded to earlier—I'm in complete agreement with him, right, is that we take advantage of the volatility like we see in December. We added names that I had been watching and waiting to buy but had been unwilling to buy because I didn't think the valuation offered us an attractive enough risk reward.

When we enter environments like that, you're going to expect to see—you should expect to see new names because that's us sort of taking advantage of when the market panics, when the market makes some potentially bad decisions, when ETFs sell a whole sector and the baby gets thrown out with the bath water. We want to go find those babies because those are great opportunities for us longer term to build wealth for our investors.

Broadly speaking, expect the philosophy, its low turnover, but expect it to take advantage of opportunities when we see it. That's how the approach is on this fund.

John Quigley

Thank you.

Paul Holba, Vice President, Retail Distribution

Great. Thank you.

Operator

Thank you.

Paul Holba, Vice President, Retail Distribution

We are out of time for questions, so I'm going to thank Maud for managing that, and thank you all of you for your questions.

I also would like to thank Ian, Ashley and Albert for providing their insights today on the markets and current events, and thanks to everybody on the call today for taking the time to call in.

As I mentioned at the beginning, we did make several product enhancements in 2018. Just to run through them, we expanded our Emblem GIF portfolios, our popular managed program. We added four new global investment options and we added new global funds to both our GIF and our Cost Plus 3.0 lineup. I encourage you to look at our seg funds and other mutual funds as we now offer a full range of domestic and global choices.

The investment team continues to find investment opportunities in all market cycles. As we just have heard from Ashley, we're always on the look out for new opportunities.

Stay informed on the investment team's activities. We've got our investments blog. We have our Emblem Portfolios Asset Allocation Updates. We have our Portfolio Manager Interviews and our newsletter from the desk of Ian Hardacre. All of these you'll find at empirelifeinvestments.ca. We're trying to be more communicative with you in terms of what we're doing and what's happening within each of our funds and portfolios.

If you do have any questions about today's call, or any questions at all about any of our industry leading choices, please do contact your Empire Life sales team. We would all love to come and talk to you.

This conference call and a transcript of it is going to be posted on our website shortly. We'll then send an email blast to all of our advisors so you can listen to it again at your leisure, as well as recommend it to any of your colleagues who may have missed today's call because I know it's a busy time of year. I think you'll agree there's been a lot of information that's very valuable that's been shared here today.

Thank you again for calling in and we do look forward to seeing you soon. Maud, thank you for managing the call and this officially ends our call today.

Operator

Thank you very much. The conference call has now ended. Please disconnect your lines at this time, and we thank you for your participation.

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