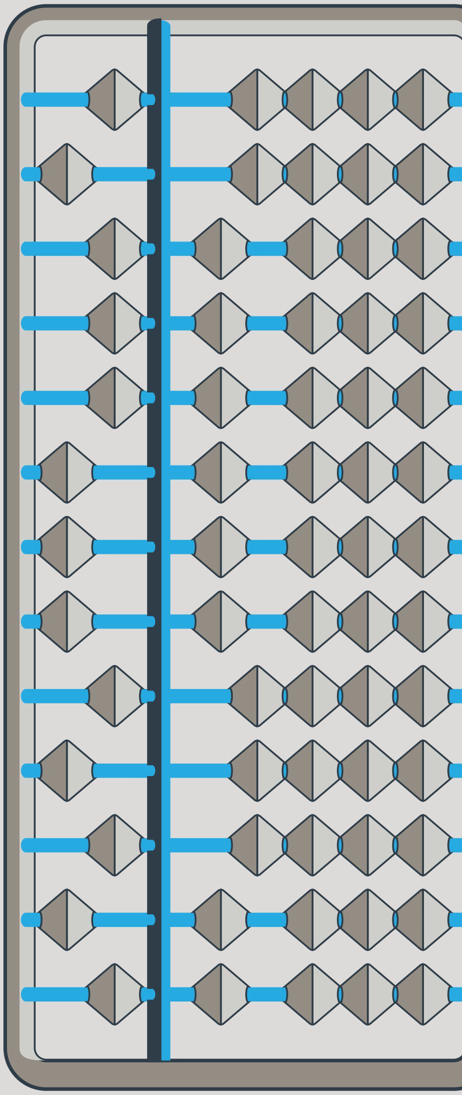
PICTON MAHONEY
Asset Management

ADJUSTING YOUR STRATEGIC ASSET ALLOCATION TO REFLECT CHANGES IN YOUR CAPITAL MARKET ASSUMPTIONS

A TOTAL PORTFOLIO APPROACH TO "FIXING" FIXED INCOME

The importance of strategic asset allocation is widely acknowledged. By efficiently blending different asset classes and strategies, an advisor can help investors build a resilient and well-diversified portfolio designed to achieve their investment objectives more efficiently. The goal is to create a baseline portfolio that will benefit your client over a long-term horizon relative to simply investing in a broad portfolio of Canadian stocks and bonds.



One of the most important inputs to the strategic asset allocation decision are the capital market assumptions underlying a portfolio. Capital market assumptions are an advisor's forecasted expectations of the long-term return, volatility and correlations of various asset classes and strategies. As capital market assumptions change, the corresponding strategic asset allocation should similarly adjust to reflect these changing views.

Over the past decade, the capital market assumptions of many professional asset managers, industry organizations and institutional investors have changed significantly. For example, earlier this year the FP Canada Standards Council and the Institut québécois de planification financière published their updated projection assumption guidelines to help financial planners make projections regarding future inflation, borrowing and investment rates for the purpose of financial planning. Their 2021 guidelines estimated long horizon (10+ year) fixed income returns of 2.7%[1] annualized for the year (before fees paid by clients for products and advice). This represents a 32.5% decrease compared to the fixed income projections from the 2016 guidelines and a decrease of 57% compared to the fixed income projections from 2011 guidelines.

As capital market assumptions change to reflect the reality of the current low interest rate environment, it should come as no surprise that there has been a growing trend in which advisors seek ways to reduce the allocation to core bonds in their strategic asset allocation in an effort to design a portfolio with the potential to achieve their return target.

The typical approach is to simply focus on fixed income – replacing core bonds with credit strategies. While this approach generally improves the return potential of the portfolio, it also creates potential to compromise the resiliency of the portfolio. We therefore believe that investors can take a multi-pronged approach by replacing both traditional bond and equity exposures with alternative strategies. By taking a total portfolio approach, there is potential to achieve an improved portfolio outcome – enhancing return potential while at the same time enhancing the potential resiliency of the portfolio.

[1] Projection Assumption Guidelines. Effective Date April 30, 2021. FP Canada Standards Council and Institut québecois de planification financière (IQPF). https://fpcanada.ca/docs/default-source/standards/2021-pag---english.pdf

TAKING A MULTI-PRONGED APPROACH TO SEEK IMPROVED PORTFOLIO OUTCOMES

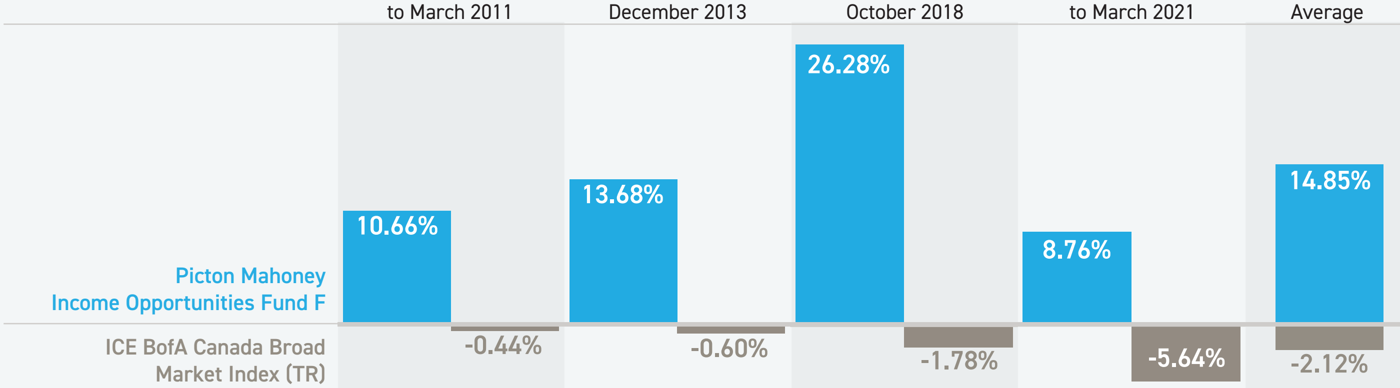
Step 1

REPLACE CORE BONDS WITH LONG SHORT CREDIT

Objective: Seek higher returns and more yield

Long short credit strategies offer the potential for reduced interest rate sensitivity, a larger yield cushion and enhanced return relative to core bonds while potentially mitigating the drawdown risk of traditional long-only credit exposures. The trade-off to adding credit is the potential for the fixed income sleeve to provide less ballast during equity drawdowns.

Figure 1: Long Short Credit strategies offer the potential for reduced interest rate sensitivity (Performance when rates rose 100+ bps)



	September 2010 to March 2011	August 2012 to December 2013	August 2016 to October 2018	August 2020 to March 2021	Average
+/-	11.10%	14.28%	28.06%	14.04%	16.96%
Change in U.S. 10-Year	+100bps	+153bps	+169bps	+119bps	+135bps

Sources: Morningstar (using monthly data), Picton Mahoney Asset Management (PMAM) Research, https://fred.stlouisfed.org/series/DGS10. For full performance history of the Picton Mahoney Income Opportunities Fund (Class F) (inception date December 31, 2009), see https://www.pictonmahoney.com/Performance/Authentic-Hedge-Funds.aspx.

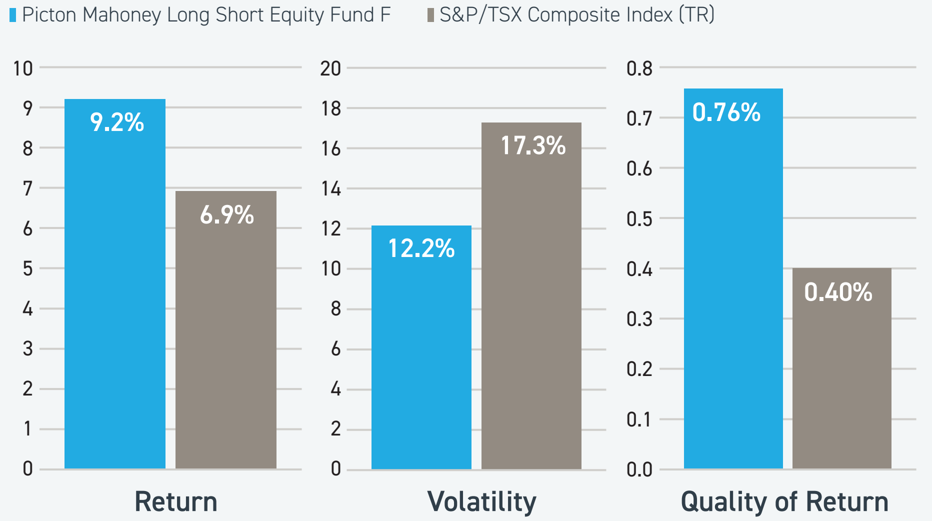
Step 2

REPLACE EQUITIES WITH LONG SHORT EQUITY

Objective: Additional downside protection and higher quality of return

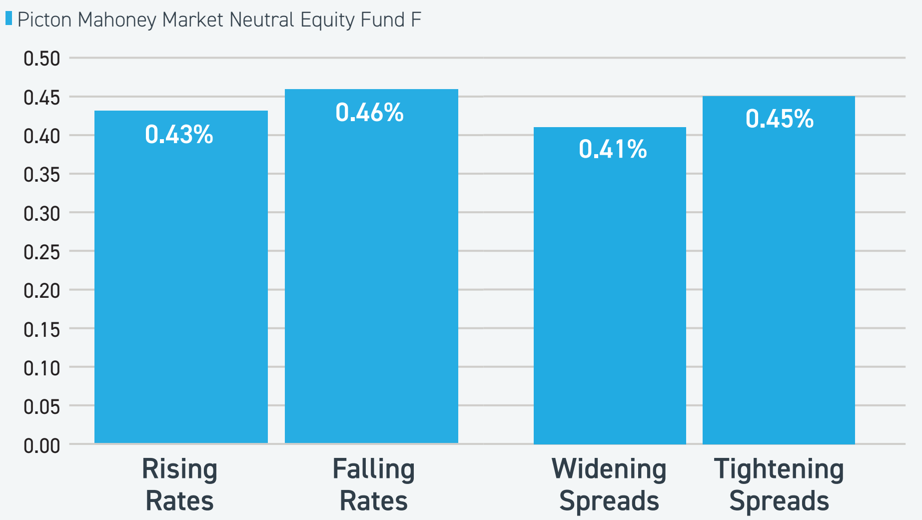
Since there will be less core bonds in the strategic asset allocation, there is a need for additional risk mitigation from the equity sleeve of the portfolio. Long short equity strategies offer the potential for improved quality of return and have tools to mitigate drawdowns during market sell offs. By implementing a more defensive equity exposure we are able to design a strategic asset allocation that seeks to benefit from the higher potential returns from credit without sacrificing on the risk mitigation that traditionally would have been sourced from a large allocation to core bonds.

Figure 2: Quality of Return



Source: PMAM Research. Data calculated since the inception date of the Picton Mahoney Long Short Equity Fund (Class F) from September 29, 2006 to August 31, 2021. For full performance history of the Picton Mahoney Long Short Equity Fund, see https://www.pictonmahoney.com/Performance/Authentic-Hedge-Funds.aspx.

Figure 3: Average monthly return when rates were rising/falling, credit spreads widening/tightening



Sources: Morningstar, PMAM Research, https://fred.stlouisfed.org/series/DGS10, https://fred.stlouisfed.org/series/BAMLH0A0HYM2. Data calculated since the inception date of the Picton Mahoney Market Neutral Fund (Class F) from September 29, 2006 to August 31, 2021. For full performance history of the Picton Mahoney Market Neutral Equity Fund, see https://www.pictonmahoney.com/Performance/Authentic-Hedge-Funds.aspx.

Step 3

ADD A SLEEVE OF LOW VOLATILITY ALTERNATIVE STRATEGIES

Objective: Reduce sensitivity to changes in the level or direction of markets

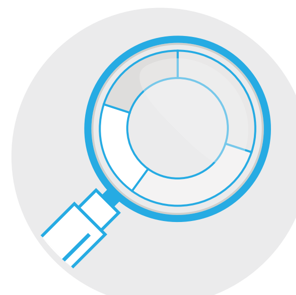
Low volatility alternative strategies can be used as a diversifier or replacement for fixed income. These strategies provide the potential to reduce sensitivity to changes in the level or direction of fixed income markets so that the diversifying sleeve of the portfolio can potentially perform well across a broader range of economic and market scenarios.

PUTTING IT ALL TOGETHER

Capital market assumptions (CMAs) are a key input into the strategic asset allocation decisions. As CMAs change, strategic asset allocation should similarly adjust to reflect these changing views.

Over the past decade the CMAs of many have changed significantly. Given the low interest rate environment many advisors are seeking thoughtful ways to reduce their allocation to core bonds in an effort to enhance returns without compromising on downside protection.

The typical approach to addressing this challenge has been to focus on fixed income, replacing core bonds with credit exposures. This generally involves a trade-off – higher return potential during periods of rising rates, but also a riskier portfolio with less downside protection.



We believe instead taking a total portfolio approach replacing both fixed income and equity exposures with alternative strategies can provide the potential for improved portfolio outcomes.

HOW CAN WE HELP?

PORTFOLIO CONSTRUCTION CONSULTATION SERVICES (PCCS)

We believe that portfolio construction is one of the great differentiators in the Canadian investment industry. Through PCCS , advisors get access to unique data, analytics and insights to help design portfolios that aim to achieve better outcomes and help clients stay invested in all market conditions.

Your Model Portfolio + **Our Risk Factor, Stress Testing & Scenario Analysis** = **Risk Awareness & Insights**

We help advisors clearly define their investment goals, diagnose unintended risks, and design portfolios that offer the potential to more efficiently and consistently achieve desired outcomes.

Our experienced portfolio consulting professionals are a multi-disciplinary team with backgrounds in asset allocation, risk management, quantitative research and portfolio management.

Our analytics focus on four key areas:

- Strategic asset allocation
- Tactical asset allocation
- Factor analysis
- Evaluation for alpha sources

GET STARTED.

Contact Robert Wilson to request a review.

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