

LONG-TERM STRATEGIC ASSET ALLOCATION

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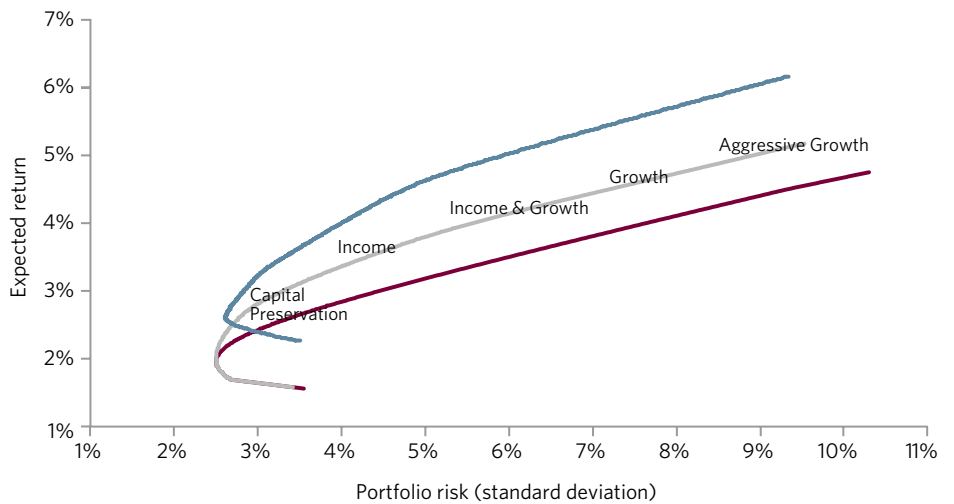
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Objective: To provide a stable long-term asset allocation strategy that responds to individual investor objectives and risk tolerance, ignoring short-term market noise.

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Efficient frontier (2020 forward-looking estimates)



— Canadian Assets only — Including Global Equities, Debt and High Yield — Including All Diversifiers

Source: CIBC Asset Management Inc.

Highlights

- The long-term strategic asset allocation (LTSAA) model incorporates the CIBC Asset Management (CIBC AM) Multi-Asset and Currency Management forward-looking asset class views for the next 10-year period. This is complemented by tactical short-term opportunities aimed at maximizing risk-adjusted return profiles.
- Given current low yields and long-term policy normalization expectations in developed markets, fixed income securities are expected to produce low long-term returns. As a result, we have maintained last year's strategic recommendations, which reallocated 5% from bonds to cash in most investor profiles.
- Our five investor profiles had a strong positive performance in 2019, following a mostly flat and volatile performance in 2018. Annual returns during 2019 ranged from 7.6% for the most conservative profile (Capital Preservation) to 20.1% for the most aggressive profile (Aggressive Growth).
- Increased monetary stimulus and low or negative yields in most developing countries have lowered long-term expected returns in fixed income assets and increased equity premiums. We continue to recommend diversification to reduce overall portfolio risk and navigate around these concerns. We maintain a broad global asset allocation model within global equities and high yield bonds to further improve risk-adjusted returns for each profile.

- Diversification within a number of alternative asset classes will continue to gain focus and we have added recommendations about how to include these asset classes in client portfolios. We have also augmented our traditional portfolios with a number of alternative investments such as private equity, real assets and liquid alternatives. These will further broaden asset allocation and provide additional sources of diversification in the face of higher expected volatility and lower expected returns. These strategies can potentially improve the efficiency of investor profiles by providing low expected correlation to equities.
- Investors who are concerned about the impact of policy normalization on fixed income can increase their allocation to short-term instruments to reduce overall duration—these instruments could include high yield bonds, floating rate loans and multi-sector fixed income alternatives. These options can also potentially enhance yield and help diversify the portfolio.
- An allocation to global markets in a Canadian portfolio increases foreign exchange risk over the short run. However, over the long run investing globally has provided diversification, increased return and reduced risk. To account for the risks associated with foreign currency exposure, investors with a shorter time horizon should consider global fixed income and equity products hedged to the Canadian dollar (CAD).
- Adjusting long-term allocations based on short-term volatility or momentum may prevent investors from reaching their long-term financial goals. Investors should remain diversified and invested to reduce unnecessary risks. This can be accomplished by regularly reviewing and rebalancing portfolios to ensure allocations are aligned to meet long-term financial goals.

Capital market review

Global markets recovered from the downturn in late 2018 and posted their best year since the 2008 financial crisis. The MSCI World Index jumped by 21.9% CAD (28.4% USD) during the year, supported mainly by U.S. growth stocks and strong performance in Eurozone and Asian equities. The rally came despite the IMF's warning that the global economy was at its weakest state since the financial crisis, given the impact of China-U.S. trade relations. A partial resolution of the trade war during Q4, combined with monetary policy support in 2019 improved business sentiment globally and lowered the probability of a recession in 2020.¹

The liquidity provided by central banks, particularly the U.S. Federal Reserve (Fed), was supportive of both equity markets and economic growth for 2020. The S&P 500 Index rebounded strongly after posting a loss in 2018, hitting new record-high levels. In its 11-year bull market starting in March 2009, the S&P 500 Index has returned over 465% CAD (451% USD) cumulatively, averaging 17.3% CAD (17.1% USD) per year. This has resulted in U.S. stocks having the highest price-to-trailing-12-month-earnings ratio relative to other markets—21.4 versus 18.7 for MSCI EAFE. Outperformance was concentrated in four sectors: information technology, health care, consumer discretionary and communication services. Information technology stood out with a 42.7% CAD (50.3% USD) return for the year. In 2019, the U.S. dollar returned +2.0% vs. the euro and -5.1% vs. Canadian dollar.

Similar to other developed markets, Canadian equities posted strong performance of 22.8%² in 2019. Canadian equities have posted a strong cumulative gain of 289% since the financial crisis (March 2009 through December 2019), but have underperformed other major developed markets during this period. Similar to U.S. markets, the information technology sector posted the strongest returns of 64.9%, primarily driven by shares of e-commerce firm Shopify, which more than doubled in the year. More defensive sectors, such as utilities and real estate, also had strong performance, supported by lower interest rates in 2019. While lower rates tend to benefit businesses with longer duration and levered structures, they can negatively impact financial sector companies whose earnings are linked to the differential between deposit and loan rates. The energy sector (+21.4%) benefited from higher oil prices in 2019, while banks reported mixed results but continued to benefit from a strong economy, culminating in a 21.4% return for the S&P/TSX Financials Index. Due to their defensive nature, less cyclically-sensitive sectors lagged in the risk-on market environment, with the communication services and consumer staples sectors returning 13.0% and 14.4% respectively.

International equities returned 16.5% CAD (22.7% USD) in 2019 but trailed other developed markets. Similar to other indices, the technology sector led major markets higher. 2019 eurozone market performance was impacted by uncertainty in reaching a Brexit solution and resulted in the UK FTSE 100 Index returning 15.0% CAD, (21.1% USD). A majority government election win for Boris Johnson's Conservative Party at year-end brought resolution to multi-year Brexit questions and a strong rally in the pound sterling. Continued political instability due to growing populism in France and the inability to reach fiscal targets in Italy led to increased volatility among European equities.

Equity market performance (% , CAD)

Asset Class	Index	2019	2018	2017	2016	2015	2014
Canadian Equity	S&P/TSX Composite	22.8	-8.9	9.1	21.1	-8.3	10.5
U.S. Equity	S&P 500	24.8	4.2	13.8	8.1	21.6	23.9
Global Equity	MSCI World	21.9	0.1	15.0	4.4	19.6	15.0
International Equity	MSCI EAFE	16.5	-5.6	17.4	-2.0	19.5	4.1

Source: Bloomberg, CIBC Asset Management Inc.

The MSCI Emerging Markets (EM) Index ended the year on a positive note, returning 12.9% CAD (18.9% USD) for 2019 despite trailing developed markets (in aggregate) and increased volatility. This positive performance more than recovered the 14.2% market decline in 2018. Volatility was mainly driven by uncertainties stemming from tariffs and trade. After the U.S. imposed a 10% tariff on Chinese goods in Q3, the two countries reached an agreement to reverse the tariffs in a Phase 1 trade deal that helped EM stocks recover at year end. The 2019 trade deal reached between the U.S., Canada and Mexico was also positive for market performance, while political unrest in Hong Kong, Lebanon and multiple Latin American countries contributed to EM volatility in 2019. Volatility was also observed in oil prices due to concerns over excess supply.

As the business cycle extends further into its late stages, we are observing a continuation of accommodative monetary policy globally. 2019 began with a reversal in global monetary policy, as the slowdown in global manufacturing and uncertainties surrounding trade conflicts resulted in most major central banks lowering key interest rates. The unexpected 50 basis points (bps) summer rate cuts by the Fed were followed by a subsequent 25 bps decrease in October, bringing the FOMC target range to 1.5-1.75%. Despite reaching as low as 1.5% in Q3, U.S. 10-year Treasury yields ended the year near 1.9%. The investment grade corporate bond segment was the best-performing asset class in the U.S. bond market, with long-term, A-rated bonds returning 14.5% USD, outperforming the Barclays U.S. Treasury 7-10 Year Index (8.5% USD).

Bond market performance (% , CAD)

Asset Class	Index	2019	2018	2017	2016	2015	2014
Canadian Bonds	FTSE Canada Universe Bond	6.9	1.4	2.5	1.7	3.5	8.8
Canadian Government Bonds	FTSE Canada All Government Bond	6.4	1.5	2.2	0.9	3.8	9.3
Canadian Corporate Bonds	FTSE Canada All Corporate Bond	8.1	1.1	3.4	3.7	2.7	7.6
U.S. Bonds	Barclays U.S. Aggregate Bond	3.2	9.0	-3.3	-0.9	20.6	15.5
Global Bonds	Barclays Global Aggregate Bond	1.4	7.7	0.4	-1.5	16.2	9.7
U.S. High Yield	Bank of America Merrill Lynch U.S. High Yield Master II	8.5	6.6	0.4	13.4	14.4	11.7
Canadian Cash	FTSE Canada 91 Day T-Bill	1.6	1.4	0.6	0.5	0.6	0.9

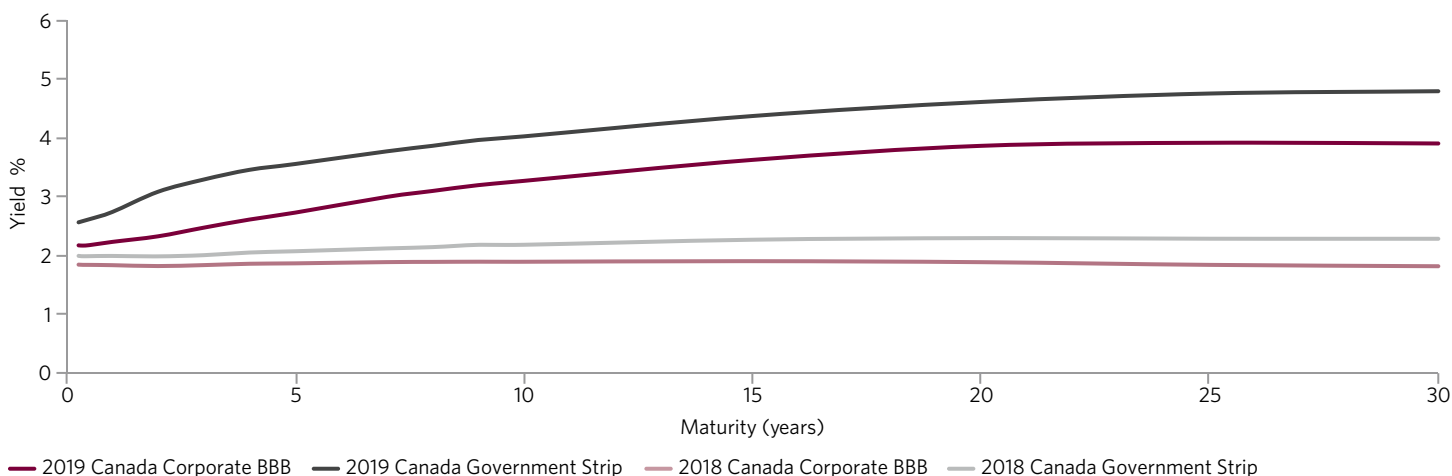
Source: Bloomberg, CIBC Asset Management Inc.

The Bloomberg Barclays Global Aggregate Bond Index returned 1.4% CAD (6.8% USD) for the year. Inflation expectations have fallen globally, resulting in lower yields as global growth expectations slow as well. Negative-yielding debt increased to \$17 trillion in 2019 (25% of investment grade debt) while ending the year at slightly lower levels. Yields on 10-year German bunds closed the year at -20 bps, while Japanese 10-year government bonds closed at -2 bps. Accommodative monetary policy has done little for Germany's economy, which stalled at -0.2% and 0.1% GDP growth in Q2 and Q3 2019, respectively. The German manufacturing index has shown declining activity and inflation has remained below the 2% EU target. At such low yields, demand has turned to North American fixed income markets.

The Bank of Canada was an outlier in 2019, leaving administered rates unchanged at 1.75%, given projections that the economy will remain below potential at 1.5% in 2019 followed by 1.7% in 2020. Higher rates relative to other developed markets led to increased global demand for Canadian fixed income (\$38.7B YTD as of September 2019)³, which in turn supported bond prices. The FTSE Canada Universe Bond Index returned 6.9% for the year, with corporate debt the best-performing segment in a risk-on environment. Canadian corporate credit spreads tightened overall, with the Canadian 10-year BBB-rated credit spreads declining 47 bps year-over-year, to end the year at 1.38%.

U.S. bonds, as represented by the Bloomberg Barclays U.S. Aggregate Bond Index, gained 8.7% USD in 2019 but only 3.2% CAD as a result of the decline in the U.S. dollar in 2019. Government issues underperformed corporate and high yield bonds. The Bloomberg Barclays U.S. Government Index rose 9.7% USD, while the Bloomberg Barclays U.S. Corporate Index and the Bank of America Merrill Lynch U.S. High Yield Master II Index were up 14.5% and 14.3% respectively (USD). U.S. high yield spreads ended the year at 3.5% (versus 5.3% at the beginning of the year), while Canadian high yield credit spreads⁴ similarly decreased to 3.5% to end 2019 (versus 4.3% at the beginning of the year), after reaching a 10-year low of 3.1% in June.

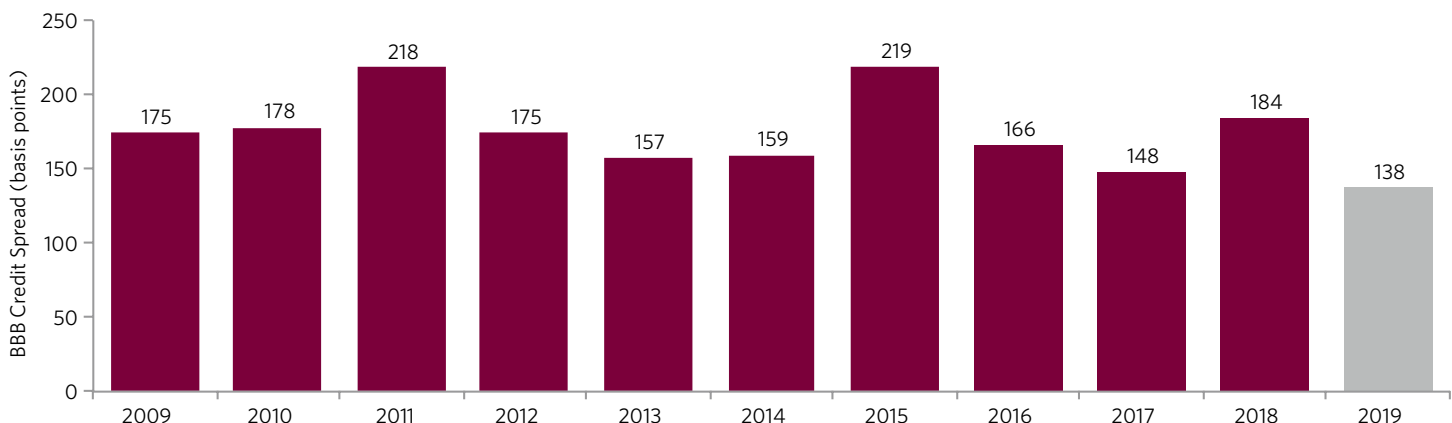
Canadian government yield curve changes



Source: Bloomberg, CIBC Asset Management Inc., as of December 31, 2019

In Canada, the yield curve continued to flatten. Ten-year Government of Canada yields ended the year at 1.89%, a decrease of 29 bps year-over-year. On the short end of the curve, two-year yields decreased from 1.98% to 1.82%. Overall, short-term bonds underperformed long-term bonds, which were also helped by the rising price of longer-dated corporate bonds as credit spreads narrowed. The FTSE Canada Short Term Bond Index returned 3.1%, while the FTSE Canada Long Term Bond Index returned 12.7% in 2019.

End-of-year Canadian BBB credit spreads



Source: Bloomberg, CIBC Asset Management Inc., as of December 31, 2019

Investor profile performance

Using the returns of major asset class indices as proxies, balanced investors in our five investor profiles enjoyed strong performance in 2019. The methodology for these investor profiles is explained in subsequent asset allocation sections.

Calendar year investor profile⁵ performance (% , CAD)

Profiles	2019	2018	2017	2016	2015	2014
Capital Preservation	7.6	1.6	3.1	4.3	4.0	7.9
Income	10.1	1.0	4.5	5.8	4.7	9.5
Income & Growth	13.7	0.3	6.2	7.3	5.2	10.2
Growth	16.2	0.0	8.8	7.9	7.2	11.6
Aggressive Growth	20.1	-1.2	11.6	9.1	9.6	13.0

Source: Bloomberg, CIBC Asset Management Inc.

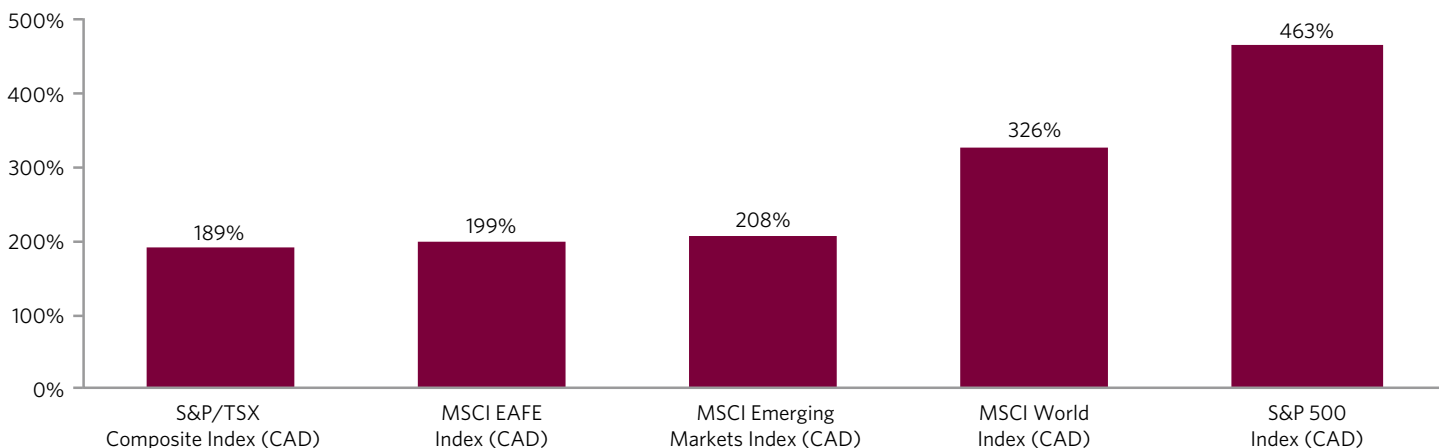
The importance of strategic asset allocation

There are a number of asset classes available to investors, but choosing the right combination of assets to include in a portfolio to meet specific investor objectives can be difficult. Below we outline a number of ways that strategic asset allocation can add value to long-term returns and help meet investment goals.

Home country bias⁶

Many Canadian investors have a home-country bias, meaning that the proportion of domestic equities held by the countries' citizens is materially higher than the country's weight in global equity indices. Home bias has been shown to be most pronounced in Canada, second only to Australia. Within equity portfolio holdings, Canadian investors have an average allocation of 50% to domestic equities, while Canada makes up only 3% of the MSCI ACWI Index. This tendency exposes Canadian investors to uncompensated portfolio risk, such as undue concentration in three highly correlated sectors. Canada's top three equity sectors—financials, energy, and industrials—make up nearly two-thirds of the S&P/TSX Composite Index. As shown in the table below, performance of the Canadian stock market has lagged the main global indices since the beginning of the boom market (March 2009).

Canadian equities vs. developed markets cumulative performance (March 2009-December 2019)



Source: Bloomberg, CIBC Asset Management Inc., as of December 31, 2019

Diversification by asset class

In the long run, investors who don't take advantage of a broad opportunity set of asset classes and remain invested in one or two asset classes can miss the benefits of efficiency (return per unit of risk) that can be achieved in a more diversified asset allocation framework. While many conservative investors prefer the safety of cash over other asset classes, proper diversification over the long term has been shown to outperform most individual asset classes on a risk-adjusted basis. Investing in a balanced mix of asset classes will ensure at least some participation in the highest-performing asset classes at any given time.

Annual returns for major asset classes

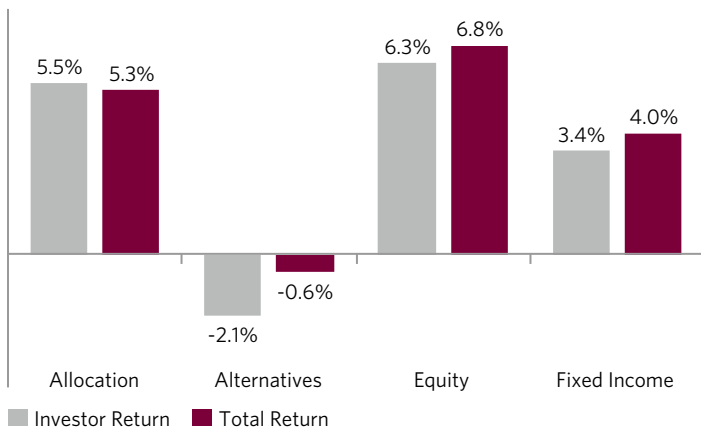
2019	2018	2017	2016	2015	2014
U.S. Equity 24.8%	Global Fixed Income 7.7%	Emerging Market Equities 28.7%	Canadian Equity 21.1%	U.S. Equity 21.6%	U.S. Equity 23.9%
Canadian Equity 22.8%	U.S. High Yield 6.5%	International Equities 17.4%	U.S. High Yield 8.1%	International Equities 19.5%	Real Assets 13.8%
International Equities 16.5%	U.S. Equity 4.2%	U.S. Equity 13.8%	U.S. Equity 8.1%	Global Fixed Income 16.2%	U.S. High Yield 11.7%
Emerging Market Equities 12.9%	Canadian Fixed Income 1.4%	Canadian Equity 9.1%	Emerging Market Equities 7.7%	U.S. High Yield 14.4%	Canadian Equity 10.6%
U.S. High Yield 8.6%	International Equities -5.5%	Canadian Fixed Income 2.5%	Canadian Fixed Income 1.7%	Emerging Market Fixed Income 12.4%	Global Fixed Income 9.7%
Real Assets 7.3%	Emerging Market Equities -6.5%	U.S. High Yield 0.4%	Global Fixed Income -1.4%	Canadian Fixed Income 3.5%	Canadian Fixed Income 8.8%
Canadian Fixed Income 6.9%	Emerging Market Fixed Income -6.5%	Global Fixed Income 0.4%	International Equities -2.0%	Emerging Market Equities 2.4%	Emerging Market Equities 7.09%
Global Fixed Income 1.4%	Real Assets -8.9%	Real Assets -5.1%	Emerging Market Fixed Income -3.9%	Real Assets -0.4%	Emerging Market Fixed Income 6.0%
Emerging Market Fixed Income -2.8%	Canadian Equity -8.9%	Emerging Market Fixed Income -8.5%	Real Assets -5.5%	Canadian Equity -8.3%	International Equities 4.1%

Source: CIBC Asset Management Inc.

Investor return gap

Behavioural finance studies have shown that investors tend to be influenced by emotions and trends. By not sticking to a long-term asset allocation approach, investors tend to chase performance within select asset classes, industries or geographies. This type of behaviour has been shown to result in underperformance relative to a more diversified and regularly rebalanced asset allocation over the long term. As illustrated in the table on the next page, the average of total returns for the fund which does not take into consideration the timing of cash flows versus returns that investors actually receive over five separate 10 year periods (years ending 2014, 2015, 2016, 2017 and 2018) shows negative gaps for all asset classes but allocation funds. In general, the gap widens around dramatic market reversals such as those seen in 2008 and the end of 2018, because of the propensity for higher observed outflows near the bottom that miss out on subsequent dramatic rebounds. In addition, investors tend to enter newer asset classes at the wrong time, typically at the time of their peak performance. These observations demonstrate that trying to time markets by reacting to pessimistic or exuberant headlines can lead to suboptimal portfolio construction and returns. Sticking to a long-term strategic asset mix can help mitigate these tendencies.

Investor gap by asset class



Source: Morningstar Study: "Mind the Gap: Measuring the Cost of Bad Timing." August 15, 2019, Data as of December 31, 2018.

Equity risk dominates during volatile times

Even in well-diversified portfolios, asset class correlations tend to increase during financial turmoil. Based on historical data for a balanced portfolio of 60% equities and 40% fixed income, equities have contributed 90% of portfolio volatility versus only 10% for fixed income securities. In the current environment, where most asset classes are at historically high levels alongside historically low interest rates, investing in alternative asset classes with distinct risk and return profiles is crucial for investors to achieve long-term investment objectives.

Strategic asset allocation methodology

Our asset allocation recommendation is based on a three-step process.

First, we establish a global asset allocation model based on traditional asset classes: Canadian money market, Canadian equities, global equities, Canadian fixed income, global fixed income and high yield bonds⁷.

Second, we extend the global model to include a broader asset mix, which is expected to improve the portfolio's risk-adjusted returns. In addition to the traditional major asset classes, we include real assets, emerging market equities and debt, floating rate loans, and multi-sector fixed income. Our recommendations to fund these allocations would come from prior allocations to bonds and equities. The inclusion of these asset classes causes the efficient frontier to shift up and to the left, with higher long-term expected return and less risk (as measured by standard deviation).

Lastly, we look at alternative strategies offered through absolute return strategies and private assets to diversify the portfolio (in the case of liquid alternatives) or earn a higher return (in the case of private investments).

High Yield Bonds

As a hybrid asset class with both debt and equity characteristics, high yield debt provides diversification benefits to a balanced portfolio. High yield debt offers additional credit spread (versus investment-grade issuers) to compensate investors for the additional risk when investing in these securities. High yield credit spreads, which are a function of the issuer's credit quality, are positive and increase in times of crisis due to deteriorating issuer fundamentals, which are reflected in both spreads and equity prices. As such, high yield debt does not generally provide all of the much-needed diversification benefits of bonds during bear markets and should not be considered a direct replacement for traditional bonds.

In addition to credit performance, high yield debt provides diversification through shorter duration (i.e. lower interest rate sensitivity) on average versus traditional bonds. As an example, the average duration of U.S. high yield bonds is 4.2 years, considerably shorter than global bonds with a duration of 7 years⁸. The lower the duration of the asset class, the lower its sensitivity to interest rate movements; consequently, high yield debt should provide less sensitivity than government bonds in a rising-rate environment.

Portfolio diversifiers

Real Assets⁹

Real asset strategies can improve diversification through exposure to both infrastructure and real estate assets. Infrastructure investments provide the benefits of stable cash flows, based on essential services with relatively low competition, and long-term returns that are highly correlated to economic growth. Infrastructure has a low, but positive, correlation to debt and is also positively correlated to equities. In the long run, we believe that infrastructure investments will be impacted by a number of uncorrelated factors. Slow but steady economic growth will positively impact more cyclical sectors, while regulated sectors will feel the negative impact of their longer-dated cash flows in a rising-rate environment. The required liquidity premium for holding these long-term assets increases as duration risk increases.

Investment in real estate also provides the benefits of potential growth and high dividend income streams. Dividends in real estate typically come in the form of relatively stable rents paid to real estate investment trust (REIT) companies. Investments in real estate remain well diversified across real estate sectors and countries. In multi-asset portfolios, REITs act as diversifiers to broad equity markets due to their low correlation with equities. Notwithstanding, REITs can experience severe downturns, such as occurred during the 2008 financial crisis. In the current environment, REIT investments are expected to benefit from a focus on demand for new developments combined with low borrowing costs. As a result of performance pattern diversification, the addition of REITs and infrastructure to balanced portfolios broadens the asset mix and potentially improves their risk/return profiles.

Emerging Market Equities

Emerging market equities are a growing asset class that is slowly becoming part of investors' asset allocation. Today, emerging markets make up 55% of the world's GDP as compared to 37% for developed markets—this trend is expected to continue due to higher growth rates vs. the developed world. Emerging market growth prospects exceed those of advanced economies for the foreseeable future, partly because they are supported by a slow convergence of living standards towards those of advanced economies. As the middle class expands, companies might benefit from growing consumer purchasing power and shifts in spending patterns. A combination of improved living standards through increases in wages, access to higher quality education and improved technology are changing the economy with more service-oriented industries slowly comprising a higher portion of the economy. Higher expected returns for emerging markets come with increased risk versus developed countries. While volatility is a concern for the asset class, it's expected to be a declining trend, mainly supported by a stronger reliance on internal markets, lower current account vulnerability and maintained inflation levels due to lower overall global inflation.

Emerging Market Debt

Despite higher perceived or actual risk, emerging market debt (EMD) can offer higher yields, exposure to rapid growth and lower volatility than emerging market equities. As emerging markets expand, so do the opportunity set of investments. While EMD investments have traditionally focused on sovereign U.S. dollar-denominated debt, corporate and local-currency EMD markets are rapidly developing. While many emerging market investments are impacted by local macroeconomic risks, the credit quality of EMD is gradually improving.

Approximately two-thirds of emerging market bonds are now rated investment grade, compared to only 16.5% in 1998.¹⁰ The debt markets in developing countries have room for significant growth, as indicated by the growing economic impact of these countries globally. In addition to attractive yields and higher potential returns, EMD also offers diversification benefits due to a lower correlation with other fixed income asset classes.¹¹

Floating Rate Loans

Floating rate loans are debt instruments with a variable interest rate component, and a relatively high fixed credit spread. The variable component is reset on a scheduled and frequent basis based on market rates. When interest rates rise, the interest paid by a floating rate loan will also rise. Thus, floating rate loans provide protection against rising interest rates. The debt of these companies is typically rated below investment grade, providing a credit risk similar to high yield. However, floating rate loans represent a senior/secured claim against the company, and holders of the loans have first claim on the company's assets in the event of default. From a diversification viewpoint, floating rate loans have low-to-negative correlation to traditional investment-grade fixed income and equity asset classes, and thus inclusion can lead to improved portfolio profiles.

Multi-Sector Fixed Income¹²

The multi-sector fixed income component incorporates a wide range of fixed income securities, with the goal of minimizing risk while producing sufficient yield to meet return objectives. A multi-sector portfolio can add value through tactical allocations among a number of fixed income instruments. These include global government and agency bonds, money markets, corporate investment-grade and high yield debt, asset-backed securities, mortgage-backed securities and local and U.S. dollar-denominated emerging market debt. Tactical allocation to multiple fixed income assets can potentially lower volatility relative to individual asset classes like high yield or emerging market debt.

Alternative Investments

In the search for diversified sources of return, investors are increasingly turning to alternative asset classes. Alternatives have been shown to improve the efficiency of balanced portfolios by increasing returns, in the case of private assets, or managing downside risk, in the case of liquid alternatives.

Private Assets

The recent search for yield and the demand for alternatives to traditional publicly-traded equities has led to considerable growth in private investments. Private assets' net asset value has grown more than sevenfold since 2002, and twice as fast as global public equities.¹³ The larger the pool of investments, the more diverse the revenue streams resulting from various sources of growth, innovation and corporate restructuring within private investments. Private equity firms take advantage of growth opportunities in emerging investment themes such as disruptive technology, e-commerce, sustainable investing initiatives as well as emerging market investments with relatively small public markets.

Liquidity risk is the main difference between public and private investments and this is believed to be a main contributor to additional returns. As such, when considering the addition of private assets to a portfolio, investors need to fully understand the unique liquidity features and constraints of these less liquid assets. Private investments are often most suitable for long-term investors, as access to the funds may not always be possible or may be subject to additional fees. Demand for liquidity is often more pronounced at times of market declines, which in turn increases the correlation between public and private investments.

Similar to public markets, private assets valuations are impacted by investors moving money into equity markets later in the business cycle—a result of buildup in “dry powder”. The idiosyncratic nature of a relatively concentrated portfolio, and the private valuing of these assets (as compared to valuation in a publicly-traded market) may increase investment risks. Leveraging experienced and specialized investors is key to managing downside risk.

Liquid Alternatives

Liquid alternatives use a combination of traditional asset classes, derivatives, and leverage to create a risk profile that strives to be more efficient than asset classes with comparable returns. The underlying securities are much more frequently priced versus private investments. The additional liquidity they provide makes them a good complement to private investments. It is worth noting that since the financial crisis, hedge fund performance has lagged public equities. With monetary stimulus boosting the performance for the majority of asset classes/securities, concentration into riskier assets has been more rewarded than the approach taken by hedge funds to manage overall volatility.

Liquid alternatives can be grouped into the following asset classes: long-short equity, managed futures, global macro, distressed securities, arbitrage (convertibles, bonds, mergers, structured products) and multi-asset strategies. Hedge funds provide diverse risk/return profiles by having reduced constraints, and a number of uncorrelated strategies which can help hedge against market volatility.

CIBC's Multi-Asset Absolute Return Strategy (MAARS)¹⁴ is an absolute return strategy that differs from traditional asset classes that are benchmarked to indices where performance can be highly correlated. The addition of a benchmark-agnostic absolute return strategy can potentially reduce the equity risk of balanced portfolios and achieve a smoother investment experience. They also provide greater liquidity versus other alternative investments.

The MAARS strategy can add value to a balanced portfolio by 1) seeking an absolute positive return over a cash benchmark regardless of the global macro environment and equity market cycle, and 2) lowering potential risk by managing volatility relative to equities. It can achieve this through diversification to securities outside of traditional stock and bond markets. These could include options, currencies, commodities and factor-based strategies, as well as short exposure to various asset classes. As such, when considering the addition of private assets to a portfolio, investors need to fully understand the unique liquidity features and constraints of these less liquid assets. Private investments are often most suitable for long-term investors, as access to the funds may not always be possible or may be subject to additional fees. Demand for liquidity is often more pronounced at times of market declines, which in turn increases the correlation between public and private investments.

Long-term capital markets assumptions

The strategic allocation methodology is based on forward-looking estimates for 10-year returns. We believe that longer-term, forward-looking estimates best capture the current and potential global economic and financial environment. CIBC Asset Management (CIBC AM) Multi-Asset and Currency Management's 10-year forward looking returns were incorporated into our asset allocation models. This process is described as follows:

Expected return and risk methodology

We use a macroeconomic textbook framework to make our projections, where GDP growth is a function of labour and capital inputs, as well as total factor productivity. A key feature of our approach is that we augment the textbook specification to take into account the negative impact of monetary policy renormalization in a context of elevated indebtedness across major economies.

The most important views stated in CAM's projections are:

- The global economy will continue to grow at a more moderate pace due to changing demographics that will depress growth. Productivity growth is unlikely to provide the necessary positive offset.
- Among advanced economies, growth prospects are highest for the U.S. and lowest in Japan and Europe. In Canada, GDP forecasts are better than the eurozone, supported by healthier demographics, but still trail the U.S.
- Policy normalization by central banks will be gradual but will still negatively impact growth. A low growth environment will continue to support low inflation.
- Fixed Income: Government bonds in advanced economies will deliver low returns, owing to low starting yields and partial policy normalization. Longer-term bonds are not expected to provide a duration risk premium. Emerging market sovereign and U.S. high yield bonds are expected to offer a meaningful risk premium.
- Equities: In the U.S. and advanced economies, current valuation exceeds long-term fair value estimates, which will weigh negatively on future capital appreciation. Within emerging markets, valuations are lower relative to long-term fundamentals and earnings growth. Overall risk/return prospects are better than most developed markets based on stronger economic growth.

2020 expected long-term asset class returns and risk

Our projections and forecasts resulted in the following long-term expected returns and risk (in CAD):

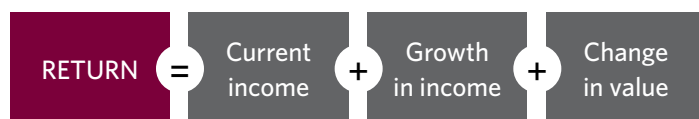
Expected long-term asset class risk and returns (% , CAD)

Expected Return/Risk (%)	Global Equity	Int'l Equity	U.S. Equity	Cdn Equity	Real Assets Equity	EM Equity	Global Fixed Income	Cdn Fixed Income	Money Market	U.S. High Yield Debt	Emerging Markets Debt	Multi-Sector Fixed Income	MAARS Proxy (alt.)	Private Equity (alt.)
Expected return ¹⁷	4.7	4.8	3.2	5.3	4.1	11.1	0.8	1.6	2.1	5.1	6.4	4.2	7.1	7.7
Expected risk	11.1	12.6	11.2	12.4	10.8	16.0	9.0	3.6	0.4	8.5	8.8	7.7	5.6	20.9

Source: CIBC Asset Management Inc.

Long-term capital market expected returns

For the asset classes we cover, we calculate expected returns based on the following approach¹⁵.



Where:

- [Current Income] is the coupon yield (fixed income), or the dividend yield (equity).
- [Growth in Income] refers to earnings growth. This only applies for equity.
- [Change in Value] is the impact of varying interest rates (fixed income), or cyclically-adjusted P/E ratios converging towards their long-term equilibrium value (equity).

Expected volatilities and correlations

In estimating expected volatilities and correlations, we select a time period that will produce stable estimates and capture multiple economic cycles. We believe that too long a time period may not capture structural changes to asset classes. Conversely, too short a time frame may not capture idiosyncrasies of the asset class over a full business cycle. As such, we have used 13 years of historical data, extending from last year's estimate that used 12 years. This period covers both recession and growth periods and spans a full business cycle, appropriate for estimating volatility and correlation parameters.

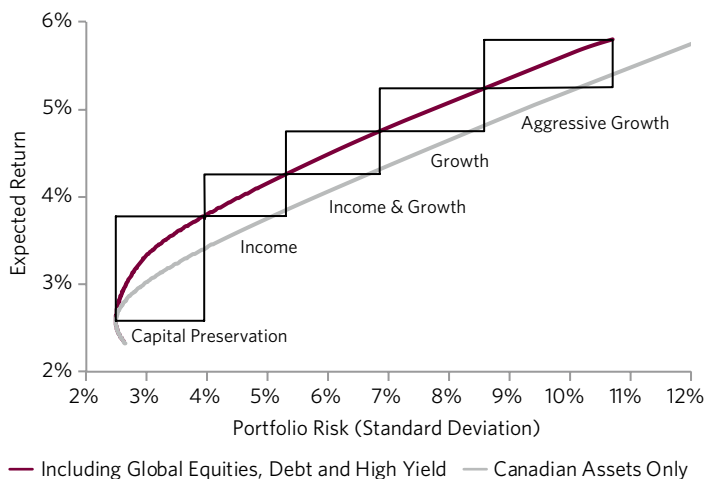
Strategic asset allocation process

The asset allocation process is built on the principle that each combination of stocks, bonds and cash will provide a different expected risk and return level. In this step, we determine an optimal allocation for each asset class, based on our long-term expectations of return and risk.

For every level of risk, a portfolio is constructed and optimized with the combination of cash, bonds and equities that results in the highest expected return. In this way, the optimization process eliminates portfolio combinations that have a lower expected return with the same level of risk. The remaining portfolios are the most efficient given our long-term expectations. These portfolios form the efficient frontier, which we have plotted for both Canadian-only and Canadian-plus-global investments.

The efficient frontier (page 1) is then divided into five segments, corresponding to our investor profiles. Our five investor profiles are intended to serve as guidelines for clients, covering a variety of investor and risk profiles. From most conservative to the most aggressive, these are: Capital Preservation, Income, Income and Growth, Growth and Aggressive Growth. Our asset allocation recommendations blend equity, bond and cash weightings for each profile.

Efficient frontier (2020 forward-looking estimates)



Source: CIBC Asset Management Inc.

2020 recommendations

The asset allocation chart (next page) illustrates recommended global strategic allocations based on the broader asset classes. Across profiles, the expected return is lower versus last year as a result of reduced equity and bond expected returns. We maintain the allocation recommendation from 2019 and do not recommend any changes for the traditional profiles.

The lower returns across profiles can be largely attributed to much lower expected returns for Canadian and global bonds. This is due to negative valuation effects associated with monetary policy normalization through higher interest rates.

Within equities, lower returns are partly driven by global equities, and U.S. equities in particular. Following a strong rally in 2019, U.S. equities are now the most overvalued asset class within developed equities and relative to their long-term cyclically adjusted price-to-earnings (CAPE) fair value. Lowered expectations for U.S. equities are counterbalanced by emerging market equity projections, as those markets remain undervalued relative to long-term CAPE fair value. The growth differential between emerging markets and developed markets also favours emerging markets. As Canadian equities are trading closer to fair value than U.S. equities and provide comparable earnings growth prospects relative to other developed countries, Canadian equities remain attractive.

We expect higher returns for cash versus long-term bonds. As a result of its risk-free status and improved yields in recent years, cash is currently the most attractive risk-adjusted asset class within a balanced portfolio. Traditional bonds are not expected to provide much of a term premium or yield enhancement over short-term bonds. However, traditional bonds do provide a shock absorber to equity drawdowns. We maintain last year's recommendation, which saw a 5% reallocation from longer duration global and Canadian bonds in most risk profiles to cash or short-term equivalents.

Within fixed income, relatively riskier segments such as high yield, floating rate loans and emerging markets debt offer higher yields and shorter duration. We maintain the 15% allocation to high yield in our profiles and recommend that the allocation is fulfilled through a combination of higher yielding products.

2020 asset allocation for Canadian investors (% CAD)

Profiles	Global Equities	Cdn Equities	Global Bonds	Cdn Bonds	High Yield	Canadian Cash	Expected Return ¹⁶	Expected Std. Dev.
Capital Preservation	5	15	20	30	5	25	2.5	3.1
Income	10	20	15	25	15	15	3.2	4.2
Income & Growth	25	25	10	15	15	10	3.9	5.8
Growth	40	25	10	5	15	5	4	7.3
Aggressive Growth	60	25	0	0	15	0	5.1	9.5

Source: CIBC Asset Management Inc.

Existing high yield debt allocations can be further diversified through a number of debt instruments, including floating-rate loans and other fixed income found within a multi-sector fixed income strategy. Allocations are tilted towards U.S. high yield debt, given its higher return/risk outlook versus other debt instruments. Floating rate loans feature low interest rate sensitivity and are therefore recommended reallocations from high yield, given the projected rising interest rate environment.

Recommended strategic mix within the High Yield asset class (% CAD)

High Yield Fixed Income ¹²	Weight	Expected Returns ¹⁷	Volatility
Multi-Sector Fixed Income	20	4.2	7.7
Floating Rate Loans	30	5.1	8.7
U.S. High Yield Debt	50	5.1	8.5

Source: CIBC Asset Management Inc.

For clients investing in Canadian asset classes only, we maintain the same allocation as last year. Given reduced Canadian bond return expectations, reallocations are recommended to cash equivalents. In addition, equity allocations have been reduced in higher-risk profiles as follows:

Recommended asset allocation using domestic only assets (%)

Profiles	Exp. Return ¹⁷	Exp. Volatility	Cdn. Equity	Cdn. Bonds	Cdn. Cash
Capital Preservation	2.4	3.4	18	60	22
Income	2.7	4.5	30	60	10
Income & Growth	3.5	6.1	50	45	5
Growth	4.2	7.6	70	25	5
Aggressive Growth	4.7	9.6	85	15	0

Source: CIBC Asset Management Inc.

2020 asset allocation including diversifiers

In the search for yield, investors are looking at a number of different asset classes to meet their long-term investment objectives. We believe increased diversification is the key to lowering risk while maintaining long-term return targets. In this section, we provide guidance on reallocating existing asset classes into a number of diversifying investments, to minimize concentration in one particular asset class and associated risks. The overarching themes that led to the below recommendations are summarized as follows:

- 1) Traditional fixed income asset classes are expected to provide lower-than-historical returns as a result of low starting yields and a slow path to interest rate normalization. In this environment, diversifying into higher yielding asset classes such as high yield debt, floating rate, multi-sector fixed income and even emerging market debt for the riskier profiles can improve the portfolio efficiency.
- 2) Traditional fixed income still plays an important role in portfolio construction. However, given the low and even negative yields seen in global fixed income markets, the insurance provided from investing in bonds comes at a cost. Given this backdrop, a dedicated allocation to real assets which exhibit some fixed income characteristics can be beneficial. Allocation to real asset is done through proportional reallocations from fixed income and equities that result in no net addition to portfolio risk.
- 3) Absolute return strategies have been added to this year's global strategic mix, as they represent a return stream that is expected to be uncorrelated with global macro events that can impact global equities. This is expected to provide stable returns in environments where long-term expected returns are low and accompanied by increasing volatility.
- 4) Low growth levels versus historical standards combined with low inflation levels have put downside pressure on forecast equity returns in the long run. For investors looking for portfolio growth, private assets can provide an expected return premium over public equities, albeit at increased risk.

2020 Asset allocation recommendation with diversified asset classes

Asset Allocation (%)	Expected Standard Dev.	Expected Return ¹⁷	Int'l Equity	U.S. Equity	Cdn Equity	Global Fixed Income	Cdn Fixed Income	Money Market Fixed	H.Y. & Flt Rate Debt Fixed Income	Multi-Sector Proxy Fixed Income	EM Market Bonds*	Real Assets*	MAARs Proxy*	EM Equity*	Private Equity*
Income	4.5	3.3	5	10	15	10	20	15	10	5	0	5	5	0	0
Income & Growth	5.9	3.9	10	15	15	7	15	10	10	5	0	5	3	5	0
Growth	8	4.7	12	15	20	8	5	5	7	5	3	5	0	5	10
Aggressive Growth	10.4	5.7	15	20	20	0	0	0	7	5	3	5	0	10	15

*Diversifiers
Source: CIBC Asset Management Inc.

Currency impact for Canadian investors

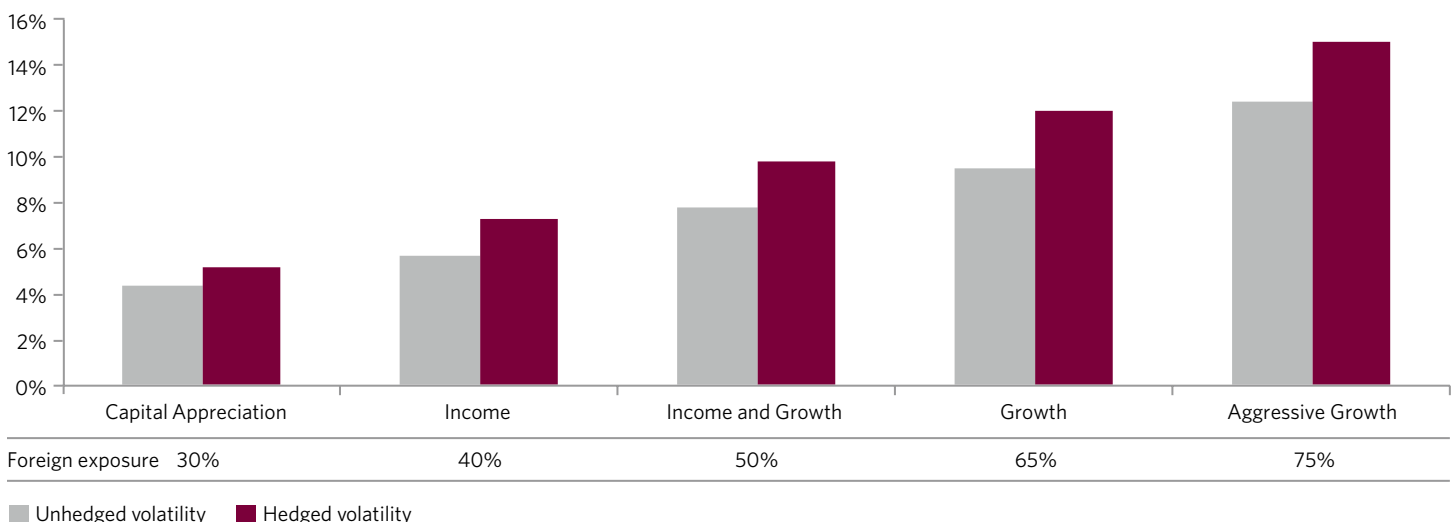
Currency exposure can introduce foreign exchange fluctuations to portfolio returns in the short run. Examples of this were observed when the Canadian dollar traded above par with the U.S. dollar in late 2007 and again in 2011, only to steadily retreat in the following time periods. However, over a longer time frame, foreign exchange exposure becomes less of a concern, and represents a small risk relative to the benefits of global diversification.

When determining our long-term asset allocation profiles, we factored in foreign exchange risk with respect to the risk and return objective of each investor profile. Foreign exposure increases for riskier profiles, as these investors will typically have longer time horizons, lower liquidity requirements and higher risk tolerance.

Conversely, an investor with lower risk tolerance will likely have higher short-term liquidity requirements and more sensitivity to foreign exchange volatility. These investors will also typically have less foreign content and therefore less exposure to currency fluctuations.

In the long run, the inclusion of additional currencies in balanced portfolios has resulted in the diversification benefit of reduced volatility. Historical data shows a positive correlation between Canadian equities and Canadian currency because they are still both highly influenced by oil prices. However, there is a lower correlation between domestic asset classes and unhedged global assets. The effect of lower correlations, as shown in the next exhibit, is improved diversification and reduced volatility in all of the portfolios.

Historical volatility for unhedged and hedged portfolios (January 1991 - December 2019)

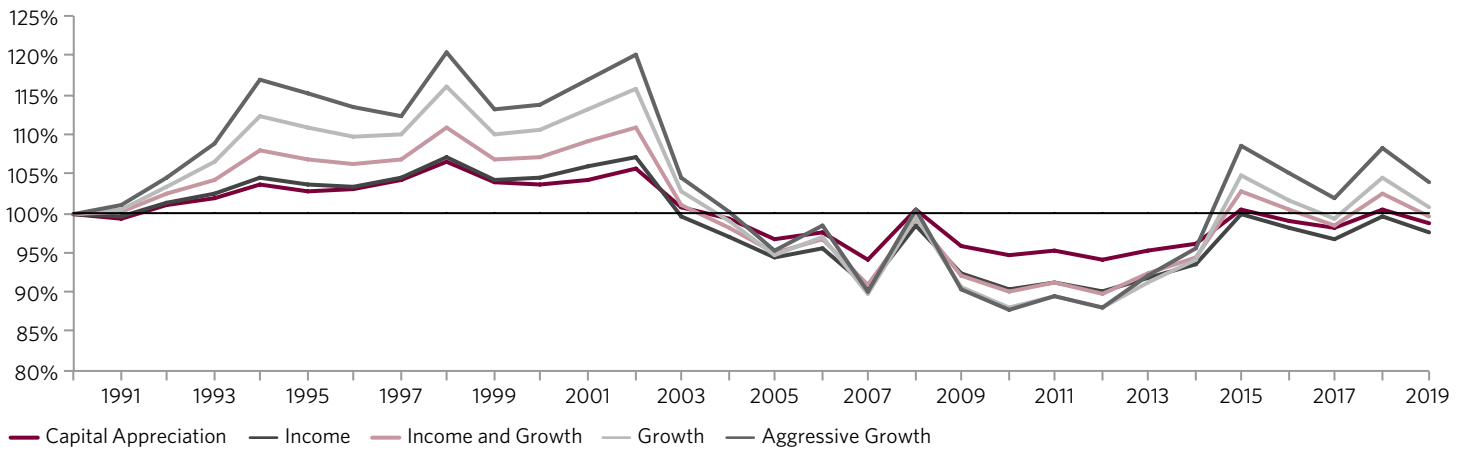


Source: CIBC Asset Management Inc. for model portfolio weights; Bloomberg for index returns as proxies for asset class performance.

The impact of a hedged investment on total returns is also a key consideration. Currency fluctuations in any one year could materially impact returns in the short run and highlights that lower-risk portfolios could potentially benefit from hedging, given their shorter investment horizons. Generally, in years when the Canadian dollar appreciates, hedging enhances non-domestic returns; otherwise, hedging impedes returns. In 2018, for example, the Canadian dollar depreciated 7.7% against the U.S. dollar, and hedged portfolios underperformed unhedged portfolios by 2.2% for the Capital Preservation profile, and by 6.0% for the Aggressive Growth profile; In 2019, on the other hand, the Canadian dollar appreciated 5.3% against the U.S. dollar, and hedged portfolios underperformed unhedged portfolios by 1.7% for the Capital Preservation profile, and by 3.8% for the Aggressive Growth profile.

To hedge or not to hedge depends on risk tolerance, investment horizon and currency outlook. We recommend that clients with short-term requirements use hedged products for non-domestic investments to lessen the impact of currency fluctuations. However, over the long run, an unhedged portfolio has historically provided better risk-adjusted returns as compared to a hedged portfolio.

Cumulative Excess Return of Unhedged vs. Hedged Proxy Portfolios (January 1991 - December 2019)



Source: CIBC Asset Management Inc. for model portfolio weights; Bloomberg for index returns as proxies for asset class performance.

Finding the optimal profile

Investors’ goals and risk tolerance, time horizon, financial situation, income needs, liquidity, tax considerations, unique circumstances and attitude toward global investing are variables that need to be considered when determining an appropriate investment profile. When selecting an appropriate profile, it’s also necessary for an investor to determine long-term return objectives. Importantly, risk tolerance should not be based on the last 12 months of performance and volatility, but instead on longer periods that better coincide with the investor’s time horizon. Investors need to be comfortable with the volatility of their asset allocation in every type of market through a full market cycle.

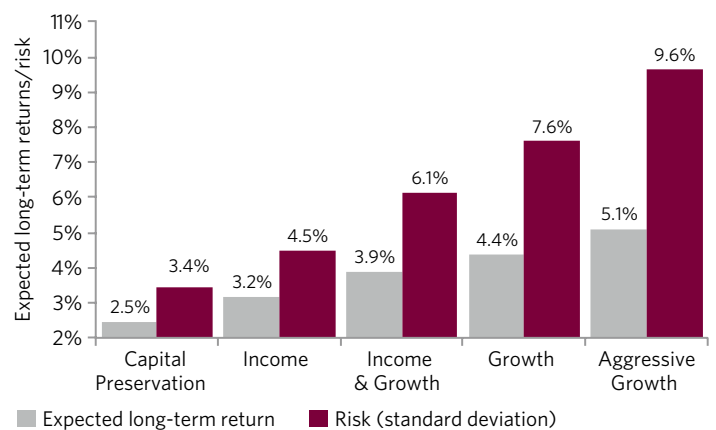
The search for an optimal investor profile begins with a risk/return analysis. Risk and return characteristics must be viewed in tandem, as each provides an essential piece of the asset allocation puzzle. The expected return must be sufficient to achieve the investor’s long-term goals, while the risk must be tolerable.

The risk measures discussed throughout this paper can help investors decide on the suitability of each profile. Historically,

over the long- term, equities have outperformed bonds and bonds have outperformed cash; but outperformance comes with the cost of higher risk as measured by volatility (i.e. standard deviation).

Regardless of the measurement used to quantify risk, higher returns are accompanied by higher risk. The five investor profiles, ranging from Capital Preservation to Aggressive Growth, have incrementally higher levels of expected return and volatility, as shown below.

Investor profile expected returns and risk¹⁶



Source: CIBC Asset Management Inc.

The following table summarizes the historical returns for the five investor risk profiles. The ranges of performance illustrate the short-term volatility risk and benefits of remaining invested for the long run. The longer the investment horizon, the lower the likelihood of experiencing negative average returns.

Investor profile allocations and returns (% , 1950-2019)

Profiles	Global Equities	Canadian Equities	Global Bonds	Canadian Bonds	U.S. High Yield	Cash	Expected Return	Expected Std. Dev.	Historical Return	Historical Std. Dev.
Capital Preservation	5	15	20	30	5	25	2.5	3.1	7.2	4.1
Income	10	20	15	25	15	15	3.2	4.2	8.2	5.6
Income & Growth	25	25	10	15	15	10	3.9	5.8	9.1	7.5
Growth	40	25	10	5	15	5	4	7.3	9.8	9
Aggressive Growth	60	25	0	0	15	0	5.1	9.5	10.7	11.3

Source: CIBC Asset Management Inc.

Annualized return variability 1950-2019 (% , not annualized if less than 1 year)

Profiles	Monthly best	Monthly worst	3 month best	3 month worst	6 month best	6 month worst	1 year best	1 year worst	3 years best	3 years worst	5 years best	5 years worst	10 years best	10 years worst	% neg. month
Capital Preservation	6.1	-4.1	14.8	-5.5	23.3	-8.4	35.1	-8.8	21.3	1.8	19.1	2.8	14.4	3.9	28.9
Income	7.8	-6	17	-10	26.5	-13.4	42.2	-16.5	23.7	-0.3	21.7	1.7	15.9	3.3	32
Income & Growth	10.5	-8.5	17.4	-15.5	29.4	-18.9	47.7	-23.8	27.1	-4.6	25.3	0.1	18	2.2	32.4
Growth	12.4	-11.7	19.1	-18.6	30.7	-23.7	49.9	-29.3	31.8	-8.2	28.5	-1.4	20	0.8	33.7
Aggressive Growth	15.1	-15.9	24.2	-23.7	37.8	-30.9	54.8	-36.3	37.8	-13.1	32.6	-3.3	22.2	-0.9	35.3

Source: CIBC Asset Management Inc.

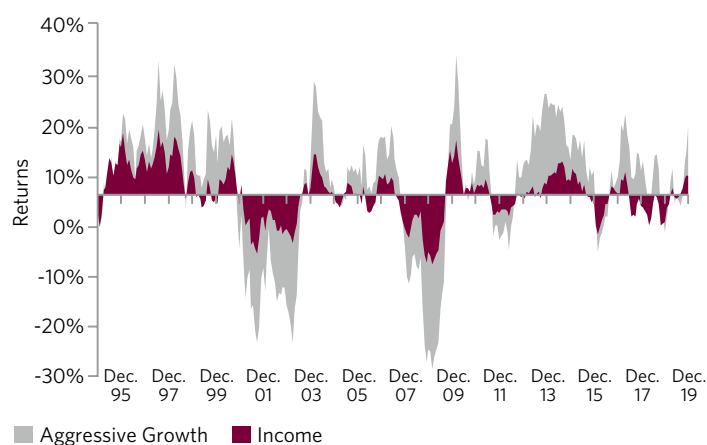
Risk analysis of investor profiles

Different measurements may be used to quantify risk. There is no preferred method but combining various risk measurements provides a more comprehensive analysis of the risk characteristics of an investment portfolio.

Standard deviation is one of the most commonly used risk measurements in investment theory, as it measures the variability around historical or expected returns. The lower the observed standard deviation, the lower the risk.

The variability chart demonstrates the risk for two investor profiles over the past 25 years. The historical 25-year annual standard deviation for the Aggressive Growth portfolio is 12.9% and 5.3% for the Income portfolio. Clearly, the returns are more variable for the Aggressive Growth profile. However, with a starting investment of \$1000 25 years ago, the Aggressive Growth investor would have grown the investment to \$6026 (annualized 7.4% return) by the end of 2018. This is materially higher than the Income investor, who would have grown the same starting investment to \$4477 (annualized 6.2% return).

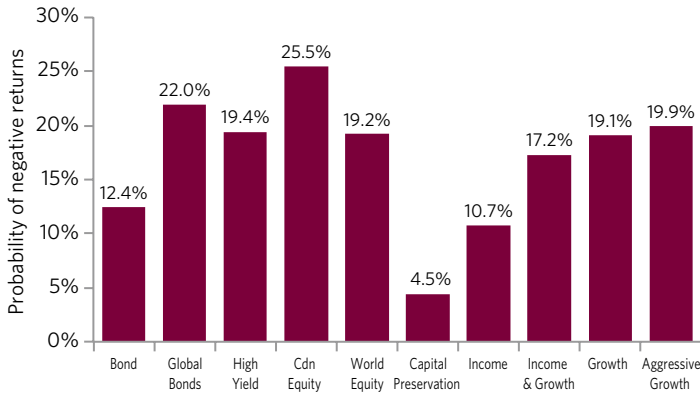
Variability in one year historical returns for the income and aggressive growth profiles (December 1994 – December 2019)



Source: CIBC Asset Management Inc., Bloomberg

Another measurement to quantify risk is the probability of negative returns over a specific period. As shown in the chart below, the Capital Preservation portfolio has only a 4.0% chance of losing money over a one-year period, while the Growth portfolio has a much higher chance, at 18.0%.

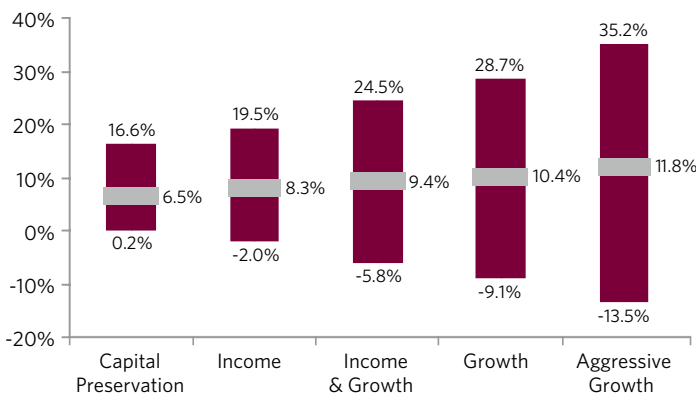
Probability of negative annual returns in a one-year period (1950 - 2019)



Source: CIBC Asset Management Inc., Bloomberg

One problem with the “probability of negative returns” as a measurement of risk is that it doesn’t address the magnitude of potential loss. A particular investment may have a small chance of experiencing a loss, but if the loss occurs it may be larger than the investor can tolerate. Return percentile is another risk measurement that combines the probability of loss occurrence with the magnitude of the corresponding return. The 5th percentile shows the lowest 5% for returns. The table below shows the 5th, 50th and 95th annual return percentiles for the five investor profiles from January 1950 through December 2019.

5th, 50th and 95th annual return percentiles (1950 - 2019)



Source: CIBC Asset Management Inc., Bloomberg

Another risk-assessment approach is to test the length of time it took each profile to traverse from peak to trough and back to the original peak again during the prior 69 years. Impressively, the most conservative Capital Preservation profile only required one year to recover once in the last 69 years. Conversely, the Aggressive Growth profile endured ten periods that required more than a year to recover and three periods required more than three years to regain their previous peak. The maximum period observed for the Aggressive Growth profile to recover was 73 months, after the dot.com bubble of 2000. Once again, this demonstrates the importance of time horizon when determining an appropriate investor profile.

Frequency of extended recovery periods (1950 - 2019)

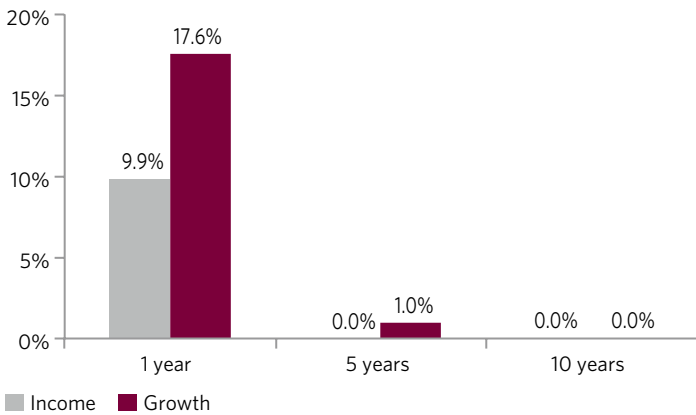
Asset Allocation	3 or more years to recover	2 to 3 years to recover	1 to 2 years to recover
Capital Preservation	0	0	1
Income	0	1	6
Income & Growth	2	1	6
Growth	2	1	6
Aggressive Growth	3	1	6

Source: CIBC Asset Management Inc.

Remain diversified and fully invested

Investors are advised to set long-term financial goals and maintain a disciplined asset allocation approach. This will help them meet their long-term goals in accordance with their risk profiles. Timing the markets typically prevents investors from achieving their long-term goals, as risk decreases over a longer time horizon. This should encourage investors to be patient, as the probability of realizing a loss diminishes over time. Based on the past 69 years, the probability of a negative return for the Income profile or the Growth profile is 10% and 17.9% respectively on a one-year basis, decreasing to 0.0% and 1.0% respectively on a five-year basis and 0% for both profiles over a ten-year period.

Percentage of negative annualized returns for the Income and Growth profiles (1950 - 2019)



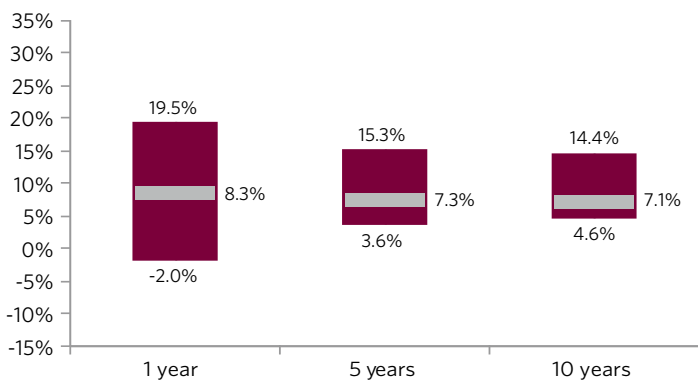
Source: CIBC Asset Management Inc.

Investing is a long journey that requires careful planning and disciplined implementation to reduce the potential for emotional and inefficient responses to volatility. Investors should not allow short-term market movements to alter their approach.

In any short-term period, investors may face higher volatility and negative returns. However, this should not discourage them from investing—volatility tends to decrease in the long run and returns tend to revert to a narrower band around a long-term average.

Supported by this data, investors should establish a link between time horizon and their risk profile. For example, investors with a five-year time horizon may be comfortable investing in the Income portfolio.

5th, 50th & 95th annualized return percentile over time (1950 - 2019)



Source: CIBC Asset Management Inc.

Based on the past 70 years of historical returns, the Income portfolio has a 50% chance of achieving an annualized return of 7.3% or better over a five-year period. It has only a 5% chance

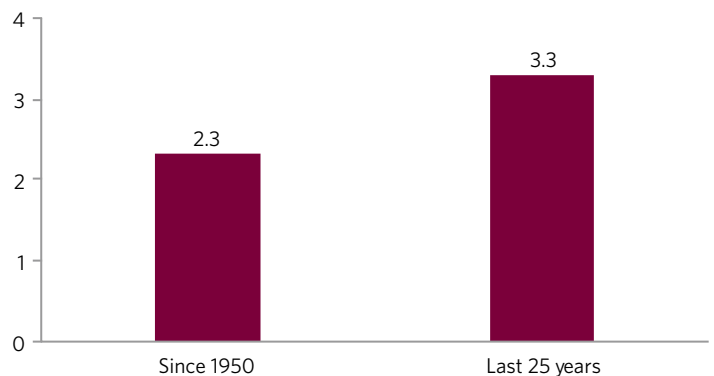
of an annualized return of less than 3.6% over a five-year period. We can compare that to the current expected returns for Canadian money market at 2.5%. The probability over a one-year period of achieving an annualized return less than 2.5% is 21%. In other words, over the last 70 years, the return for the Income portfolio (over one year) was greater than the current Canadian money market expected return 79% of the time. If we extend the measurement to a five-year holding period—over the past 70 years, the Income portfolio had 4 occurrences where the annualized return was lower than 2.5% (two occurrences in the 2008/9 financial crisis and two occurrences in the 1973/1974 stock market crash).

These statistics should be a point of consideration for risk-averse investors with a five-year time horizon who have all their money in saving accounts or cash. Many risk-averse investors believe that cash is a safer investment than the Income portfolio in a five-year period. This may not be the case, particularly when taking historical probabilities and opportunity costs (upside volatility) into account.

Equities produce the best returns over the long-term

In periods of strong equity market returns, investors can be tempted to establish or maintain very high allocations to equities in an effort to capture further gains. However, investors may not account for the fact that the higher potential returns of equities come with higher risk. Conversely, in periods of weak equity market returns, investors can be tempted to sell out of equities to reduce the risk of further losses. In all scenarios, investors should heed the long history of capital markets and maintain a disciplined, long-term asset allocation approach, taking into account their time horizon, liquidity needs and risk tolerance.

Bonds mitigate risk during equity drawdowns (1950 - 2019)
Average monthly return (bps) of Canadian bonds per 100 bps of TSX sell off

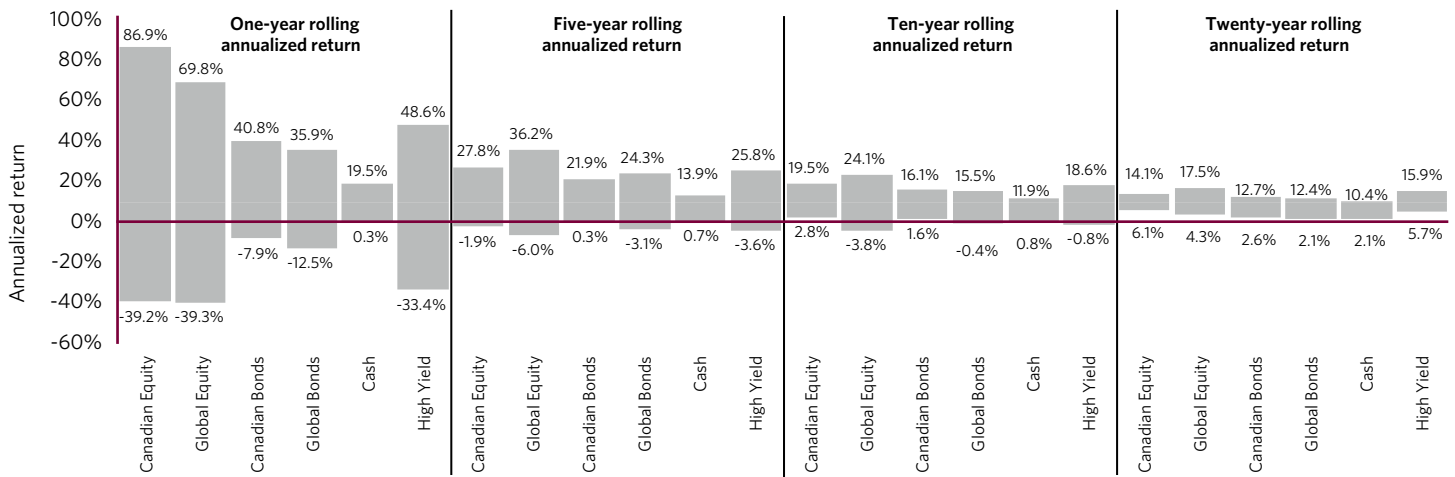


Source: CIBC Asset Management Inc.

Most investors would agree that, in the short-term, equities are more volatile than bonds and cash. In general, investors with very short-term goals may be better served by guaranteed investments. A well-diversified portfolio should include an allocation to bonds, as they continue to be an effective shock absorber, and offer stability relative to a portfolio's equity holdings.

However, in the long-run, equities have been the superior asset class for investment growth. The worst 20-year period for Canadian equities (annualized return of 6.1%), is similar to the average performance from the Canadian bond market (6.5%) over the last 70 years. Over this same period, Canadian equities have outperformed Canadian bonds 72% of the time on a 10-year rolling basis.

Worst and best annualized asset class returns (1950 - 2019)



Source: CIBC Asset Management Inc., Bloomberg

Conclusion

After a very volatile December 2018, markets bounced back in 2019 to post some of the strongest returns of the near decade-long expansion. Looking forward, we expect increased market volatility relative to the post crises period, which has a powerful impact on investor sentiment. Similarly, behavioural psychology has shown that investors will often want to increase equity weightings at or near market peaks and reduce or eliminate equities near a market trough. Long-term experience has shown that discipline is paramount in difficult market environments and diversification can be a powerful tool to manage volatility. Although equities have historically provided higher returns than bonds, bonds remain an important part of a well-diversified portfolio, as they can help offset the risks inherent in equity returns.

Long-term strategic asset allocation has allowed investors to reduce their large exposure to familiar asset classes and home country investments and take advantage of enhanced return opportunities by investing in a diversified asset mix.

Diversification also helps to ensure at least some market participation in the most attractive asset classes at any given time.

Our research suggests that a balanced global portfolio's risk/return profile can also be improved by the addition of a number of asset classes including: global debt, high yield debt, multi-sector fixed income strategies, global real assets, emerging debt and emerging market equities, as well as alternatives such as private equity and absolute return strategies. This is due to their low correlation to traditional global asset classes.

Currency risk is one of the main risks that Canadian investors face when adding foreign investments. To mitigate this risk, hedged portfolio products can provide the added benefits of exposure to global growth, with limited currency risk for investors with short time horizons. Over the long term, however, investors can achieve higher risk-adjusted returns using the additional diversification provided by adding unhedged currency risk.

Tactical asset allocation opportunities

Luc de la Durantaye, CFA

Global Outlook

A new policy regime ahead

The most striking feature of 2019 was the year-long optimism of global investors, despite the fact that the global economy clearly shifted into lower gear. By year end, global equity markets were trading at all-time highs, while credit spreads and market volatility hit all-time lows. There was good reason to feel more upbeat in late 2019, with the December announcement of a U.S.-China trade deal agreement. Global central bankers also haven't been gun shy, deploying more stimulus to keep the global economy expanding.

Our world real GDP forecast for 2020 calls for a global growth slowdown, with growth averaging +2.8% over the 12-month forecast horizon. Our bigger concern is that monetary authorities don't have the policy leeway to cushion the landing, and the problem is not just ultra-low interest rates. The unorthodox policies (i.e. QE and sub-zero policy rates) of recent years came with negative side effects.

In the developed world, few central banks still have room to further cut policy rates—the U.S. Federal Reserve (Fed) and the Bank of Canada (BoC) are the exceptions and they are also fast approaching the zero bound. One of the key features of 2020 will likely be a move to an MMT (Modern Monetary Theory)-style regime, where central banks set the stage to allow some loosening of their government's fiscal stance. The new regime comes with major risks, and the associated governance and decision rights need to be carefully engineered. Navigating this change will be challenging for investors, making continued historically low financial market volatility unlikely in 2020.

Alternative scenarios

In our Global Reflation scenario, the buildup in inflationary pressure becomes strong enough to convince central bankers to "lift a foot off the accelerator". Policy tightening would resume, but stronger earnings growth would provide an offset to higher interest rates. This would support equity market valuation and provide stronger-than-expected equity returns but weaker fixed income returns. Continued Chinese easing efforts and constructive political developments in Italy could lead to improved business and consumer sentiment and stronger economic activity.

Our Global Recession scenario is more likely to emerge from Asia and/or Europe. Both regions are currently coping with a cyclical growth slowdown and policy stimulus won't be sufficient to avoid a pronounced economic downturn, with spillover effects to the rest of the world. Cyclical and risky assets would face a significant correction as investors challenge the assumptions that 1) lower interest rates were a reasonable justification for rising valuations and 2) earnings growth would remain resilient.

Equity Market outlook

A stabilizing economic cycle could trigger a rotation away from U.S. equities in favour of more cyclical markets such as emerging market equities. While technology, consumer and rate-sensitive equities were very strong in 2019, small caps and highly cyclical sectors lagged and could still benefit if the cycle improves.

Fixed Income

Disappointing economic growth (compared to consensus) should keep a lid on bond yields. In addition, the risks of inflationary pressure coming from the energy sector are tilted to the downside. The U.S. Treasury 10-year yield should hover in a range of 1.35%-2.30% and Canadian 10-year sovereign bond yields should trade between 1.15% and 2.10% over the forecast horizon.

Currencies

U.S. dollar

With the Fed switching to easing mode, the cyclical forces supporting the U.S. dollar in recent years are quickly fading. It's too soon to call for the start of a widespread U.S. dollar trend reversal, but the greenback will be under intensifying pressure in 2020.

Canadian dollar

Canadian goods-producing industries have started to act as a big drag on Canadian real GDP growth. That will be more than enough to convince market participants that the Bank of Canada is about to take a dovish turn, translating into Canadian dollar weakness.

Euro

Relative ECB-Fed policy rates are widening and the Fed is expanding its balance sheet at a faster pace than the ECB. In other words, the cyclical forces exerting downward pressure on the euro against the U.S. dollar are dissipating. This means that the fate of the euro will increasingly be determined by developments on the trade front.

Japanese Yen

The Bank of Japan will likely continue to buy enough JGBs to roughly match the government borrowing needs. It will also keep short rates close to zero and target 0% for 10-year JGB yields. This should maintain the yen in a tight trading range between 100 and 112.

Economic outlook underlying our views

United States

The U.S. economy slowed materially in the past year due to two negative shocks on U.S. non-financial corporations—intensifying global trade headwinds and a severe squeeze on profitability. These two shocks largely explain why U.S. real GDP growth decelerated from more than +3% in 2018 to +2.1% in late 2019. We project real GDP growth will further decelerate in 2020, averaging +1.5% over the forecast horizon.

The squeeze on non-financial corporation profitability is projected to intensify further moving into 2020, owing to fast-rising unit labour costs and falling PPI inflation. To cope with this shock, non-financial corporations will have to further cut back on investment spending, while slowing the pace for hiring workers. The now modest boost to the U.S. economy from capital spending will likely turn into a drag in 2020. Spillovers to households will likely start to become apparent, with slower employment growth and a smaller boost to GDP growth from consumer spending.

To combat deteriorating growth prospects, we believe the Fed will need to implement additional rate cuts, further expansion of its balance sheet and a new repo facility over the forecast horizon.

Europe

E.U. exports to the U.S. provided a +0.2% boost to nominal GDP growth in 2019, more than offsetting the decline in exports to China. The trade imbalances between the U.S. and the eurozone are now bigger than ever, and big enough to be on the U.S. Administration's radar screen. Since 2015, the ECB has been fighting hard to keep the euro undervalued and fuel an export-led expansion by cutting rates aggressively and massively expanding its balance sheet. The U.S. administration has all the arguments it needs to justify the adoption of more retaliation measures against the eurozone in 2020, as it did with China in 2019.

For Europe to avoid losing market share, a new trade weapon is being created—the ability to match U.S. tariffs with just-as-big E.U. tariffs. Meanwhile, the ECB will be changing its monetary policy regime by targeting zero policy rates and steeper yield curves to alleviate pressure on the financial sector.

Overall, any strengthening in foreign demand from Asia will likely be offset by weaker export growth to the United States. For this reason, eurozone growth will likely continue to disappoint, with average real GDP growth at +0.8% in 2020.

China

The de-escalation in the trade dispute, along with a phase-one trade deal, will provide some relief for Chinese growth starting in Q2 2020 and we're raising our GDP growth forecast to an average 5.6% for 2020. That said, not all headwinds on external demand have been removed. The continued expected weakness in the euro area is a negative shock for China that partially offsets the positive developments from the U.S.-China trade war.

The Chinese consumer is an important part of the domestic demand outlook, but indicators of consumer appetite for spending have been disappointing. With the ratio of household debt to disposable income reaching 100%, it's unlikely that the consumer can keep up the same strong borrowing pace. Fiscal policy will continue to support growth, with very little accommodation coming from monetary policy in the first half of the year. Inflationary pressures are expected to ease, which would provide some additional flexibility for a more proactive central bank if needed later in the year.

Canada

Growing global trade headwinds are now hitting Canadian manufacturing and trade sectors and acting as a big drag on Canadian real GDP growth. Canadian households have no room to increase their pace of consumption growth—particularly in the context of decelerating job creation and a low savings rate. Our forecast calls for real Canadian GDP growth to decelerate to +1.1% (from +1.6% currently) over the forecast horizon. With this backdrop, the BoC won't be able to stay on the sidelines for too long and will eventually follow the Fed's lead with a policy rate cut.

¹The World Bank Group flagship report Global Economic Prospects, January 2020

²Proxied by the S&P/TSX Composite Index

³"Foreign Investments in Canadian Securities", STATCAN, <https://www150.statcan.gc.ca/n1/daily-quotidien/191115/cg-a001-eng.htm>

⁴Canadian High Yield credit spread is the difference between the yield of the Bank of America Merrill Lynch Canada High Yield Index and that of the Bank of America Merrill Lynch Canadian Government Index. The US High Yield Spread is the difference between the yield of the Bank of America Merrill Lynch High Yield Master II Index and that of the Bank of America Merrill Lynch US Treasury Master Index.

⁵Rebalanced on a calendar year end basis using Strategic Asset Allocation recommendations based on IMR Long Term Strategic Asset Allocation papers (2012-2019).

⁶"Making Canadian Portfolios Strong and Free of Home Country Bias", CIBC Asset Management Inc.

⁷Proxy indices for these asset classes are: FTSE TMX Canada 91 Day T-Bills Index for cash; FTSE TMX Bond Universe Index for Canadian bonds since inception (1990), prior to 1990, All Government Canadian Bonds with 10yr + maturity; Barclay's Global Aggregate Bond Index for global bonds since inception (1990). 1986 to 1990 JP Morgan Global Government Bond Ex Canada, 1960 to 1985 U.S. Intermediate Government (%Total Return) in Canadian Dollars, 1950 to 1960 U.S. Intermediate Government (%Total Return) - Currency Prorated; Merrill Lynch U.S. High Yield Master II Index for U.S. high yield bonds since inception (1986). Prior to 1986, U.S. high yield asset class returns were approximated with a 20/80 blend of the S&P 500 Index with either U.S. government bonds (1950 to 1975) or the Barclays Global Aggregate Debt Index (1975 to 1986). S&P/TSX Composite Index for Canadian Stock returns since inception (1956), prior to 1956 data was from the Montreal Exchange and Toronto Stock Exchange Market Review (1950 to 1955); MSCI World Index for Global Stocks since inception (1982), 1950-1982 Global Financial Data C\$ World.

⁸High yield is represented by the Bank of America Merrill Lynch US High Yield Master II Index, Global Bonds is represented by the Bloomberg Barclays Global Aggregate Index. Duration as of December 31st, 2019

⁹Real Assets returns is approximated through a blend of 40% Real Estate Equities (FTSE EPRA/NAREIT Developed Real Estate Index), 50% Infrastructure Equities (Dow Jones Brookfield Global Infrastructure Index) and 10% Real Asset Debt (70% Bank of America Merrill Lynch Global High Yield Index + 30% Bank of America Merrill Lynch Global Corporate Index)

¹⁰JP Morgan, BlackRock, July 2015. Based on the JP Morgan EMBI Global Diversified and JP Morgan CEMBI Broad Diversified indices

¹¹See IMR's paper "Is Your Portfolio Yield-Starved? Take a Bite of Multi-Sector Fixed Income", April 2016, CIBC Asset Management

¹²Multi-sector fixed income returns were approximated through a blend of the Barclay's Aggregate Bond Index (50%), BoA Merrill Lynch U.S. High Yield Index (25%) and the J.P. Morgan Emerging Markets Bond Index (25%). Floating rate loans are approximated by the Credit Suisse Leveraged Loan Index and U.S. high yield debt by the BoA Merrill Lynch U.S. High Yield II Index.

¹³"McKinsey and Company, 2019, "Private Markets Come of Age, McKinsey Global Private Markets Review 2019 "

¹⁴Absolute Return Strategy returns is approximated by using MSCI ACWI index and an expected return of 5% above Canadian cash.

¹⁵A more detailed explanation can be found in "Long Term Capital Market Returns", Éric Morin, January 2020

¹⁶Historical performance for each risk profile is based on historical returns for the component asset classes based on proxy indices⁷ monthly rebalanced to the 2019 Long Term strategic global allocation recommendation.

¹⁷Expected Returns and Expected Standard Deviations for the component asset classes are based on 10-year forecast returns as explained in Long-Term Capital Markets Assumptions section of the paper.

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