From the desk of Sarah Riopelle

MARCH 20, 2020

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By now, referring to the last few weeks as unprecedented seems inadequate. As COVID-19 has continued to spread, world economies, capital markets and our daily lives have all been affected. While our team may be working from different locations, we are in constant contact and working hard to manage the funds through this period of volatility that has sent bond yields to historic lows and equities down almost 30% from the market peak.

Managing drift in volatile markets

In late February, before the virus spread on a global scale, we were analyzing data on previous corrections, bear markets and crisis events and felt that based on that history, much of the damage to capital markets may have been behind us. We began executing some small trades to address drift, meaning we were selling bonds and buying stocks as falling bond yields and declining stock prices were moving us away from our targeted asset mix. In retrospect, our initial move into equities was too soon. That reinforces a concept that I have talked about in the past – timing the market is extremely difficult, even for the professionals. But that's why we were only making small, opportunistic moves – dipping our toes in if you will. We know we won't be able to time the exact bottom, but we also know that it will be extremely difficult to position portfolios for the recovery after it begins.

With the extreme volatility and consecutive days of falling markets, we were faced with the challenge of managing drift as the magnitude of the moves frequently pushed our position weights well beyond our tactical targets. For background, we maintain a range around our target weights for every asset class. When any asset class exceeds those thresholds, either positively or negatively, we look for an opportunity to move the portfolio back toward our target weights. Market movements in the last few weeks, have resulted in us being sellers of bonds and buyers of stocks.

These unprecedented times have also caused us to expand what we view as an effective drift threshold. In more stable market environments, we are comfortable allowing the asset class weights to drift up or down by 100 bps (1%) before we consider whether we need to rebalance. The market movements of the past few weeks has pushed the asset class weights up or down 100 to 200 bps in a single day! So adhering to our existing threshold of 100 bps would have caused us to trade more often than we would have liked. Therefore, we have expanded our drift threshold to 200 bps (2%). We believe this is prudent given the magnitude of the market moves that we've seen since the latter half of February. But it is also worth remembering that triggering the drift thresholds doesn't mean that we must trade, only that I need to discuss the positions with our CIO and the RBC Investment Policy Committee to determine next steps.

Actively managing the positions in the funds to a target asset allocation is core to the value of the RBC Portfolio Solutions. Each one is aligned with a specific risk profile and we are working hard to make sure we stay true to those profiles.

Assessing risks and opportunities

We have also been making adjustments within the asset classes as opportunities arise. For example, we believe that there are some opportunities in high yield and emerging markets bonds. So when we have sold bonds to adjust for drift, we have focused those sells on universe and government bonds, and avoided selling the high yield and emerging market bond positions. This will help to gradually increase our exposure to these segments over time. In addition, with high yield spreads widening significantly, we have been reducing our underweight position in European high yield bonds.

Within equities, the rapid decline in oil prices resulting from the Saudi Arabia/Russia standoff has led us to be a little more patient in rebuilding our Canadian equity positions back to target due to our domestic economy's heavy dependence on the sector. We have also been looking for an opportunity to increase our exposure to European mid-cap equities and are adding to that position when we see opportunities.

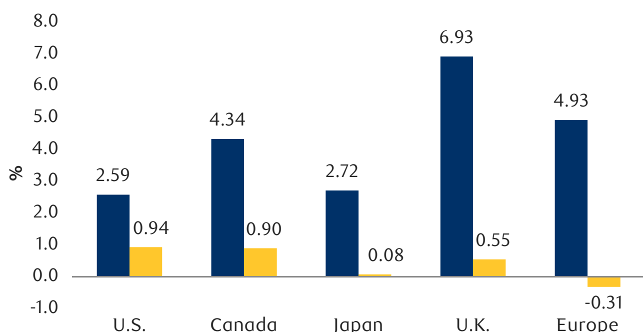
Leveraging all of the tools at our disposal

Alongside the obligation to maintain the appropriate risk level in each fund, we also have to consider *how* we achieve the desired asset mix with the market volatility that we have been experiencing. A number of years ago, we added the ability to use derivatives in the funds and this has been a valuable tool in this environment. Derivatives allow us to quickly rebalance the portfolios without overburdening the underlying fund managers as they too are busy navigating these rapidly changing markets. So we can quickly get equity market exposure using derivatives, and can add to positions in the underlying funds over time without causing disruption to those funds and their unitholders.

A Word on Yields...

Given current valuations, long term return expectations certainly favour stocks over bonds. Relative yields provide a great example of this. A Canada 10-year bond is yielding 90 bps (0.90%) versus the current dividend yield on the TSX of 4.3%. While we can't ignore the possibility that some companies will have to reduce their dividend payments in this environment, we expect the yield advantage of stocks over bonds to persist and is something that we are taking advantage of with our tactical positioning.

Equity versus fixed income yields
Dividend yield versus 10-y government bond yields



Notes: Data as at March 20, 2020. Equity indices used for U.S., Canada, Japan, U.K, and Europe were S&P 500, TSX composite, Nikkei, FTSE 100, and STOXX 600, respectively. The German bund was used for the bond yield in Europe. Source: Bloomberg, RBC GAM

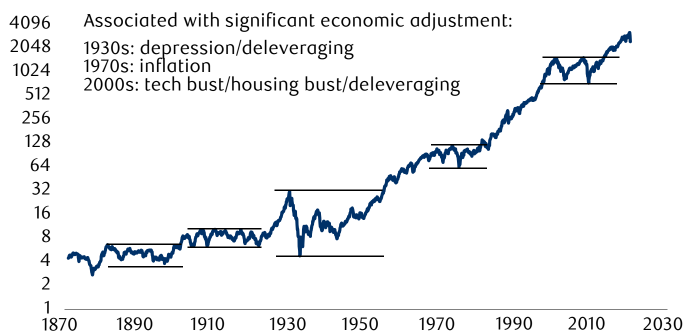
Maintaining discipline

We are sticking to our disciplined rebalancing approach, even in the face of a significant market downturn. This has served us well in the past. During the Financial Crisis of 2008/09, we continued to address the drift in the portfolios and gradually rebalanced back to our tactical targets. That meant that we had a full equity weight when the market turned higher in March 2009. While we don't know how long the current crisis will last, we are focused on adjusting the portfolios so that they are well-positioned when the turn comes.

Time is your greatest asset

At times like this, it is important that you don't abandon your investment plan and, more importantly, remember that time is your greatest asset. Many of us are investing with a 10+ year time horizon, so the ability to look out over the valley to see the other side will serve you well. That isn't to say that we think that we are all the way through this difficult market - it could still take several more weeks or even months to address the challenges in the economy and markets. But for those with long-term time horizons, this period of correction will likely prove to be a good opportunity to reduce bonds and add to stocks, although it might not feel that way right now.

Range bound markets & cyclical bull phases
S&P 500 – 1870-2020



Note: As of March 20, 2020. Source: RBC GAM, Robert J. Shiller

You have entrusted us with managing your savings and we take that responsibility very seriously. That fact is even more important during times of stress and I want to assure you that we are all actively managing the funds at every level and looking for opportunities to position them to take advantage of the rally when it comes, and it will come.

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Publication date: March 20, 2020

(20/03/2020)