Insights & Strategies

PRIVATE CLIENT SOLUTIONS

November 9, 2017

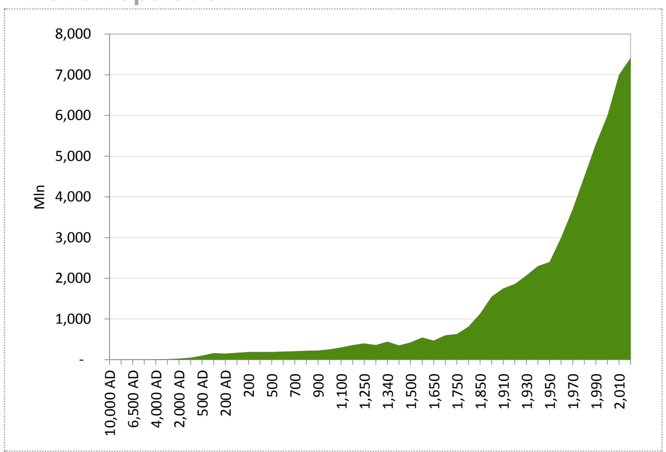
Inside this Issue

A Golden Age For Income

Demographics play an important role in shaping government and social policy. They also play a role in influencing asset prices, such as equities and bonds.

To understand our potential future path, we can glean insight from a country that has experienced a significant demographic shift over the past couple decades. Japan reached its demographic peak in the early 1990s and the average age in now 46.9 years. While Japan did experience a significant asset bubble and subsequent bursting that negatively impacted growth, demographics have also contributed to the stubbornly slow period of economic growth. These changing demographics and slower economic growth profile set Japan down a path to where it is today – a country that has the highest debt-to-GDP among the developed world. To try to spur economic activity the Bank of Japan has been pumping trillions of dollars into the economy. In recent years, governments around the world have taken similar steps when responding to a financial crisis, increased borrowing to support established government programs and lowering interest rates to spur economic growth. The problem with leverage is that it has a way of pulling future demand forward; however, it appears to be a necessary evil in the face of a global demographic trend that points to a deceleration in population growth. As the demographics and excessive leverage weighs on future global economic growth, interest rates are unlikely to return to levels experienced during the baby boom era.

World Population



Source: US Department of Commerce, Raymond James

According to United Nations estimates, for much of human history the global population grew at a very steady and predictable pace, at less than 0.1% annually. However, by the 18th century, world population experienced exponential growth. The world's population is forecast to continue to grow, but based on current estimates it will slow relative to the past 200 years. Nonetheless, the world's population will double to 11 billion by 2100 (~80 years). The last doubling in world population took just 40 years and prior to this, less than 100 years. As population growth decelerates it will have profound influence on government policies and important consequences for potential investment strategies.

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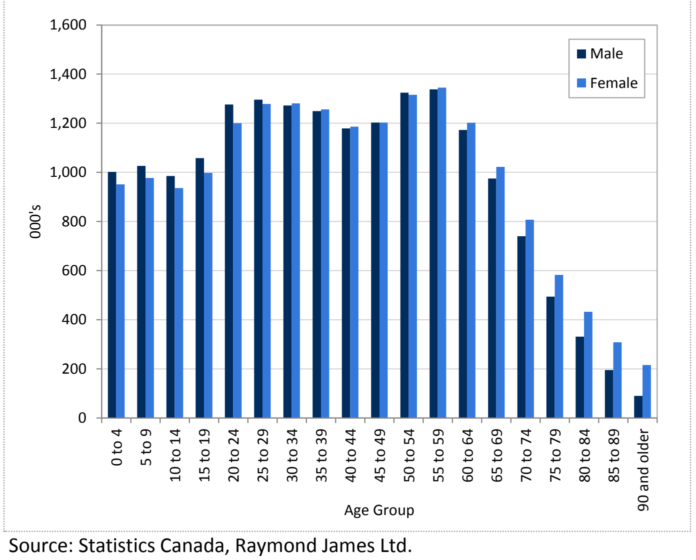
Canada and Age

Canada shares many similarities with the global demographic trend. Many developed world countries have reached their peaks in working-age population (15 to 64 years) as a share of total population and most are also forecast to see outright declines in their work forces going forward. Canada's working-age population peaked in 2007 thanks to a fall in fertility rates and a steady increase in life expectancy. Over the next fifty years, it is expected that the working-age population will fall to around 60%, or 10% below the current level. By 2056, the median age is expected to reach 46.9 years, 20 years more than it was in 1956. While there are similarities, Canada is attempting to counter these headwinds. Between 2005 and 2010, Canada experienced the strongest population growth of any G8 country, with an average annual growth rate of about 1.1%.

Canadian Population Distribution 2017



Source: Statistics Canada, Raymond James Ltd.

Migration

Canada's more rapid growth rate is attributable to greater immigration compared to other G8 countries. This can be seen in the 2016 census data, which shows approximately 20% of Canada's total population emigrated from other countries. The Canadian government is keenly aware of the challenges facing our country and has stepped up its efforts to increase the number of new immigrants. The government plan calls for 310,000 new permanent residents in 2018, 330,000 in 2019 and 340,000 in 2020. This is an increase from the past two years of 300,000 immigrants. While Canada, like its developed market peers, faces demographic headwinds we are in a relatively good spot as our immigration policies mitigates some of the headwinds. Another offsetting factor insulating our economy is that we are an exporting nation, meaning we are net sellers of capital goods and services. In this way, Canada can be an exporter to countries that are experiencing higher levels of economic growth, thereby mitigating some of the risk associated with an aging population.

Conclusion

This, however, does not change the fact that a large cohort within our society has changing investment needs. A great emphasis on generating income in an environment of lower growth and lower interest rates should be supportive of equities that offer sustainable and reliable income. Companies that typically exhibit these characteristics can be found in defensive sectors like utilities and telecommunications. Comparing the S&P/TSX utilities and telecom sector current valuations to historical levels, one can clearly walk away believing they are overvalued. However, in the context of a demographic need for income, the premium valuation may be justified. Another interesting dynamic we see is that companies that can generate growth in an environment where growth is scarce will command a premium as well.

Jason Castelli, CFA
VP, Portfolio Manager

Investing for Income & Growth

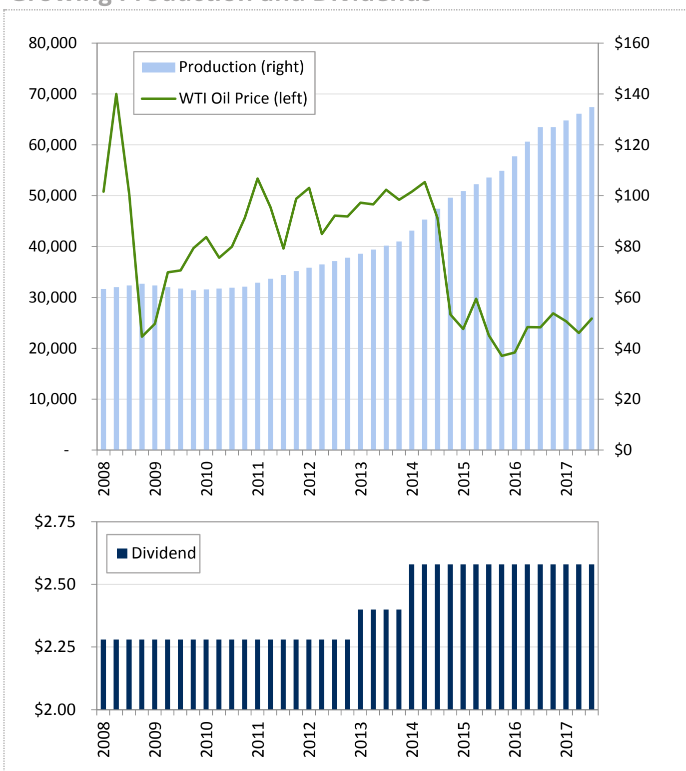
The conclusions we have drawn regarding the quest for yield, scarcity of growth and the premium valuations on the equities that provide such attributes have not been lost on CEOs and boards of directors. As a result, we have seen a trend in Canada for companies in traditionally non/low dividend-paying industries to become more creative and disciplined in their business models to sacrifice some growth in order to provide higher dividends. Two companies that fit this description are **Vermilion Energy (VET-T)** and **New Flyer Industries (NFI-T).**

Vermilion Energy

Vermilion Energy, a Calgary-based mid-cap oil and gas producer, implemented a sustainable growth and income model in 2003 and has seen the company grow from a production base of 24,132 boe/d and $2.04 annual dividend to 67,403 boe/d and $2.58 dividend in 2017. The company was able to run this type of business model in a cyclical industry by staying relatively small (i.e. not growing just for growth's sake), maintaining top-decile costs and margins (aided greatly by its international footprint) and maintaining a strong balance sheet through all market cycles (supplemented by an opportunistic hedging program).

Looking at the company's performance over the last 10 years, which includes two major oil price corrections in 2008 and 2014, the company has been able to grow production and maintain the dividend while the majority of its peer group have had to restrain growth and/or cut dividends. Looking forward into 2018, we see fundamentals for crude oil improving and Vermilion is set to continue to benefit as it forecasts a further 10% in production growth with margins and debt levels that remain amongst the very best in the peer group. The current dividend yield of 5.5% is 19% higher than the 5 year average of 4.8%. At a 4.8% yield, Vermilion would be trading at $54.00

Growing Production and Dividends

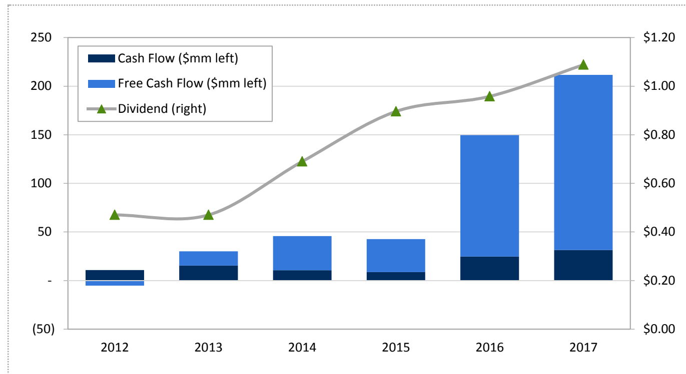


Source: Bloomberg, Raymond James Ltd.

New Flyer Industries

Winnipeg-based New Flyer is the largest manufacturer of transit buses and motor coaches in North America. Roughly 50% of the installed-base of transit buses in North America are New Flyer products. In coming years the company should benefit from higher demand for public transit coming from demographic changes, greater government spending on infrastructure and increased urbanization.

Good Cash Flows Rewards Income Investors



Source: Bloomberg, Raymond James Ltd.

The company differentiates itself from competitors through significant investment in technology and vertical integration of manufacturing, which generates a strong cost advantage over its competitors. The company's total order backlog is at an all-time high of 10,537 units and has been growing over the past four years. New Flyer buses are compliant with "Buy America" content policies, with 2/3 of manufacturing located in the US.

On the yield side of the equation, the company has been paying a dividend since 2011, with a current yield of 2.4% and an average 3 year annual growth rate of 18%. Based on the dividend track record and with forecast 8-10% annual EPS growth through 2019, we think the shares are trading at a reasonable multiple of 16.5x 2018 EPS.

Robert Mark, CFA
Portfolio Manager

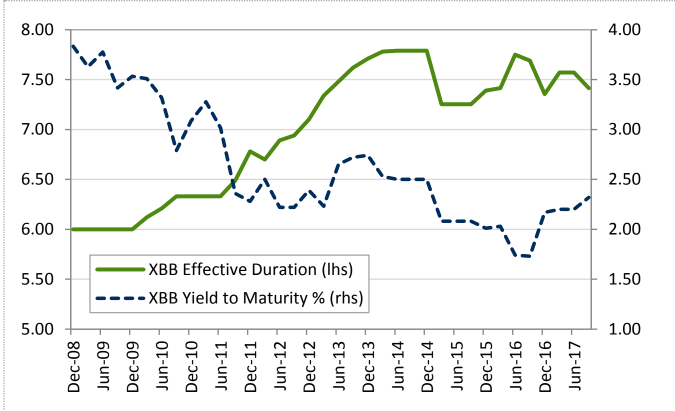
Income Solutions That Weather Rate Volatility

By now I hope we've been able to explain why we expect income mandates to remain in favour due to changing demographics. However, we have a huge problem. Interest rates are sitting near historic lows and investors are being forced higher and higher up the risk spectrum to support those income needs. So what has happened? Let's take a walk through time to set the record straight on the evolution of Canadian fixed income markets.

Lower Yield and Higher Interest Rate Risk

There is no denying that bonds are critically important to a well balanced portfolio. They have historically provided a zero to negative correlation to equity markets and also provide a nice source of returns during bear markets. However, the risk/reward of the asset class has changed dramatically.

iShares Core Canadian Universe Bond Index ETF



Source: Raymond James Ltd.

As you can see in the chart above, yields have dramatically fallen and duration has lengthened since the financial crisis. This is great for companies, as they were able to issue longer-term debt at lower borrowing costs. Business 101 would tell every well-capitalized company to take full advantage of this and they did. However, this is not to the benefit of the fixed income investor. We are now forced to take higher interest rate risk for a lower lending rate, which is not a favourable trade. For example, just last quarter the Canadian Bond Index fell 1.9% on a total return basis from a relatively meager move higher in the yield curve. Because yields have been falling for over thirty years, investors have been accustomed to generating capital gains on their bonds (yields fall, prices go up) and experiencing little to no volatility. With rates close to rock bottom, what if the experience and total return expectation for bond investors going forward is much higher volatility from increased interest rate risk and to only clip the coupon that barely beats inflation? Investors are going to need to adapt to meet their income needs.

What's the Solution?

In order to adapt, investors need to open up the full fixed income tool kit. While traditional fixed coupon bonds have been the focal point for most, the market also offers other debt products such as inflation protected debt, floating rate debt and rate-reset preferred shares, to name a few that do well in a rising rate environment. International bond markets have also grown with globalization and foreign countries have started to issue bonds in USD and CAD currency, opening up the investable universe for many portfolio managers. After all, rates don't move higher everywhere in the world at the same time. It is our belief that going forward, portfolio managers with a wider tool kit and ability to jump into different fixed income sectors and regions will have an edge. Below we highlight a global bond manager that is comfortable investing in all areas of the fixed income market.

Manulife Strategic Income

The fund's broad-based mandate allows the portfolio managers to invest in a wide range of fixed income securities, including corporates, sovereign debt, emerging market bonds, and investment grade credit. Unlike other foreign bond funds, the team also adds value by tactically managing the portfolio's foreign currency exposure.

Lead manager Dan Janis has taken full advantage of the fund's flexibility. For example, the fund held more than 60% in government bonds and unwound its currency hedges in 2008, both of which helped the fund produce a 21.1% return, outperforming its peers and benchmark by a wide margin. By market bottom in March 2009, Janis increased the portfolio's exposure to corporates and mortgage-backed securities, which helped the fund to participate in the 2009 recovery. The fund has posted strong returns historically, and given the flexible mandate, we believe Janis and co. can continue to add value in a tougher rate environment.

Return Profile

	1Yr	3yr	5yr	10Yr
Manulife Strategic Income	2.02%	5.61%	6.30%	8.34%

Source: Morningstar Direct, As at September 30, 2017.
All returns greater than 1 year are annualized.

Andrew Clee, CFA, CMT
MF/ETF Specialist and PM

Saving for Retirement

Many wonder how to construct a real retirement portfolio from your fixed income investments held in a registered account. Laddering a fixed income portfolio is considered a very conservative approach towards reaching your retirement saving goals. However, if you use a laddered stripped coupon portfolio instead, you are also positioning your portfolio in such a way that you will have predetermined cash flow when you need it during your retirement years. Also, you can tailor your investments by including a mixture of both corporate and provincial strip issues in your portfolio to match your risk profile. Typically, a stripped coupon or residual will yield more than their equivalent straight bond and you do not need to worry about reinvesting your semi-annual coupon payment; this ultimately eliminates the reinvestment risk of your portfolio.

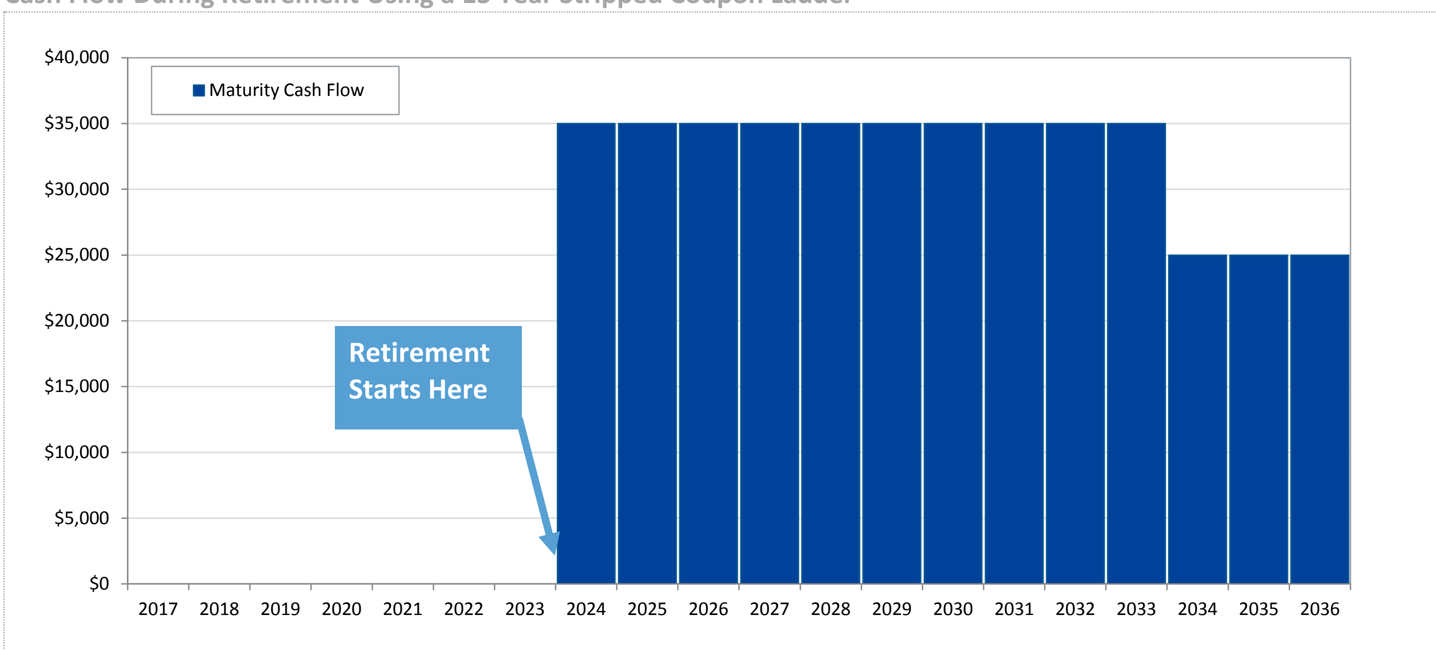
Let's take a look at an example of how this can be done. Assuming you are retiring in 20 years and that every year, beginning this year, you buy a 20 year strip coupon with a maturity value of $25,000. This will always be purchased at a discount to the $25,000 every year; however, depending on the yield to maturity, the price will vary. By always buying a 20 year maturity issue, hopefully you are taking advantage of a normal upward sloping yield curve which is the case in most economic environments which gives a better yield as you move out on the curve. After 20 years, you can then begin to withdraw $25,000 from your registered account to start to fund your retirement for the next 20 years. If more money is needed this can be supplemented by the equity portion of your account or by cash on hand.

A key defining feature of this type of portfolio is that you can predetermine the amount of funds you would like available to you during retirement. Statistically, most people spend the most in their first few years of retirement by taking advantage of their better health, taking those preplanned vacations, etc. Therefore, you can customize the cash flows by having more funds available in the first few years and then reducing cash flows in the far end of your portfolio.

Below is an example of a 13 year stripped coupon ladder with a mixture of both provincials and corporate issues, with more maturity value for the first 10 years and then layering off in the back-end of the portfolio. Payments are being delayed until retirement, which is set for seven years from now and you will receive payouts every year starting in 2024 and going out until 2043. By adopting this portfolio structure, you will have cash flow for the first 20 years of your retirement when it is ultimately complete in seven years' time.

Harvey Libby
Fixed Income & Foreign Exchange

Cash Flow During Retirement Using a 13 Year Stripped Coupon Ladder



Source: Raymond James Ltd.

Structured Notes 101

Structured notes come in many different shapes and sizes, and can be used to meet specific risk tolerances, time horizons and investment objectives. Structured notes can be utilized to enhance an existing portfolio's ability to generate income. While the structure of these note types vary in complexity, all three are designed to offer an attractive income alternative that is linked to the performance of an underlying index, ETF, a single stock, or even a basket of stocks. There are three main types of income generating structured notes: Principal protected income notes, fixed income notes and auto callable contingent income notes.

Principal Protected Income Notes

Principal protected income notes can provide a fixed income stream payable quarterly, semi-annually or annually throughout the term of the note, regardless of where the underlying is trading, in addition to offering a variable return that is tied to the underlying's performance. These notes have a set maturity date and come with 100% principal protection at maturity.

Fixed Income Notes

Fixed income notes provide a fixed income stream payable quarterly, semi-annually or annually throughout the term of the note, regardless of where the underlying is trading. These notes also have a known maturity date at the time of purchase. These notes come with a form of partial principal protection, which is to say investor capital remains protected so long as the underlying basket is trading within a pre-determined range at maturity.

Auto Callable Contingent Income Notes

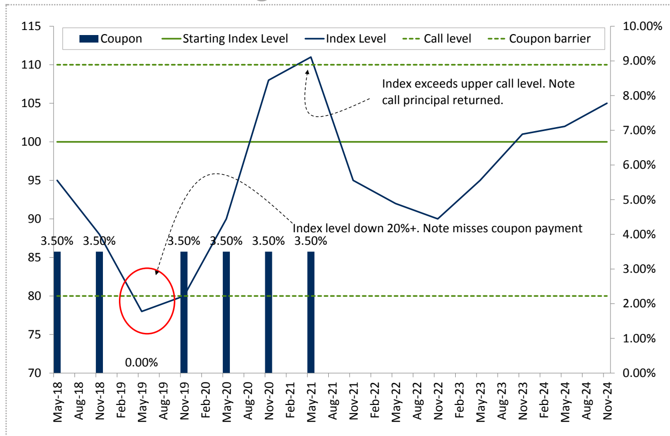
Auto callable contingent income notes are the most complicated of the three structures, making it best suited for more sophisticated investors. Generally speaking, these notes are designed to provide an income stream payable quarterly, semi-annually or annually, so long as the underlying securities are trading within a pre-determined range on a stated observation date. A key feature of these notes are that they have a callable feature whereby the notes can be redeemed by the issuer if at each observation (which typically coincides with the income payment) the underlying exposure is at or above a pre-determined level.

These notes come with a form of partial principal protection similar to fixed income notes described above. If we take a look at an auto callable contingent income note that is currently available for purchase in the market, it will give us a good idea of how it works.

TSX60 Auto Callable Contingent Income Note

- 7-year note
- Tied to the TSX60 Index
- Annual coupon of 7% (paid semi-annually)
- Coupon payment threshold of -20%
- Principal protection threshold of -20% at maturity
- Callable annually at 110% of it starting level
- F-class

Auto Callable Contingent Income Note



Source: Raymond James Ltd.

Coupon payments: This note will continue to pay coupon payments of 3.50% every six months so long as the index is not down more than -20% at each semi-annual observation. If at a semi-annual observation the note is below -20%, that particular coupon payment is simply not paid. If at the next semi-annual observation the note is at or back above -20%, the coupon payments will begin to be paid again.

Call feature: This note would be redeemed by the issuer (and the final coupon received) if at any of the semi-annual observations the performance of the index is greater than 110% of its starting level.

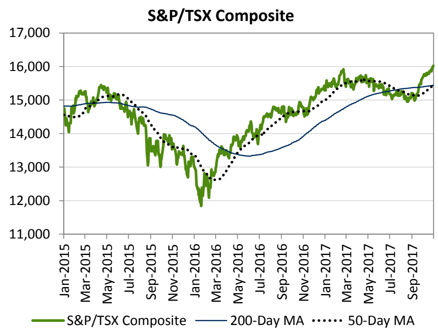
Protection of capital: This note at the end of seven years will return 100% of its capital so long as the index is not down more than -20%, keeping in mind that the worst drawn-down over a rolling seven year period on the TSX60 was approximately -4.72%.

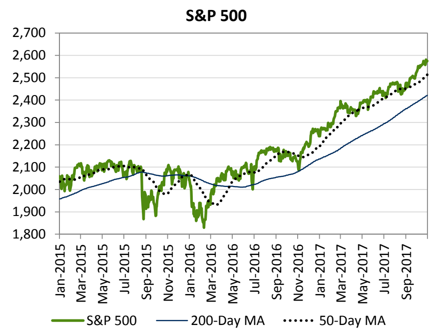
Like every investment type, structured products have risk/reward profiles that vary from issue to issue. Your financial advisor will be able to help you determine which product is best suited to achieve your financial goals.

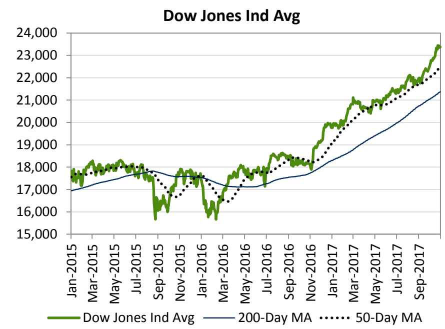
Chris Cafley, MBA, FCSI
VP, Portfolio Manager

Charts of Interest

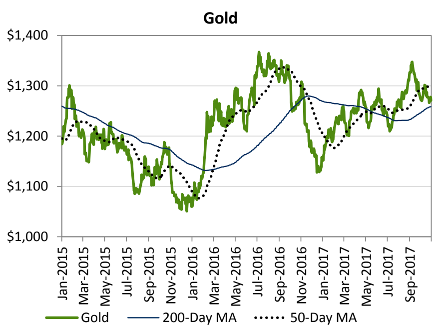
Markets

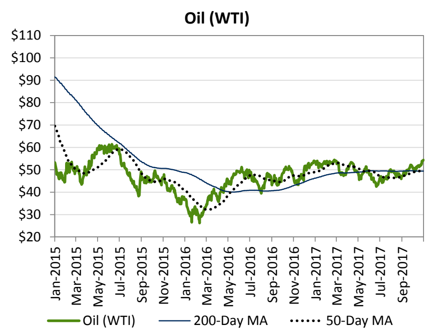


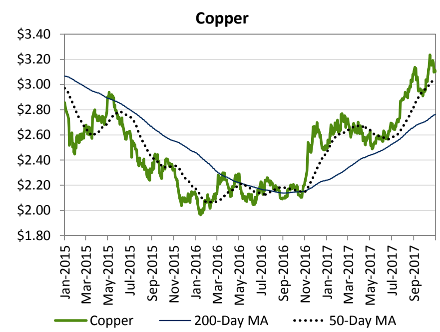




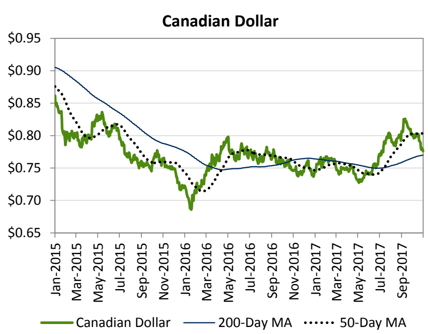
Commodities

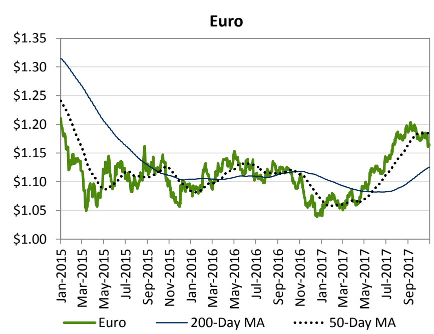


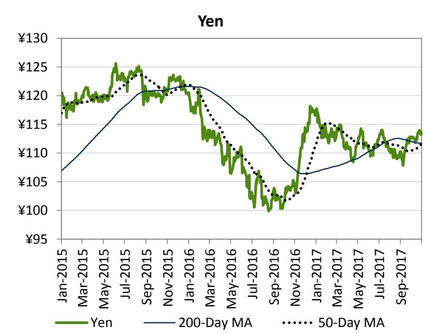




Currencies

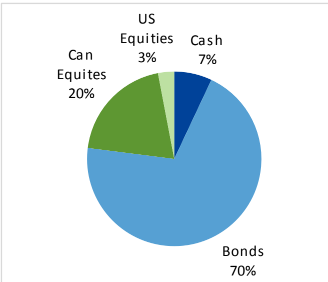
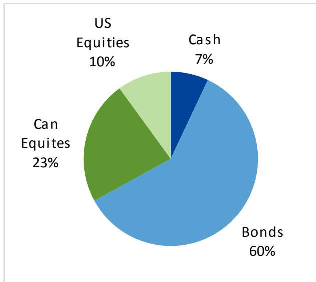
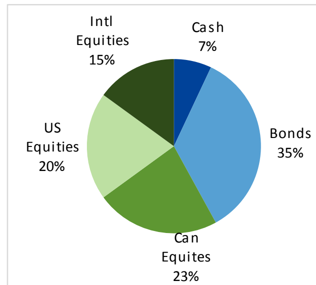
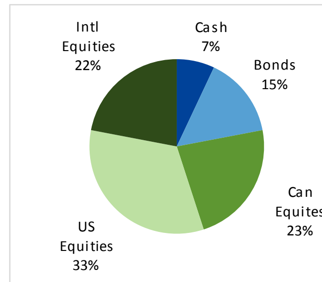
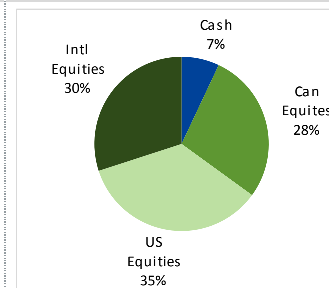






Source: Bloomberg, Raymond James Ltd. Performance as at October 31, 2017.

Investor Profiles and Asset Class Weightings

Recommended Asset Allocation					
	Capital Preservation	**Conservative**	**Moderate**	**Growth**	**Aggressive Growth**
					
Cash	7%	7%	7%	7%	7%
Bonds	70%	60%	35%	15%	0%
Can Equities	20%	23%	23%	23%	28%
US Equities	3%	10%	20%	33%	35%
Intl Equities	0%	0%	15%	22%	30%
Tactical Asset Mix (Bonds include cash)					
Bonds | Equities	77 | 23	67 | 33	42 | 58	22 | 78	7 | 93
Strategic Asset Mix (Bonds include cash)					
Bonds | Equities	80 | 20	70 | 30	50 | 50	30 | 70	10 | 90
Asset Ranges					
Cash	0-20	0-20	0-20	0-20	0-20
Bonds	60-100	50-90	20-70	10-50	0-30
Equities	0-30	10-50	30-75	50-90	70-100
Description					
	May be appropriate for investors with long-term income distribution needs who are sensitive to short-term losses. The equity portion of this portfolio generates capital appreciation, which is appropriate for investors who are sensitive to the effects of market fluctuation but need to sustain purchasing power. This portfolio, which invests primarily in fixed-income securities, seeks to keep investors ahead of the effects of inflation with an eye toward maintaining principal stability.	May be appropriate for investors with intermediate-term time horizons who are sensitive to short-term losses yet want to participate in the long-term growth of financial markets. The portfolio, which fixed-income securities tend to make up the largest proportion of holdings, seeks to keep investors well ahead of the effects of inflation with an eye toward maintaining principal stability. The portfolio has characteristics that may deliver returns lower than that of the broader market with lower levels of risk and volatility.	May be appropriate for investors seeking a balance between capital preservation and capital growth. This portfolio, which is a split between fixed-income securities and equities, seeks to keep investors well ahead of the effects of inflation with an eye toward maintaining principal stability. With roughly half of the portfolio invested in a diversified mix of Canadian and international equities, investors should be comfortable with moderate fluctuations in the portfolios.	May be appropriate for investors with long-term time horizons who are not sensitive to short-term losses and want to participate in the long-term growth of the financial markets. This portfolio, which has a higher weighting in equities, seeks to keep investors well ahead of the effects of inflation with principal stability as a secondary consideration.	May be appropriate for investors with long-term time horizons who are not sensitive to short-term losses and want to participate in the long-term growth of the financial markets. This portfolio, which is primarily invested in equities, seeks to keep investors well ahead of the effects of inflation with little regard for maintaining principal stability. The portfolio may deliver returns comparable to those of the broader equity market with similar levels of risk and volatility.

Important Investor Disclosures

Complete disclosures for companies covered by Raymond James can be viewed at: https://www.rjcapitalmarkets.com/Disclosures/Index

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A member of the PCS team responsible for preparation of this newsletter or a member of his/her household has a long position in the securities of Vermilion Energy (VET-T).

Information regarding High, Medium, and Low risk securities is available from your Financial Advisor.