

A quantitative take on recent market volatility

This fall, many investors were concerned about heightened market volatility caused by uncertainty around multiple factors, including slowing global growth, interest rate policies in the U.S. and low oil prices.

For insight on recent market activity, we spoke with four of our quantitative advisors and managers to find out what was driving the volatility, what their quantitative models were telling them and how they reacted.

Featuring:



Michael Martel, Managing Director,
State Street Global Advisors (SSGA)
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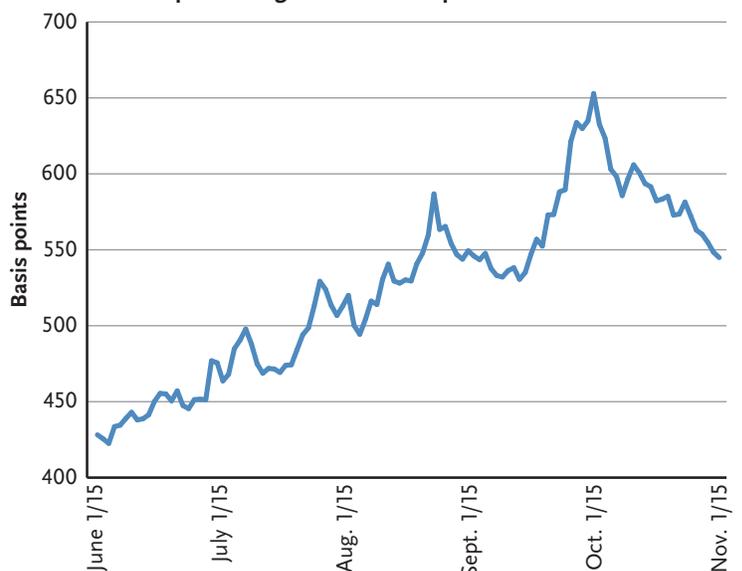


William DeRoche, CFA,
Chief Investment Officer and Portfolio Manager,
FFCM, LLC
Portfolio Advisor, AGF U.S. Sector Class

Q: In September and early October, many global markets were exhibiting high levels of volatility. What were your models indicating?

A: SSGA: When we monitor volatility, we use what we call the Market Regime Indicator (MRI), which is used to identify current risk appetites at various stages of the market cycle. The MRI is expressed as a percentage measuring sentiment signals on a rolling one-year basis. In mid-September, the indicator had begun to peak and had crossed into the 80 percentile range, which to us is fairly high. Both equity volatility and debt spreads had hit some of the highest levels we'd seen in about a year. On September 14, our models indicated an allocation of only 13% in growth assets so we were very defensively positioned for the latter half of the month. By the end of September, high yield spreads broke 650 basis points for the first time since mid-2012. Since that time, it has been a slow but steady cooling off in terms of debt spreads as well as equity implied volatility levels.

U.S. Corporate High Yield Bond Spreads



Source: Barclays Capital, November 2, 2015



What are you doing after work?®

Highstreet: At Highstreet, our market risk model consists of two components: volatility and momentum. Both components are measured against their own history. Our model signaled the first spike of volatility in mid-August and this “High” risk regime was confirmed at the end of August. Combined with weaker momentum that month, AGF U.S. Sector Class was allocated 50% to cash. Throughout September, market volatility had escalated higher so that an “Extreme” risk regime was confirmed and we moved to a 100% cash position at the end of that month. In the “Extreme” risk regime, the momentum signal doesn’t impact cash allocation.

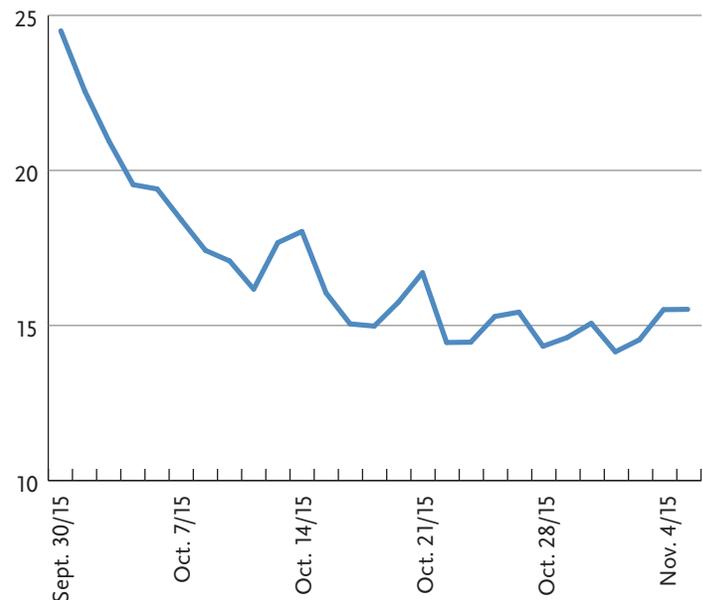
Q: Things seemed to calm down in October. Did the models support that assessment and what allocation changes, if any, were made to both AGF Flex Asset Allocation Fund and AGF U.S. Sector Class?

A: SSGA: Currency volatility had actually peaked earlier in August and begun to return to a more normal state, so by the time we rolled into the second week of October, conditions had eased to the point where we could begin the ‘re-risk process.’ So, on October 12, we provided the signal to increase the allocation to growth assets to 28% in AGF Flex Asset Allocation Fund. This was funded from a combination of defensive assets as well as from the cash allocation. Some of the Fund’s long bond exposure, which can be a defensive position we like to recommend to provide the portfolio a little bit of tail-risk protection against an equity sell-off, was also reduced. We recommended adding back to developed equities both in the U.S. and globally.

In October, we continued to see volatility decline and the markets return to a more ‘normal’ environment. So, on October 19, we received a confirming signal that conditions had eased enough that we could move forward in re-risking the portfolio and recommended raising the allocation to growth assets to 42%. Again, the longer-duration bond positions and the cash position that made up the defensive allocation were reduced.

Highstreet: Starting in the second week of October, we observed a rapid decline in market level volatility. For example, the CBOE Volatility Index (VIX), a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices, had fallen from the mid-20s at the beginning of October to mid-teens by the end of the month.

CBOE Volatility Index (VIX)



Source: Bloomberg, November 2, 2015

However, this decrease was not enough to signal a move to increase equities until the end of the month. The momentum improved through October, however it is still below its historical average. So, the momentum signal did not affect our cash allocation decision within AGF U.S. Sector Class.

We maintained a 100% cash position until the end of October. On November 2, our model confirmed a “Calm” reading on market volatility. The portfolio was therefore rebalanced with a 100% exposure to the equity market (i.e., zero cash).

Q: How are you currently positioning the portfolio following this period of high volatility? What industries or geographic regions are you focusing on?

A: SSGA: As part of our research, we look at underlying asset class models that give us signals on roughly a hundred different asset classes including countries and sectors. Geographically, the areas we continue to like are non-U.S. developed markets, specifically Europe as well as Asia-Pacific markets.

In terms of valuations, the U.S. market is currently sitting at around 16 times forward earnings, whereas Europe and the Asia-Pacific markets are closer to 13 times forward earnings. Our quantitative models get more granular than that but that is one way you can look at the underlying quantitative analysis. You couple that with the overall policy backdrop where even though we've seen timing expectations for an interest rate hike push out in the U.S., we're still looking at a more favourable policy backdrop in the European and especially Japanese market. Recent statements from the European Central Bank indicate that they're potentially getting ready to ramp up for some additional quantitative easing. In Japan, it's perhaps a little bit less clear but at the very least the government needs to take additional steps to reach their 2% inflation target from where they are right now. Within the Asia-Pacific region, we are most constructive on Japan right now. However, we think if China continues to take steps in terms of stimulus, that could be beneficial to the region as a whole.

Within our models, Canada is still negatively rated but we've seen improvements both in terms of valuations as well as sentiment. When we look at sentiment, we look at things like earnings revisions and sales revisions. So, again coming from a very low level we're not quite bullish on it yet but we're much less bearish than we used to be.

From a sector allocation perspective, we did add exposure within domestic U.S. markets, particularly in the Industrials, Consumer Discretionary and Health Care sectors. If we think about why these sectors are ranking well within our metrics, Consumer Discretionary and Health Care are benefiting from pretty good momentum in the marketplace as well as high expectations for both earnings and sales growth. In Health Care, while

it remains a bit expensive relative to other sectors, it looks pretty healthy moving forward in terms of earnings momentum and sentiment. For companies within Industrials, we have seen an improvement in earnings and sales expectations. I'll caveat that by saying it is still a fairly challenging potential environment, but the quantitative models have begun to improve quite a bit for Industrials.

In terms of our fixed-income exposure, we continue to hold a longer-term treasury position even though we did dial it back in order to increase our growth assets. We have a healthy allocation to intermediate-term corporates, which gives us broad coverage and a little bit of spread in fixed-income markets, and an allocation to cash, although down from where we were when we were in higher risk-aversion regimes. Across the fixed-income market, our holdings are predominantly U.S. fixed-income asset classes as interest rates in global developed markets like Germany and Japan are essentially one half to one quarter of the meager interest rates in places like the U.S.

FFCM: Coming into the month of October, AGF U.S. Sector Class had its largest overweight positions in Industrials and Utilities and largest underweights to Health Care and Consumer Staples. Industrials had a positive ranking based on our multi-factor value model while Utilities, the smallest sector, ranked well in our capitalization component and had moderate value and momentum scores versus the other sectors in the S&P 500. Health Care's underweight was mostly due to its high capitalization relative to other sectors and moderate value and momentum scores. Consumer Staples was the most expensive sector based on our value model causing its underweight position.

During October, Health Care's valuation rank improved substantially as stocks within the sector sold off after earnings announcements, comments made by political figures about mergers and acquisitions and drug pricing policies. The sector moved to an overweight position. Likewise, the Materials sector value ranking improved due to a recent sell off and moved from a moderate to full overweight versus the Index weight. Consumer Staples remained a maximum underweight while Financials went from a moderate to full underweight position due to its high valuation and large capitalization rankings.

Conclusion:

AGF offers investors many solutions to help manage downside volatility while still offering active market participation.

Since 1998, Highstreet Asset Management has been rooted in empirically based research and the combination of quantitative research and fundamental investing. Our quantitative capabilities are strengthened by our partners at FFCM, LLC and State Street Global Advisors.

For more information on how our teams identify risks and manage volatility, visit AGF.com/FlexAA and AGF.com/USSector.

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