TURNER INVESTMENTS COMMENTARY

Hon. Garth Turner PC

Senior Vice President, Private Client Group, Financial Advisor

416-346-0086

Douglas Rowat

Vice President, Private Client Group, Portfolio Manager

416-777-6403

David Finley

Senior Vice President, Private Client Group, Financial Advisor

416-777-7002

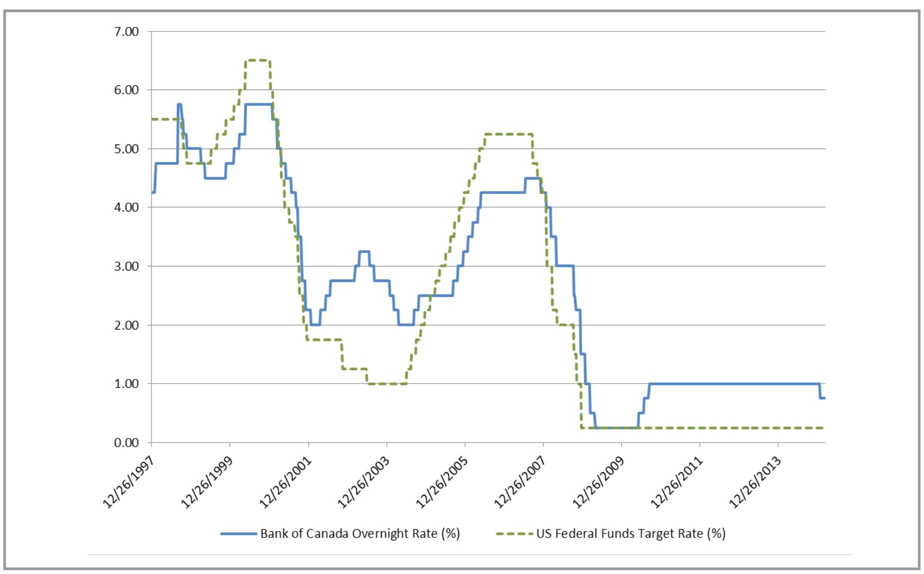
THE NEW RETIREMENT: The Rising Importance of Growth Assets

THE BOND MARKET: Between a Rock and a Hard Place

We have now been in a bond bull market for nearly 35 years with bond yields steadily moving lower and bond prices higher. Several factors drive investors towards bonds: uncertainty over market conditions, a comparatively attractive yield for bonds vs. other assets (i.e., a better risk-reward scenario) and demographics—older investors, particularly retirees, seeking the predictable income that bonds provide.

Over the near term, we are firmly in the camp that expects higher interest rates (and hence higher bond yields) later this year from both the US Federal Reserve and eventually from the Bank of Canada. Because of strong labour market data, a gradually recovering housing market and solid ISM manufacturing numbers, we fully expect that the US Fed will raise interest rates from the historically low 0.25% before the fall. And, as the chart below suggests, what the US Fed does with its interest rate policy, the Bank of Canada typically does as well.

Bank of Canada Has Generally Followed Rate Policy of US Fed



Source: Bloomberg, Raymond James Ltd.

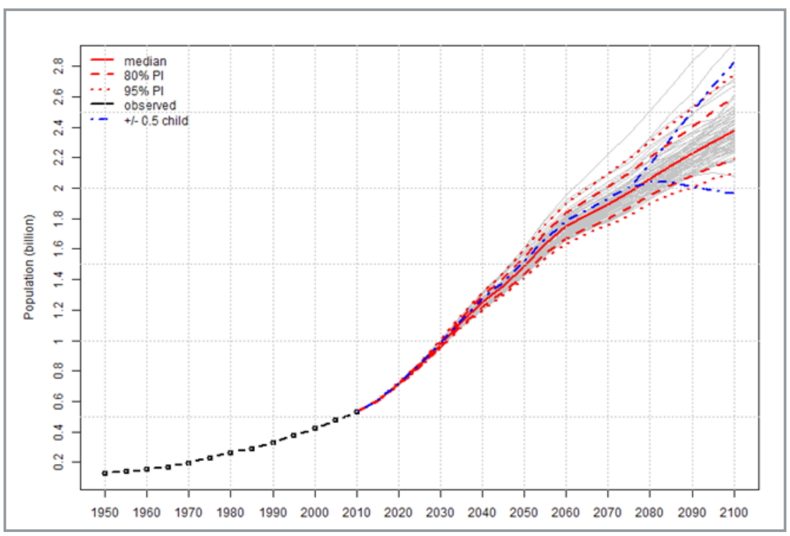
From this perspective, investors should expect interest rates and bond yields to gradually move higher over the near and even medium term. However, from a long-term perspective, we believe that sustained bond yield rallies will forever be blunted by demographics. The expected higher demand from ageing investors will ultimately cap yield expansion. In our view, we will never again see the double-digit yields of the 1980s and it’s improbable that we will even see 5% yields for most developed-market bond maturities, at least not for any sustained length of time.

Demographics are a powerful market force and have unavoidable influence. The developed world is getting older—and rapidly so—and this will forever reshape long-term investment strategies. Older investors will keep bond yields low and we believe these low yields will be insufficient to fund most retirements. Investors seeking retirement income will need to consider holding more growth assets. A future retirement asset allocation following the traditional 60% fixed income/40% growth model of the past will be ineffective. To fund retirement needs, our clients will need to consider embracing more growth assets in their portfolios. Over the longer term, we believe that the “new retirement” asset allocation is likely to require the reverse: 60% growth/40% fixed income.

THE WORLD IS GREYING

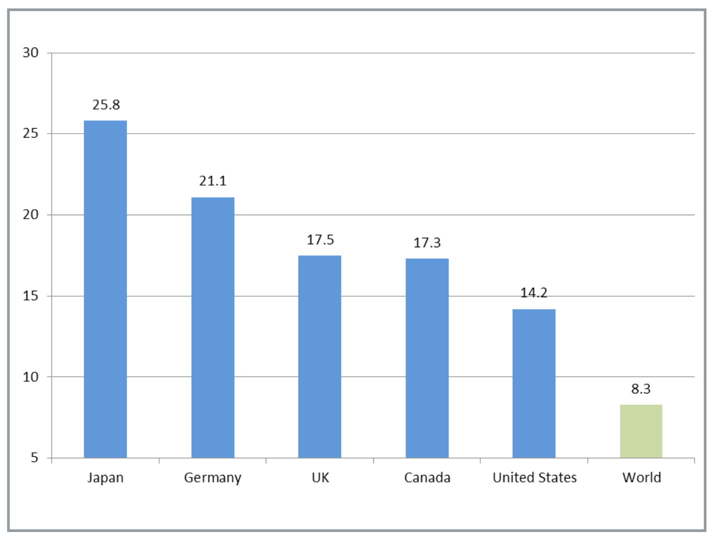
The world, particularly the developed world, is ageing. The below chart (left) highlights the inevitable and dramatic future rise in the world population age 65 and older.

World Population Age 65+



Source: United Nations

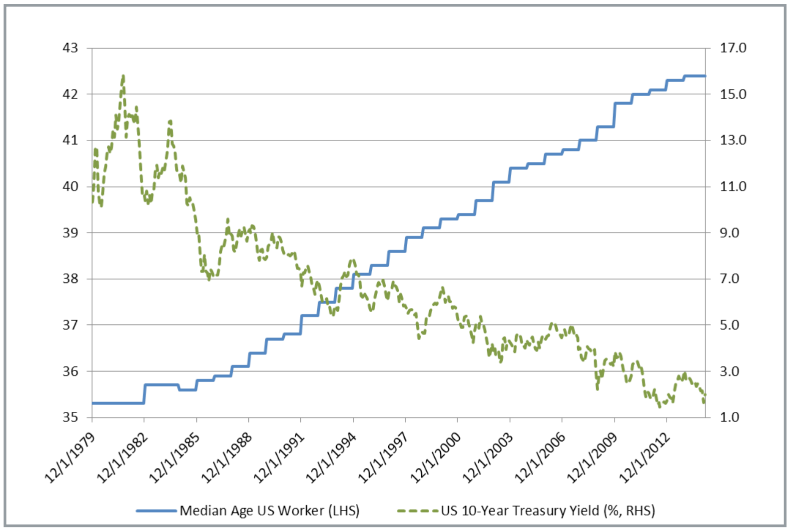
% Population Over 65 Years



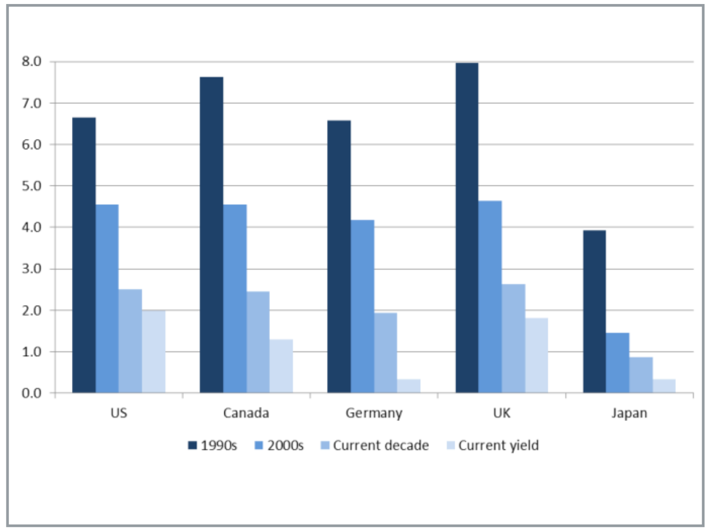
Source: Bloomberg

It should come as no surprise that older investors seek predictable income. They demand more fixed income because they have a reduced time horizon to recover from the shocks of equity market volatility (the 2008–2009 credit crisis being the most recent example) and require the stability that bonds provide. In the US, for example, we have seen a steady inverse relationship between the average age of US workers and bond yields (see chart on next page). As the population has aged, the demand for fixed income has increased and therefore bond yields have plummeted. We have seen this most dramatically in Japan, which has one of the oldest populations in the developed world (see righthand chart on page 2). Partly as a result of its ageing population, Japan's 10-year bond yield dropped to a record low of only 0.20% earlier this year.

As US Labour Force Has Aged, Bond Yields Have Plummeted



Steadily Falling 10-year Bond Yields (%) In Developed World



Source: Bloomberg, Raymond James Ltd.

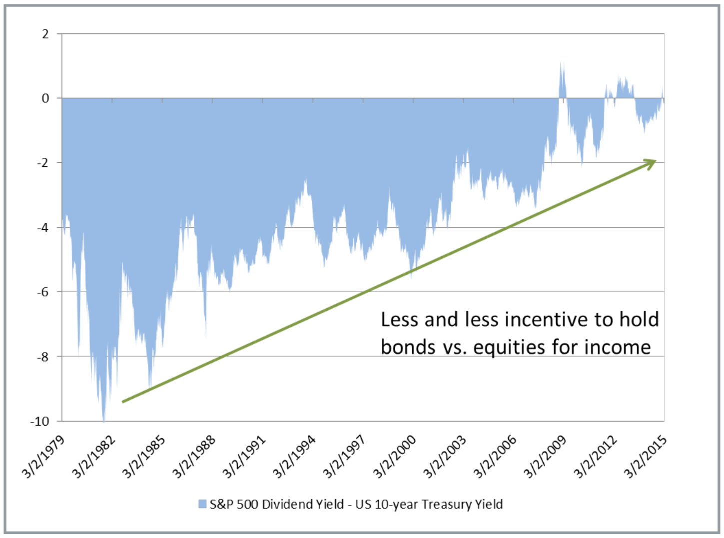
In developed markets, if bond yields become even remotely attractive, bonds will quickly be purchased by ageing investors, which will cap yields and likely keep them forever at below-normal rates. In short, we believe bond yields will never be able to rise meaningfully in the face of the upcoming shift towards an older investor base demanding safety and predictable returns.

Overall bond returns have remained attractive throughout the years because prices have moved higher; however, even this benefit of bond ownership appears to be ending. Bond *price* rallies will face the obstacle of unattractive yields. We are already starting to see this in developed markets with outright negative bond yields or bond yields that are so low that they are effectively negative after inflation is factored in. In other words, achieving a capital gain from a bond will be more difficult over time because yields have little room to move lower. The end result is that an environment of low, and rangebound, bond yields is likely to persist over the longer term: on one end capped by unattractive yields, which will discourage buying, and at the other end capped by strong demand from ageing investors, who will buy at the slightest sign of life from yields. Either way, over the long term, we believe that the resulting yields and overall gains will be unattractive for retirement income.

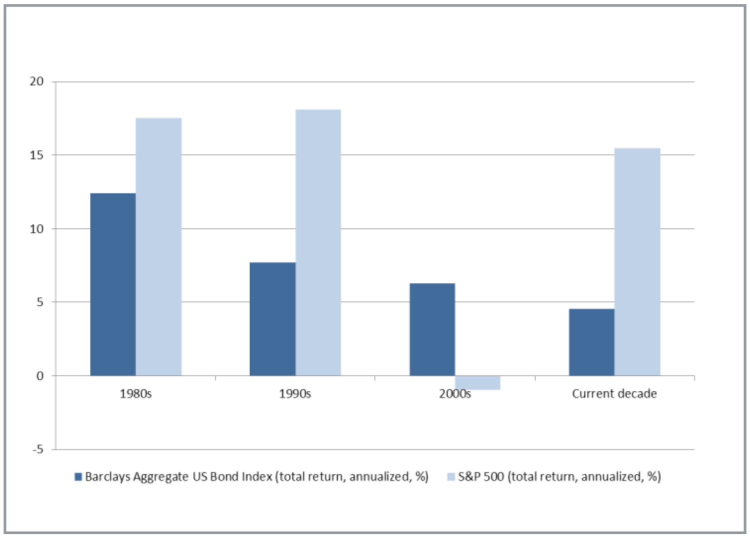
IN YOUR RETIREMENT: MORE EQUITIES

So what's the long-term solution to achieving more retirement income if bond yields and returns are likely to remain inadequate? We believe investors will need to hold more growth assets in their portfolios. As bond yields have fallen, equity dividend yields have become comparatively more attractive. In fact, to use the US market as an example, equities have almost reached yield parity with bonds (see chart below). But equities, of course, carry more growth potential than bonds and company dividends also grow over time, whereas bond coupon payments are almost always static. This means that your overall equity income is likely to, at the very least, keep pace with inflation.

US Equity Yields Near Parity with 10-Year Treasury Yield



Total Returns From US Bonds Have Steadily Been Declining Each Decade



Source: Bloomberg, Raymond James Ltd.

Naturally, equities come with more volatility and therefore require more attentive and active management. This is our job. However, we firmly believe that our clients will need to increase (or at least maintain) their equity exposure in their retirement years and defy the traditional wisdom of steadily lowering it. As long as the equity holdings are constructed in a balanced, diversified manner both in terms of market cap and global exposure, the ensuing volatility can be significantly reduced. But in the future simply having a retirement portfolio overweighted with bonds and fixed income just isn't going to cut it anymore.

TURNER INVESTMENTS OF RAYMOND JAMES LTD.

40 King Street West
Suite 5300, Toronto, Ontario   M5H 3Y2

Tel: 416-777-7000 | Fax: 416-777-7020

www.turnerinvestments.ca

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