EMPIRE LIFE ASSET ALLOCATION GIF COMMENTARY

2023 Recap of the Empire Life Asset Allocation GIF

FUNDGRADE A+®[2]
ACHIEVED FOR THE YEAR 2023

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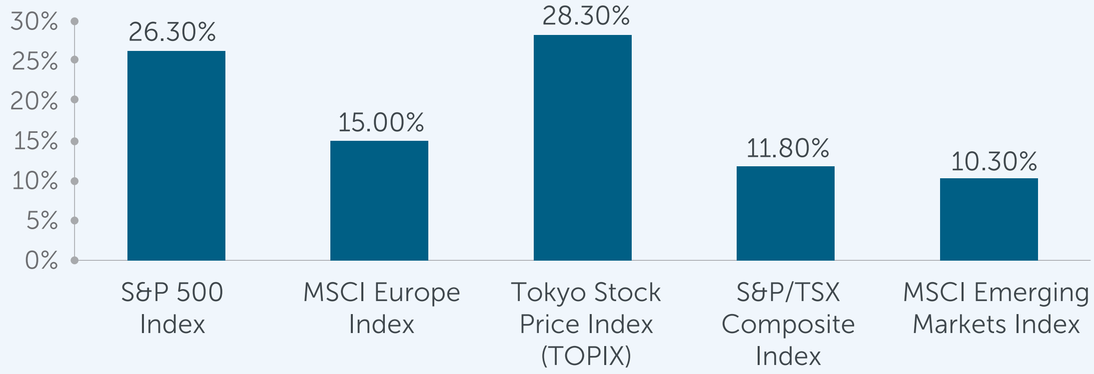
As we enter the new year, we wanted to recap some of the headlines in 2023 that have made it a very eventful year for both the equity and bond markets. Global equity markets have had a strong rebound following the dismal performance observed in 2022, with the MSCI World Index up 23.8% as of December 31, 2023. The S&P/TSX Composite Index has lagged but still finished the year at 11.8%,[1] and the FTSE Canada Universe Bond Index was up 6.7% as of December 31, 2023, following two years of declines. During this period, cash has been a "safe haven" that has offered attractive returns relative to the accompanying risk with a current yield of around 5%.

Some of the key events in 2023 include:

- The strength in both consumer spending and employment, along with higher inflation, led to further monetary policy tightening from central banks around the world. The Bank of Canada has hiked interest rates 10 times since March 2022, increasing the overnight lending rate to 5% from 0.25% at the beginning of the hiking cycle. Similarly, the U.S. Federal Reserve has raised interest rates 11 times since March 2022, increasing the target fed funds rate to 5.25%-5.5%, from 0-0.25% at the beginning of the hiking cycle.
- As we expected, inflation has trended lower throughout the year across much of the developed world. However, it still remains above most central banks' inflation targets.
- With the economy's resilience, expectations of a "soft landing" have increased investors' enthusiasm, driving a change in investor sentiment that increased equity market multiples, leading to higher valuations and strong global equity performance.
- The S&P 500 Index has been a strong performer largely due to several tech growth stocks dubbed the "Magnificent Seven," including Apple, Microsoft, Nvidia, Amazon, Meta (Facebook), Tesla and Alphabet (Google). They have accounted for approximately 60% of the gains in the S&P 500 as of December 31, 2023.

[1] The MSCI World Index and S&P/TSX Composite Index returns represent total returns in Canadian dollars.

2023 index returns



Source: Morningstar Research Inc. as of December 31, 2023. Returns are presented in local currency. The MSCI Emerging Markets Index is listed in local currency to remove the impact of foreign exchange fluctuations.

Performance of Empire Life Asset Allocation GIF

	1-year	3-year	5-year	10-year	15-year	Since Inception
Empire Life Asset Allocation GIF - Class A	7.2%	3.9%	5.2%	4.5%	5.8%	5.0%
Morningstar Canada Insurance Tactical Balanced	8.2%	1.9%	4.2%	3.0%	4.6%	n/a
Quartile Ranking	3	1	2	1	1	n/a
Number of Funds in Category	192	184	181	72	33	n/a

Source: Morningstar Research Inc., as of December 31, 2023. Performance shown represents that of the Class A fund which is no longer available to new investors. Annual Compound Returns: All returns are annual compound rates of return and calculated after taking expenses, management and administration fees into account. Past performance is no guarantee of future performance. The inception date of the fund is May 2, 1994.

The fund produced positive returns in 2023, and marginally underperformed its peers largely due to an overall underweight position in equities (overweight in bonds) and an overweight in Canadian equities, where the S&P/TSX Composite Index lagged most major indexes around the globe. For example, the MSCI World Index was up 23.8%, compared to the 11.8% gain for the S&P/TSX Composite Index.

Over a long-term horizon, the Empire Life Asset Allocation GIF has consistently outperformed its peers.

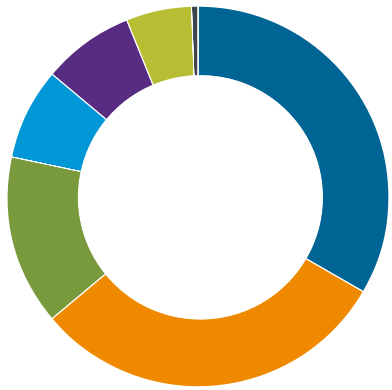
Over a two-year time period, the fund has performed very well. We believe this is particularly important as this was the beginning of the risk-off environment for both fixed income and equity markets, as the U.S. Federal Reserve and Bank of Canada began their historical interest rate increases back in March 2022. Over a two-year time period, the fund's performance was 0.2% compared to the Morningstar Canada Insurance Tactical Balanced category average of -2.1% (as of December 31, 2023).

In 2022, we positioned our portfolio with the view that high inflation would lead to higher interest rates. However, the extent of the stickiness of inflation has been a surprise to many, including us. Our bond portfolio had a shorter duration versus its benchmark. Generally, longer duration bonds underperform in a rising interest rate environment. We also tilted our equity holdings towards value stocks/markets, which tend to outperform growth stocks/markets in a rising interest rate environment. Growth stocks tend to realize a larger share of their cash-flow earnings over a longer time horizon, making them sensitive to higher interest rates that will result in a lower intrinsic value.

Tactical asset allocation decisions made in 2023:

In 2023, we made several tactical moves that improved the fund's performance. These included:

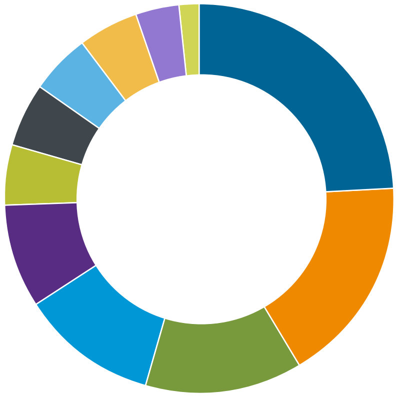
- **An increase in the fund's bond duration: from 5.7 years at the beginning of the year to 7 years as of December 31, 2023.** As central banks appear to be nearing the end of their rate hiking cycles and economic data are starting to show signs of deceleration, we feel that increasing the fund's duration is a way to increase exposure to an asset class that is expected to outperform in an environment where investors exhibit a lower appetite for risk.
- **A reduction in the fund's Canadian equity exposure from about 39% at the beginning of the year to about 31% as of December 31, 2023.** This decision is centred around the fact that we believe a macroeconomic slowdown will likely be a disadvantage to Canada's cyclical and commodity-based market. We expect that the financials and energy sectors, which comprise around half of the S&P/TSX Composite index, will be particularly affected. Despite the reduced allocation, we remain overweight in Canadian equities, which represented nearly 59% of our overall equity exposure as of December 31, 2023, compared to 69% at the beginning of the year. We believe the Canadian market is attractive from a valuation perspective, especially versus most other major global indexes.
- **Inclusion of a slight exposure to the Empire Life Global Growth GIF.** Historically, neither growth nor value investment styles have consistently outperformed the other. Instead, there are periods where growth has been in favour (e.g., 2022) while value has underperformed (e.g. 2023) and vice versa. Adding some growth exposure to a portfolio heavily tilted towards value can help from a diversification standpoint.



Asset allocation

Canadian Bond	32.8%
Canadian Equities	31.1%
U.S. Equities	14.6%
U.S. Bonds	8.0%
International Equities	7.8%
Cash and Cash Equivalents	5.6%
International Bonds	0.4%

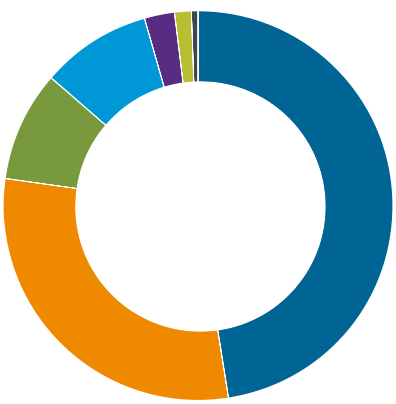
As at December 31, 2023. Source: Empire Life Investments Inc.



Equity sector allocation

Financials	24.3%
Industrials	17.3%
Information technology	12.9%
Energy	11.5%
Consumer discretionary	8.4%
Materials	5.2%
Consumer staples	5.1%
Communication services	5.1%
Health care	4.9%
Utilities	3.6%
Real Estate	1.7%

As at December 31, 2023. Source: Empire Life Investments Inc.



Bond sector allocation

Investment Grade Corporate	42.8%
Federal Government	27.0%
Provincial Government	18.1%
High Yield Corporate	8.2%
Floating Rate	2.4%
Preferred Shares	1.1%
Convertible	0.5%

As at December 31, 2023. Source: Empire Life Investments Inc.

Outlook – Maintaining caution heading into 2024:

We are maintaining the fund's conservative allocation to equities with a current equity position of 53.5%. This is below the lower end of its targeted 55% to 65% range. A combination of factors lead us to believe that the risk/reward trade-off is marginally skewed to the downside, such as signs of a macro slowdown, strong 2023 performance and what we view as fair valuations. These observations have also led us to increase the duration of the fund's bond allocation.

As always, we constantly monitor forward-looking indicators to inform our views on portfolio positioning. For example, a short-term tactical move we recently made in the portfolio included adding a low single-digit exposure to the Empire Life Global Growth GIF in mid-October. This was followed by a tactical reduction in our Canadian equity exposure by a similar amount after a strong equity market rally in November that saw the MSCI World Index benefit. While we typically take a longer-term view with our tactical moves, we felt that an 8.3% rally in the MSCI World Index in one month, versus 7.5% for the S&P/TSX Composite Index for the same period, warranted a more decisive action.

In conclusion, our team approach to running the Empire Life Asset Allocation GIF continues to serve our investors well as investment decisions are viewed through multiple lenses. We meet on a regular basis to discuss broad themes impacting the markets and portfolio positioning. We leverage our team's expertise to make informed decisions that are supported by rigorous and detailed research across different asset classes, sectors, and regions.

Contact us to find out more about the Empire Life Asset Allocation GIF!

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