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## Smoothing the ride with currency management

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The Canadian economy, on aggregate, has exceeded expectations so far in 2016. The latest data suggest that first quarter GDP growth could be more than twice what the Bank of Canada had projected at the start of the year. Though the resource sector has been a drag on global trade, a broad range of non-energy exports have posted strong results, with motor vehicles and parts, consumer goods and forestry products achieving double-digit gains over the past year. The Bank of Canada's previously dovish tone has become more neutral while, in contrast, the previously bold U.S. Federal Reserve has become more cautious, scaling back its intentions to raise interest rates due to global economic concerns. The Canadian dollar has recently come back into vogue due in large part to the shifting tones of the central banks, an improving economic outlook for Canada, and a rebound in oil prices.

We are indeed seeing the effects of mean reversion – prices and returns moving back toward their average – as the effects of several quarters of a weak currency have begun to filter into the Canadian economy, leading to a stronger exchange rate. We have also witnessed the role that valuations play in currency markets. During the first six weeks of the year when global equity markets sold off, the U.S. dollar, which would typically rise due to its role as a safe haven, was flat against the Canadian dollar and actually declined against a trade-weighted basket of global currencies. The overcrowded U.S. dollar trade began to unwind as overexcitement about the health of the domestic U.S. economy gave way to acknowledgement by the Fed and market participants that the U.S. economy would not be able to grow briskly on its own while the rest of the world is slowing.

Currency exchange rate fluctuations are largely cyclical between countries that are major trading partners, such as Canada and the United States. As a result, there is some predictability over the direction of currency values over the long term. For example, if the Canadian dollar is trading below fair value, we would expect it to rise over the long term. The further it is from fair value, the greater conviction we would have on the future direction of the currency. However, accurately forecasting the level at which a currency will change direction – in other words, calling the bottom or top – is impossible to do. For currencies that are tied to commodities, and therefore to the whim of a few wealthy foreign rulers in the case of crude oil, there is an added element of unpredictability.

The mean reversion currency strategy that we adopted in 2008 addresses the cyclical and unpredictable nature of currency fluctuations by using valuations to guide our decisions. In 2015, we benefited from the strengthening U.S. dollar though we did not participate fully, as we deemed it prudent to protect investors from the rising risk of losses from an overvalued greenback. This year, we limited the downside from foreign currency weakness by staying disciplined and maintaining high hedge ratios

when foreign currencies were at their highs. When the U.S. dollar marked its recent peak at C\$1.46, we were hedging 82% of U.S. dollar exposure. Following its quick sell-off, we brought the hedge ratio down to 60% to take profits. The result has been a smoother ride for investors.

Following the brief technical recession in Canada last year, the country is on track to achieve three consecutive quarters of GDP growth. In fact, recent data point to a strong reacceleration, which has the loonie flapping its wings harder than it has in a while. However, the Canadian dollar overshot its near-term fair value during its decline and will likely overshoot on the way back up. Some of the gains will likely be undone, but it is impossible to know exactly when. Our disciplined process removes the guesswork and provides a sensible framework for us to adjust foreign currency exposures in a reasonable and consistent manner while effectively buying low and selling high. The currency management strategy is part of our overall risk management process, which ensures that we are helping investors get from point A to B with fewer and smaller bumps.

*Combined top 15 equity holdings as of March 31, 2016 of the Evolution 40i60e Standard portfolio with Alpha-style exposure:*

1. Microsoft	6. Apple	11. Chubb Limited
2. Altagas	7. Atco	12. Synchrony Financial
3. CGI Group	8. Alphabet – Class C	13. Simon Property Group
4. Manitoba Telecom Services	9. Toronto-Dominion Bank	14. Alphabet – Class A
5. Tourmaline Oil	10. Thermo Fisher Scientific	15. Medtronic

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