Finding Income

There is a growing strain on the balance sheet of Canadian households, pushing them to find new sources of income so they can achieve their desired lifestyle upon retirement. In parallel, we are experiencing a difficult investment landscape – peak market valuations and a challenging yield environment.

Households need to focus on understanding the link between their assets and expenditures, so they can determine what their investment income needs will be upon retirement. It is clear that traditional investment portfolios are unlikely to suffice and retirees will need to unearth unique sources of investment income going forward. While this needs to be the focus of investors, the asset management industry is focused elsewhere.

We strongly believe that these issues are the most significant financial challenges Canadian families face today. In this paper we explain these challenges and one of the investment strategies – The All Weather Strategy – that we have used to tackle this problem for our families.

February 2019

Copyright © Waypoint Investment Partners

Summary

While a concise whitepaper will never be sufficient to discuss the full thinking that has gone behind issues like The Asset-Income Gap, Passive Investing, Market Valuations & Our Investment Process, the goal in writing this whitepaper is to facilitate a conversation on these key issues. Please reach out to our investment team if you'd like to learn more about any of the topics discussed in this paper.

1 An analysis of household assets, income and spending patterns suggests families will struggle to maintain their lifestyle upon retirement; we believe this is the greatest financial challenge that Canadian families face today

- Canadian families have the majority of their net-worth tied to the value of their house, with just ~40% of assets being truly liquid. We sought to understand if these liquid assets were sufficient to support their household expenditures
- By modelling the current level of liquid assets, investment income and expenditure patterns of Canadian households, it appeared unlikely that these liquid assets would be sufficient to last the entirety of one's retirement if their current standard of living / spending was maintained
- It is clear to us that during retirement years, many Canadian households will need to find ways to generate additional income, sell their real estate / other assets or find excess investment returns if they seek to maintain their standard of living
- We believe this ***"Asset-Income Gap"*** is the greatest financial challenge that Canadian families face today

2 Despite this overwhelming evidence, the asset management industry is focused elsewhere - the majority of investment options are not built around your income needs and your lifestyle

- Instead of directly designing investment strategies to tackle this challenge, we find asset managers providing an endless buffet of confusing investment options, unwarranted fees and an incentive to focus on "what to sell you" vs "what you need"
- This frustrating reality has pushed households to seek refuge in passive investments, & ETFs. We believe that these alternatives do not address the heart of the issue. Investors are mistakenly connecting "low fees & ease" with "value in the underlying investments"

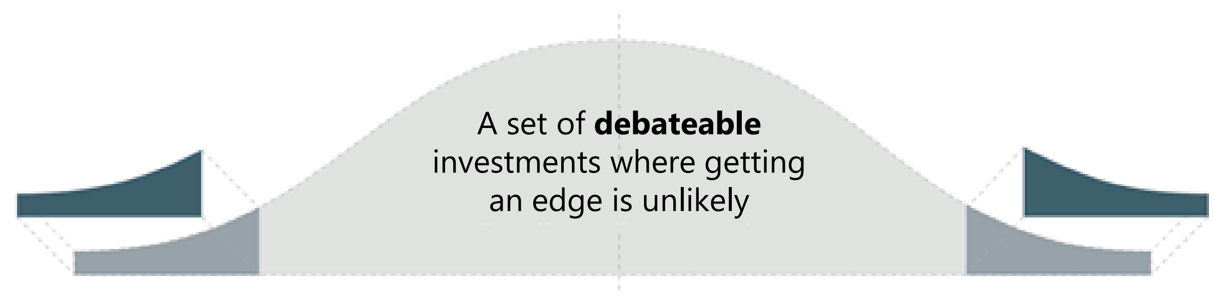
3 The investment question we have aimed to solve for our families: "In this tough investment environment, how do we ground our investment strategies in our needs and expenditures, to achieve the right compounding and income requirements so we can achieve our desired lifestyle upon retirement?"

- We believe the long-term outlook for traditional portfolio compositions of stocks and fixed income securities are historically low due to a multitude of factors - including peak market valuations and a challenging yield environment
- To achieve the income and yield requirements that have been achieved in the past (and which retirees still need) investors will have to use unique portfolio strategies, alternative sources of income, and an expanded palette of asset classes to achieve this target
- This outlook doesn't have to paint a gloomy picture for retirees. There is a clear link between liquid assets, investment returns and spending. You need to think of these three elements together. If you develop and understanding of your unique "retirement equation" based on these three elements, you can create a sense of control over your retirement outcomes and the associated peace of mind.

4 One of our approaches to these issues is the All Weather Strategy - we strive to find solutions to this challenge by unearthing businesses with unique income generating or compounding opportunities

- We focus on investing in business models we understand and management teams we have worked with historically. This approach leverages our years of investing experience to conduct rigorous due diligence on each of our investments and focuses on prudence & conservatism to protect your capital in tough economic times.
- We think of public equities as a spectrum where the majority of opportunities have highly debatable outcomes – their "investment thesis" is highly debated between portfolio managers and covered by most firms – making it difficult to invest with confidence
- Instead, we narrow our focus to business models that provide investors with (i) high yields that we rigorously diligence to ensure cash flow sustainability and (ii) companies with undebatable financial evidence of their ability to compound cash flows at attractive returns on capital. Combined, we can create a unique portfolio of 20-30 companies where we can invest with confidence.
- We then structure an options overlay to minimize large market draw downs

Capital Distributors
Unique opportunities to find income and attractive yields in a tough "yield environment"



Capital Compounders
Companies that provide long-term growth with attractive returns on invested capital

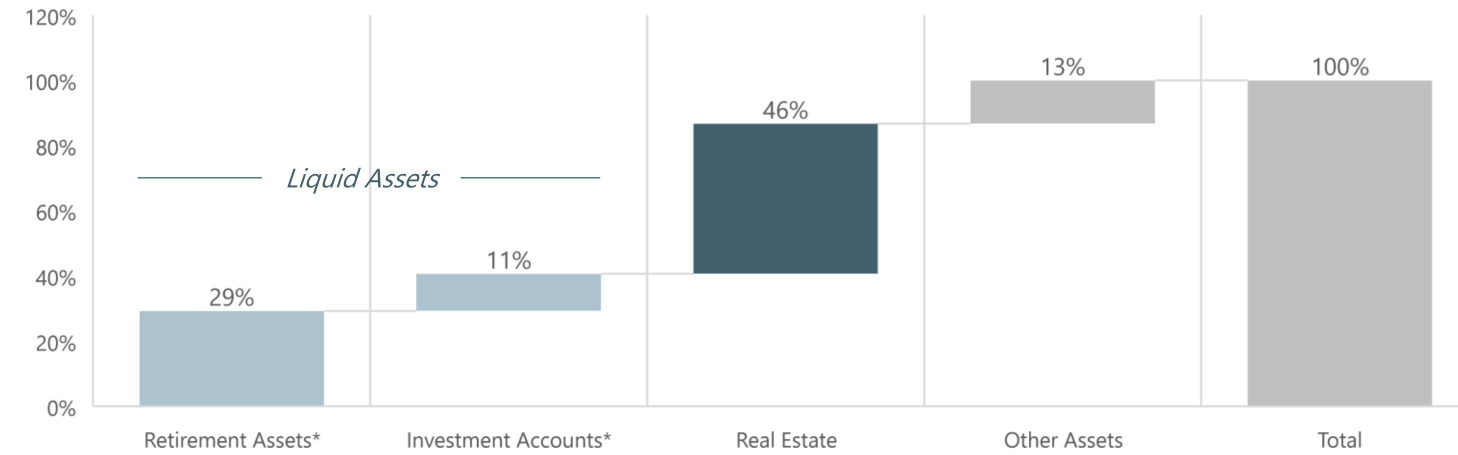
1 An analysis of household assets, income and spending patterns suggests families will struggle to maintain their lifestyle upon retirement; we believe this is the greatest financial challenge that Canadian families face today

The majority of Canadians' household assets are linked directly to the value of their house. Their "liquid assets" – assets they could readily access for income - accounted for approximately 40% of their total household assets, while nearly half of their assets were tied to real estate (Figure 1).

Upon retirement, a household might have to decide to:

- Sell their real estate assets to create more cash or rely on real estate for rental income
- Reduce their standard of living / expenditures
- Attempt to find investors who can deliver excess returns to increase the value of their investments
- Work longer to increase employment income

Figure 1: Distribution of Canadian Household Assets



Source: Statistics Canada, CANSIM 205-0004 2016 Assets, Waypoint Investment Partners Analysis
* Retirement Assets (RRSPs, LIRAs etc), Liquid Investments (Stocks, Bonds, & Other Liquid Securities)

Planning for retirement usually involves the following steps. A family:

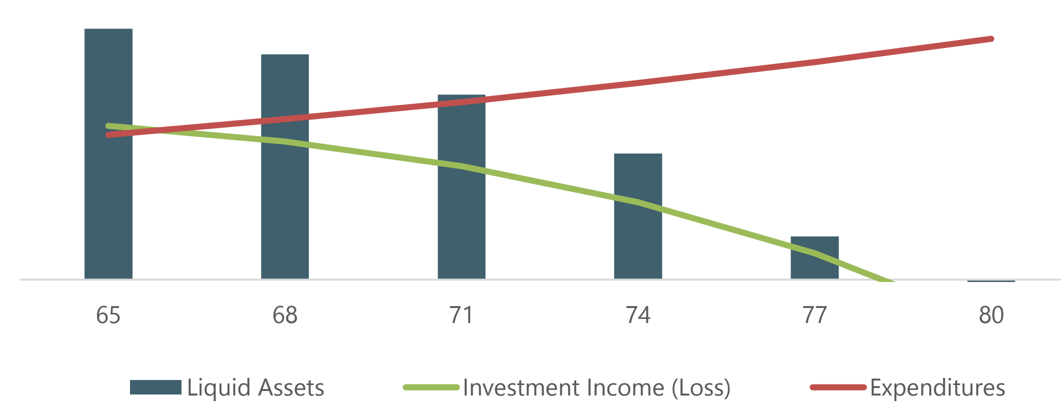
1. Determines the **value of the liquid assets** they will have upon retirement	2. Understands monthly / yearly **expenditures** they make to allow for their desired lifestyle	3. Sets realistic expectations for the **investment income** they will be able to generate	4. Uses these to determine **how long their liquid assets will last** and if one of the 4 alternatives need to be considered

In fact, it is informative to apply these four steps for the average Canadian household in general.

Statistics Canada produces detailed reports on Households assets, debts, liquid investments and spending patterns, allowing us to build a model for Canadian households on average using:

- The median & average asset level for Canadians between 55-64
- Expenditure levels for the same age group (adjusted to exclude mortgages they finish paying by retirement + dependants who they no longer pay for at retirement)
- An assumed reinvestment rate between 5-10%, and appropriate tax rates
- Using historical averages for investment returns, Canadians could maintain their lifestyle for 10-15 years (Figure 2: The graph uses 7% as a midpoint)

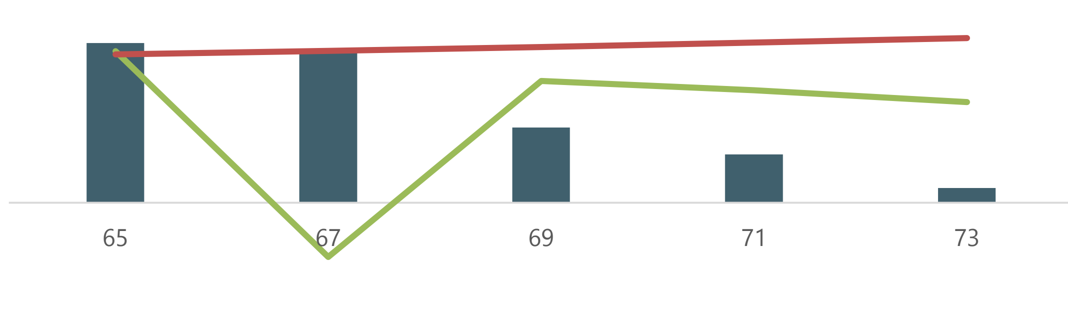
Figure 2: Under the status quo, households' liquid assets would last 10-15 years



Source: Statistics Canada, CANSIM 205-0002, 205-0004, 203-0026, Waypoint Investment Partners Analysis
Graphical representation uses 7% as a target compounding rate

Under the status quo, Canadian households would only have sufficient liquid assets to maintain their current lifestyle for ~13 years – making it unlikely that these liquid assets will be sufficient to last their entire retirement.

Figure 3: A significant market downturn could imply liquid assets would last ~8 years



Source: Statistics Canada, CANSIM 205-0002, 205-0004, 203-0026, Waypoint Investment Partners Analysis. Graphical representation uses 7% as a target compounding rate but assumes in year 2 markets are down 15% and in year 3 are down 5%

If we adjust this model slightly to incorporate 1-2 years of negative investment performance, this equation becomes even harder to maintain. Shortly after you retire, a "market downturn" (a 15-20% market correction) would cause those liquid assets to last 4 years less.

Canadian households will need to consider how to generate additional income or liquid assets if they seek to maintain their standard of living

Retirees will find it necessary to consider alternative financial means to finance their retirement. As mentioned before, households could consider (i) selling their real estate or other assets to create more cash or rely (ii) reduce their standard of living / expenditures (iii) attempt to find investors who can deliver excess returns to increase the value of their investments (iv) work longer to increase employment income etc.

2 Despite acknowledging these retirement challenges, the asset management industry is focused elsewhere - the majority of investment options are not built around income requirements that allow customers to maintain their lifestyle

The investment management business is largely comprised of pooled funds attempting to scale through a "one size fits all" approach. These products have not changed since the 1980s and the general approach unchanged for the past 50 years. The current generation of investors has been dealt a different set of variables than the past and therefore requires a management approach that acknowledges these differences.

Certain industry behaviors have created a lack of trust in the asset management industry…

- A confusing "buffet" of investment options that don't directly approach your lifestyle needs
- Unwarranted fees, incentive structures build around "what to sell you" vs. "what you need"
- Confusing financial jargon and false promises to "beat the market"

…creating a huge flow of funds into passive investing & ETF strategies…

- Canadian ETF AuM has grown from $19.4B in 2008 to ~$146B today (~25% Avg. Annual Growth)
- AuM has doubled since 2014 ($77B -> $146B)
- Sources: Canadian ETF Association November 30th 2017 ETF Flows Report

…but this doesn't address the issues, your needs and presents a number of potential risks

- "Bubble-like" characteristics; equities trading less on fundamentals or the value of the underlying securities the indices hold
- Investors are mistakenly connecting low cost of ownership to value in the underlying securities
- Passive investments do not solve the root retiree issue as we have articulated above

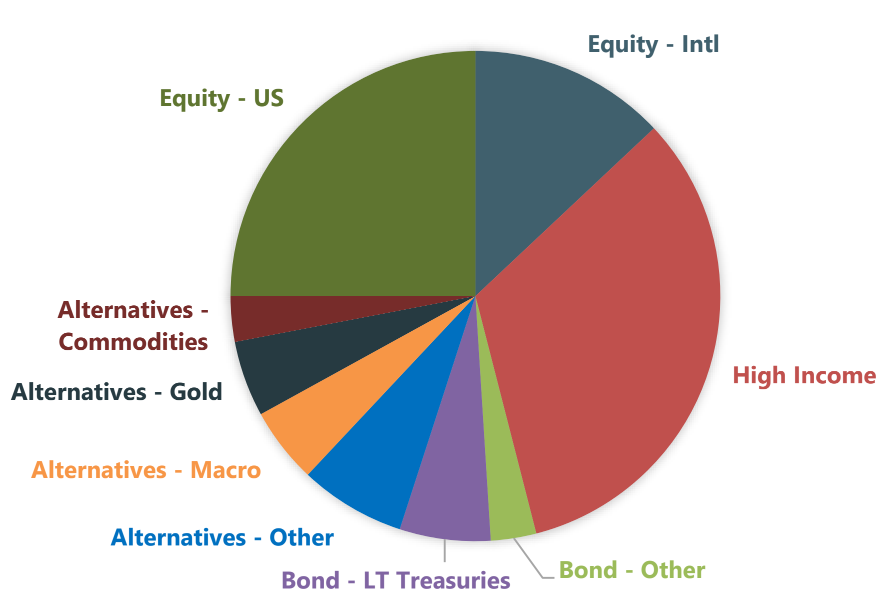
Most households will need to find additional sources of income post-retirement to maintain their standard of living and we believe this will be one of the greatest financial challenges Canadians face today. As such, we can't help by wonder why so many asset managers are not focused on:

- A clear understanding of your specific financial situation (e.g, expenditures, income, lifestyle etc)
- Investment strategies built around those financial needs
- A clear investment process & philosophy that explains how and why they invest the way they do and the reason they have an edge
- A level of honesty and transparency around what your investment expectations should be

Traditional portfolio construction principles (the "balanced" portfolio) fund managers often employ were designed to have a mix of Fixed Income and Equities depending on their clients' age and preferences.

As these portfolios no longer provided clients with the income they need, many fund managers often use a broader range of financial products and attempt to incorporate them into their offerings to clients. The "pie" of a client's assets tend to look more complex with several new products, assets classes and asset mixes. In the illustration below, there are several bond, equity and alternative assets classes built around a "high income" product.

ILLUSTRATIVE "OPTIMAL PORTFOLIO" CONSTRUCTION



Such portfolios do not get to the heart of the asset-income gap that we spoke to earlier. Such portfolios:

- Are highly complex
- Are created from a "buffet" of asset classes
- Appear highly conducive to earning fees – the variety of complex products and strategies tend to be more expensive and the fees associated with all these products would be very lucrative to a financial institution…
- …but still, is not grounded in your financial situation, or necessarily provide you with the income you need to support your lifestyle

3 The real investment question we aim to solve for our families is: "In this tough yield environment, how do we ground our investment strategies in our needs & expenditures to achieve the right compounding and income requirements so we can improve and maintain our lifestyle when we retire?"

We believe the long-term outlook for traditional "balanced" portfolios with traditional stock and fixed income securities are historically low. To achieve the income / yield requirements that have been achieved in the past (which retirees still need) investors will have to use unique portfolio strategies, alternative sources of income, and an expanded palette of asset classes to achieve this target

How can one achieve an acceptable return under the following constraints & parameters:

1 Your assets need to remain liquid so that you can draw on them for income

These assets need to be invested, but they still must be liquid enough for you to regularly draw from – it is replacing your employment income. This biases you to liquid asset classes, namely public equities & fixed income.

2 **You want to invest with prudence and conservativism; avoid succumbing to a market downturn and avoid losses early in your retirement years**

As long term investors, we largely ignore short term market fluctuations. For those who are retiring however, we see that the impact of a market correction <u>when you start drawing from these assets</u> can have material impact (Section 1, Figure 3). Avoid those large losses during retirement years becomes critical.

Even if you are not retiring, one key learning from our experience as investors has been that true long term value creation comes from avoiding negative market forces and never fully participating in market losses.

3 **The need for liquidity & conservatism biases you towards reliable yield, income, dividends & cash-on-cash returns**

Lets recall your objectives: (i) investing your assets to generate an acceptable return (ii) constant liquidity and access to these assets so you can fund your expenditures (iii) conservatism in your investment choices to avoid being tied to large market downturns. By definition, this biases you towards asset classes that provide steady income, yield & dividends.

4 **We have been in an all-time low interest rate environment – making it a challenge to generate steady yield and income from your investments**

This low interest-rate environment we have been in since 2008 has pushed asset managers to find steady dividend-providing companies in the public markets as well. There is significant investor competition for yield, in an environment where yield is not easy to find.

Sources : Bank of Canada (Canadian Interest Rates, Bank of Canada Historical Interest Rate Datasets),

5 **In parallel, equities have been at peak valuations. The returns investors earned in the previous 10 years may not be achievable over the next 10 years.**

History suggests that valuations and prices have to revert / normalize at some point. It would be prudent to assume that investing in equities today will not provide you the same returns they did in the past.

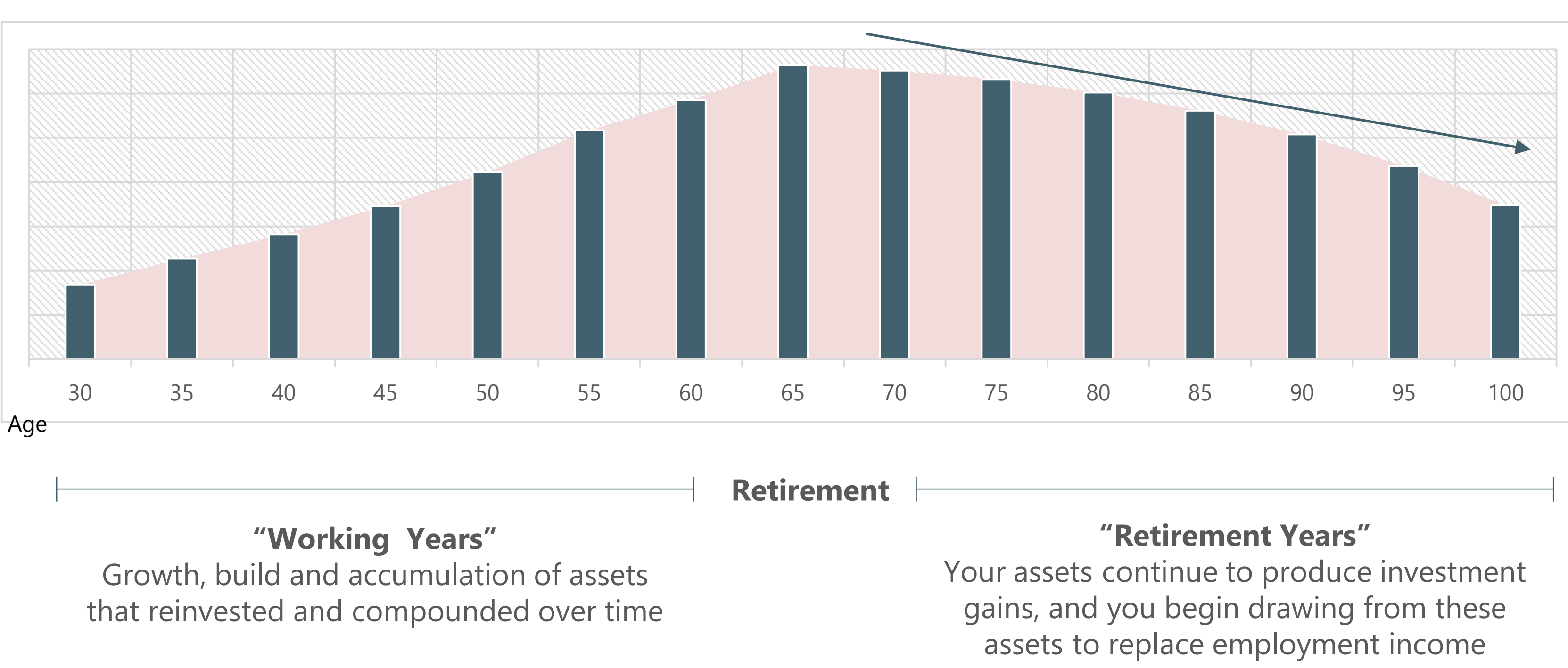
6 **The outlook for traditional portfolios suggests investors need to identify unique strategies, investments and assets classes to deliver this target return**

Projected economist and institutional outlooks for traditional US, Canadian equity & bond markets are at historical lows. A simulated portfolio based on projected market outlooks for various asset classes requires heavy usage of more unique asset classes such as (i) small cap securities (ii) levered loans (iii) niche high yield securities among others.

Sources : Sources: Newfound Research – Portfolios in Wonderland, Shiller Data Library, RBC Global Investment Outlook 2017 (used for data), JP Morgan Capital Markets Assumptions (used for data), Waypoint Investment Partners Analysis

To deal with these parameters, one should develop a clear "retirement equation" that links investment returns, expenditures, and liquid assets. While developing a retirement equation seems daunting, it is a powerful tool to understand your financial situation – and it needn't be overly complicated.

Illustrative: An ideal build of household wealth and eventual usage of that wealth upon retirement



In Retirement:

- The value of these liquid assets reduce over time because household <u>expenses</u> are larger than the investment gains being realized every year
- Alternatively, your expenditures are greater than the investment returns targeted
- In this illustration, the asset base & household expenditures have been chosen such that the assets don't run out

This illustration is meant to depict that "ideal scenario" we referenced earlier. This illustration implies that:

- During your working years, you saved a large enough portion of your employment income (after taxes and your household expenditures) to make regular contributions to your investments and you invested that at a long term growth rate of ~7% (hopefully better!) over time. You built your wealth during these working years.
- You retired with the right mix of (i) sufficient liquid assets (ii) expenditures within your means and (iii) continues to find ways to generate investment income of ~7%
- Because you had the right mix of all three elements, you never had worry about your asset base depleting during retirement, you didn't have to consider income alternatives (selling property, working longer etc), and you still had a large asset base well into retirement.
- Your equation must factor in nuances around taxation, investment accounts (RRSPs, LIRAs, TFSAs etc), how to project what expenditures will look like over time etc.

One of our approaches to these issues is the All Weather Strategy - we strive to find solutions to this challenge by unearthing businesses with unique income generating or compounding opportunities

At Waypoint, every investment we make is geared around one fundamental question: **What is our edge?** Public investing is hard – sustained outperformance is statistically improbable and only the very best do it. We know there are a plethora of smart fundamental investors in the markets, and thus, Waypoint seeks to ensure that we have a clearly defined edge in any investment strategy we undertake.

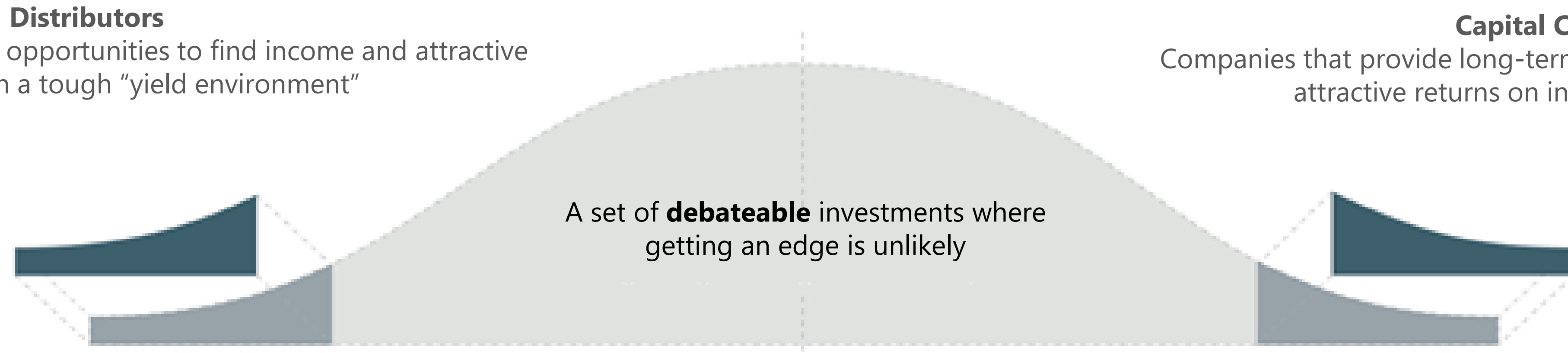
An investment edge comes from three main places:

- Finding investments that are underfollowed and misunderstood, thus increasing likelihood of mispricing
- A rigorous investment process & portfolio strategy that lets you procure & process public information better than others
- Avoiding cultural and institutional constraints that could limit the types of assets one can invest in

Our public equity approach geared toward the Asset-Income Gap – The All Weather Strategy – is structured to create these investment "edges". We think of public equities as a spectrum where the majority of opportunities have highly debatable outcomes – their "investment thesis" is highly debated between portfolio managers and covered by most firms – making it difficult to actually invest with an edge.   We focus on the outliers.

Capital Distributors
Unique opportunities to find income and attractive yields in a tough "yield environment"

Capital Compounders
Companies that provide long-term growth with attractive returns on invested capital



Unique income-generating businesses with strong underlying cash flows and track record of growing dividends

Management teams that are aligned and incentivized to payout a majority of their excess cash flow

Businesses with strong financial position enabling them to maintain cash flow during difficult economic periods

Small and Mid Cap public companies that are underfollowed and misunderstood

Proven track record of generating returns on capital above their cost of capital

Management teams that are aligned with long-term value creation

A portfolio of 20-30 companies

A robust fundamental due diligence process

Portfolio structured to provide steady investment income (yield)
(Which can be reinvested if you desire)

An innovative approach to minimizing drawdowns

What Does This Strategy Provide?

- **Unique Portfolio of Businesses:** A unique portfolio of 20-30 businesses that we identify from these two niche pockets of the market
- **Rigorous Due Diligence:** Our team focuses on our investment process – a robust approach to fundamental due diligence. We have developed our in-house approach to diligence and valuation within each of the two pockets mentioned above
- **Yield & Investment Income:** Leveraging the "sustainable yield" bucket, we construct the portfolio to have regular cash distributions and dividends from the highest quality companies within this space. This allows us to produce regular streams of cash flow that can provide us income (or that we can reinvest should we choose)
- **Minimize Market Drawdowns:** We have developed an innovative portfolio structure that uses a series of put option strategies that provide level of protection and avoidance of large market corrections particularly during retirement years

Please reach out to our investment team if you'd like to learn more about the topics discussed in this paper.

Copyright © Waypoint Investment Partners