iA Clarington

2021 Mid-Year Review

iA Clarington™ Investments

2021 Mid-Year Review

The largely successful global vaccination campaign, coupled with continued fiscal and monetary support, have paved the way for the full reopening of economies and vaulted major equity markets to record highs. But the accelerated pace of the recovery has brought with it a number of risks, most notably a level of inflation not seen in two decades and the very real possibility that broad price increases are a secular, rather transitory phenomenon.

As we move into the second half of 2021, our portfolio managers take a look back at their outlook in January and reflect on the impact of the major developments of the first two quarters. They also explain how they have positioned their portfolios and what they are anticipating for the remainder of the year and beyond.

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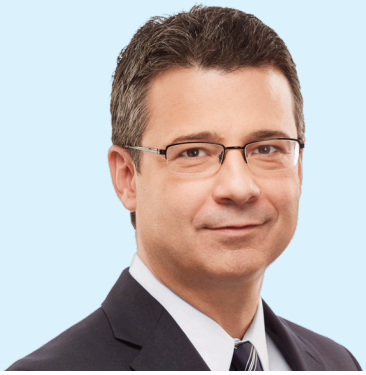


Dan Bastasic MBA, CFA

IA Clarington Investments Inc.

IA Clarington Focused Balanced Class
IA Clarington Focused Balanced Fund
IA Clarington Strategic Corporate Bond Fund
IA Clarington Strategic Equity Income Fund
IA Clarington Strategic Equity Income Class
IA Clarington Strategic Equity Income GIF
IA Clarington Strategic Income Fund
IA Clarington Strategic Income GIF
IA Clarington Strategic U.S. Growth & Income Fund
IA Clarington Tactical Income Class

What was the initial outlook in January 2021?

After all the uncertainty related to the events of 2020, we were relatively certain at the beginning of the year that the historic injection of liquidity by central banks and their commitment to keep borrowing costs low were going to backstop the economy and most securities markets until economic normalization returned. We expected economic growth and earnings to accelerate to levels not seen in decades as a result of the combined efforts of central banks and a return of our economic engine.

We expected this abnormal growth to propel equities and high-yield bonds for years to come relative to interest rate sensitive government bonds. Financials, cyclicals and consumer-related securities would most likely be the largest beneficiaries of current monetary policies and the backstop provided by excess liquidity in the economy.

Within fixed income, we preferred to allocate capital towards high-yield corporate debt while maintaining a low-duration strategy. We predicated this decision on many of the same arguments that shaped our expectations for the economy, including excess money supply and pent-up demand, coupled with lower defaults and a lack of alternatives for yield.

How have the portfolios been positioned to take advantage of this outlook?

We increased our exposure to financials as well as some consumer-related equities at the end of last year and during the first two quarters of 2021. Our primary exposure in fixed income came from high-yielding bonds with a BB- average credit quality. Low duration remains a key focus of our investment strategy as we expect interest rates to follow economic growth higher during the year and into 2022, creating headwinds for interest rate sensitive portfolios.

We increased our overall equity exposure during the first half of the year relative to the prior year, as we believed the risk-to-reward ratio favoured a higher exposure to equities within our funds. Our focus was to increase exposure to securities that would benefit from expanding economic growth, higher prices and higher interest rates. We remained majority hedged in our U.S. dollar exposure, as we expect the greenback to depreciate over the coming years.

What has transpired this year?

There have not been many surprises this year in terms of the return behavior of different asset classes. Stimulus

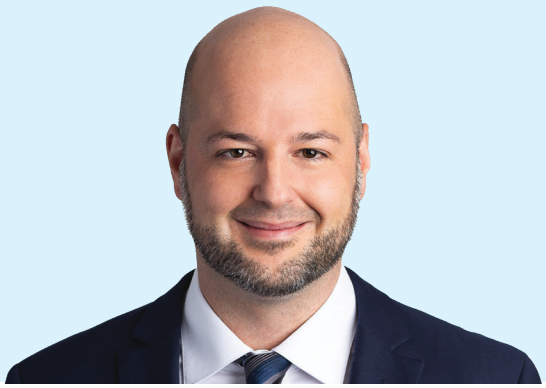
is high, consumer savings rates are high and global economies have just begun to reopen after many fits and starts over the past 12 months. Sectors that did well last year have generally lagged in the first half of 2021, including technology, materials and gold, while those that were overly burdened with last year's lockdowns have done well to recover, including financials, energy, and consumer-related, as well as the high-yield bond asset class.

As expected, interest rates have increased during the first half of the year, causing problems for long-duration portfolios while being a source of economic growth confirmation for corporate credit. The Canadian dollar has appreciated relative to the U.S. dollar as growth has shifted to economies with higher cyclical and commodity exposure.

What is your outlook for the rest of 2021?

We remain positive on equities and high-yield corporate credit for at least the next 12 months. Although the rate of economic growth has likely peaked during the current quarter and will probably decline from current high levels, it will remain relatively strong, underpinned by $2.5 trillion of excess consumer savings and loose monetary and fiscal policies. We expect a value bias to continue for the remainder of the year and interest rates to continue moving towards 1.90% on the 10-year U.S. government bond. Recent U.S. dollar appreciation will likely be short lived and we expect a weaker U.S. dollar from current levels as the year progresses.

There will be periods of higher volatility as we approach year-end, but we expect them to be relatively brief. We believe 2022 and 2023 are more likely to see pronounced corrections and higher bouts of volatility – a bull market lifts all boats, until it doesn't. We remain balanced in our investment approach between economic-sensitive securities and defensives that provide higher yield potential and favourable characteristics for those unforeseen moments that are sure to arrive.



Jean-Pierre Chevalier CFA

iA Investment Management Inc.

IA Clarington Canadian Leaders Class
IA Clarington Global Value Fund
IA Clarington Global Value GIF
IA Clarington Thematic Innovation Class

What was the initial outlook in January 2021?

At the start of the year, consensus expectations were for a gradual reopening of the economy as vaccines were made available globally. Equity markets were already pricing some of this in, with significant outperformance of cyclical industries since last summer and especially in November.

We thought there were still outperformance opportunities in companies that were disrupted by COVID-19, but viewed these opportunities as very tactical in nature. As a result of stimulus payments and months of discretionary spending cutbacks, savings levels were very high.

Thus, we thought that post-vaccine, we could see a very strong consumer boom in the U.S. This could mean positive earnings revisions for domestic-exposed companies. The U.S. equity market's valuation was elevated on an historical price-to-earnings (P/E) ratio basis, but it was important to remember that the equity market valuation is inversely correlated to the level of interest rates on a non-linear basis.

We also believed COVID-19 permanently accelerated the growth of intangible asset innovations and their deflationary pressures. This is adding up to very high debt levels, aging demographics in many major economies, low monetary velocity and globalization – all of which are deflationary.

We thought a possible pitfall was to have an approach that fails to adjust for the significant rerating of cyclicals following the first vaccine announcement.

How have the portfolios been positioned to take advantage of this outlook?

IA Clarington Thematic Innovation Class is a U.S. equity fund that invests in companies from sectors benefitting from technological advances and a perpetually changing environment. It is a well-diversified strategy, making it possible to have a strong focus on risk management while adding alpha potential from a deep understanding of long-term innovation themes.

We construct the portfolio using a barbell strategy. On one side, we like to have exposure to innovators and keep between 5–15% in small- and mid-cap stocks. On the other end, we went with dominant firms that provide more exposure to the reopening of the economy. But we have now taken profits in holdings in industries such as banks and airlines and reinvested in long-term quality compounders in the health care sector.

We think the recovery will be more targeted towards productivity than new capacity. To take advantage of this, we are currently invested in themes including smart cities, building efficiency and industrial automation. The pandemic brought attention to the importance of investing in the future of health care. We think the

confluence of connectivity and genomics is resulting in many opportunities from a stock selection point of view. In our view, artificial intelligence, genomics, and smart energy technologies will be driving U.S. equity returns over the next decade in the same way that digital advertising, e-commerce and cloud computing explained most of the returns in the last decade.

We live in a world of technology-driven change and COVID-19 is further accelerating this theme. The impact is broad and affects all sectors and industries. How companies deal with this is central from a stock selection perspective.

What has transpired this year?

In hindsight, the positive earnings revisions were broad-based and spectacular. In fact, the P/E multiple of the S&P 500 stayed relatively stable since last summer, but earnings estimates (and the price level of the index) went up significantly. As is often the case, strong returns happened while climbing a wall of worry.

Political instability to start the year, inflation fears after that, slow vaccine distribution at first, resurgent COVID-19 variants and high valuation levels were building the wall this time. The equity market was not really worried about all of this as it significantly rewarded cyclicals, with defensives underperforming. In fact, the best-performing sectors were energy and financials, while the worst were consumer staples and utilities.

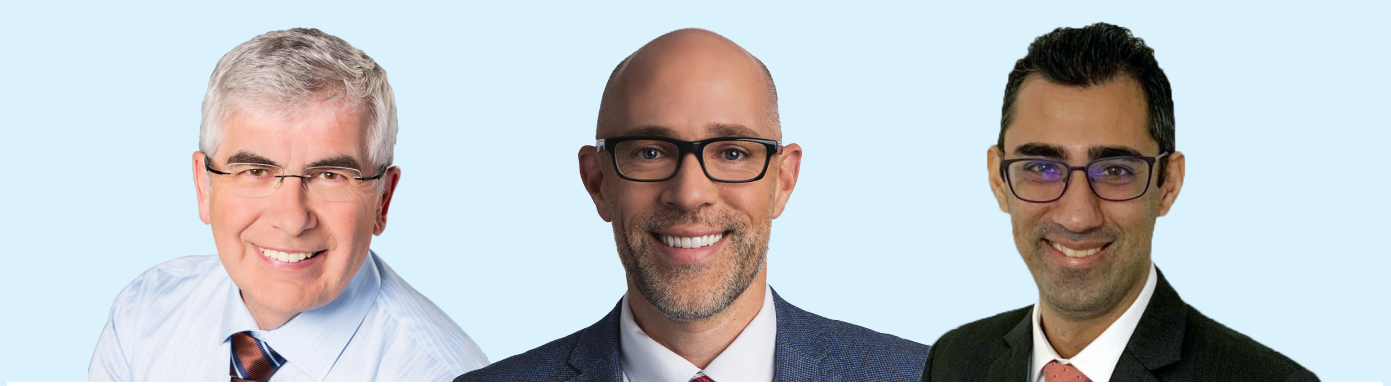
What is your outlook for the rest of 2021?

After this summer, we think we will be at peak economic growth driven by peak fiscal and monetary policies, peak reopening, peak inflation in the U.S. and peak credit impulse in China. All of this should favour outperformance of the U.S. equity market (given its defensive and structural growth attributes) as markets stop rewarding cyclical exposures in the face of slowing improvements going forward. There is already a high level of visibility on all these factors, except perhaps inflation, which could stay at a slightly higher-than-expected level in the short term. But the jury is still out.

While we do think monetary and fiscal policies will continue to support growth, we do not think that it will get any better. Historically, that is never good for an average cyclical's outperformance prospects. Cyclicals continued to outperform in the first half of the year, but we think it is now important to take profits in some of these situations and reinvest in other parts of the market.

This is leading us back to many themes where we have started to see more investment opportunities in the last few weeks. We apply a technology lifecycle model called the hype cycle along with our traditional discounted cash flow valuation model, which led us to take profits in some of last year's winners. Subsequently, this framework did not disappoint, and we saw corrections in many themes that had seen their stock prices move too high, too quickly. Fast forward to today, and we are sharpening our pencils and coming back with new positions in themes that have been severely punished year to date.

The best expression of this is our return to the smart energy theme with exposures to renewables and energy storage. While their stock prices corrected significantly, the big picture improved with an increasing alignment of innovation, public support and political support. Last year was a record year for investment in the energy transition and this is just the start. In fact, according to the International Renewable Energy Agency, we will need to spend 2.5 times more per year on average until 2050 to get anywhere close to the long-term objectives of the 2016 Paris Agreement. These targets could also be heightened with a big catalyst coming from the UN Climate Change Conference of the Parties (COP26) being held in Glasgow this fall, where we expect further engagements from worldwide governments, so stay tuned! To conclude, we will continue to work on our unique thematic style while incorporating our differentiated view of the markets.



Clément Gignac MESc

Sébastien Mc Mahon MA, CFA

Tej Rai

iA Investment Management Inc.

IA Clarington Global Yield Opportunities Fund
IA Clarington Monthly Income Balanced Fund
IA Clarington Monthly Income Balanced GIF
IA Clarington Yield Opportunities Fund
IA Wealth Enhanced Bond Pool
IA Wealth Conservative Portfolio
IA Wealth Moderate Portfolio
IA Wealth Balanced Portfolio
IA Wealth Growth Portfolio
IA Wealth High Growth Portfolio

What was the initial outlook in January 2021?

We expected equities to post positive returns in 2021, with Canada, emerging markets and EAFE (Europe, Australasia, and the Far East) outperforming the U.S. stock market. Our outlook on bonds was more pessimistic, as the ongoing reopening of the global economy, fueled by the vaccination campaign and massive fiscal and monetary stimulus, would push expectations for growth and inflation higher, taking interest rates along for the ride.

We were cognizant that the macro landscape would be marked by record uncertainty, and that investors and forecasters would need to be humble in their expectations and rein in their risk appetite.

How have the portfolios been positioned to take advantage of this outlook?

Our funds have been overweight equities and significantly underweight bonds since March 2020. We only started scaling down our equity exposure near the end of the second quarter as we saw signs of fragility emerging.

The overweight in stocks has been systematically concentrated in Canadian and European equities. Our U.S. equity allocation, by contrast, has been underweight to neutral through the first half of the year. The macro background also led us to maintain a partial hedging of our exposure to foreign currencies in the last year, as we have been bullish on the loonie – a notable risk-on currency.

What has transpired this year?

The wonders of science never cease to amaze us, and the speed with which the vaccines were developed and distributed has made even our most optimistic scenarios from last year look gloomy at this point.

The first year of the bull market, which started in late-March 2020, is now officially behind us. That was the "easy" part of the stock market cycle and we are now entering the phase where active management makes a big difference, in our view. Historically, while the second year of a bull market remains positive, on average, volatility tends to return to the forefront. Since 1957, the average return for the second year of an S&P 500 bull market has been 13.3%, but with an average correction of 9.8% along the way.

After an initial, swift rise in the first quarter, 10-year interest rates have taken a breather and now diverge significantly from their long-term relationship with core

inflation. This suggests investors share the view of the U.S. Federal Reserve (Fed) that recent inflation is only temporary. As a result, investors are again willing to hold federal bonds despite historically low potential returns. If this view among investors were to change abruptly (e.g., as a result of higher inflation figures or a change in the Fed's tone), there is potential for a rapid and disorderly rise in interest rates.

What is your outlook for the rest of 2021?

We expect economic data to remain very strong over the rest of the year, but Q2 might have been the high-water mark for the pace of economic growth. Absent a new, vaccine-resisting variant strain, our lives should steadily return to normal, meaning more progress for the labour market and an unwinding of savings rates. Businesses are also showing their hands with respect to capital expenditure intentions in coming quarters, resulting in a very strong economic foundation.

The main risk is inflation being too strong, making central banks seem behind the curve. We are keeping an eye on wage growth – the main vector of sustainable inflation pressures – as well as the bottlenecks in both manufacturing and services.

Following the initial rise of interest rates since the summer of 2020, we expect them to continue rising until the end of the year, resulting in negative returns for bond portfolios. Overweighting cash helps limit the impact of market declines and puts investors in a good position to plunge back into the stock market in the event of a correction.

The low level of interest rates, combined with the strong outlook for economic growth and inflation, lead us to remain largely underweight bonds and favour cash as a risk-mitigation tool. Our optimism on Canadian assets also extends to the loonie, which we see rising into the 85–90 cent range by the end of the year.

As we move into the second half of 2021, we have a more cautious stance on the balance of risks, taking profits on winning positions and standing ready to deploy cash as opportunities arise in the months ahead.

Alexandre Morin CFA

iA Investment Management Inc.

IA Clarington Bond GIF
IA Clarington Money Market Fund
IA Clarington Money Market GIF
IA Clarington Real Return Bond Fund
IA Wealth Core Bond Pool

What was the initial outlook in January 2021?

We believed the significant borrowing needs of governments, combined with overnight rates near zero, would result in higher bond yields and additional yield curve steepening in 2021. We were expecting major central banks to be very patient in the conduct of their respective monetary policies given inflation has been low for several years. The U.S. Federal Reserve (Fed), for example, made it clear it wanted to see inflation overshoot the target level coming out of the pandemic.

Since we were anticipating yields to increase – and more so for North American than European bonds – we expected credits to outperform government bonds.

How have the portfolios been positioned to take advantage of this outlook?

For almost the entire year-to-date period, our portfolios have had a shorter duration than the benchmark and have been positioned to take advantage of a steepening yield curve, with duration short bets being applied for the most part to the long end of the curve.

We have been largely overweight credit, particularly corporates and municipals. Amid rising bond yields, we bought some U.S. dollar-denominated ETFs that provide exposure to U.S. investment grade and high-yield corporate bonds with low duration risk. We had a small allocation to real return bonds to protect the portfolios against an increase in inflation and, as usual, we were overweight bonds issued by cities and towns in Quebec for their good carry and low interest rate risk.

What has transpired this year?

Yields and yield volatility increased sharply in the first quarter as the reflation trade was being priced in against the backdrop of rapid distribution of COVID-19 vaccines and the vote for another fiscal package in the U.S.

Since then, bond yields decreased slightly, as market participants judged that the first-quarter increase was excessive and new lockdowns were imposed to contain the spread of COVID-19. Markets were keeping a close eye on the evolution of the delta variant and its impact on infection rates.

In April, the Bank of Canada announced additional tapering of its asset purchases, but there was no impact on the markets. The Fed's change of tone in mid-June caught markets by surprise, with several Federal Open Market Committee members saying they expect to increase the overnight rate more quickly than initially planned. This resulted in a rapid flattening of the U.S. yield curve.

Investment grade and provincial credit spreads stabilized at the low end of the range after the wild swings of 2020, while high-yield spreads continued to tighten and now sit close to their all-time low.

What is your outlook for the rest of 2021?

We still expect bond yields to increase until year-end as the economy reopens and the successful vaccination campaign continues here in Canada. But the delta variant is a risk that we are watching closely.

The Fed's change of tone suggests the U.S. yield curve is more likely to flatten than steepen. Accordingly, we are short duration in the 5-year bucket. On the Canadian side, we continue to expect the yield curve to steepen given the sharp increase in federal and provincial issuance of long-dated bonds. But with no further steepening coming from the U.S. yield curve, steepening of the Canadian curve could be less dramatic than expected.

With investment grade spreads at the low end of their range, we reduced our overweight to the asset class, judging that the risk-to-reward ratio was less compelling than a few months ago – especially with the change in tone coming from the Fed.

We still think short-duration credit – investment grade, high yield and municipals – has attractive potential. We remain nimble in our duration management because we think volatility could be back in the rates markets as we get closer to the possibility of a formal tapering announcement from the Fed.

Donny Moss CFA

iA Investment Management Inc.

IA Clarington Canadian Conservative Equity Class
IA Clarington Canadian Conservative Equity Fund
IA Clarington Canadian Conservative Equity GIF
IA Clarington Canadian Dividend Fund
IA Clarington Dividend Growth Class
IA Clarington Dividend Growth GIF
IA Clarington U.S. Dividend Growth Fund
IA Clarington U.S. Dividend Growth GIF
IA Clarington U.S. Dividend Growth Registered Fund

What was the initial outlook in January 2021?

In our view, 2021 was to be a recovery year, with sector returns more evenly dispersed than they were in 2020 as the economy and daily life gradually returned to normal.

We expressed some concern on valuations as we witnessed a large rally at the end of 2020, while the pandemic was only beginning to improve. With this setup, earnings growth would need to be strong for the market to continue to move higher.

We highlighted financials, real estate and consumer discretionary as sectors that looked attractive given the gradual recovery of the economy driven by the vaccine rollout.

How have the portfolios been positioned to take advantage of this outlook?

We maintained a heavy weighting in banks, as earnings have been well ahead of expectations due to the economic recovery and unprecedented levels of government support have kept loan losses at low levels.

We increased our weighting in the energy sector early in the year. While the increase in commodity prices is an obvious tailwind, equally impressive has been the focus on capital allocation, with debt reduction and dividends/buybacks taking preference over production growth.

We increased our exposure to multifamily real estate, as the dynamics of that sub-sector were more positive than the market suggested, in our view. Specifically, high housing prices and a return to immigration would benefit the rental housing market and lead to a quick recovery.

We have increased our exposure to renewable-focused utilities after a sharp pullback in 2021. This sub-sector should grow well in excess of GDP for many years as countries and corporations increase their focus on decarbonization. We believe leading companies in the renewables space will have a long runway of organic growth opportunities.

Our investment process remains focused on finding well-managed companies that have durable competitive advantages and the ability to grow their dividends over the long term without using excessive leverage.

What has transpired this year?

The stock market has remained exceptionally strong this year amid continued fiscal and monetary support, earnings growth, low rates and excellent progress on the COVID-19 vaccine rollout.

Bond yields rose materially in the first part of the year, a move that would have threatened the equity market had it continued. However, yields topped out in the spring and have been declining recently, which has been good news for quality and higher-multiple stocks.

Earnings growth has been well ahead of expectations, with the vast majority of companies beating estimates as the recovery takes hold and businesses retain some of the cost savings brought about by the pandemic. This has allowed stocks to move substantially higher without valuations moving to extreme levels.

The Canadian market has been led by the energy and financials sectors in the first half of the year. Energy has been strong due to rising commodity prices and greater free cash flow, which has helped the sector rapidly deleverage. Financials have outperformed due to low loan losses and rising yields, while strong earnings growth has meant that valuations remain reasonable.

What is your outlook for the rest of 2021?

In our view, the market has entered a 'goldilocks' zone, where earnings growth should continue, aided by the reopening of the economy, low interest rates and continuing levels of government support. Stocks have the potential to continue their run as long as this situation holds.

We believe the Office of the Superintendent of Financial Institutions (OSFI) will remove its restrictions on dividend increases and share buybacks for Canadian financials in late Q3 or Q4, which will be a positive catalyst for dividend growth and a signal that these companies have successfully navigated the pandemic.

Inflation remains our biggest concern for the remainder of the year. If inflation is not transitory and sustains for the medium term, it will have a negative effect on profit margins for many of the companies that we own and would serve as a negative catalyst for stocks. There will be a premium on companies that are either unaffected by inflation or have the pricing power to efficiently pass the additional cost on to their customers.

Our other concern lies in the massive amount of government support of the economy in both the U.S. and Canada. We may see volatility if this support is quickly lifted.

While yields rose off the lows of 2020, they continue to be very low versus historical levels. Income from dividends remains very attractive versus the alternatives and will continue to be an important source of total returns. In addition, our focus on dividend growers is important, as a rising yearly income stream will help offset the effects of inflation.

Matthew J. Eagan MBA, CFA
Eileen N. Riley MBA, CFA
David W. Rolley CFA
Lee M. Rosenbaum MBA

Loomis, Sayles & Company, L.P.

IA Clarington Loomis Global Allocation Class
IA Clarington Loomis Global Allocation Fund
IA Clarington Loomis Global Equity Opportunities Fund
IA Clarington Loomis Global Equity Opportunities GIF
IA Clarington Global Opportunities Class
IA Clarington Global Opportunities Fund

What was the initial outlook in January 2021?

We were encouraged by the growth outlook coming into the new year. Consumers were healthier in aggregate, the housing market was recovering, central banks remained accommodative, and the positive developments on vaccines suggested there was light at the end of the tunnel.

We anticipated further volatility in global equities as the world continued to contend with the pandemic. However, we believed – and continue to believe – our portfolio of companies had the flexibility to navigate the environment through sustainable competitive advantages and strong balance sheets.

In fixed income, investment grade credit spreads (the incremental yield relative to comparable-maturity Treasuries) looked fairly expensive at the end of 2020, given the strong rally at the end of the year. Nevertheless, we felt there was better value in corporate bonds given the positive economic outlook. Our view was that near-record-low interest rates, sizeable liquidity and strong investor demand for yield would help keep volatility at bay while additional fiscal stimulus, solid consumer health and vaccine efficacy would provide a considerable tailwind for corporate profits.

We expected global developed market yield curves would remain fairly anchored at the front end, but longer-term yields could drift higher as the economic recovery took hold. We anticipated an environment fundamentally similar to pre-crisis conditions, characterized by moderate growth and limited inflationary pressure. Under these circumstances, the potential for bond yields to rise would be fairly limited.

Lastly, we anticipated the dollar would continue to slowly trend weaker relative to other world currencies, given strong investor risk appetite and a weakening dollar are historically consistent with cyclical improvement in the global economy. Widening U.S. fiscal and trade deficits also supported this view.

How have the portfolios been positioned to take advantage of this outlook?

As we entered 2021, IA Clarington Loomis Global Allocation Fund was positioned with a majority equity allocation, reflecting our view that valuations were more attractive in equities than fixed income.

In both the global allocation mandate and our pure equity funds, we began the year with significant exposure to the information technology, consumer discretionary and health care sectors. We had no exposure to utilities, real estate and energy stocks.

In fixed income, we reduced relative credit exposure further during the first quarter on valuation concerns, but retained a modest overweight as global central bank support remained significant and economic acceleration was anticipated. We remained short duration as global growth recovered and inflation became more of a concern.

At the mid-year point, we continue to maintain a majority equity allocation in IA Clarington Loomis Global Allocation Fund. Our equity sector positioning across all mandates remains largely the same – we continue to find opportunities in information technology, consumer discretionary and health care and have no exposure to utilities, real estate and energy.

In fixed income, we further reduced duration to an underweight position given our expectation for government bond yields to rise alongside continued economic expansion and potential for progression toward central bank policy normalization. We continue to favour select local emerging markets where high real yields are attractive and a potential recovery may counteract post-pandemic debt challenges.

What has transpired this year?

Global equity markets were strong in the first half of 2021, notwithstanding some volatility. In the first few months of the year, the global growth outlook was buoyed by positive news around the COVID-19 vaccine rollout and a possible 'return to normal.'

Despite inflation and labour shortages emerging as risks later in the first half of the year, investors continued to support equities, with some indices reaching record highs. The MSCI All Country World Index registered just over 9% in Canadian-dollar terms, with the majority of sectors posting positive results. The energy, financials, communication services and real estate sectors outperformed the broader market, while the utilities sector registered negative returns.

In fixed income, spreads tightened during the first half of the year. Meanwhile, the 10-year U.S. Treasury, which began the year at 0.91%, had risen to 1.74% by the end of the first quarter, only to then move back down to 1.47% by the end of the second quarter.

The uptick in vaccination rates over the last six months has created economic momentum in terms of job hiring, consumer spending, corporate earnings and consumer sentiment. This pickup in growth has led to markedly higher inflation, which has been particularly pronounced in the U.S. Notably, labour shortages and supply chain congestion have disrupted supply in certain sectors.

What is your outlook for the rest of 2021?

Equities

The economic recovery in large part continues to depend on the successful rollout of vaccines on a global scale. While much of the developed world has made demonstrable progress in terms of infection rates, COVID-19 cases continue to grow in many emerging markets, which on balance have fewer resources to manage the virus.

A recovery is also reliant on the scope of continued fiscal and monetary support, and other relief packages, in the U.S. and globally. Thus, our focus remains on investing in companies we believe have the ability to successfully navigate the current environment and generate value over the longer term.

We currently hold a diverse group of technology names spanning digital payments, cloud storage and collaboration, and semiconductor manufacturing and equipment. We have selective exposure to consumer-related names, focusing on best-in-class e-commerce platform retailers and physical retailers with compelling value propositions. We also have exposure to the growing online fitness industry.

Our health care exposure is focused on higher-growth areas of the industry and away from areas exposed to reimbursement risk. We continue to have no direct exposure to energy or utilities, as we typically do not find many opportunities in these sectors that exhibit our three alpha drivers – quality, intrinsic value growth and attractive valuation.

As the pandemic continues to evolve, there could be further volatility in global equities. However, we believe the companies in the portfolio have sustainable competitive advantages and strong balance sheets, which should enable them to weather challenging environments and quite possibly emerge stronger.

Fixed income

The pickup in growth has led to markedly higher inflation across a number of metrics and put the fear of higher, sustained inflation on the radar for the first time in decades. We expect inflation to gradually shift upwards after the transitory effects roll off given the enormous fiscal stimulus and the cyclical upturn from a growing economy. We will look to the labour market – particularly wages – and shelter components for evidence of more persistent inflationary pressures.

Credit spreads should remain well supported by the improvement in corporate profits and continued accommodative monetary and fiscal policies. We expect positive earnings momentum to continue, although at a more moderate pace. Companies should be able to pass on higher input costs to their customers, keeping profit margins steady in the near term.

We expect the U.S. dollar to remain broadly rangebound, having recently strengthened on expectations of a slightly firmer U.S. Federal Reserve. This may unwind in the future, if either non-U.S. growth or policy catch up, or the U.S. current account widens from a deferred consumption spree.

Clement Chiang MBA, CFA
Ian Cooke CFA
Darren Dansereau CFA
Mathew Hermary CFA
Joe Jugovic CFA

QV Investors Inc.

IA Clarington Canadian Balanced Class
IA Clarington Canadian Balanced Fund
IA Clarington Canadian Balanced GIF
IA Clarington Canadian Small Cap Class
IA Clarington Canadian Small Cap Fund
IA Clarington Canadian Small Cap GIF
IA Clarington Global Equity Fund
IA Clarington Global Equity GIF
IA Clarington U.S. Equity Class
IA Clarington U.S. Equity Currency Neutral Fund

What was the initial outlook in January 2021?

Unparalleled monetary stimulus would begin to have its impact on the real economy, with economic data continuing to improve, while corporate earnings would recover on the back of normalized consumer spending and bottoming industrial activity.

We expected that significant divergences within the market would begin to normalize, as much of the equity market was not participating in the recovery.

The companies in our portfolios are high-quality, so we expected them to navigate the environment very well. We simply needed to remain patient for the market to take notice of this quality.

How have the portfolios been positioned to take advantage of this outlook?

The portfolios remain true to our risk-managed investment discipline, defined by fundamental characteristics of balance sheet strength, valuation advantage and resilient-earning franchises. Since the beginning of the year, cash levels have been historically low, reflecting plentiful opportunities within our areas of focus.

The portfolios have been positioned to perform through an economic cycle. They are well diversified and not focused on businesses most in favour in the short-term pandemic environment. Rather, with material exposure to high-quality cyclicals, our portfolios are well positioned to benefit from a gradual economic recovery, in our view.

What has transpired this year?

Even though the rollout of the COVID-19 vaccine picked up in earnest, the world found itself in a deadly third wave. Economies remained closed and uncertainty remained elevated. Nonetheless, meaningful vaccination progress and continued monetary and fiscal support have allowed global equity markets to post double-digit returns year to date.

Corporate earnings led a faster-than-anticipated economic recovery, with upward revisions occurring throughout the first half of the year. The pandemic high-flyers of last year started to lose some of their luster as markets finally started to broaden out in response to the wider earnings recovery.

Inflationary pressures have skyrocketed, as have commodity prices. Given the Canadian stock market's exposure to such cyclical businesses, Canada has been one of the top-performing markets in the world year to date.

What is your outlook for the rest of 2021?

Over a year has passed since the bottom of the pandemic-induced global bear market. To date, we have witnessed a V-shaped economic recovery, and a powerful one at that. This year's earnings recovery outpaces those following the recessions of 2001 and 2008 and, correspondingly, so has market performance.

Significant uncertainty over the past 12 months created very attractive opportunities for us to add to existing holdings as well as buy new investments at attractive valuations. We believe we are now transitioning from the recovery period into a mid-cycle economic expansion. Historically, the recovery period has presented the best risk-reward opportunity – widespread fear and very low valuations provide both a margin of safety and outsized future return potential. In this next stage we anticipate more muted returns.

Returns are most likely to be driven by further gains in earnings as opposed to further valuation expansion. Our portfolios are highly diversified and earnings streams are resilient across changing economic environments. For this reason, we anticipate our businesses will continue to generate attractive profitability, but at a slower rate than what we currently see.

Valuation multiples for the broad market have increased dramatically since last year. While multiples may stay high, they have become a risk that needs to be managed.

Investor psychology has transitioned from outright fear to optimism in a short period of time. Flows into equities are at very high levels as the lack of acceptable returns in the bond market continues to cause a troubling dilemma for investors. Until the bond market offers a more attractive real yield, equities will remain a more favourable asset class in the context of continued global economic growth.

The question as to what may act as a catalyst for higher bond yields remains. In this respect, we consider that policymaker actions could lead to either higher inflation or a policy surprise, both of which would be a headwind for equity investors. If such a challenge does play out, our risk-managed portfolios are positioned to protect capital through their attractive valuations and strong balance sheets. While the U.S. is bouncing back sharply from the pandemic, many other countries continue to struggle and weigh on the global recovery.

Although our businesses exhibit strong performance potential, fundamentals are healthy and we see continued opportunity for further gains, we are more cautious over the second half of the year as the rate of change in economic growth and monetary stimulus decelerates.

Jeffrey Adams CFA, CIM, RIS
Wes Dearborn CFA
Kelly Hirsch CFA, RIS
Jeffrey Lew CFA
Marc Sheard CFA

Vancity Investment Management Ltd.

IA Clarington Inhance Bond SRI Fund
IA Clarington Inhance Balanced SRI Portfolio
IA Clarington Inhance Canadian Equity SRI Class
IA Clarington Inhance Conservative SRI Portfolio
IA Clarington Inhance Global Equity SRI Class
IA Clarington Inhance Growth SRI Portfolio
IA Clarington Inhance Monthly Income SRI Fund
IA Clarington Inhance Monthly Income SRI GIF

What was the initial outlook in January 2021?

Positive vaccine announcements supported our view that 2021 would see a trend towards more normalized consumption that would result in strong corporate earnings growth and a support for equity valuations. This was reinforced by improving indicators of economic activity, such as global Purchasing Managers' Index data and the rapid recovery in employment.

We expected bond yields to slowly begin to rise alongside the economic recovery, coupled with a steepening of the yield curve as short rates remained anchored by the Bank of Canada maintaining its policy rate at the effective zero bound.

How have the portfolios been positioned to take advantage of this outlook?

Our process is centred on identifying high-quality companies through a collaborative approach that integrates environmental, social and governance (ESG) analysis with bottom-up fundamental analysis. The result is a portfolio of sustainable businesses with long-term outperformance potential.

We look to take advantage of market dislocations where short-term concerns create opportunities to invest in high-quality companies at reasonable prices. On this basis, we increased our exposure to consumer discretionary and industrials names that are positioned to benefit from the continued economic reopening and exhibit attractive potential to compound growth over the next several years.

Our bond mandate has been defensively positioned for rising rates, maintaining a slightly short duration and underweight in long-term bonds. The fund has also maintained an overweight to high-quality short-term bonds, which offer attractive yield carry and potential for capital appreciation.

What has transpired this year?

Equity markets continued trending upward in the first half of 2021 as investors celebrated a constellation of positive developments – the acceleration of vaccination campaigns, robust corporate earnings, the reopening of local economies and jobs growth.

After a strong year in 2020, the renewable energy space has seen a significant retraction in share prices. We still believe, however, that companies in this sector are well

positioned to benefit in the long run from the global imperative to combat climate change. Fossil fuels have had a strong run, with oil prices up by more than 50% in the first half of 2021 and energy posting the best sector returns within the MSCI World Index.

Equity markets have also seen a rotation from growth to value. Three main factors are driving this shift: the economic recovery, which has pushed the earnings power of value stocks; the potential for higher interest rates hurting growth stocks more, as they tend to be longer-duration assets; and the extreme valuation discrepancy that was present between growth and value stocks last year.

Climate action has accelerated and is expected to continue throughout the year. In May 2021, the International Energy Agency released *Net Zero by 2050: A Roadmap for the Global Energy Sector*, the first comprehensive study on how to transition to a net-zero energy system. The study shows that to reach net-zero emissions by 2050, annual clean energy investment worldwide will need to more than triple by 2030 to around $4 trillion. There has been rapid growth in countries pledging to achieve net-zero emissions, with around 70% of global carbon emissions covered by a net-zero target.

Within the fixed-income markets, mid- and longer-dated bond yields rapidly increased during the first quarter of 2021 as strong economic growth projections and rising inflation expectations pushed yields all the way back to pre-pandemic levels. Bonds have subsequently retraced approximately one-third of the move and have been rallying lower in yield since the middle of May. Overall, mid- and longer-dated yields remain significantly higher than they were at the end of last year and the Canadian yield curve has steepened, as short rates have remained relatively anchored.

Corporate spreads have generally traded within a narrow range over the first half of the year and corporates have outperformed government bonds.

What is your outlook for the rest of 2021?

The economic recovery is well underway as countries look to fully reopen in the second half of 2021. While both the Bank of Canada and the U.S. Federal Reserve have repeatedly stated that recent price pressures are a temporary result of pent-up consumer demand and supply chain issues, inflation will likely remain a key concern for investors in the coming months.

Short-term bond yields have room to gradually increase as the Bank of Canada will slowly begin to raise its policy rate in 2022 if the current economic trend persists. The outlook for mid- and longer-term bond yields is less certain given the significant rise that has already occurred this year. However, inflation will likely be a key driver of directionality and needs to be closely monitored as base effects from a weak 2020 comparison fade into the fourth quarter.

On the ESG front, companies with supply chain management systems that integrate transparency and supply chain mapping along with environmental and social audits are best positioned to manage increasing supply chain risks. In particular, regulatory actions related to China's repression of the Uighurs in the Xinjiang Uighur Autonomous Region are expected to accelerate and further complicate global supply chains. The U.S., along with many other Western nations, have labelled China's treatment of minority populations in the region a genocide. The U.S. Senate is poised to pass measures that would restrict imports from the region that cannot be confirmed to be free of forced labour. Companies that have integrated ESG considerations into their operations are best positioned to mitigate these risks.

Amar Dhanoya MBA, CFA

Jeff Sujitno HBA, CPA, CIM

Wellington Square

IA Clarington Core Plus Bond Fund

IA Clarington Core Plus Bond GIF

IA Clarington Floating Rate Income Fund

IA Clarington U.S. Dollar Floating Rate Income Fund

What was the initial outlook in January 2021?

We expected the best opportunities to be in non-investment grade credit and to see continued capital flows into this space as investors searched for higher yields. Within investment grade credit we favoured BBB rated securities.

We anticipated opportunities for capital appreciation, but in our view the beta trade was over. Security selection would be critical to generating alpha throughout the year.

Finally, we expected to see a steepening of the sovereign bond yield curve.

How have the portfolios been positioned to take advantage of this outlook?

IA Clarington Core Plus Bond Fund has been positioned with a near-maximum weight in non-investment grade holdings and at the high end of our target duration range. The fund's investment grade holdings are focused on BBB rated names.

Positioning in the floating rate income funds has been conservative, with the portfolio skewed towards larger, more liquid holdings with higher credit ratings. The funds have limited exposure to CCC rated debt and almost no exposure to commodities.

In both strategies, cash levels are minimal and currency exposure is fully hedged.

What has transpired this year?

Non-investment grade credit has outperformed. We have seen strong investor demand for higher-yielding credit, with inflows from U.S. retail investors into loan funds and ETFs at $26.8 billion for the first half of 2021, compared to an outflow of $22.1 billion for the same period last year, according to Refinitive Lipper.

The sovereign bond yield curve has steepened in response to strong economic data and inflation concerns, with the U.S. Treasury 2/10 spread increasing 43 basis points (bps) to end the first half of 2021 at 122 bps.

All broad investment grade indices we track printed negative returns in the first half of 2021 amid rising sovereign bond yields. The Bloomberg Barclays Global Aggregate Index, a flagship measure of the global investment grade debt market, returned -3.2% over this period. By contrast, the lowest-rated parts of the credit market outperformed, with CCC rated loans within the Credit Suisse Leveraged Loan Index returning 12.1% in the first half of 2021, compared to just 1.5% for BB rated loans. The return differential between these segments of the market is unprecedented.

What is your outlook for the rest of 2021?

We expect default rates will continue to decline based on the limited number of credits currently trading at distressed levels and the increase in the number of credit rating upgrades relative to downgrades. Despite the low

credit risk environment, we believe that CCC rated loans and bonds have limited upside given steep valuations. For example, investors in CCC rated bonds are receiving the lowest amount of premium over B rated bonds in the past 10 years.

We believe BB rated and higher-quality B rated loans and bonds should outperform in the second half of 2021. This will be driven, in our view, by investors rotating into the higher-quality parts of the loan and high-yield bond market on concerns around reduced central bank accommodation and a potential resurgence of COVID-19 infection numbers in the fall.

Duration is less of a concern now than at the start of the year. The U.S. 10-year Treasury yield high of 1.74% reached on March 31, 2021, may prove to be the year's high point. We believe Canadian investment grade corporate bonds have the potential to outperform their U.S. peers based on valuation. At June 30, the Bloomberg Barclays Canada Corporate Index spread was 25 bps higher than the comparable U.S. index.

Wellington Square refers to Wellington Square Capital Partners Inc. (sub-advisor) and Wellington Square Advisors Inc. (sub-sub advisor).

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And we will be invested in you.

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As at June 30, 2021, unless otherwise indicated.

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