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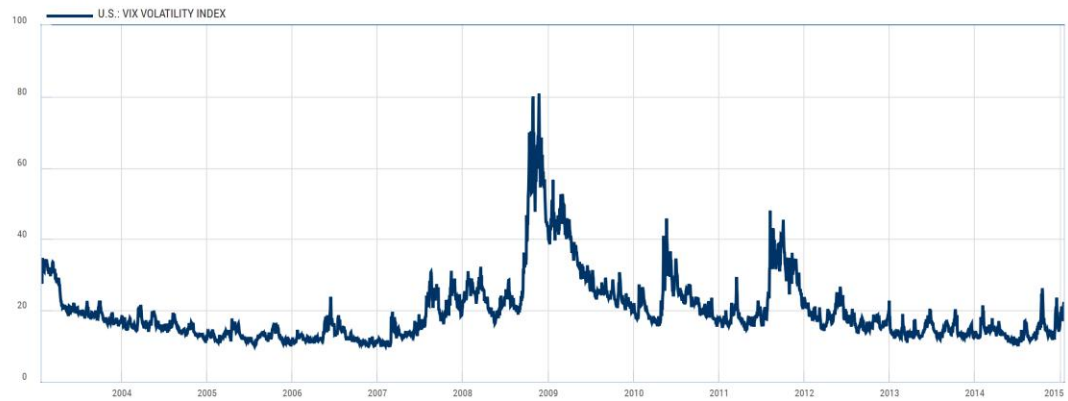
LAURENT WERMENLINGER, PL.FIN., FCSI®
VICE-PRESIDENT AND PORTFOLIO MANAGER

Strategic Outlook, January 2015

Over the past few months, investors have noted that financial markets are slightly more volatile. Nothing could be more normal after the "long pause" in the aftermath of the woes of 2008 when the VIX (*) Index rose to record highs (Chart 1).

Vix Volatility Index



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It was almost too good to be true! First observation: We can expect that markets will return to a more normal environment with some increase in the volatility of returns. Second observation: Over the past few years, the returns of the major asset classes have significantly exceeded expectations. The statistical phenomenon of regression to the mean could probably occur in the coming years and lead to lower returns than what we have seen recently.

What should we expect in terms of expected returns for the U.S. market as represented by the S&P 500 Index? There is a simple and efficient method to help us come up with an answer. Here it is:

1- The current rate of return with zero risk (as at January 20, 2015, according to Bloomberg) as represented by U.S. Treasury bills with a 3-month term to maturity: 0.02%

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Added to this is:

2- The inflation rate in the U.S. in 2014, as measured by the U.S. Consumer Price Index, less food and energy, according to the Bureau of Labor Statistics, U.S. Department of Labor: 1.6%

We add to the two variables previously mentioned:

3- The historical risk premium (Chart 2) an investor receives when he holds stocks (the average compensation obtained for the risk): 4%

S&P 500 Equity Risk Premium

*BASED ON CYCLICALLY-ADJUSTED OPERATING EARNINGS, BOND YIELDS AND TREND GDP GROWTH.

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Thus, over the coming years, the expected return of U.S. stocks should hover around 5.62% (0.02 +1.6 +4). The same calculation applies to the other asset classes. If the two first variables change, the expected return is modified accordingly. This is not a scientific calculation but merely a valid estimate, and nothing more.

Of course, markets are heavily influenced by a significant number of variables. Moreover, fluctuations of the Canadian dollar relative to other major currencies (U.S. dollar, Euro, Yen, etc.) influence the returns of Canadian investors who hold a portfolio containing international securities.

Once again, here are our key strategic guidelines:

1- Underweight debt securities in favor of stocks.
2- Underweight debt securities issued by governments in favor of corporate debt instruments and alternative securities.

3- Reduce the average term of fixed-income securities; reduce credit risks; active and selective approach regarding issuers; internationalization of securities and issuers.
4- Use of cash and/or other alternative strategies on a temporary basis to limit the volatility of securities making up the portfolios.
5- Pursue a selective approach with regard to sectors and countries included in the portfolios.
6- Europe and China are two major economic entities that we should favor over the coming years.
7- Technology, health sciences, renewable energy and financial services are sectors with good growth potential.
8- Maintain a “value” and “small cap” bias in stocks.

Once again, I thank you for the confidence you have placed in us. All the members of our team are fully aware that such confidence is earned each day through our constant focus on adding value to each action we take and to any advice that we give.

Laurent Wermenlinger, Pl.Fin., FCSI®
Vice-President and Portfolio Manager