ATB INVESTMENT MANAGEMENT

ATBIM SUB-ADVISOR SEARCH AND SELECTION PROCESS

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HOW WE CHOOSE OUR SUB-ADVISORS

One of the few things we're absolutely certain of is that no one knows everything. That's why ATB Investment Management Inc. (ATBIM), doesn't just diversify across stocks, regions and industries; it also diversifies across investment management firms. ATBIM uses an independent business model,a rare strategy in our industry. This means the professionals who choose the individual bonds and stocks that make up ATBIM portfolios are not limited to our in-house team.

Including external fund managers as part of our extended team means being able to offer investors the best expertise and assurance that we're putting their interests first. Let's dig into some of the key characteristics that ATBIM looks for when selecting an external sub-advisor.

DEFINING THE ASSET CLASS AND DECIDING ON ACTIVE OR PASSIVE MANAGEMENT

We've constructed the Compass Portfolios and ATBIS Pools to feature a mix of passive and active management. Passive investing can be defined as an investment strategy that tracks an index. A familiar example of an index would be the S&P/TSX Composite (TSX) in Canada. This index is composed of roughly 230 of the largest Canadian stocks that together represent about 95% of the investable public equity market in Canada. Each stock in the index is weighted in proportion to the company's size—commonly known as market-capitalization weighted. The largest stocks therefore might be 5 to 7%, whereas the smallest companies might only be held at a fraction of a percent. There are thousands of these indices globally that track various asset classes which can be further narrowed by regions, sectors, company sizes, and style (such as value or growth). There is a suite of investment products available where their main objective is to track these indices, ie. to replicate the performance of a specific index as closely as possible. Exposure to a desired asset class through these products can benefit an investor via lower costs, more liquidity and increased transparency.

Active investing on the other hand would involve selecting securities with the intention of outperforming an appropriate index. Using the same example as the TSX, a Canadian equity manager could build a portfolio of 30 Canadian stocks because they believe those securities can perform better than the broader 230 stocks held in the TSX Index. By performing better, that could be targeting higher returns, less volatility, or a combination of both. Active management can offer higher performance when compared to an index, but that is certainly not guaranteed.

At ATBIM, we assess whether an index for a particular asset class is efficient or not. The idea here is that an efficient index can be hard to beat, while an inefficient index allows more opportunities to achieve outperformance and/or lower volatility. To define efficiency, we look for evidence that a median manager would have a consistently higher probability of outperforming the index over time. If we find that this is true and the median manager consistently outperforms, we believe it can be supportive of choosing an active manager for that specific asset class rather than a passive index.

In assessing performance compared to the benchmark index, we look at a range of variables. Some of the variables we assess are:

1. Probability of median manager's outperformance over a medium-term timeframe (typically trailing four years on a quarterly rolling basis)
2. Magnitude of outperformance or underperformance
3. Tendency of median manager to exhibit lower volatility than the benchmark and magnitude of volatility reduction
4. Tendency of median manager to exhibit improved reward to risk ratio (return per unit of risk) than the benchmark and magnitude of improvement in that ratio

If the median manager has shown consistently positive attributes on these parameters and the fees don't offset the expected benefit, then we can conclude that the benchmark may not be efficient and an active manager should have a reasonable chance of adding value for an investor.

SEARCH AND SELECTION PROCESS

Once an asset class is determined to be a good candidate for active management, the next step of the process is to find a manager. Hiring every manager within an asset class might sound appealing from a diversification perspective, but isn't practical from an implementation standpoint.

We implement a consistent process for manager search and selection. The process incorporates **ATBIM's investment philosophy** at each stage. The process involves three steps:

1. Universe screening

Institutional managers for a particular investment universe are grouped, and quantitative information is gathered for the purpose of comparison against the passive index as well as against each other in the universe. Managers may be screened out at this early stage if their history is too short, or they exhibit a clear record of higher risk metrics or lower risk adjusted performance compared to the group.

2. Quantitative analysis

For those managers in consideration at this stage, a more in-depth quantitative analysis is conducted on an absolute and relative basis. While we include return related variables, variables highlighting risk measures dominate the analysis at this stage.

3. Qualitative analysis

At this point the field has narrowed considerably. A qualitative assessment is completed that may look for criteria such as:

a. A stable organizational structure
b. Team depth and experience
c. A disciplined and clear investment process
d. Consistency across multiple mandates (not just the one mandate we are considering)
e. Reasonable fees for service

The three-step search and selection process typically results in one or more managers that meet our criteria. Those managers, along with the supporting analysis for their selection, are then put forward to the ATBIM Investment Committee for final approval. Once approved, that manager can be used by the portfolio manager within each ATBIM product.

OVERSIGHT PROCESS ONCE A MANAGER HAS BEEN HIRED

We constantly monitor managers to assess if they are adding value to the platform and are performing in line with our expectations over a long period. This oversight is performed through numerous meetings, discussions and analysis throughout the year. We are cognizant of the fact that to perform better than benchmarks, managers have to be different than their benchmarks, which unavoidably will result in underperformance during certain periods. While we monitor our managers constantly, we don't evaluate them on short-term performance.

We evaluate managers with proper perspective by trying to dissect the reason for their relative performance. These reasons can be an unsustainable rally in lower quality stocks (typically occurs when the economy is coming out of recession) or manager style is out of/in favor (value vs. growth). We also try to ensure that managers are consistent in their investment approach, process and decision making and are not indulging in performance chasing behavior or experiencing style drift.

WHEN WE WOULD STOP WORKING WITH A SUB-ADVISOR

A relationship with a sub-advisor typically lasts several years, but there could be a few reasons to part ways with a sub-advisor. It could be as simple as ATBIM no longer finding the asset class attractive, or market structure has shifted. This happened with the dedicated real estate investment trust (REIT) position within our Compass Portfolios, which was originally added to complement equities as an asset class that exhibited attractive return characteristics and lower correlation when compared with other equity sectors. Over time, a major thing changed — the REIT sector was included as a part of the TSX Composite.

A manager could also be removed for consistently poor performance, and/or deviating from their investment philosophy or objective. For example, let's say we use a Canadian equity manager whose investment strategy focuses more on value-oriented stocks, and it underperforms the TSX Composite during a period when growth stocks outperform value stocks.

1. If they have stuck to their investment strategy, then they are doing what they were hired for and hence there is no reason to question their performance. It could just be timing; for example, this period just happened to favor growth stocks.

2. If they stray from their investment strategy, however, by picking stocks that don't fit their thesis, this could be a cause for review and eventual removal.

3. If there is persistent underperformance, even during periods when value stocks are doing well relative to growth stocks, this could also be cause for review and eventual removal. The reason could be that their stock picks have been poor.

CLOSING

Sub-advisor search and selection is a robust process led by ATBIM's research team. We utilize sub-advisors to deliver the highest expertise for a given asset class based on our search criteria above. This is our unwavering commitment to putting our unitholders' interests first to build exceptional portfolios for their long-term goals.