

INSTITUTIONAL

# ENDOWMENT AND FOUNDATION INVESTORS HAVE REASONS TO BE CHEERFUL

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## Introduction

Public equity and bond markets have climbed a wall of worry during 2023, with investors focused on pronounced geopolitical, inflation and recession risks.

As fiduciaries responsible for the management of perpetual capital, Endowments and Foundations (E&F's) have the opportunity to look through these near-term risks, without fear of capital withdrawals from nervous stakeholders. This longer-term perspective allows for a more optimistic outlook. We use our strategic asset allocation (SAA) framework and an illustrative case study to discuss why E&F investors have reasons to be cheerful despite a pervasive sense of near-term gloom. These reasons—expected long-term nominal returns, lower inflation and diversification—offer confidence E&F's can achieve required rates of return if they remain focused on core principles of long-horizon investing.

## Strategic asset allocation is essential to long-horizon investing

Strategic Asset Allocation (SAA) is the essential core of long-horizon investing. It begins with a recognition investors do not share common goals and objectives. E&F's are relatively unique. This reflects a combination of perpetual capital, a mandated annual average spend rate of 5%, and a target return gross of Consumer Price Inflation (CPI) to maintain real capital value (5%+CPI). They have a long-term investment horizon, an emphasis on both capital accumulation and income generation, and a willingness to remain invested through the volatility of economic and market cycles.

## Constructing an optimal portfolio allocation requires investment breadth and diversification to achieve long-term performance targets

Informed by an understanding of key investment objectives and constraints, the first step in the SAA process is to construct an optimal portfolio allocation. This rests on two important and related characteristics: investment breadth and diversification. In the absence of limiting constraints, well-constructed portfolios encompass a broad set of complementary, diversifying and rewarded risks. Breadth is synonymous with opportunity. A basketball team with players who can score three pointers, make lay ups, or slam dunk is better able to adapt to maximize their win probability in any situation; a one-dimensional team needs conditions to work in its favour in order to succeed. The same is true for investing: the broader the set of distinct and diversified opportunities within a strategic portfolio, the higher the probability investors will achieve their long-term performance targets in an uncertain world.

## Alternative investments can complement traditional asset classes to maximize geographic and sector diversification and embrace tactical opportunity

For E&F investors, an emphasis on breadth and diversification argues for relatively high exposure to equity risk, both domestic and foreign, as well as a mix of large- and small-cap exposures. It also suggests an appropriately sized role for illiquidity risk, realized via thoughtful allocations to private market alternatives. Many investors also allow for temporary tactical deviations from SAAs to take advantage of short-term market opportunities as an additional contribution to performance. We consider this a useful addition to E&F strategic portfolios.

## In diversifying portfolios, it's important to assess whether exposure to individual risks is acceptable

We consider a portfolio not simply as an optimized allocation to a set of assets, but also as a set of exposures to various risks. As each augmentation to the investment universe is considered, it makes sense to include only those risks that have fundamentally distinct and diversifying sources of value creation. Only these risks offer the possibility to enhance investment outcomes beyond those expected from a narrower portfolio. And even if a risk is diversifying, it's also important to assess whether investors are comfortable accepting exposure to it. At CIBC Asset Management (CIBC AM), we always take a view on the appropriateness of a risk first, and then appraise the diversification benefits it may offer as a secondary consideration.

## Continual oversight and review is key to attractive long-term performance

Optimal portfolio allocations reflect current investor objectives and constraints, as well as our current understanding of macroeconomic relationships that drive expected asset returns, volatilities, and correlations. These relationships inevitably change in a dynamic world. This makes it essential to regularly assess the appropriateness of strategic allocations. We recommend an annual review. And while continual rigorous oversight and monitoring is critical, we must also be careful not to overreact to emotions or personal biases, and instead use facts, experience, and diversity of thought to distinguish signal from noise.

## Reasons to be cheerful

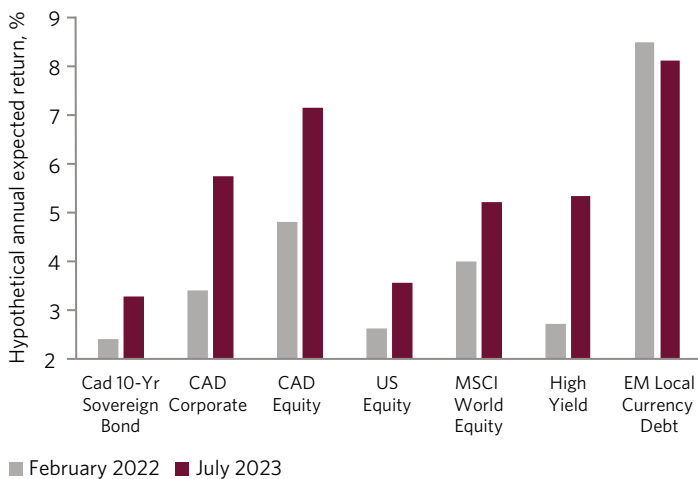
Long-horizon E&F investors who adhere to a disciplined SAA process can reasonably expect to achieve their mandated annual average return target of 5% plus CPI. We identify three reasons for cheer.

### 1. Expected nominal returns have increased and can be enhanced by active risk-taking where appropriate

There are two parts to a mandated annualized average return target: nominal returns and inflation. Let's start with the good news on nominal returns: passive expected long-term returns to traditional public-market equities and bonds have improved over the past couple of years (Chart 1). To be clear, they do not compare to average annualized returns realized over the past 50 years, and certainly pale in comparison with the recent golden era beginning with the global economy's liquidity-driven recovery after the 2007/08 Global Financial Crisis (GFC).

However, our goal is not to match the performance in either of these periods. Rather, it's to maximize the probability of achieving a targeted annualized average return of 5%+CPI. Based on our analysis, traditional public market asset classes are likely to get investors most of the way to this target, particularly if we enhance passive expected returns with active risk-taking where appropriate in less efficient asset classes. In particular, yields offered by high-quality corporates have risen to relatively attractive levels, and long-term expected returns appear compelling for investors willing to move out the fixed income risk curve into high-yield and emerging market debt. E&F allocations to fixed income have been trending lower. This made sense in the era of low or negative interest rates and a narrow focus on traditional developed market sovereign bonds. It does not make sense today.

**Chart 1 - Hypothetical expected annual returns to select public market asset classes**



The information was prepared by CIBC Asset Management Inc. using the following third-party data: Bloomberg®, Refinitiv Datastream. Data as at July 31, 2023. These data represent expected returns to asset classes assuming exposures are passively managed. They do not include any additional return that may be expected to accrue in those classes that may warrant the choice of active management. These hypothetical scenarios are shown for illustrative purposes only and are not indicative of future results. Please refer to the disclaimers at the bottom of this document for further information.

Portfolios can be enhanced further by embracing an allocation to alternative investments (alternatives) that allow investors to access diversifying sources of expected return and income not available from traditional public market buy-and-hold strategies. These alternatives also likely provide a better ability to hedge inflation and other risks. They include diversifying liquid alternatives such as global macro and alternative credit strategies, as well as private market alternatives offering enhanced expected return and income in exchange for investors foregoing some portfolio liquidity (Chart 2).

That said, care is required with private market alternatives. Ahead of the GFC, many E&F's, as well as other investor types, under-appreciated the risk associated with illiquid investments (Petzel, 2022). Similarly, public market drawdowns in 2022 left many investors with exposure to illiquid investments above investment policy maximums. In addition, many private market strategies have high—explicit and embedded—fees which may challenge the ability of E&F's to achieve net-of-fee returns consistent with annual spend rates. Allocating to liquid alternatives that replicate private strategies in highly liquid and regulated lower-fee vehicles can often make sense.

**Chart 2 - Private market alternatives offer investors a range of distinct attributes.**

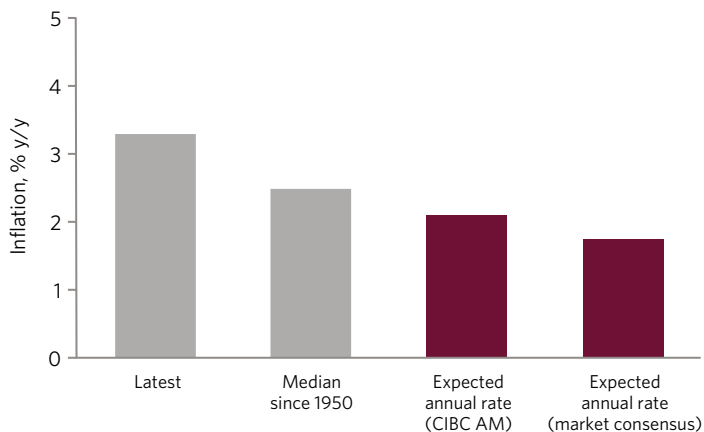
Private market alternative	Purpose for portfolio allocation				
	Enhanced return	Enhanced income	Enhanced diversification	Hedge against inflation	Hedge against tail risk
Private equity	✓		✓		
Private credit	✓	✓	✓	✓	✓
Real estate debt	✓	✓	✓	✓	
Real estate equity		✓	✓	✓	
Infrastructure debt	✓	✓	✓	✓	
Infrastructure equity	✓		✓	✓	
Hedge funds	✓		✓	✓	✓

The information was prepared by CIBC Asset Management Inc. This chart is for illustrative and general information purposes only.

**2. Inflation will likely continue to decelerate**

Current rates of inflation remain uncomfortably high and make a 5%+CPI return target more difficult to achieve. But nothing lasts forever; inflation has peaked in this cycle and is expected to continue decelerating as central bank policy remains relatively restrictive (Chart 3). This expected deceleration emphasizes the importance for long-horizon investors of looking through short-term volatility and instead focusing on the annual average inflation rate expected to prevail over a more relevant investment horizon. We focus on rolling 10-year periods and expect an annual average rate of 2.1% in the next decade for Canada, and a little higher for the US. Several factors—including high indebtedness, poor demographics, and the trend towards production nearshoring—suggest inflation will be higher than the average rate expected by the market consensus. But we are likely to get back and then stay relatively close to central banks' mandated 2% targets, on average.

Chart 3 – Canada Inflation – Historical and Expected



The information was prepared by CIBC Asset Management Inc. using the following third-party data: Bloomberg®. Data as of August 31, 2023. CIBC AM expected rate is average of next 10 years. Market consensus is measured using the 10-year Canada Breakeven rate Bloomberg® 10-year Canada Breakeven Rate Index, mnemonic: CDGGBE10 Index).

### 3. Diversification can smooth out short-term performance volatility

Many portfolios are dominated by public equity— or economic growth—risk. This means they typically perform well when economic growth is robust, and less well in periods when the economy is relatively moribund.

We expect public equity markets to remain the cornerstone of financial wealth creation for many decades. For this reason, a significant allocation to equity risk makes sense, particularly for long-horizon E&F investors.

However, well-constructed portfolios do not rely on a single source of risk and return. The challenge is how to diversify away from this risk in order to smooth out short-term performance volatility in a way that doesn't diminish long-term expected returns or require investors to forego too much liquidity.

In search of solutions, most attention is paid to average pairwise asset class correlations, with a focus on the least correlated corners of the investment universe (those with the deepest blue shading in Chart 4).

Chart 4 – Strategic portfolio allocations should embrace the opportunity to combine asset classes with attractive correlations

Asset class	Cash	Canada Govt. Bonds	Canada Corp. Bonds	Global High Yield	EM Bonds	Canadian Equity	US Equity	INTL Equity	Global Equity	Global Small Cap	Emerging Cap	Private Credit	Real Estate	Global Infra.	Private Equity	Comm.	Global Macro	Active Currency
Cash	1.00																	
Canada Govt. Bonds	0.12	1.00																
Canada Corp. Bonds	0.02	0.89	1.00															
Global High Yield	0.04	0.60	0.69	1.00														
Emerging Market Bonds	0.19	0.48	0.52	0.59	1.00													
Canadian Equity	-0.14	0.28	0.53	0.38	0.21	1.00												
US Equity	0.00	0.43	0.54	0.59	0.27	0.70	1.00											
International Equity	0.05	0.42	0.55	0.65	0.49	0.69	0.80	1.00										
Global Equity	0.01	0.45	0.60	0.65	0.42	0.75	0.96	0.92	1.00									
Global Small Cap Equity	-0.10	0.35	0.56	0.62	0.28	0.79	0.87	0.83	0.91	1.00								
Emerging Equity	0.00	0.35	0.53	0.49	0.65	0.54	0.52	0.68	0.69	0.60	1.00							
Private Credit	-0.12	-0.02	0.11	0.01	0.11	0.15	-0.03	0.04	0.02	0.08	0.11	1.00						
Real Estate	-0.09	0.09	-0.10	0.18	-0.02	-0.45	-0.11	-0.16	-0.17	-0.20	-0.26	0.11	1.00					
Global Infrastructure	-0.09	0.45	0.61	0.63	0.52	0.72	0.66	0.76	0.74	0.71	0.58	0.17	-0.08	1.00				
Private Equity	-0.20	0.00	0.01	0.01	-0.06	0.08	0.09	0.11	0.09	0.11	0.04	0.10	0.05	0.18	1.00			
Commodities	-0.19	-0.18	-0.02	0.22	0.14	0.37	0.13	0.24	0.20	0.29	0.22	0.15	-0.12	0.33	-0.10	1.00		
Global Macro	0.09	0.27	0.19	0.19	0.35	0.11	0.25	0.27	0.28	0.15	0.31	-0.23	-0.18	0.02	0.04	-0.19	1.00	
Active Currency	-0.10	0.14	0.31	0.32	0.36	0.44	0.40	0.37	0.42	0.39	0.29	0.24	-0.07	0.50	-0.01	0.16	0.23	1.00

Blue Cells Indicate Highest Potential Diversification

The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: Bloomberg® Finance L.P. Maximum sample range: January 1973 – July 2023. Deeper blue cells identify the greatest opportunity for diversification

Average correlations tell only part of the story. We don't need diversification when equity markets enter the most rewarding segments of bull markets. Diversification is valuable when public equities are either experiencing losses or trading in a sideways range. Few portfolios exhibit this type of diversification. But attaining it can be relatively straightforward, including for long-horizon E&F investors.

One way to introduce effective diversification is to allocate at least some portfolio capital to an eclectic mix of public fixed income strategies. Although the persistent negative equity/bond correlation investors became accustomed to in the first two decades of this century is the historical exception and not the norm, fixed income is expected to offer diversification during periods of equity stress, as well as a relatively attractive expected return and yield.

An allocation to a set of liquid alternative absolute-return strategies can be another source of effective diversification (Chart 5). There are many absolute return strategies to select from. Some are relatively narrow and exploit a specific risk. For instance, short-bias funds are designed to profit during periods of equity market drawdowns. Others are broad and expect to deliver relatively consistent returns exhibiting low correlation to both public equity and fixed income. Examples include macro, multi-strategy, and fund-of-funds strategies.

Private market alternatives can provide diversification through two routes. First, they allow investors access to opportunities not available from traditional public market vehicles. For instance, private credit lending strategies offer different sources of return and risk than developed-market sovereign or corporate bonds, or public equity. And inflation-indexed rental income accessed by private real estate and contractual agreements offered by many infrastructure assets mean these asset classes may represent better hedges against inflation than either public equity or fixed income.

**Chart 5 - Absolute Return strategies offer the opportunity to diversify portfolios when public equities experience market drawdowns**



The information was prepared by CIBC Asset Management Inc. using the following third-party data: Bloomberg®. Data as of July 31, 2023. Maximum sample is January 1994 - July 2023.

The second source of diversification associated with private market alternatives comes from artificial return smoothing. This smoothing reflects irregular marking-to-market of a fund's net asset value (NAV), due to the illiquidity of underlying investments. It allows valuation methodologies to look through market volatility and concentrate on the long-term fundamentals driving expected future cash flows. In particular, smoothing minimizes the risk of ill-timed asset allocation switches during periods of market downturn. These often lead to long-term underperformance relative to a portfolio that remains fully invested (the so-called 'investor gap'). As the well-worn saying suggests, the lion's share of long-term performance is driven by "time in the market, not timing the market."

Return smoothing associated with private market alternatives does come at a price. This includes a reduction in the magnitude of any expected return premium received in exchange for foregoing portfolio liquidity. Smoothing may also obscure the true risk of an investment. This presents measurement challenges and has the potential to breed investor complacency.

## An illustrative strategic asset allocation case study

Let's bring to life all the observations discussed in the previous section with some illustrative portfolio allocations. To ensure our illustrative examples encompass a broad set of E&F investors, we provide three strategic portfolios: conservative, moderate and aggressive. We can think of these profiles in terms of either risk tolerance or asset size. E&F's with assets of more than \$1 billion typically exhibit a more aggressive allocation to alternatives. This is reflected in the asset class allocation of our illustrative portfolios (Chart 6). Importantly, for all profiles we combine allocations to illiquid private market solutions with liquid alternative investments. Ensuring adequate liquidity consistent with near-term spending commitments is paramount for investors. We also recommend an allocation to an unfunded active currency strategy, sized equivalent to the E&F's notional allocation to international equity risk. This strategy is a low-fee, capital-efficient, diversifying, and liquid additional source of expected return.

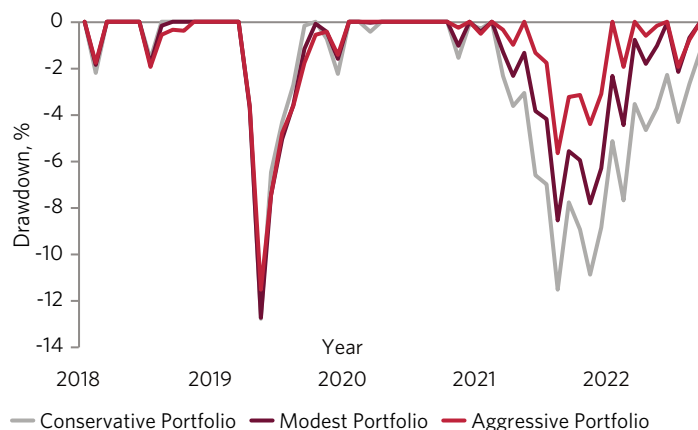
**Chart 6 - Strategic asset allocation for three illustrative E&F investor profiles**

Asset class	Allocation			Annual Expected Return
	Conservative Portfolio	Modest Portfolio	Aggressive Portfolio	
Cash	2.5%	2.5%	2.5%	3.9%
Canadian Sovereign Bonds	10.0%	5.0%	2.5%	3.3%
Canadian Corporate Bonds	22.5%	15.0%	5.0%	6.1%
High Yield Bonds	2.5%	2.5%	2.5%	6.3%
Emerging Market Bonds	0.0%	2.5%	2.5%	9.3%
<b>TOTAL FIXED INCOME</b>	<b>37.5%</b>	<b>27.50%</b>	<b>15.0%</b>	
Canadian Equity	25.0%	20.0%	15.0%	8.7%
Global Equity	20.0%	15.0%	15.0%	6.7%
Global Small Cap	5.0%	5.0%	5.0%	7.9%
Emerging Market Equity	0.0%	5.0%	5.0%	11.9%
<b>TOTAL PUBLIC EQUITY</b>	<b>50.0%</b>	<b>45.0%</b>	<b>40.0%</b>	
Private Credit	2.5%	5.0%	7.5%	7.8%
Real Estate	2.5%	5.0%	10.0%	7.7%
Real Assets	2.5%	7.5%	10.0%	7.8%
Private Equity	2.5%	5.0%	10.0%	11.2%
<b>TOTAL PRIVATE MARKETS</b>	<b>10.0%</b>	<b>22.5%</b>	<b>37.5%</b>	
Absolute Return	2.5%	5.0%	7.5%	10.0%
<b>TOTAL LIQUID ALTS.</b>	<b>2.5%</b>	<b>5.0%</b>	<b>7.5%</b>	
<b>TOTAL</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	
Unfunded Active Currency	25.0%	25.0%	25.0%	2.0%
<b>Hypothetical Exp. Return</b>	<b>7.6%</b>	<b>8.3%</b>	<b>8.8%</b>	

The information was prepared by CIBC Asset Management Inc. using the following third-party data: Bloomberg. Data as of July 31, 2023. These data represent expected returns to asset classes assuming a mix of passive and active management, as appropriate. These hypothetical scenarios are shown for illustrative purposes only and are not indicative of future results. Please refer to the disclaimers at the bottom of this document for further information.

Investors traditionally consider portfolio construction and risk in terms of two metrics: the asset class composition of portfolios, and the standard deviation of returns. This is a narrow perspective. Allocating according to asset class labels such as "equities," "fixed income," and "alternatives" obscures

the true source of portfolio risk. For instance, we label the first of our three illustrative portfolios conservative because it has the lowest notional exposure to alternatives and the highest to public fixed income. However, this portfolio would have experienced the largest drawdown in recent years. Capital drawdown is another pertinent definition of risk (Chart 7).

**Chart 7 - Historical capital drawdowns to three illustrative E&F portfolios**

The information was prepared by CIBC Asset Management Inc. using the following third-party data: Bloomberg®. Data as of July 31, 2023. Illustrative example only.

Relying on standard deviation as a core risk measure for portfolios that include private market alternatives is not coherent. As discussed above, returns to private market alternatives are often artificially smoothed, reflecting irregular marking-to-market of fund NAVs. This smoothing alters the profile and volatility of returns, and therefore their fit and risk within a portfolio. It requires investors to broaden definitions of risk to include scenario analysis, as well as metrics such value-at-risk, leverage, cashflow and liquidity, in order to adequately assess the riskiness of their portfolio.

Another way to assess portfolio risk is to look under the hood of asset class names and identify exposure to risk factors, including growth, interest rate, credit, inflation and illiquidity (Chart 8). This is important since only those asset classes and strategies that have fundamentally distinct sources of risk, and therefore value creation, offer true diversification and the ability to enhance risk-adjusted expected returns. Each of our three illustrative portfolios has been constructed to ensure exposure to a range of relevant risks, to maximize expected portfolio performance and to minimize reliance on one or other risk factor.

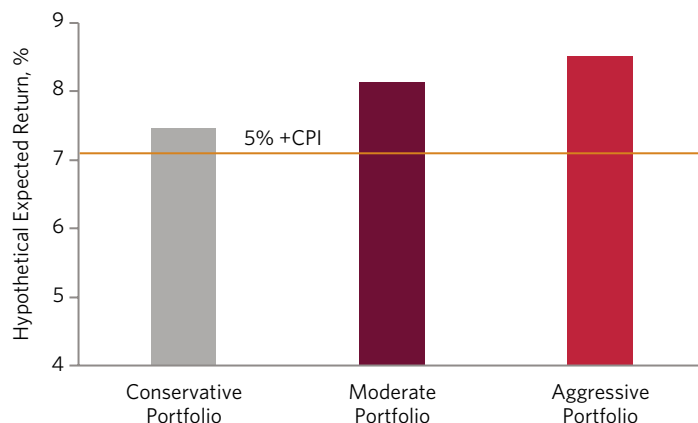
**Chart 8 - Indicative risk factor exposures in three illustrative E&F portfolios**

Risk Factor Exposure	Conservative Portfolio	Moderate Portfolio	Aggressive Portfolio
Growth	52.5%	50.0%	50.0%
Interest Rates	12.5%	7.5%	5.0%
Credit	27.5%	25.0%	17.5%
Inflation	5.0%	12.5%	20.0%
Illiquidity	15.0%	30.0%	42.5%

The information was prepared by CIBC Asset Management Inc. using the following third-party data: Bloomberg®. Data as of July 31, 2023. Illustrative example only. Intuitive risk factor loadings grouped using notional allocations. Columns intentionally sum to more than 100% as several risk factors share common features.

Armed with this knowledge, investors can better understand how their portfolio will likely perform in different market and macroeconomic environments, and maximize their ability to achieve or exceed long-term performance objectives. Chart 9 shows hypothetical expected performance for three illustrative E&F portfolios gross of management fees. A key element of maximizing the ability to achieve long-term performance objectives is to manage fee budgets. This includes, as appropriate, combining active and passive fulfillment choices across portfolios.

**Chart 9 - Hypothetical expected performance of three illustrative E&F portfolios**



The information was prepared by CIBC Asset Management Inc. using the following third-party data: Bloomberg®. Data as of July 31, 2023. The orange line identifies the E&F mandated annual average spend target of 5% plus Consumer Price Inflation (CPI), assumed to be an annual 2.1%. These data represent expected returns to asset classes assuming a mix of passive and active management, as appropriate. Illustrative example only. These hypothetical scenarios are shown for illustrative purposes only and are not indicative of future results. Please refer to the disclaimers at the bottom of this document for further information.

## E&F investors who adhere to well-established principles of SAA have three reasons to be cheerful

E&F's are unique investors with specific objectives and constraints. As long-horizon investors, they have the opportunity to look through near-term volatility and cyclical economic risks and focus on delivering performance consistent with their mandated spending targets. We think this is a realistic goal as long as E&F's adhere to well-established principles of strategic asset allocation. These principles emphasize the importance of breadth and diversification. They offer the opportunity to maximize expected returns, mitigate inflation risks, and realize the full benefit of diversification between an eclectic set of traditional public, liquid alternative, and private market solutions. Reasons to be cheerful, one, two, three.

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We provide our clients with our research insights and expertise on industry issues and themes that matter most to them.

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