PICTON INVESTMENTS

PORTFOLIO CONSTRUCTION TRENDS

THE PICTON REPORT 2025 MID-YEAR UPDATE

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MINDSET RESET: USING A "BUDGETING" FRAMEWORK TO ACHIEVE BETTER INVESTMENT OUTCOMES

HOW TO NAVIGATE UNCERTAINTY AND ACHIEVE CLIENT GOALS WITH GREATER CERTAINTY BY ALLOCATING RISK AND COST WITH PRECISION.

Navigating Complexity with Deliberate Portfolio Construction

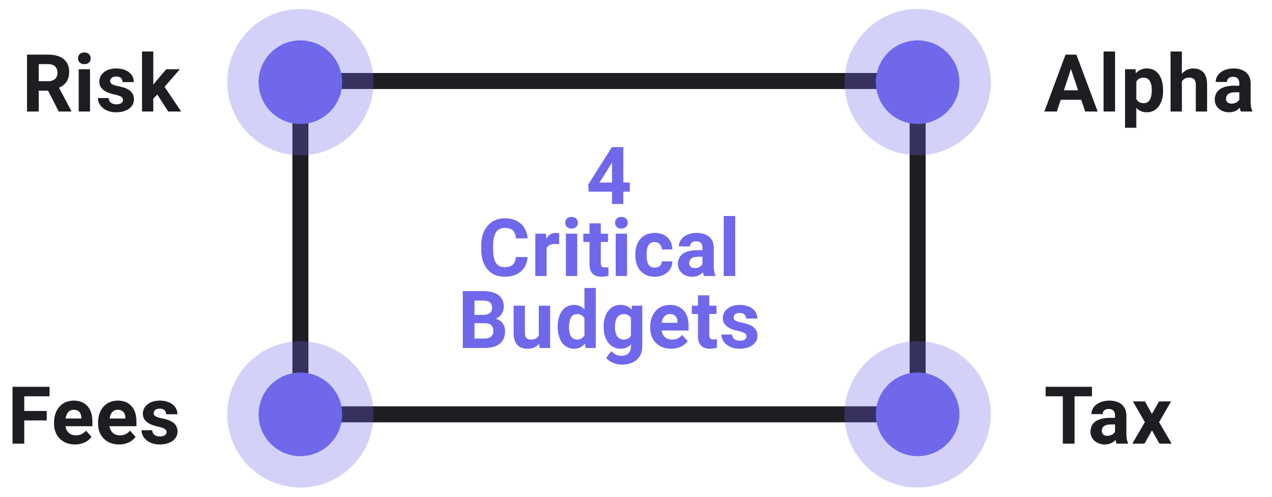
The macroeconomic outlook for the remainder of 2025 is expected to remain uncertain with persistent inflation concerns, interest rate ambiguity, and ongoing geopolitical risk. This calls for allocators to use disciplined, consistent and defensible approaches to constructing portfolios. We believe that against this backdrop of uncertainty advisors helping their clients make smarter, data-driven decisions to improve portfolio outcomes is becoming more challenging, and for many will require a re-think of existing behaviours.

We are encouraged by our ongoing work with advisors as they apply new tools and frameworks to enhance diversification, eliminate unintentional and inappropriately scaled risk exposures, and direct fee budgets where they can create the most value for their clients. Acting on these insights, they are realigning portfolios more closely with their clients' goals and seeking to reduce the likelihood of shortfalls against rising client expectations.

Adopting a Budgeting Mindset

In our view, one of the most effective frameworks for approaching portfolio design is through a budgeting lens, one that treats key dimensions of portfolio construction as finite resources to be allocated deliberately.

We advocate for a disciplined focus on four critical budgets:



Each of these can play a pivotal role in shaping long-term outcomes. Over-allocating in one can erode the efficiency of another. Overlooking any of these areas can destabilize the entire investment strategy.

For advisors looking to reposition portfolios in the second half of 2025, reassessing both the Risk and Fee budgets could be valuable. Thoughtful management of these two areas can reduce unintended exposures, enhance diversification, and improve value relative to cost.

Conclusion: Resilience Through Re-Allocation

Advisors today have more tools than ever to design portfolios with precision. By using these tools to apply a "budgeting" framework, advisors can:

- Build portfolios that are more diversified by source of return
- Reduce exposure to hidden concentrations and wasted costs
- Unlock higher-value outcomes per dollar of risk or fee deployed

By reshaping portfolios through data-driven, disciplined portfolio design advisors can deliver more resilient, cost-effective portfolios that may stand a greater chance of meeting (and exceeding) their clients' long-term goals.

> "*One of the most effective frameworks for approaching portfolio design is **through a budgeting lens**, one that treats key dimensions of portfolio construction as finite resources to be allocated deliberately.*"

RE-ALLOCATING RISK: A FRAMEWORK FOR GREATER PRECISION

Volatility: A Starting Point, Not a Solution

Since the advent of Modern Portfolio Theory (MPT) in 1952, volatility has become a widely accepted proxy for risk. However, volatility is generally a poor measure of risk. It rewards illiquidity, fails to distinguish directionality, ignores regime shifts, and underrepresents tail risks.

It does not account for the broader behavioural characteristics of asset classes, such as mean reversion or momentum. In isolation, it can create a false sense of understanding of portfolio risk.

> ***Volatility is generally a poor measure of risk...*** *it can create a false sense of understanding portfolio risk.*

Risk Budgeting: Evolving Towards a Total Portfolio View of Risk

The benefit of MPT was that it provided a framework for allocating risk in a portfolio rather than simply allocating capital. However, over the past 73 years allocators have built on this foundation to create more comprehensive approaches to risk budgeting in portfolio construction. For example, risk factor models are now used to provide a total portfolio view of risk that looks through each asset and strategy to enable risk to be thoughtfully allocated in multi-asset multi-strategy portfolios.

This approach allows for portfolios constructed with building blocks that aren't just diversified by label, but that are diversified by risk exposure, avoiding the hidden correlations and unintended exposures that can cause portfolios to disappoint at the worst times.

Key Principles for Deploying a Risk Budget Effectively

01. Begin with the Beta Footprint

Leverage a robust factor model to understand the primary drivers of risk and return. This ensures exposures are intentional and appropriately scaled, rather than incidental or redundant.

02. Become Unanchored to the Past

Markets rarely repeat the same movements they did in the past. Preparation is about considering what surprises could impact markets and portfolios, not just looking at how markets reacted to perceived risks in the past.

03. Allocate Risk, Not Dollars

Dollar-weighted allocations show where money is positioned within a portfolios; risk-weighted allocations reveal where outcomes are driven. Shifting to a risk-based lens can empower advisors to diversify more meaningfully, reduce concentration risk, and align allocations with true contribution to portfolio behaviour.

04. Incorporate a Goal-Based Framework

Beyond traditional volatility, consider shortfall risk—the probability of failing to meet financial goals. This may require reducing exposure to interest rate sensitivity or equity beta, creating portfolios capable of withstanding a wider range of economic and market regimes.

Case Study: Moving from Capital Allocation to Risk Allocation

Synopsis: A balanced investor holds a traditional 60/40 portfolio (60% global equities, 40% government bonds) that appears to be diversified on paper, as they own over 1,200 equities providing exposure to large and mid-cap equities from developed markets countries around the world, complemented by over 500 government bonds of varying maturity and credit quality. They wish to maximize their spending power in retirement by seeking higher returns and by reducing the concentration risk in their portfolio so that they can decrease the likelihood of taking a large loss at an inopportune time.

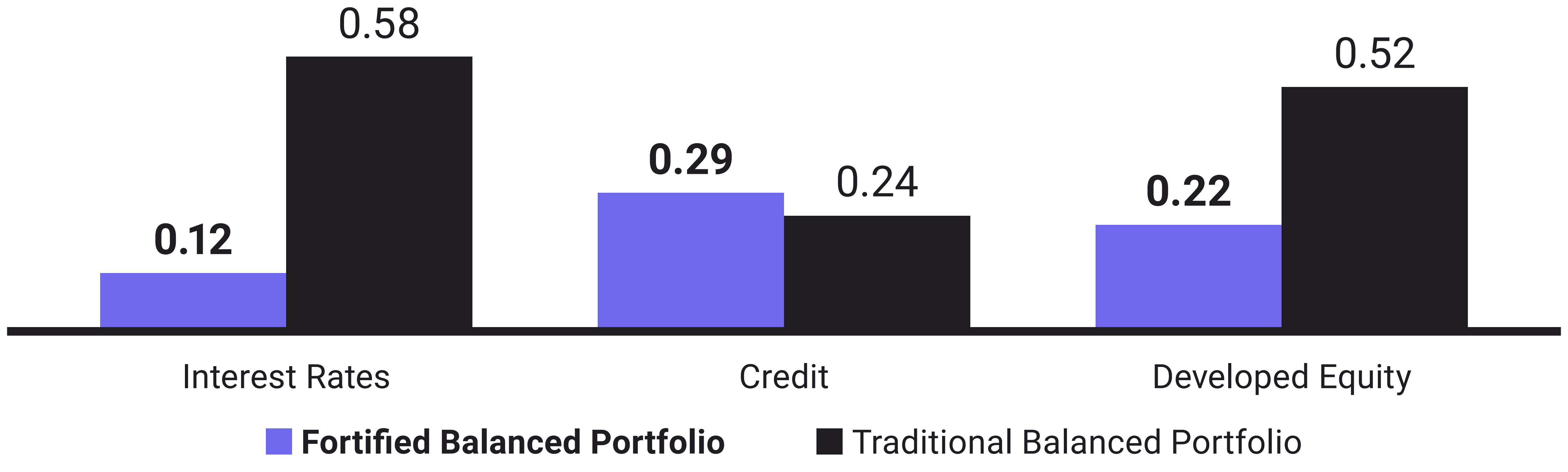
The investor decided to reallocate into the Fortified Balanced Portfolio which seeks to deliver higher returns while offering greater breadth of diversification so that returns are less dependent on the equity market and resilience is less dependent on interest rates.

This diversification of risk in a Fortified Balanced Portfolio can be less sensitive to changes in the broad equity markets and changing interest rates.

> *A balanced investor holds a* ***traditional 60/40 portfolio*** *that appears to be diversified on paper.*

FIGURE 2

Beta Exposure - Fortified Balanced Portfolio vs Traditional Balanced Portfolio



Source: Picton Mahoney Asset Management Research. Based on data from Jan 1, 2025 to May 31, 2025. Beta exposures provided above are based on a multiple regression of the items against the PMAM asset classes as indicated above. The PMAM asset classes have been constructed using a proprietary PMAM process using the return streams of the individual assets. These individual assets are represented using actual and historical performance data of the investible indices or futures contracts. When assembling the individual assets into asset classes we assume monthly rebalancing and there is no impact due to transaction costs, fees, expenses or commissions. Performance of an actual portfolio may differ significantly.

FIGURE 1

Fortified Balanced Portfolio vs. Traditional Balanced Portfolio – Asset Allocation & Risk Allocation

Fortified Balanced Portfolio	Dollar Weight	Risk Weight
Equity	**30.5%**	**53.0%**
Fixed Income	**16.5%**	**9.3%**
Alternative	**51.0%**	**37.7%**
Enhancers	14.0%	11.9%
Diversifiers	27.0%	19.5%
Inflation Protection	10.0%	6.3%
Cash	**2.0%**	**0.0%**

Traditional Balanced Portfolio	Dollar Weight	Risk Weight
Equity	**60%**	**80.4%**
Fixed Income	**40%**	**19.6%**
Alternative	-	-
Enhancers	-	-
Diversifiers	-	-
Inflation Protection	-	-
Cash	-	-

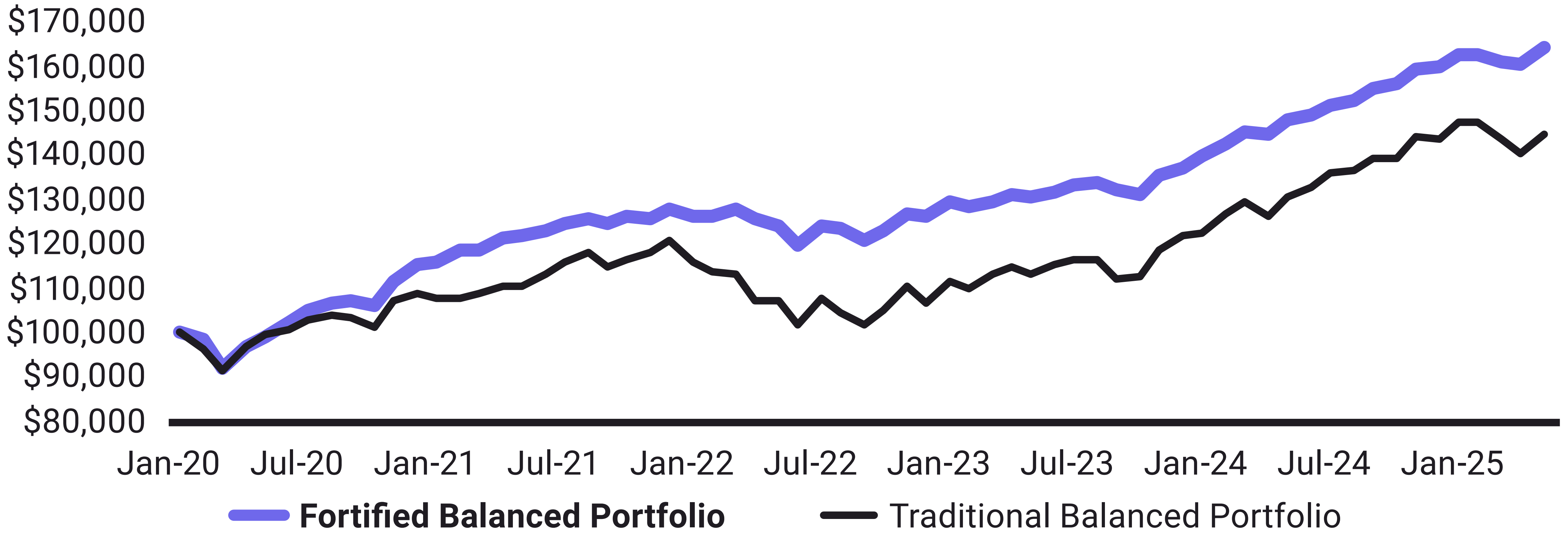
Source: Picton Mahoney Asset Management Research. As of May 31, 2025. For illustrative purposes only. Dollar weight refers to the percentage of the total portfolio value represented by a specific investment or asset class. Risk Weight is intended to measure the risk contribution to total portfolio risk (in percentage) by asset class and by holding. Generally, asset classes and holdings with higher stand-alone volatility, greater weight, or higher correlation tend to make a larger contribution to portfolio risk.

With equity risk more evenly distributed in the Fortified Balanced Portfolio, it aims to achieve better risk-adjusted returns with less volatility, while improving the risk-reward profile of the portfolio.

FIGURE 3

Fortified Balanced Portfolio vs. Traditional Balanced Portfolio Performance

Growth of C$100,000



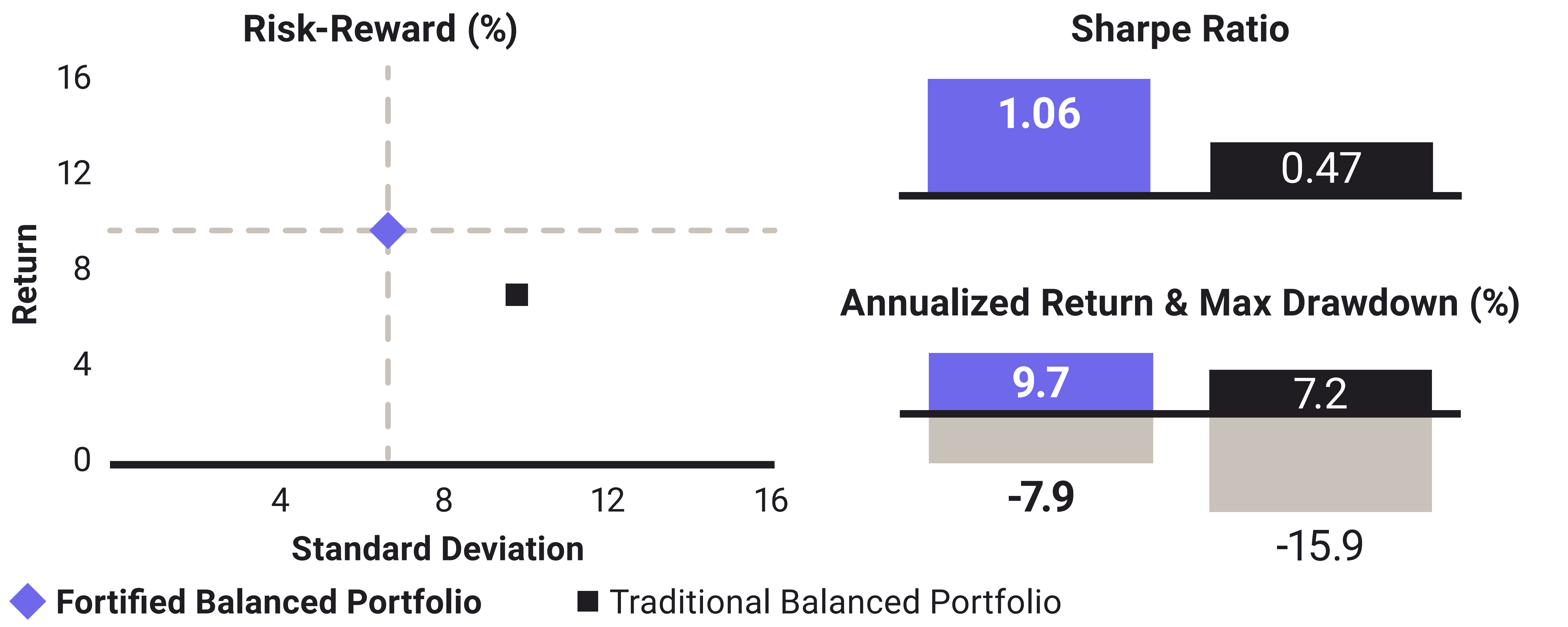
Source: Morningstar, Picton Mahoney Asset Management Research. From Jan 31, 2020 to May 31, 2025. The rate of return shown is used only to illustrate the effects of the compound growth rate and is not intended to reflect future values of the investment or returns on investment.

Trailing Returns	Fortified Balanced Portfolio	Traditional Balanced Portfolio
1 M	2.3%	3.1%
3 M	0.8%	-2.1%
YTD	2.6%	0.7%
1 Yr	11.0%	10.8%
3 Yrs	9.8%	10.5%
5 Yrs	10.6%	7.8%
Since Inception*		
Return	9.7%	7.2%
Volatility	6.7%	9.8%
Sharpe Ratio	1.06	0.47
Sortino Ratio	1.42	0.76
Max Drawndown	-7.9%	-15.9%

> “*This diversification of risk in a **Fortified Balanced Portfolio** can be less sensitive to changes in the broad equity markets and changing interest rates.*”

FIGURE 4

Redistributing equity risks can provide competitive returns with less volatility



Source: Morningstar, Picton Mahoney Asset Management Research. From Jan 31, 2020 to May 31, 2025, annualized based on monthly returns.

ENHANCING VALUE: THE ROLE OF FEE BUDGETING IN PORTFOLIO OPTIMIZATION

Global Shifts in Fee Allocation

Over the past two decades, we've seen a meaningful evolution in how capital and fee budgets are allocated in a portfolio:

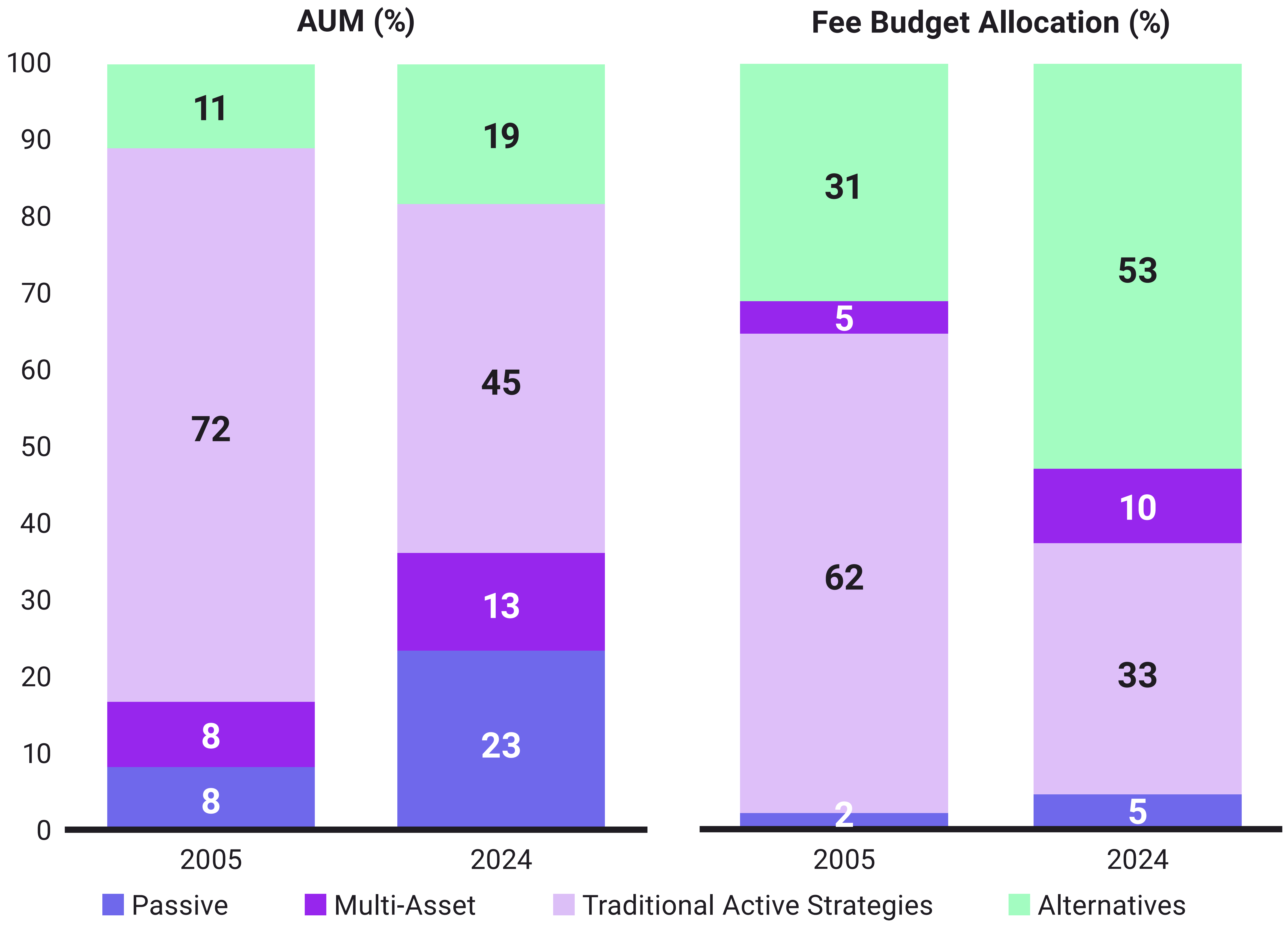
Two decades ago, 72% of capital was allocated into traditional long-only active funds. Today, that share has declined to 45%, while allocations to alternatives and low-cost passive strategies have risen to a combined 42%.

Fee allocations have shifted in parallel. Traditional active management's share of total fees has dropped from 62% to 33%, while alternatives now command 53% of the fee budget (this is based on management fees and excludes performance fees).

This trend reflects not a rejection of active management, but rather a realization that potential manager skill can be accessed at a lower overall cost by pairing high value add alternative strategies with cost-efficient market exposures.

> *Two decades ago, **72% of capital** was allocated into traditional long-only active funds. Today, that share has **declined to 45%.***

FIGURE 5
The Evolution of Capital and Fee Budget Allocations in Portfolios



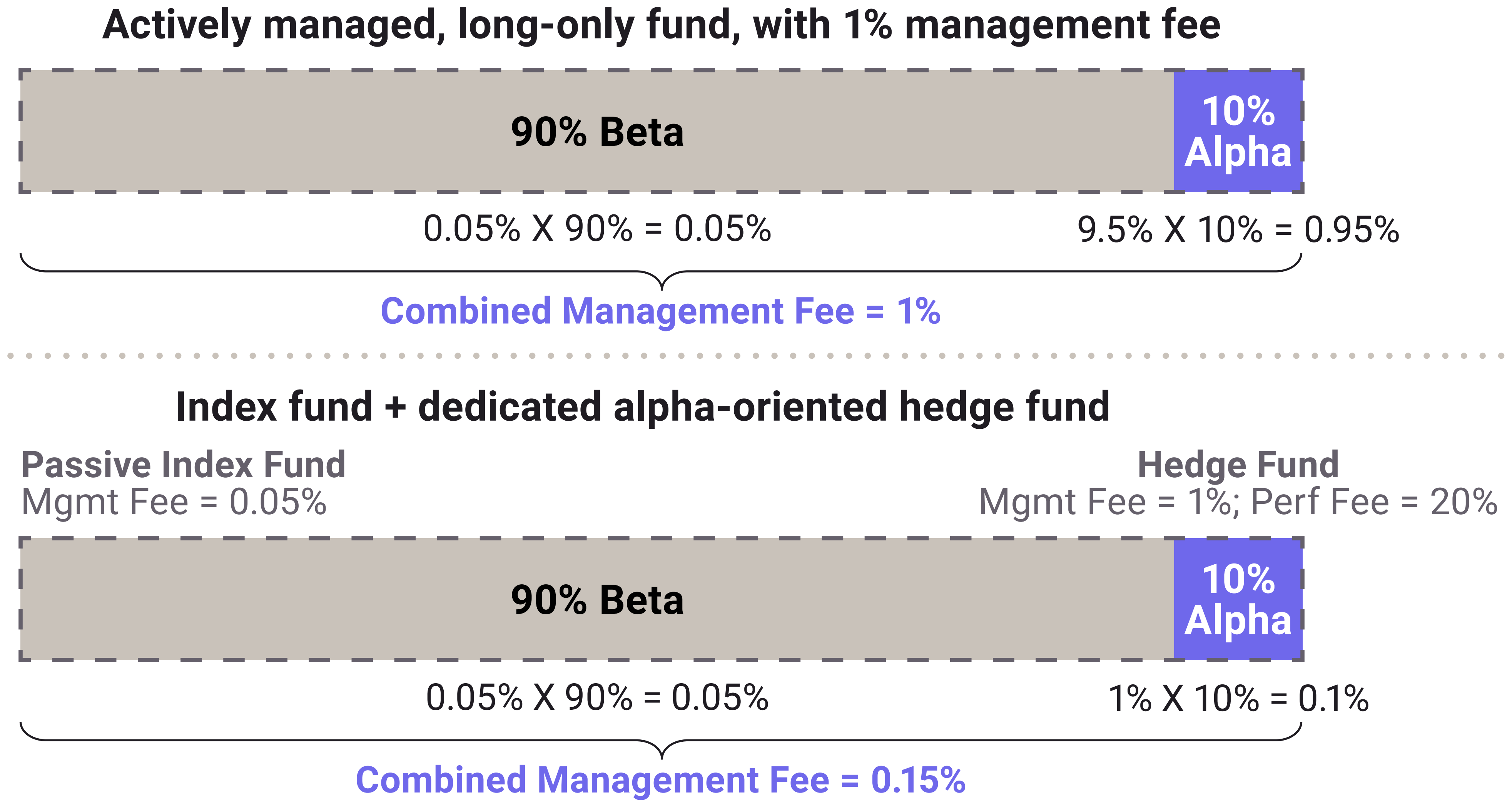
Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2005 to May 2025.

A Useful Analogy: Lessons of the Streaming Era to Investing

Just as streaming platforms have disrupted cable by offering curated, on-demand access to only the content consumers value, modern portfolio construction enables investors to "unbundle" market exposure from manager skill. In the past, a mutual fund bundled both together and charged for the whole package. Today, investors no longer are forced to access manager skill by buying a traditional long-only mutual fund and paying active fees for the entire package—even if only a small portion was worth the premium. Instead, investors can separate market exposure (via low-cost passive funds) from manager skill (via high-value alternatives), with the aim to achieve better outcomes at lower costs. It's the streaming model for investing.

FIGURE 6

Unbundling Alpha to Help Reduce Costs



Source: Picton Mahoney Asset Management Research. For illustrative purposes only.

Fee Budgeting in Action: A Comparative Example

Consider a traditional actively managed long-only equity fund charging 1% management fee. If 90% of the fund's returns come from market beta, the investor is effectively paying 95 bps for the 10% of active value—equating to a 9.5% fee on that small portion.

Now compare that to an "unbundled" allocation: 90% in a passive index ETF (with an assumption that management fee is 5 bps) and 10% in a hedge fund (with an assumption of 1% management fee). The total management fee drops by 85% to 0.15%. Even factoring in a 20% performance fee, the hedge fund would need to earn a gross return of 43.5% before total fees matched the traditional fund's 1% flat rate.

A 70/30 split still lowers management fees by 67% (to 0.33%) while tripling exposure to manager skill. Management and performance fees for this approach could only surpass the traditional actively managed fund's management fee if the hedge fund delivered more than 11.17% gross return.

As you can see, combining high value add alternatives with cost efficient market exposures can be a dominant strategy that may provide investors with meaningfully more access to manager skill at a meaningfully lower overall cost.

Looking Ahead: Strategic Asset Re-allocation

Using a budgeting framework to allocate risk and cost in a portfolio with precision can offer the compelling advantage of making a portfolio more resilient while improving value delivered relative to costs.

Equally importantly, it fosters a mindset reset that aligns portfolio construction more closely with investor goals. By deliberately allocating every unit of risk and dollar of fee spend advisors can gain a defensible, repeatable process that can adapt as their client goals market regimes and regulatory landscapes evolve.

In practice, this can be a meaningful step for advisors as they move towards a Total Portfolio Approach with the goal to deliver greater certainty in meeting their client goals while navigating tomorrow's unknowns.

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