REPORT

To: ONE Joint Investment Board
From: Keith Taylor, Chief Investment Officer, ONE Investment
Date: March 1, 2023
Re: Fund Manager Performance Review Q4 2022
Report: ONE JIB 2023-004

1. RECOMMENDATIONS

It is recommended that the Board:

1. Receive the report.

2. SUMMARY

This report summarizes the performance of the ONE Investment Prudent Investment Funds for the fourth quarter of 2022, including a brief overview of factors contributing to performance.

The key themes affecting the markets in the quarter included signs that inflation numbers may have already peaked, indications that central banks are set to slow the pace of interest rate increases, and the ongoing Russian invasion of Ukraine. The tone in the financial markets improved after several quarters of challenging performance. Equity markets had strong returns in the fourth quarter as sentiment improved and bond returns were bolstered by narrowing credit spreads and an improving interest rate outlook.

While all the pooled funds had positive returns in the fourth quarter, they were not sufficiently large to offset the weakness from previous quarters. All funds had negative returns for the 2022 calendar year with both equities and fixed income weak, which is a highly unusual outcome. The surging inflation and aggressive interest rate hikes by central banks meant that asset class diversification proved less effective than expected in mitigating investment losses in the year. The performance of the funds as of December 31, 2022, is summarized below:

	Quarter	1 Year
ONE Canadian Equity Fund	7.0%	-7.7%
ONE Global Equity Fund	8.3%	-10.8%
ONE Canadian Corporate Bond Fund	0.6%	-8.3%
ONE Canadian Government Bond Fund	0.6%	-3.6%
ONE Global Bond Fund	3.2%	-8.6%

3. BACKGROUND

ONE JIB and ONE Investment have a responsibility to review the performance of the investment managers

As outlined in ONE JIB's Policy for Reviewing External Fund Managers, ONE Investment is to report to ONE JIB on a quarterly basis, identifying any issues arising from the quarterly review of the external investment managers. The report is to include a summary of the positioning of the mandates, information on investment performance, an explanation of the drivers of performance, and commentary to explain the performance and market context.

4. ANALYSIS

Inflation surged earlier in 2022 but started to abate in the second half of the year

One of the main investment themes in 2022 was the recognition by central banks that inflation pressures were not transitory and that aggressive action by central banks was required to arrest the surging inflation figures. Almost all major global central banks raised interest rates sharply, hoping to contain inflationary pressures. Historical experience has shown that once high inflation levels get entrenched in the economy, they set expectations that can lead to persistently high inflation, making them very difficult to reverse. As a result, central bankers were aggressive in their attempts to fight inflation.

In the fourth quarter there were continued signs that inflation may have peaked and was starting to moderate. Inflation in the United States and Canada peaked at 9.1% and 8.1% respectively in June and has trended down somewhat thereafter, ending the year around 6.5%. Several months of declining inflation figures indicate that inflation may have peaked, and central banks have started to hint that rate hikes would slow in the near future.

Central Banks continued to raise interest rates in the fourth quarter, but rate hikes are set to slow

Central banks aggressively increased interest rates in 2022, with the US Federal Reserve bank raising its target rate seven times during the year to increase rates by 4.25%. The Bank of Canada also increased its policy interest rates seven times, moving the rate from 0.25% at the start of the year to 4.25% by year end. These are very significant policy moves that are intended to slow an overheating economy and address the surging inflation pressures.

Policy interest rates set by central banks continued to rise in the fourth quarter, with the Bank of Canada raising its policy rate by 1% and the US Federal Reserve increasing its policy rate by 1.25%. These rates hikes were widely expected by the financial markets and were largely discounted in the performance of equity and bond markets in previous quarters. Signs that inflation may have already peaked and hints from central bankers that the pace of rate hikes would slow were well received by markets. The rising interest rates in 2022 were a major contributor to sharp weakness in both global bond and equity markets. Signs that these rate hikes may soon end led to strength across the financial markets in the fourth quarter.

Investor sentiment improved in the fourth quarter, leading to stronger performance for corporate credit and equities

It is not uncommon for higher risk profile investments to have more challenging performance amid uncertainty and this theme helps characterise some of the market trends in 2022. Earlier in the year the Russian invasion of Ukraine, surging inflation and rising yields gave investors reasons to worry and the uncertainty led to weakness in higher risk profile investment types, including high yield bonds and equities. As interest rates started to increase, credit spreads, the extra yield offered by corporate bonds above sovereign bond yields, started to become wider, compounding the weakness for corporate credit and especially high yield bonds. Treasuries and sovereign bonds, the traditional safe-haven investments, normally tend to perform well when higher risk profile investments are weak, but they too had weak performance due to the rising interest rates.

In the fourth quarter the prospect that rate hikes would slow bolstered sentiment, leading to a rally in equity markets globally and a recovery in bond markets. Credit spreads narrowed in the fourth quarter, leading to outsized returns, especially for high yield bonds. While fixed income and equity markets performed strongly in the fourth quarter, the gains in the quarter were insufficient to offset weaker performance experienced earlier in the year.

The ONE Canadian Equity Fund had returns of 7.0 % in the quarter, bringing full year 2022 returns to negative 7.7%

The Fund had strong performance in the fourth quarter with returns of 7%, outperforming its benchmark by about one percentage point. Both sector allocation and security selection contributed to this outperformance, but security selection had a more pronounced effect. The strong performance in the fourth quarter was insufficient to offset the weakness experienced earlier in the year. For the full year the ONE Canadian Equity Fund had returns of negative 7.7% with the Fund underperforming its benchmark by about 2%. The under-performance for the 2022 calendar year was primarily a result of sector allocations that collectively detracted over 3% from index relative performance. Security selection for the Fund for the 12-month period had a positive contribution on returns, adding over 1% to performance relative to the benchmark.

Commodity-related industries tended to perform well in the quarter and for the calendar year, which the Fund was not able to fully benefit from. The Fund typically holds about one half of the exposure to the Materials and Energy sector versus its benchmark, which reflects a structural underweight in these sectors that is intended to reduce the volatility of returns. For the full year this underweight allocation had a significant negative impact on performance, as these sectors outperformed the Canadian equity market; this created a drag on its performance relative to the benchmark of over 3%. In the fourth quarter, the effect of underweight exposure to these two sectors was much smaller, detracting about 0.4% from Fund performance relative to the benchmark. The Fund held a large position in Finning International, which rents and sells Caterpillar equipment used in the construction and resource sectors. This holding, which represents about 4% of the fund, rose 39.7% in the quarter, making a significant contribution to overall Fund returns in the quarter. While this holding may not be part of the Energy or Materials sectors, it benefitted from the strength in these sectors.

The ONE Global Equity Fund had returns of 8.3% in the quarter, with full year 2022 returns of negative 10.8%

The ONE Global Equity Fund had strong performance in the fourth quarter with returns of 8.3%, performing broadly in-line with its benchmark. These strong returns in the quarter helped to offset some of the weak performance in the previous three quarters, leading to returns of negative 10.8% for the 12-month period ending December 31, 2022. For the full year the Fund outperformed its benchmark by about 1.6%.

The investment manager's focus on security selection contributed to performance in the quarter. Several individual holdings made a significant contribution to returns, including Moderna, Inc. with returns of 51.9%. Holdings in BMW also made a significant contribution as the preferred and common shares held, which collectively represent 4.7% of the Fund, were up about 19%. The performance of FTI Consulting, Inc., which represents 3.5% of the Fund, was a drag on performance with returns of negative 4.2% in the quarter.

Currency movements in the quarter contributed to performance. The Fund does not hedge foreign currency exposure, so large currency movements can affect total returns. During the quarter many major currencies strengthened versus the Canadian dollar with the Pound Sterling up 6%, the Euro up 7%, Yen up 8%. The translation of local currency returns of foreign holdings back to Canadian dollars collectively contributed positively to Fund returns, increasing the total returns by about 1.9%.

The two Canadian fixed income funds both had returns of 0.6% in the quarter, outperforming their benchmarks, primarily due to their heavy corporate bond exposure

The ONE Canadian Government Bond Fund and the ONE Canadian Corporate Bond Fund both had returns of 0.6%, both slightly outperforming their performance benchmarks in the quarter. A heavy allocation to corporate credit and lower allocation to government bonds versus their benchmarks helped performance in the fourth quarter as the narrowing of credit spreads in the quarter led them to outperform government bonds. Security selection within corporate bond holdings for both Canadian Bond funds made a modest positive contribution to returns, helping performance relative to their benchmarks.

For the full year ONE Canadian Government Bond Fund and the ONE Canadian Corporate Bond Fund both had returns of -3.6% and -8.3% respectively. The ONE Canadian Corporate Bond Fund has a longer duration and hence is more sensitive to the effects of rising interest rates, which resulted in weaker performance than the ONE Canadian Government Bond Fund during the year.

Both Canadian bond funds had slightly less duration than their benchmarks at the start of the quarter, but during the quarter duration increased to approximately the benchmark levels. The movements in interest rates had minimal direct effect on overall index-relative performance but positioning across different segments of the yield curve had a small impact on returns. Both Canadian Bond Funds had underweight key rate positioning to the 6-month segment of the curve, which made a small positive contribution to relative performance, which was mostly offset by their overweight positioning to the 2-year segment of the curve.

Performance of the ONE Global Bond Fund improved in the fourth quarter as credit spreads narrowed, leading to returns of 3.2%

The ONE Global Bond Fund had returns of 3.2% in the fourth quarter, outperforming its benchmark in the period. This fourth quarter performance helped to offset some of the weaker performance experienced in the previous quarter. Despite outperforming its benchmark by about 2.9%, the Fund had full year 2022 returns of negative 8.6%. These annual returns reflect the challenging environment for fixed income investments during the year.

Currency movements had a notable negative impact on performance. The ONE Global Bond Fund has a variable currency hedging policy, and currently has 86% of its foreign currency exposure hedged against the Canadian dollar. Except for the US dollar, most major global currencies were much stronger versus the Canadian dollar. The Yen, Euro and Pound Sterling appreciated 8%, 7% and 6% respectively in the quarter. The currency movement led to strong Canadian dollar returns from the individual securities that the Fund was not able to fully benefit from, as losses on the currency hedges eliminated most of this positive currency effect.

The Fund's allocation across segments of the global bond markets in the quarter made a positive contribution to returns relative to its benchmark. Higher risk profile investments performed well in the quarter, which benefitted high yield bonds. The Fund has a heavy allocation to high yield bonds and a light exposure to treasuries relative to its benchmark. Credit spreads declined in the fourth quarter leading to outsized returns for corporate credit, especially for high yield bonds. While high yield bonds represent only about 3% of the holdings in the Fund's benchmark, the Fund has over 24% in high yield bonds, so the strength in this segment of the fixed income markets had a large contribution to the Fund's returns in the quarter. The manager of the ONE Global Bond Fund reduced exposure to high yield bonds in the quarter with allocations declining by about 5%.

The maturity profile of investments and their positioning along the yield curve helped index relative performance. The shorter duration profile of the Fund relative to its index meant that rising interest rates had a smaller negative impact on Fund performance than on its benchmark. The Fund has about 7% less exposure to bonds with maturities between 1 and 4 years than its benchmark. Shorter term yields rose in the quarter, which had a smaller negative effect on Fund performance than its benchmark. The manager has increased the interest rate sensitivity of the Fund over the year, raising bond duration from 3.8 years at the start of 2022 to 4.9 years at the close of the year. The average bond duration of the Fund's benchmark declined by 0.8 years over this same time frame. The Fund continues to be less sensitive to interest rate changes than its benchmark.

5. CONCLUSION

The fourth quarter review of manager performance did not identify any major performance issues that warrant concern. The performance of the ONE Prudent Investment Funds in the quarter improved as the outlook for interest rates changed. Central banks are now signalling that the interest rate hikes may slow as there are signs that recent rate hikes are having the desired effect of reducing inflationary pressures. This led to strength in both equity and bond markets in the fourth quarter, but these gains were not sufficient to offset weakness in the previous three quarters of 2022, leading to negative returns for all the funds for the 2022 calendar year.

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