REPORT

To: ONE Joint Investment Board
From: Keith Taylor, Chief Investment Officer, ONE Investment
Date: June 1, 2023
Re: Fund Manager Performance Review Q1 2023
Report: ONE JIB 2023-021

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 first quarter of 2023, including a brief overview of factors contributing to performance.

The key themes affecting financial markets in the first quarter included:

1) Macro-economic themes: Inflation figures trending lower but remaining above central bank targets amidst signs of economic growth and tight labour markets;
2) A changing interest rate outlook with many central banks poised to pause interest rate hikes; and
3) Stress in the banking sector that led to the failure of two US regional banks and the merger of Credit Suisse with UBS.

The tone in financial markets was positive in January and February as inflation figures continued to trend lower amidst signs of continued strong economic growth. However, the tone was dampened somewhat in March as developments in the banking sector surfaced. The failure of two US regional banks in mid-March caught many by surprise and highlighted risks that had not been fully appreciated by the markets. Central banks stepped in to provide liquidity to the banking sector, helping to ensure stability in the financial markets. These events had limited impact on equity markets, but in fixed income markets, credit spreads moved slightly higher while longer-term bond yields trended lower, leading to higher bond prices.

All the pooled funds had positive returns for a second consecutive quarter, as markets continue to bounce back after challenging performance in 2022. Equity markets were quite strong, encouraged by the outlook for continued economic growth, while fixed income returns were bolstered by falling longer-term bond yields. Performance of the funds over the last 12 months was more mixed, with some of the funds experiencing negative returns. The performance of the funds as of March 31, 2023, is summarized below.

	Quarter	1 Year
ONE Canadian Equity Fund	5.9%	-1.0%
ONE Global Equity Fund	7.3%	3.7%
ONE Canadian Corporate Bond Fund	2.5%	-0.7%
ONE Canadian Government Bond Fund	1.7%	0.4%
ONE Global Bond Fund	2.9%	-1.8%

3. BACKGROUND

ONE JIB and ONE Investment have a responsibility to review the performance of the fund 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 fund 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.

After surging in 2022, inflation continues to trend lower, but remains well above central bank targets

Inflation surged in most major global economies in 2022, peaking in the United States and Canada at 9.1% and 8.1%, respectively, in June last year, but aggressive interest rate hikes in 2022 helped address these inflation pressures. Inflation figures have trended down steadily since last June, reaching 5.0% and 4.3%, respectively, in the United States and Canada by quarter end. While this remains above the central banks' 2% inflation target, the progress is encouraging.

There has been concern that rapidly rising interest rates could lead to a sharp slowdown in economic activity and the potential for an economic recession. Currently, labour markets continue to be tight, and economic activity continues to be robust. There is hope that inflation can be brought back to target levels without causing a recession and that a 'soft landing' for the economy can be engineered. As economic activity reacts to interest rate hikes with a significant lag, it is not yet clear if this can be achieved.

After aggressive interest rate hikes last year, central banks are poised to pause increases

The Bank of Canada became the first major global central bank to put further interest rate hikes on hold, indicating that it is confident that higher borrowing costs are working to slow demand. After raising interest rates by a total of 4.25% since the start of 2022, the Bank indicated that it would hold the policy rate at current levels, conditional on developments evolving broadly in line with its outlook. The US Federal Reserve Bank (Fed) continued to raise rates in the quarter, but at a slower pace. The Fed raised its policy rate by 25 basis points in February and was widely anticipated to increase rates by an additional 50 basis points in March. Due to the developing issues in the banking sector, only a 25 basis point rate hike was announced in March. While the Fed has not announced its intention to stop interest rate hikes, it is broadly understood that it is nearing the end of rate hikes, and financial markets are already anticipating that rate cuts are on the horizon. In Europe and the United Kingdom, further interest rate increases are still anticipated, but markets are anticipating that interest rates may start to fall later this year.

Turmoil within segments of the banking sector emerged in the quarter, highlighting risks to the outlook

The banking sector became a source of concern in March as two US regional banks failed and troubles at Credit Suisse resulted in it being acquired by UBS. These developments were completely unexpected, and many were surprised by how quickly they unfolded.
On March 8, Silicon Valley Bank announced that it would book $1.8 billion in losses after selling investments to cover increasing withdrawals and would be raising additional capital. This alarmed investors and depositors, setting the stage for its collapse. The following day, depositors attempted to withdraw $42 billion, and in the equity market, its share price fell 60%. It was a classic "bank run" that forced regulators to seize the bank the following morning. Banks are very stable businesses, but the business model requires confidence from investors and depositors. Once confidence is lost, banks may face liquidity issues if clients pull out their deposits and counterparties become reluctant to extend credit. This happened at Silicon Valley Bank with alarming speed.

Worries of bank runs spread to other banks, compelling regulators to step in. On March 12th, regulators announced that they had taken control of a second bank (Signature Bank), and the Fed announced a new lending program for banks to address the liquidity pressures that had rapidly emerged. This new lending program (Bank Term Funding Program) proved to be very effective in mitigating further problems. While there remains concern about further distress in US regional banks, these measures helped to provide liquidity, allowing for issues to be resolved in a more orderly manner. Credit spreads widened in mid-March based on these developments. This widening was partially offset by a fall in long-term government bond yields. More recently, financial markets have largely stabilized, and many indicators of financial conditions have improved.

These events have affected the capital market outlook. While the US Federal Reserve Bank remains focused on inflation levels and has continued to raise interest rates, the potential for further issues in the banking sector could prompt a change in its policy measures. As noted above, the issues facing regional banks may have already influenced the Fed's interest rate policy, reducing the size of March's rate hike. They may also give reason for the Fed to pause further interest rate hikes.

Funding costs for US banks have increased (as banks will need to offer higher deposit rates and credit spreads), and there is a risk that conditions in the sector could deteriorate further. Consequently, some pullback in lending is expected, particularly at US regional banks. The turmoil in the banking sector is primarily an issue for US regional banks and does not directly affect Canadian banks, nor do ONE Investment pooled funds hold securities that were directly affected by these events. That said, these events have highlighted risks that may influence the capital market outlook and fund performance. This remains a developing issue.

4. ANALYSIS

The ONE Canadian Equity Fund had returns of 5.8% in the quarter, outperforming its

benchmark

The ONE Canadian Equity Fund had strong performance for a second quarter in a row as equity markets continued to rebound from weak performance earlier in 2022. These results bring returns over a 12-month period to -1.4%. The fund outperformed its benchmark in the quarter and over the last 12 months.

The Canadian equity market showed broad-based strength in the quarter, with positive returns for all sectors except the Energy sector. The Energy sector, where the fund has a significant underweight exposure relative to the benchmark, had returns of about negative 2% in the quarter. The fund's light allocation to the sector is not an active investment choice of the manager but instead reflects the fund's structural underweight in the Energy and Materials sectors, which helps to dampen the volatility of returns for the fund.

The best performing sector for the Canadian equity market in the quarter was the Information Technology sector, with returns that exceeded 25%. Over the last year, this sector has been much weaker than other market sectors, so the rebound in share prices has significantly outpaced other sectors. The fund has an overweight exposure to this sector, so the sector's strength made a meaningful contribution to both absolute and index-relative fund performance. The fund's largest holding in the sector is CGI Group, representing about 5% of fund holdings. This holding had returns of 11.6%, underperforming the sector but outperforming the broader market.

While the fund outperformance in the quarter was primarily a result of sector selection, security selection also helped. The performance of one holding made a significant contribution to overall fund performance in the quarter. SNC Lavalin Group shares had returns of 39% in the quarter. As this holding represents 2% of the fund, its strong performance made a strong positive contribution to overall fund returns in the quarter.

The ONE Global Equity Fund performed well in the quarter, with returns of 7.3%

Global equity markets out-performed Canadian equities in the quarter, with the global equity fund producing returns of 7.3%, largely in line with the fund's benchmark. For the 12- month period ending March 31st, 2023, the fund's returns were 7.3%, outperforming its benchmark.

Almost all countries experienced positive returns in the quarter, although returns from certain regions outpaced others. Continental European markets tended to be some of the strongest markets with French and German exchanges experiencing returns more than 12% in the quarter, while US and Japanese stock markets saw returns in the range of 7%. Returns from other countries were lower, but since US, Japan and Europe (excluding UK) represent over 70% of the global equity universe, the returns of global equity markets in aggregate were very strong. The fund's heavy overweight exposure to Continental European equities benefitted from strong returns in France and Germany. Continental European equities represent 27% of fund holdings, double the allocation in the fund's benchmark.

Growth-oriented sectors in the global equity markets, like Information Technology, Communication Services, and Consumer Discretionary tended to have strong performance in the quarter, rebounding after weak performance in 2022. The Information Technology sector was the strongest, with returns of about 22% in the quarter. The Fund's performance was helped by improving prospects for the sector, but the Fund had light exposure to this sector and had no exposure to Nvidia or Apple, large market capitalization companies with returns of 90% and 27%, respectively, in the quarter. The fund benefited from the sector's strength but was not able to fully participate in the sector's upside.

The manager's focus on stock selection helped performance in the quarter. Holdings of BMW's common and preferred shares, which together represent 4.5% of fund holdings, had returns of about 20%, helping overall fund performance. Alimentation Couche-Tard and CGI Inc., two Canadian holdings that collectively represent more than 7% of the fund, also helped overall fund performance with returns of 14% and 12%, respectively.

The ONE Canadian Government Bond Fund had returns of 1.7% in the quarter, with performance benefitting from a modestly lower yield curve

The ONE Canadian Government Bond Fund had returns of 1.7% in the quarter, largely in line with returns for its benchmarks. For the 12-month period ending March 31st, 2023, returns were 0.3%, slightly weaker than its benchmark. The fund's duration of 2.4 years remains similar to its benchmark, which is relatively short. The short duration implies that the fund returns are not overly sensitive to changes in interest rates. Modestly lower market interest rates helped fund performance in the quarter, but the short duration limited the upside. Security selection detracted from performance in the quarter, especially in provincial bonds, with Alberta and Ontario bonds underperforming.

The ONE Canadian Corporate Bond Fund had returns of 2.5% while returns over a 12-month period were negative 0.7%

The ONE Canadian Corporate Bond Fund had returns of 2.5% in the quarter and -0.7% for the 12-month period ending March 31, 2023. The returns over both periods matched the fund's benchmark returns. The fund's duration of 5.1 years remains similar to its benchmark, and more than twice the duration of the ONE Canadian Government Bond Fund. The ONE Canadian Corporate Bond Fund is therefore more sensitive to changes in interest rates and produced stronger returns in the first quarter of 2023 as interest rates fell modestly. This is the opposite pattern versus the trailing 12-month period, when rising market yields led to negative performance for the fund while the ONE Canadian Government Bond Fund was able to produce positive returns.

Security selection within financials had a positive contribution to performance, with returns from chartered bank bonds performing well. The portfolio's overweight to corporate bonds and underweight to federal bonds also helped performance, as spreads narrowed and corporate bonds outperformed, especially through the first two months of the year. This trend was partially offset by market movements in March, when credit spreads widened somewhat after issues surfaced in US regional banks.

The ONE Global Bond Fund had returns of 2.9% in the quarter, benefiting from lower yields, while returns over the trailing 12 months were -1.8%, primarily due to asset allocation

and currency hedging choices

The One Global Bond Fund returned 2.9% in the quarter as bond yields declined broadly across the world, with intermediate and long-term bond yields falling the most. These returns were in line with the returns from the fund's benchmark. Turmoil spreading across the global banking system led to a 'flight to quality' in global financial markets, where investors tend to favour lower-risk investments, which bolstered demand for bonds. This trend helped fund returns in the quarter.

The fund's light duration versus its benchmark detracted from index relative performance as yields declined across fixed income markets in the quarter, while losses on the currency hedges also had a small negative impact on performance. At quarter end, 81% of the foreign currency exposure of fund holdings was hedged back to the Canadian dollar, down 5.3% versus the prior quarter. The issues in the banking sector did not directly affect the fund's holdings in the quarter.

Over the 12-month period ending March 31, 2023, the fund experienced returns of -1.8%, underperforming its benchmark. This weak performance reflected several contributing factors. Rising yields over the period created a headwind for performance that led to returns slightly below zero for the fund's benchmark. The fund's underperformance resulted primarily from losses on the fund's currency hedges over the period. While the performance of fund holdings in the USA and Europe may have benefited from strength in the US dollar and Europe, up 8.1% and 5.9%, respectively versus the Canadian dollar in the quarter, currency hedges largely offset this upside. Additionally, the fund's heavy exposure to high-yield bonds contributed to the underperformance as credit spreads widened over the 12-month period.

The fund's unconstrained fixed income mandate means that the manager's allocations may differ significantly from the benchmark which affects index relative performance. The manager does not attempt to match benchmark performance but instead seeks to deliver a strong, consistent total investment return over a full market cycle.

Over recent months the ONE Global Bond has continued to reposition the investment exposure

The manager has been slowly adjusting the investment exposure of the fund in response to the changing macroeconomic backdrop. The fund's duration has typically been significantly lower than its benchmark, but over the last year, its duration has increased. As a result, the fund has been less sensitive to changes in interest rates, which has helped performance relative to the benchmark as interest rates rose sharply last year. With the prospects for interest rates to stabilize or potentially start falling, the manager has been increasing the duration of the fund. The fund's duration at quarter end was 5.1 years, up from 3.7 years a year earlier. The fund has also been decreasing exposure to high yield bonds over the last year, with exposure now closer to 21%, about 10% lower than a year ago. This continues to be a significant overweight relative to its benchmark, which has less than 6% exposure to high-yield bonds.

5. CONCLUSION

The first quarter review of manager performance did not identify any major performance issues that warranted concern. The performance of the ONE Prudent Investment funds was strong, with all funds producing positive returns and all funds having performance that matched or exceeded benchmark returns in the quarter. Despite some noise in the banking sector in the quarter, the capital market outlook remains positive as economic growth remains robust and inflationary pressures continue to ease. There is a risk that the positive outlook could deteriorate in the coming quarters under certain scenarios. There remains a risk that economic growth, which tends to respond to interest rate hikes with a significant lag, may deteriorate, leading to a recession. There is also a risk that further turmoil in the banking sector could surface. On balance, the funds are well positioned for any environment.

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