



REPORT

To: ONE Joint Investment Board
From: Keith Taylor, Chief Investment Officer, ONE Investment
Date: September 6, 2023
Re: Fund Manager Performance Review Q2 2023
Report: ONE JIB 2023-O52

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 second quarter of 2023, including a brief overview of factors contributing to performance. More notable themes influencing fixed income market performance over the second quarter of 2023 include the continued focus on inflation and how it may influence the trajectory of interest rates. More notable themes influencing equity markets include the attention being paid to Artificial Intelligence (AI), which has led to massive share price increases for firms involved in this industry.

All the ONE pooled funds had positive returns for the 12-month period ending June 30, 2023, but returns were mixed in the second quarter. Returns from the equity-oriented pooled funds were positive, with both funds benefiting from the ongoing rally in global equity markets, but fixed income returns were negative. All three fixed-income-oriented pooled funds had modestly negative returns in the quarter in response to further increases in interest rates by major global central banks. The review of manager performance during the second quarter of 2023 did not identify any performance issues that warranted concern. The performance of the funds as of June 30, 2023, is summarized below.

	Quarter	1 Year
ONE Canadian Equity Fund	3.5%	17.0%
ONE Global Equity Fund	3.3%	19.4%
ONE Canadian Corporate Bond Fund	-0.4%	2.8%
ONE Canadian Government Bond Fund	-0.7%	1.2%
ONE Global Bond Fund	-0.2%	4.1%

3. BACKGROUND

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

As outlined in the 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.

Inflation pressures continue to abate in most major economies, yet inflation remains above central bank targets

Inflation, which peaked in June 2020 above 8% in both the US and Canada, has continued to decline and is now in the range of 3%. While this shows the success that central banks have had in fighting inflation, the fight is not yet over, as these inflation levels remain above the 2% target that central banks typically target. While the Bank of Canada indicated that it would pause interest rate hikes in the first quarter, this pause was short-lived, and the bank increased rates in the second quarter to address ongoing inflation concerns. The US Federal Reserve also raised interest rates in the quarter. Policy interest rates increased by 0.25% in both the US and Canada during the second quarter, with both countries announcing an additional 0.25% rate hike in July, bringing policy rates to 5.5% and 5.0% respectively.

Interest rates may remain higher for longer than previously anticipated

While the consensus view is that we are close to the end of interest rate hikes, there remains considerable uncertainty regarding when interest rates will start to decline. At the start of the second quarter, the pricing of interest rate futures implied that the market was expecting central banks in Canada and the United States to start cutting their policy interest rates in the latter half of 2023. This is no longer the case, as persistent inflation pressures have led to expectations of additional rate hikes, pushing out the timeline for when rate cuts may potentially start. The market seems to have been making inferences about what the central banks may do in the future, but there is little evidence to suggest that the central banks are ready to cut interest rates. Inflation continues to be the focus for central banks, and the future path of policy decisions will be data-dependent, making the outlook for interest rates highly uncertain.

Where interest rates ultimately converge over time continues to be debated. The consensus view has been that interest rates will retreat to levels seen prior to the COVID crisis, but during the quarter some expressed concern that this may be too optimistic a view. There has been discussion by market strategists, and US Federal reserve officials that suggest that interest rates may remain elevated for an extended period. Economists often use the term 'neutral rate of interest' in this context, which refers to an interest rate that over the long term would neither be expansionary nor contractionary. Many are starting to wonder if the neutral rate of interest will be higher in the future. This means that there is not only uncertainty about *when* interest rates will decline, but there is also discussion about *how much* interest rates will decline, with some suggesting that interest rates may remain permanently higher than pre-crisis levels. These are highly relevant discussions as they influence interest rate expectations that affect future returns for both fixed income and equity investments.

The widely anticipated economic recession has yet to arrive

While many had anticipated that last year's massive interest rate increases would lead to an economic recession, the recession has yet to arrive. Rising interest rates are typically contractionary and tend to reduce economic activity, which is why they help contain inflation. When the economy is operating at (or beyond) full capacity, inflation pressures often emerge, and higher interest rates, in theory, should dampen economic demand and thereby dampen inflation pressures. Unfortunately, there is little evidence that the dramatically higher interest rates have significantly dampened economic activity. Unemployment rates in the US and Canada are near historic lows, suggesting that central banks may still have the flexibility to raise interest rates further to combat inflation. While some traditional leading economic indicators have been flagging a potential recession on the horizon, there seems to be growing confidence that a 'soft landing' for the economy can be engineered. This rosy outlook has, in part, been supportive for equity prices, helping to fuel the ongoing rally in equity markets. As it takes between 12 and 18 months for the full impact of interest rate hikes to affect economic activity, it may not be clear yet that a recession has been avoided. This remains a risk for the equity market outlook and has implications for the interest rate outlook as well.

4. ANALYSIS

The ONE Canadian Equity Fund had returns of 3.5% in the second quarter, bringing returns to 17% for the 12-month period ending June 30, 2023

Canadian equity markets performed well in the quarter, with the ONE Canadian Equity Fund generating returns of 3.5%. The fund outperformed the broader market by more than 2.5% in the quarter, with both security selection and sector allocation contributing to the fund's outperformance.

The best-performing sector in the quarter was the Information Technology sector, where the fund has an overweight allocation relative to its benchmark. While the heavy allocation to this sector helped fund performance, security selection detracted from performance within this sector. The fund currently has no holdings in Shopify, a large-cap stock that had returns of 32% in the quarter. The manager sold its position in this stock last year as the firm's outlook was deteriorating. The weakest sector of the Canadian equity market was the Materials sector, which was down almost 7%. The fund has less than half the exposure to this sector as its benchmark, which reflects how the mandate was constructed to reduce volatility in returns. The fund's light exposure to the Materials sector contributed to its overall outperformance compared to its benchmark in the quarter. To a large extent, this positioning reflects the structure of the mandate rather than an active investment choice by the manager.

Security selection within the Industrial sector made a significant contribution to returns, explaining about half of the fund's outperformance relative to its benchmark. Two stocks where the fund has a large overweight position accounted for the bulk of this contribution. Finning

International, which sells and rents heavy equipment used in the construction and resource sectors, had returns of 21.8% in the quarter. As this holding represented over 4% of the fund's holdings, it made a large contribution to overall returns. Boyd Group, which operates automotive collision repair centres, was up about 17% also made a significant contribution to overall fund returns.

The ONE Global Equity Fund had strong returns in the quarter of 3.3%, with returns for the 12-month period ending June 30, 2023 of 19.3%

Global equity markets continue to recover from the weakness experienced in 2022, with global equities posting gains for three consecutive quarters. The fund's 3.3% returns in the quarter modestly underperformed benchmark returns, with returns over the 12-month period ending June 30, 2023, being in line with benchmark returns.

The Information Technology sector was the best-performing sector of the market in the quarter, with returns of over 15% as the sector continues to recover from the sharp weakness experienced last year. The emergence of AI was a prominent theme affecting stock performance, with firms associated with AI experiencing spectacular returns in 2023. This was exemplified by the performance of Nvidia Corp., which has become a leading player in the emerging AI field. Nvidia had returns of 52% in the quarter, which comes after 90% returns experienced in the first quarter of 2023. The strength within the technology sector has tended to favour firms associated with AI and has tended to focus on the larger market-capitalization firms. The fund has a notable underweight allocation to this sector, limiting its ability to participate in the strong sector performance, and security selection within the sector has not helped. The fund has no holdings in Nvidia and has no exposure to some of the larger market capitalization firms that have had strong performance, like Apple Inc., which represents about 4.5% of the benchmark that was up 18%.

The fund's holdings in the Financial sector performed particularly well in the quarter. While the Financial sector's slightly underperformed the broader global equity market, fund holdings in this sector had much stronger performance. Holdings in XP Inc., which operates as an investment management company, had returns of 90% in the quarter, making a significant contribution to fund returns. The fund holds a 1.4% weight in the shares of XP Inc., which is not represented in the fund's performance benchmark. Holdings in Marsh & McLennan Companies, Inc., an insurance broker and risk management firm, also made a significant positive contribution to returns, as they represented almost 5% of fund holdings and had returns of 13% in the quarter.

Currency movements and regional exposure also influenced performance but had a smaller overall impact on performance relative to the benchmark. The strength of the Canadian dollar negatively affected fund performance, with the translation of foreign currency-denominated returns to Canadian dollar returns reducing returns by about 2%. The fund also has a large underweight exposure to the Asia ex-Japan region, which had flat performance in the quarter. Performance in this region was affected by a disappointing economic outlook in China.

All three fixed income funds had modestly negative returns in the quarter in response to another round of central bank rate hikes

A new round of interest rate hikes by central banks created a headwind for the performance of the fixed income market in the quarter, as interest rates were generally higher across the yield

curve. The US 10-year bond yield rose 37 basis points in the quarter, ending the quarter at 3.84%. The magnitude of the increase was much smaller than moves experienced over the last year, leading to modest losses for all three funds. The ONE Canadian Government Bond Fund and the ONE Canadian Corporate Bond Fund had returns of -0.4% and -0.7%, respectively, in the quarter, while the ONE Global Bond Fund fared slightly better with returns of -0.2%. All three funds generated positive returns in the 12-month period ending June 30, 2023.

The ONE Canadian Government Bond Fund and the ONE Canadian Corporate Bond Fund are currently positioned with an effective duration that is very similar to their benchmark. This means that the funds' interest rate sensitivity is similar to their benchmarks, and rising interest rates should not lead to fund outperformance. At quarter's end, the effective duration of these two funds was 2.6 and 5.1 years, respectively.

The ONE Global Bond Fund has somewhat lower interest rate sensitivity than its benchmark. Its duration is 5.5 years, which is about 1 year less than the duration of its benchmark. The effect of a lower duration made a small positive contribution to performance relative to the fund's benchmark. Over the last year, the manager has increased the duration of the fund significantly, which reflects its changing investment outlook.

The ONE Global Bond Fund has an unconstrained bond mandate, which means the manager is less concerned about the position of the fund relative to its benchmark. 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.

All three ONE Investment fixed income funds benefitted from narrowing credit spreads in the quarter

During the quarter, credit spreads (the yield that corporate bonds offer in excess of sovereign bond yields) narrowed, with the credit spreads narrowing more for lower credit quality bonds than for higher credit quality bonds. Narrowing credit spreads typically lead to corporate bonds outperforming sovereign bonds. This had a positive impact on the fund performance of all three funds as they all have more credit exposure than their benchmark.

The ONE Canadian Government Bond Fund has an allocation of 42% to very high credit quality corporate bonds versus zero in its benchmark, while the ONE Canadian Corporate Bond Fund has a 69% allocation to high credit quality corporate bonds versus 50% in its benchmark. The narrowing of credit spreads had a small positive impact on the relative performance of these funds, helping both to outperform their benchmarks in the quarter. These two funds only hold bonds with a credit quality of A- or above, unlike the ONE Global Bond Fund, which holds lower-quality bonds, including high-yield bonds.

The ONE Global Bond Fund has a heavy allocation to high-yield bonds, with about an 18% allocation versus about 5% in its benchmark. This fund also has a 32% allocation to BBB credit-quality bonds, more than twice the allocation in its benchmark. As credit spreads narrowed more for high-yield and BBB bonds, the impact of narrowing credit spreads had a larger positive

influence on the relative performance of the ONE Global Bond Fund than the Canadian-oriented bond funds.

While the Canadian bond funds outperformed their benchmark by a small margin, the ONE Global Bond Fund's soundly outperformed its benchmark

Both the ONE Canadian Government Bond Fund and the ONE Corporate Bond Fund modestly outperformed their benchmarks, with fund performance net of fees exceeding benchmark performance by more than 20 basis points (bps), largely because of the heavy allocation to corporate bonds.

While this also helped the performance of the ONE Global Bond Fund, adding an estimated 40 bps to relative performance, the main driver of the Global Bond Fund's outperformance was related to currency movements. The fund outperformed its benchmark by more than 300 basis points in the quarter, with the bulk of this outperformance coming from foreign exchange gains related to currency hedges. The hedge gains offset what would have been more pronounced negative returns in the quarter. The ONE Global Bond Fund can actively hedge currency exposure, and over the last few years, almost all of the foreign currency exposure of its holdings has been hedged back to the Canadian dollar. The Canadian dollar was strong versus most major international currencies in the quarter, which led to significant gains on these currency hedges. The manager reduced the funds' currency hedging in the quarter, with 74.7% of the portfolio hedged back to the Canadian dollar at the end of the quarter, down 6.25% from the start of the quarter.

5. CONCLUSION

The review of manager performance during the second quarter of 2023 did not identify any performance issues that warrant concern. The performance of the ONE Prudent Investment Funds was satisfactory, with four of the five ONE Investment pooled funds outperforming their benchmarks. Equity-oriented pooled funds produced positive returns, while all three fixed-income-oriented pooled funds experienced modestly negative returns in response to rising interest rates. Overall, the economic backdrop remains a source of uncertainty. It is not yet clear what the final effect of the recent interest rate hikes will be, and there remains a risk that they may cause an economic recession. This has direct implications for the interest rate outlook, which affects bond prices and corporate profits, which drive equity performance. The positioning of the investment mandates has taken the current capital market outlook and economic backdrop into consideration. On balance, the funds are well positioned for any environment.

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