REPORT

To: ONE Joint Investment Board
From: Keith Taylor, Chief Investment Officer
Date: December 15, 2020
Re: Investment Manager Quarterly Report – Q3 2020
Report: 20-037

1. RECOMMENDATIONS

It is recommended that the Board:

a. Receive the report on Investment Manager Performance for the 3rd quarter of 2020

2. SUMMARY

This report summarizes the performance of each of the ONE Investment Prudent Investment funds. All Prudent Investors funds performed well in the quarter, with each of them generating positive returns in the quarter.

A short explanation of performance for each mandate is provided to understand the drivers of performance and to provide context.

3. ANALYSIS

The performance of the Canadian Fixed Income Funds was positively affected by exposure to corporate credit, but these Funds were not able to fully participate in the strength in lower credit quality bonds.

The ONE Canadian Government Bond Fund (Govt Bond Fund) and ONE Canadian Corporate Bond Fund (Corp Bond Fund) both generated returns of 0.7% in the quarter. These returns of the Govt Bond Fund outperformed its benchmark by approximately 35 bps in the quarter while the One Canadian Corp Bond Fund's performance was in line with its performance benchmark.

The performance of the Canadian fixed income mandates, the Govt Bond Fund and the Corp Bond Fund reflect the very high credit quality of the funds. Both funds have significant exposure to corporate credit but exclude BBB credit quality bonds. Figure 1 below details the credit exposure of the two Canadian fixed income funds.

Figure 1

Govt Bond Portfolio	
Credit Rating	Allocation
AAA	25.9%
AA	40.6%
A	28.3%
Average Quality	AA
Corporate Credit	41.6%

Corp Bond Portfolio	
Credit Rating	Allocation
AAA	13.3%
AA	40.3%
A	43.1%
Average Quality	AA-
Corporate Credit	71.4%

Over 70% of the Corp Bond Fund is invested in corporate credit and over 40% of the Govt Bond Fund is similarly invested in corporate credit. These allocations to corporate credit are high relative to their respective benchmarks. Corporate credit generally performed well in the quarter, outperforming government debt securities. Lower credit quality bonds tended to benefit more from this trend. However, the Investment Management Agreements for these two funds do not allow them to own sub-investment grade bonds (credit ratings below BBB-) and, even within investment grade bonds, they are not allowed to include BBB bonds in the portfolio. These constraints on the investment manager may be relaxed at a later date, following a review of these mandates by the ONE JIB.

Interest rates movements did not have a significant impact on performance in the quarter.

Global bond holdings performed well in the quarter, benefitting from tightening credit spreads

The performance of the global fixed income offering was adversely affected by the timing of the transition to prudent investing. Because funds were transitioned into the underlying Manulife pooled fund on July 6, 2020, the investments were not deployed for the full quarter. The gross performance of the Global Bond Fund was 1.8% for the period after transition, whereas the underlying Manulife pooled fund returned 2.6% for the full third quarter period. There were notable movements in the financial markets in the first few days of July which the Fund was not able to capture, which is a reflection of the elevated volatility in financial markets in recent past.

The Global Bond Fund has significant exposure to corporate bonds, including high yield bonds, which helped performance in the quarter. As investor confidence continued to improve in the second quarter, investors' demand for credit exposure increased, which tended to push up the prices of corporate bonds more than government bonds. This theme, known as 'compression of credit spreads', led to stronger performance by bonds with lower credit quality. The Global Bond Fund not only has exposure to BBB-rated bonds, but the Fund also has almost 30% allocation to high yield bonds. Both of these exposures benefitted from the compression of credit spreads in the quarter, contributing to overall performance.

The manager of the Global Bond Fund has a guarded outlook, noting that market volatility may remain high as the continuing impact of COVID-19 may weigh on economic growth. This has influenced portfolio positioning, as noted in their quarterly investment report:

> *We believe the more speculative tiers of the high-yield bond market remain vulnerable to an extended economic slowdown in the short term. We are being selective in emerging markets exposure and remain cautious on the further spread of COVID-19 in countries that lack infrastructure and the ability to treat a widespread viral outbreak.*

The credit quality of the Fund remains investment grade with an average rating of BBB+. The maturity profile of the fund implies significantly less interest rate sensitivity than the broader bond market (duration of 3.7 years vs global bond benchmarks with duration in the range of 7 years)

While Global Equity markets performed well in the quarter, the timing of performance prevented the Global Equity Fund to fully participate in the upside

While global equity markets rallied about 6% in the quarter, the Global Equity Fund generated returns of 3.4%. As funds were transitioned into the underlying Mawer pooled fund on July 6, 2020, the Global Equity Fund did not participate in a full quarter, which led to a performance differential. The sharp move in equity markets over this period is a reflection of the elevated market volatility experience early this year.

The rebound in global equity markets that started in the second quarter continued into the third quarter, but at a less frenzied pace. The recovery was uneven in the third quarter, with certain parts of the market such as the industrial, consumer discretionary and technology sectors generating strong returns while the energy sector performed poorly. The Fund's significant overweight exposure to the industrial sector and zero exposure to the energy sector was highly favorable positioning that contributed to the performance of the Fund. Security selection within the industrial sector also had a meaningful contribution to performance, while light exposure to the consumer discretionary sector and stock selection within that sector were factors that detracted from relative performance.

The manager's outlook is positive but cautious, as they note that the recovery in equity prices is driven by fiscal and economic stimulus, rather than improving fundamentals or earnings. They note that valuations seem to be less concerning for market participants of late and that virtual business models that demonstrate high growth have garnered much attention. These types of companies may not seem like obvious candidates for Mawer's investment approach, which focuses on reasonable valuation and discount to intrinsic value. However, they are increasingly scrutinizing companies that fit this profile. They already hold positions in Microsoft and Alphabet supported by discounted cashflow analysis, rather than justification of price earnings multiples.

The Canadian Equity Fund performed well in the quarter

The Canadian Equity Fund generated returns of 5.4% in the quarter, performing better than the broad Canadian equity markets. The Fund was seeded primarily with securities that liquidated from Legal List Investment portfolios of the Founding Municipalities. This allowed the transition into the Canadian Equity Fund to happen seamlessly on July 2, 2020 but the performance of the Fund did not capture the full quarter due to the late transition.

The sector positioning for the Fund shared some similarities with the Global Equity Fund, as it was positioned with a significant overweight exposure to the industrial sector and significant underweight exposure to the energy sector. This positioning had a meaningful contribution to performance as these two sectors were the best performing and worst performing sectors, respectively, of the Canadian equity markets. The Fund's low exposure to materials and energy reflects the risk mitigation embedded in its investment approach. The manager explicitly limits exposure to commodity-driven companies, which tend to have more volatile earnings and share prices. By limiting exposure to the materials and energy sector, the manager can deploy funds into the equites of other industries where earnings are more stable, and outcomes are more reflective of management choices rather than commodity price swings. The fund's underweight exposure to the materials sector meant that it was not able to benefit fully from the strong returns in that sector.

The Prudent Investment Canadian Equity Fund is positioned in a very similar way to the ONE Equity Portfolio available under the Legal List, with the exception of two holdings. The ONE Canadian Equity Fund holds small positions in BCE and "CAP REIT'.

Performance has been certified by the investment managers

As part of the ongoing documentation process, each investment manager has provided a written confirmation that the mandates were managed within the investment guidelines detailed in their Investment Management Agreements. The Chief Investment Officer has certified to each Participating Municipality that their money not required immediately invested with ONE JIB has been invested *"in accordance with the terms of the ONE JIB Agreement, and in a manner consistent with the Investment Policy Statement and the Investment Plan of the Participating Municipality."*

4. CONCLUSION

All of the ONE Investment Prudent Investors funds generated positive returns in the quarter. The Chief Investment Officer has reviewed the performance and has not identified performance issues that require further investigation.

This report summarizes the key drivers of performance of the Prudent Investor funds in the 3rd quarter. The ONE JIB should receive the report regarding the performance of investment managers in the 3rd quarter and as appropriate, further discuss the performance.

Drafted by: Keith Taylor, Chief Investment Officer.
Approved for submission by: Judy Dezell and Donna Herridge - Co-Presidents/CEO