REPORT

To: ONE Joint Investment Board
From: Keith Taylor, Chief Investment Officer, ONE Investment
Date: November 29, 2023
Re: Fund Manager Performance Review Q3 2023
Report: ONE JIB 2023-076

1. RECOMMENDATIONS

It is recommended that the Board:

1. Confirm that its members have reviewed the Fund Manager Performance Reports – Q3 2023 provided in the Resource Library.
2. Receive this report.

2. SUMMARY

This report summarizes the performance of the ONE Investment Prudent Investment Funds for the third quarter of 2023, including a brief overview of factors contributing to performance. The main theme influencing fixed income market performance in the quarter is the continued focus on inflation and how it may influence the trajectory of interest rates. Interest rates were volatile in the quarter as many global central banks raised rates again, and the outlook for future interest rates changed in the quarter. With short-term interest rates 1.75% higher than a year ago, central banks are less inclined to raise interest rates further and may opt to keep interest rates higher for a more extended period to address inflation. This led to a flattening of the yield curve as longer-term interest rates increased faster than rates rose in the short end of the yield curve.

All the ONE Investment pooled funds had modestly negative returns for the quarter. The returns for all three fixed-income-oriented pooled funds were directly affected by higher interest rates, leading to negative returns. The prospects for interest rates remaining higher for longer imply lower future growth, leading to softness in equity markets as well. In contrast, during the 12-month period ending September 30, 2023, all funds had positive returns, with returns from equity funds showing much stronger results. The review of manager performance during the third quarter of 2023 did not identify any performance issues that warranted concern. The performance of the funds as of September 30, 2023, is summarized below.

	Quarter	1 Year
ONE Canadian Equity Fund	-1.3%	15.8%
ONE Global Equity Fund	-0.9%	19.1%
ONE Canadian Corporate Bond Fund	-2.1%	0.5%

ONE Canadian Government Bond Fund	-0.2%	1.3%
ONE Global Bond Fund	-1.9%	3.9%

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 have declined since peaking in mid-2022, but despite the deceleration in inflation, it has yet to reach central bank targets

Inflation peaked in June 2022 above 8% in both the United States (US) and Canada, declining significantly since then, but it has yet to reach the 2% range that central banks are targeting in both Canada and the US. The consumer price index (CPI) in Canada and the US started the quarter at 2.8% and 3.0%, respectively, but ended the quarter higher at 3.8% and 3.7%. Inflation has stopped converging on the central banks' target, so it is not yet clear if the interest rate hikes over the last year have been sufficient. It is well known that interest rate moves affect the economy with long and variable lags, so it is not clear if further interest rates will be required to address inflation pressures or if more time is needed for prior rate hikes to show results.

The interest rate outlook changed in the quarter, with short-term rates moving slightly higher and with more significant increases in long term bond yields, resulting in a less inverted yield curve

While market participants had been hoping that the increases in interest rates would come to an end and rate cuts were on the horizon, the exact opposite happened in the quarter. In response to inflation levels persisting above target, central banks raised their short-term policy interest rate by 0.25% in July, bringing the rate to 5.0% in Canada and 5.5% in the US. More importantly, the outlook for future interest rates also changed, and the consensus view now accepts that interest rates will remain higher for a longer period of time.

Typically, longer-term yields are higher than short-term rates to reflect the additional risk that is associated with investing over a longer investment horizon. This is known as the "term premium," and it is normally positive, but since July 2022, it has been negative, and the yield curve has been inverted. An inverted yield curve, where short-term bond yields are higher than long-term bond yields, is not a normal situation and frequently precedes a recession.

The Bank of Canada has attempted to address inflation by pushing short-term interest rates higher in hopes of slowing economic activity. It has sharply increased interest rates, with its policy interest rate increasing from 0.25% to 5.0% since the start of 2022, which resulted in an inverted yield curve. In the third quarter, the yield curve became less inverted despite a further short-term interest rate increase as the outlook for future interest rates changed.

In the quarter, most global central banks signaled that interest rates would be maintained at higher levels for an extended period, changing market expectations. The hope that interest rates would start to decline within months was displaced by the acceptance that they may remain higher for longer. This directly affected the pricing of longer-term bonds, leading to a more significant increase in the yields on longer-term bonds. These changes led to increased volatility in fixed income markets, which in part reflects some uncertainty in the economic outlook. While central banks are notoriously vague about their future policy actions, they have signaled clearly that interest rates will not decline in the near term but left the door open for further rate hikes. It is reasonable to expect that they will need to be nimble and respond to the signals in economic indicators. They remain data dependent.

Economic activity remains robust in the US despite concerns of an economic slowdown, but in Europe and Canada signs of economic deterioration have emerged

Leading economic indicators in most major western nations have been soft, suggesting the possibility of an economic recession may be on the horizon. The yield curve, which is one of the components of the leading economic indicators, has been signaling a pending recession for over a year, but this recession has yet to arrive. In the US, a recession currently seems unlikely as the GDP data remains very strong, as GDP growth was reported at 4.9% in the third quarter and the labour markets remain very tight. The consensus view is that the US economy will achieve a "soft landing" and avoid a recession. This contrasts with Canada and Europe, where it is clearer that GDP growth has been decelerating. Canadian GDP slowed to 0.9% in the third quarter, while GDP growth in Europe was barely positive, posting 0.1% year-on-year growth. This is occurring while softness in other macroeconomic indicators has emerged.

Mawer Investment Management announced personnel changes relevant to the management of investment in the ONE Global Equity Fund

Mawer Investment Management provided details to ONE Investment about senior management changes on October 25, 2023. The Chief Investment Officer discussed these details with the Chief Compliance Officer to ensure that there was a common view of the implications for the management of the ONE Global Equity Fund. These changes appear to be an orderly succession plan that should not be detrimental to the management of the fund. The relevant sections of the announcement are below:

> ***Christian Deckart, CFA, PhD appointed Chief Investment Officer***
> Effective July 1, 2024, Christian Deckart, CFA, PhD, will assume the role of Chief Investment Officer. Mr. Deckart has been with the firm since 2013 and Deputy CIO since 2018. He is the lead manager of Mawer’s Global Equity strategy and Global Small Cap strategy. Paul Moroz, CFA will transition off the strategy as of March 31, 2024. Christian Deckart will remain lead manager.
>
> ***Manar Hassan-Agha, CFA, appointed co-manager of Mawer’s Global Equity strategy***

Effective today, Manar Hassan-Agha, CFA is a co-manager of the Mawer Global Equity strategy. Prior to joining the firm in 2021, Mr. Hassan-Agha held positions at Fulcrum Capital Partners Inc and KPMG.

The ONE Canadian Government Bond's **mandate changed effective October 1, 2023 and monies from Prudent Investor ONE HISA accounts were transitioned into this fund at the end of the third quarter, which created distortion in the quarter end positioning of the fund**

On the last day of the third quarter, the fund's assets under management more than doubled, as more than $51 million in HISA balances were injected into the fund. Cash and cash equivalents represented 59% of the fund, which resulted in a significantly lower average effective duration of 1.02 years for the fund, well below the fund's typical positioning. As the arriving cash balances were temporarily invested in Treasury securities and the holding period was very short, this transition did not have a meaningful effect on fund performance in the quarter. The reorientation of the mandate occurred in October, as the Treasuries were liquidated, and the holdings were adjusted to reflect the changed investment mandate of the ONE Canadian Government Bond Fund.

4. ANALYSIS

The Canadian Equity Fund had returns of -1.3% in the quarter, while 12-month returns were +15.8%

Canadian equity markets were modestly weaker in the quarter, with the ONE Canadian Equity Fund producing returns of negative 1.3%. The fund slightly outperformed the broader Canadian market, as manager security selection choices had a strong positive impact, offsetting the negative impact of sector allocation within the Fund. Only two sectors of the Canadian market saw gains during the quarter; the most notable was the Energy sector, which increased by more than 10% in response to a $20 per barrel rise in oil prices. To lower the portfolio's overall volatility, the manager has always had a sizable underweight exposure to this sector. The Fund's Energy sector holdings had returns of over 19% during the quarter, significantly outperforming the broader sector. The positive effect of these stock selection decisions more than compensated for the fund's 8% underweight position relative to its benchmark.

The positive influence of stock selection in other sectors also helped the portfolio's overall performance. In the Information Technology sector, Celestica's performance stood out. This holding, which had a 2.3% weight when it was added to the portfolio in June, increased by 73% in the third quarter. In the Industrials sector, SNC Lavalin, which represents 4% of the overall portfolio, was up 30.5%.

Although the manager's sector allocation choices collectively detracted from fund performance, the manager's stock selection choices more than compensated for this, resulting in the fund outperforming the Canadian equity market in the quarter by less than 1%.

The ONE Global Equity Fund returns were -0.9% in the quarter while 12-month returns were 19.1%

Following strong returns in the first half of 2023, investors adopted a more cautious stance towards equity markets, resulting in a minor decline in global equities markets during the quarter. The ONE Global Equity Fund had returns of negative 0.9% in the quarter but achieved much stronger returns of 19.1% for the 12-month period ending September 30, 2023. Global equities were softer during the quarter amidst several negative developments, including signs that the global economy was starting to slow, further concerns surrounding the property sector in China, additional interest rate hikes in many developed economies, and a changing interest rate outlook that implies that interest rates will remain higher for a longer period of time.

The Energy sector was the strongest sector in global equity markets, up about 13% in the quarter. The ONE Global Equity Fund did not benefit from this, having no exposure to the Energy sector. The manager prefers to invest in companies that have a sustainable competitive advantage, attractive valuations, and good business models, believing that this will lead to better returns, but prospects for firms in the Energy sector are mostly tied to the trends in commodity prices, which are largely unpredictable.

All three ONE Investment fixed income funds had negative returns for quarter, primarily as a result of rising short- and longer-term interest rates

Higher bond yields are the direct result of falling bond prices, so it is an expected outcome that all three ONE Investment fixed income-oriented pooled funds would have negative returns as interest rates rose. The returns on bonds with a longer "duration" statistic are more sensitive to the movements in bond yields, leading to weaker results in the quarter. The ONE Canadian Government Bond Fund had returns in the quarter of negative 0.1%, as its short duration limited the effect of higher interest rates on fund returns. The ONE Canadian Corporate Bond Fund, with a duration of 4.8 years, was more affected by rising interest rates, leading to returns of negative 2.2%. The ONE Global Bond Fund's duration is broadly similar at 5.2 years, and it had returns of negative 1.9% in the quarter. While rising interest rates have led to negative returns for fixed-income investors in the recent past, these losses could be offset by gains in the future when interest rates start to fall.

Credit spreads were slightly tighter in the quarter, leading to corporate bonds marginally outperforming sovereign bonds in the quarter. The One Global Bond's Fund's currency hedges also affected performance. The fund holdings are 71% hedged back to the Canadian dollar, so the fund does have some exposure to currency movements. The strength of the US dollar in the quarter had a small negative impact on fund performance.

5. CONCLUSION

The review of manager performance during the third quarter of 2023 did not identify any performance issues that warrant concern. All five ONE Investment Funds had modestly negative returns in the quarter, reflecting movements in the broader fixed income and equity markets. Over the 12-month period, all funds produced positive returns and outperformed their benchmarks. Equity-oriented funds had very strong performance, with the ONE Canadian Equity Fund up 15.8% and the ONE Global Equity Fund up 19.1%.

Overall, the economic backdrop remains a source of uncertainty, creating uncertainty about the interest rate outlook. In the quarter, there was a broad acceptance that interest rates would remain at higher levels for a longer period. 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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