REPORT

To: ONE Joint Investment Board
From: Keith Taylor, Chief Investment Officer, ONE Investment
Date: February 28, 2024
Re: Fund Manager Performance Review Q4 and full year 2023
Report: ONE JIB 2024-014

1. RECOMMENDATIONS

It is recommended that the Board:

1. Confirm that its members have reviewed the Fund Manager Performance Reports for Q4 and full year 2023 provided in the Resource Library.

2. Receive the report.

2. SUMMARY

This report summarizes the performance of the ONE Investment Prudent Investment Funds for the fourth quarter and full year 2023, including a brief overview of factors contributing to performance.

The changing outlook for interest rates was the main theme influencing market performance in the quarter. Central banks increased interest rates aggressively in 2022 and 2023 to address inflation pressures, but in the fourth quarter of 2023, it became more widely accepted that further rate hikes were not needed and meaningful cuts in interest rates were expected for 2024. When the US Federal Reserve (Fed) signaled rate cuts on the horizon, the market reacted. Bond prices rose in anticipation of rate cuts, and equity markets also reacted positively. Both the fixed income and equity markets had strong performance in the quarter, with all of ONE Investment's pooled funds participating in the market strength. Fourth quarter returns made a significant contribution to full-year 2023 returns, leading to positive returns for all ONE Investment pooled funds and strong returns for equity holdings.

	Quarter	1 Year
ONE Canadian Equity Fund	8.6%	17.5%
ONE Global Equity Fund	6.9%	17.5%
ONE Canadian Corporate Bond Fund	6.3%	6.2%
ONE Canadian Government Bond Fund	2.5%	3.1%
ONE Global Bond Fund	5.7%	6.5%

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.

Economic activity has held up well despite concerns that higher interest rates could spark a recession

Many economists had feared that major global economies could fall into recession in 2023 in response to the dramatic increase in interest rates. Economic activity continued to remain robust, and the feared recession has not yet arrived. It has become the consensus view that the US economy will be able to achieve what is known as a 'soft landing', where economic activity can be constrained enough to contain inflation without sending the economy into a recession. At 3.3%, the US GDP in the fourth quarter remains very strong, and the labour market continues to show signs of strength. In Canada and other major economies, GDP has moderated more than in the US, but without triggering a recession. It is not yet clear if a recession will be experienced in Canada or major European economies. The Chinese economy has continued to disappoint in 2023, with economic activity lagging expectations. This led to weakness in the Chinese equity markets, one of the few equity markets with negative returns in 2023.

Improvements in inflation indicators have stalled after dropping sharply in the latter half of 2022 and the first part of 2023

The level of inflation has been a major concern globally since mid-2022 when inflation peaked at 9.1% in the US and hit similarly high levels across most other major economies. Aggressive action by central banks has helped to bring inflation levels down, with inflation converging on the 3% range by mid-2023 in Canada and the US. Since then, there has been little improvement in inflation numbers, which have continued to hover around 3%. This remains above the 2% level that central banks typically target. To a large degree, the prospects for lower interest rates are tied to the outlook for inflation. Until central banks have confidence that inflation pressures have been contained, they will be reluctant to cut interest rates.

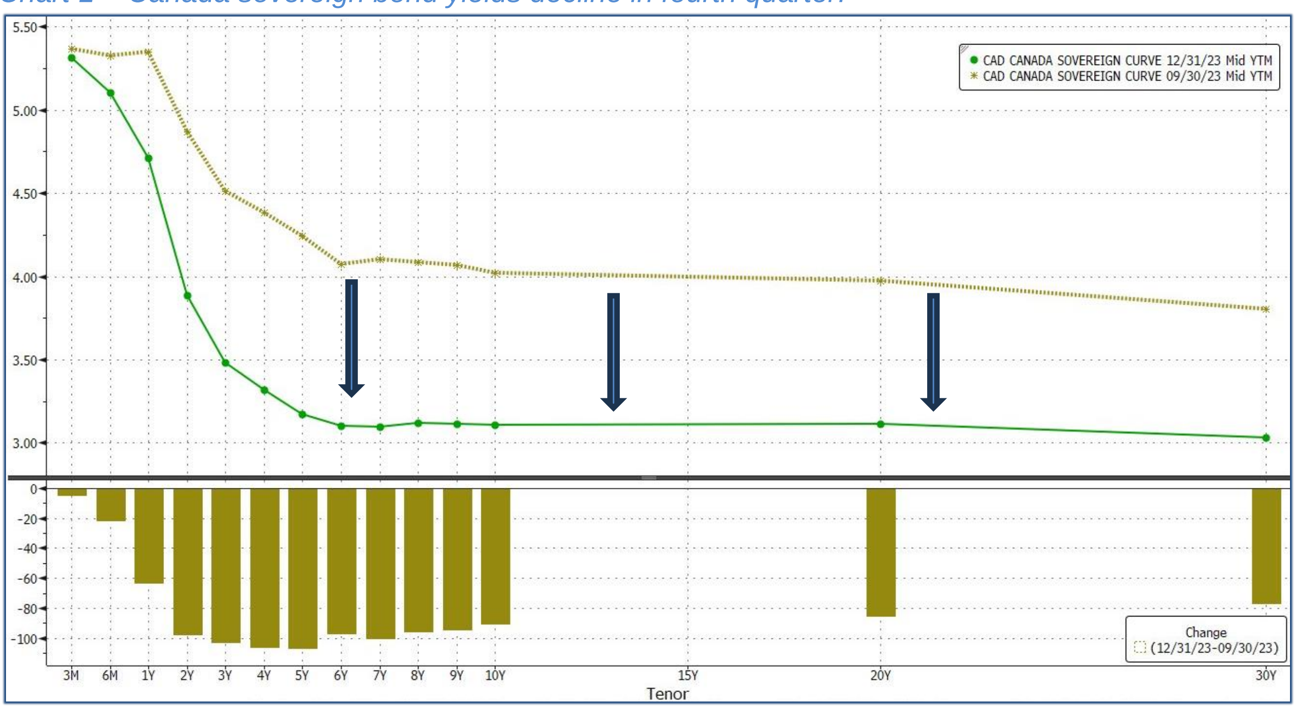
In the fourth quarter the market gained greater confidence that interest rates have already peaked and that central banks are poised to make significant rate cuts in interest rates in 2024

Markets have been anticipating the end of rate hikes and looking forward to when interest rates start to decline, but until the fourth quarter, central banks had been reluctant to confirm this. Comments by US Federal Reserve Chairman Powel indicated that the Fed was becoming more 'dovish', implying that it was pivoting toward easing monetary policy. Deceleration in growth in Canada and other major economies suggested significant rate cuts should also be anticipated in Canada, the UK, and the Eurozone. Bond prices reacted in anticipation of several rounds of central bank rate cuts in 2024, which led to strength in bond markets as yields in the bond market declined. The US 10-year bond yield dropped from 4.57% at the start of the quarter to 3.88% by year-end. Similarly, the Canadian 10-year bond yield dropped from 4.02% to 3.11% by year-end. There has been some volatility in rates since year-end, as economic releases post-quarter-end have suggested that the US labour markets continue to show signs of strength, and inflation data has not been supportive of imminent rate cuts. Any changes in central bank policy continue to be data dependent.

Yields declined in the quarter by about 1% with larger declines in bonds with an intermediate maturity profile

During the quarter, bond yields dropped by about 1%, with larger declines in bonds with intermediate maturities while longer-term bonds declined less. As short-term bond yields are more dependent on the central bank's policy interest rates, they did not decline as much. This is shown graphically in Chart 1 below, where the top panel shows the Canadian sovereign yield curve at the start and end of the fourth quarter and the bottom panel shows how much yields declined across differing tenors (maturities). This was similar to the movements in US Treasury securities in the quarter.

Chart 1 – Canada sovereign bond yields decline in fourth quarter.



Source: Bloomberg LLP.

The rally in global equity markets was uneven, with US markets being particularly strong

Most global equity markets were stronger in the quarter as equity markets reacted positively to the prospect of meaningful interest rate cuts in 2024 and were encouraged by signs of strength in the US economy. Markets seemed to bounce back in 2023 after a punishing performance in 2022.

Returns in US equity markets outpaced those in other regions, as the S&P 500 Index rallied almost 12% in the quarter while the Canadian and many European equity markets generated high single-digit returns. For the 2023 calendar year, US equity markets were also among the strongest globally, up about 25%. For the full year, the Canadian equity markets were also strong, with returns of about 12%, but this lagged behind the performance of many larger markets like the US, Japan, France, and Germany, which all had annual returns in excess of 20%. The Chinese equity market did not participate in the global rally in equity markets as Chinese economic growth has been slower than anticipated, leading to negative returns in equity markets in the mainland and Hong Kong.

4. ANALYSIS

The ONE Canadian Equity Fund had returns of 8.6% in the quarter, bringing full year 2023 returns to 17.5%

The ONE Canadian Equity Fund had strong performance in the fourth quarter with returns of 8.6%, modestly outperforming its benchmark. Fund performance was aided in the quarter by large allocations in Gildan Activewear and Restaurant Brands International, which collectively represent about 10% of fund holdings. Both of these stocks had returns in excess of 15% in the quarter, leading to a large contribution to overall fund returns. Brookfield Corp. also made a large contribution, as the fund has a 4% weight in this stock with returns of 25%. The fund’s structural underweight to commodity-related exposure helped performance relative to its benchmark, as these two sectors were the weakest sectors of the Canadian market in the quarter. The fund has always maintained light exposure to these commodity-related sectors to help reduce the overall volatility of returns in the fund.

For the full year, the ONE Canadian Equity Fund had strong returns of 17.5%, with the fund outperforming its benchmark by almost 6%. The outperformance for the 2023 calendar year was a result of both manager stock selection and sector allocation. Much like in the fourth quarter, the fund’s strategic underweight to the Energy and Material sectors helped performance, as these were two of the weaker sectors of the market in 2023.

The fund has a significant overweight exposure to the Information Technology sector, which was the best performing sector of the market last year. Fund holdings in Celestica Inc. and Open Text made a large contribution to overall fund performance, with returns of 130% and 42%, respectively, last year. The average performance of holdings in the Information Technology sector lagged behind the benchmark’s sector returns as the fund has no holdings in Shopify Inc., a large capitalization company with returns of 119% last year. Other large contributors to full year returns included SNC-Lavalin Group, which was up 79%; Stantec Inc., up 70%, and Cameco Inc., with returns of 67%.

The ONE Global Equity Fund had returns of 6.9% in the quarter, with full year 2023 returns of 17.5%

The ONE Global Equity Fund had strong performance in the fourth quarter with returns of 6.9%, which contributed to solid 2023 calendar year returns of 17.5%. These returns slightly underperformed benchmark returns. The results were achieved in the wake of rapid interest rate increases, ongoing concern about elevated inflation levels, market worries about a looming global recession, and military conflicts in Ukraine and the Middle East. This serves as a reminder that financial markets are forward-looking, and the prospects for inflation to abate and interest rates to fall helped support investor optimism that led to these strong equity market returns.

One notable source of fund underperformance relative to its benchmark was its positioning in the financial sector. Aon PLC and Marsh & McLennan, which operate as insurance brokers and consulting firms, were two of the few companies in the funds that had negative returns in the quarter. While Marsh & McLennan's returns were relatively flat in the quarter, Aon PLC was down 10%, as the stock sold off after the firm announced an acquisition that was not well received by investors.

While the manager's sector allocation choices had a minimal overall impact on performance in the fourth quarter, they did have a negative impact on full year performance relative to its benchmark. The fund has no exposure to the Energy sector, which was one of the weakest-performing sectors last year, which helped fund performance relative to the benchmark. The fund's light allocation to the Information Technology sector did not help performance relative to the benchmark. This sector was the best performing sector last year, with returns of over 50%. Light exposure meant that the fund did not fully participate in the upside in this sector.

US equity markets saw some of the strongest returns last year, producing returns in excess of 26%, with strength focused primarily on the seven biggest technology-focused companies, which have become known as the 'Magnificent 7' stocks. These seven stocks had spectacular returns last year that accounted for the bulk of US equity market returns in 2023. The Global Equity Fund has exposure to some of the seven stocks, including Microsoft, Amazon, and Alphabet Inc. (Google), but the Fund has no exposure to the best-performing stocks from this group, Nvidia and Tesla Inc., which had returns of 239% and 101%, respectively, last year. This was a contributing factor to the fund's underperformance relative to the benchmark last year.

The ONE Investment fixed income funds had strong performance in the fourth quarter, responding to the prospects for rate cuts, with fourth quarter returns effectively accounting for all the gains for the full year

The global bond markets had strong performance as bond yields dropped sharply in the quarter. The ONE Canadian Government Bond Fund had returns of 2.5% in the quarter, the ONE Canadian Corporate Bond Fund had returns of 6.3%, and the ONE Global Bond Fund had returns of 5.7%. The strong fourth quarter results effectively accounted for all the full year returns in 2023, with the portfolios generating returns of 3.1%, 6.2%, and 6.5%, respectively, for the calendar year.

For most of the year, bond markets were focused on the prospect of further interest rate increases by the global central banks, which put downward pressure on bond prices. In November and December, the outlook became more positive, as it became more evident that central banks might be done raising interest rates, and investors anticipated that the US Federal Reserve Bank would make meaningful cuts in interest rates in 2024. This was reflected in bond prices, and yields dropped by about 1% in the fourth quarter, with longer-term bonds tending to benefit more from the anticipated falling interest rates. The ONE Canadian Corporate Bond Fund and the ONE Global Bond Fund are both sensitive to changes in interest rates due to the relatively long maturity profiles of the bonds held (both funds have an average maturity of about 6.4 years). The falling interest rates led to strong returns for these funds. Changes in the investment orientation of the ONE Canadian Government Fund at the start of the fourth quarter decreased the fund's average maturity of 1.8 years. This lowered the sensitivity of interest rate changes for this fund, limiting the impact of rising interest rates on fund returns.

Fund performance in the ONE Global Bond Fund and the ONE Canadian Corporate Bond Fund was aided by an overweight allocation to corporate bonds as credit spreads declined in the quarter. The more positive market outlook that emerged in the quarter was favorable for investments that are considered riskier. The same theme that led to stronger equity markets also led to lower credit spreads, with credit spreads declining more for high-yield bonds than investment-grade bonds. This had a more pronounced effect on the ONE Global Bond Fund due to its overweight exposure to high-yield bonds. The ONE Canadian Corporate Bond Fund also benefited from declining credit spreads to a lesser degree, but the ONE Canadian Government Bond Fund did not benefit from this trend. The changes in the investment orientation of this fund in the fourth quarter also reoriented the fund to only hold government bonds, and the fund was largely unaffected by the change in credit spreads.

5. CONCLUSION

The review of manager performance during the fourth quarter of 2023 did not identify any performance issues that warrant concern. The performance of the ONE Prudent Investment Funds was satisfactory, with all the ONE Investment pooled funds generating positive performance for the quarter and the 2023 calendar year. Equity-oriented pooled funds produced strong returns for the quarter and full year. The fixed income oriented pooled funds had more modest returns in the quarter after mixed performance in earlier quarters. The fourth quarter returns for fixed income funds accounted for the bulk of the calendar year returns for these funds. The outlook for economic growth and inflation continues to factor into interest rate expectations, which seem to be the focal point of investor attention. As investors gained greater confidence in the prospects for 2024 interest rate cuts by central banks, equity and bond markets performed well, allowing both asset classes to close off the 2023 year with positive returns.

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