REPORT

To: ONE Joint Investment Board
From: Keith Taylor, Chief Investment Officer, ONE Investment
Date: May 29, 2024
Re: Fund Manager Performance Review Q1 2024
Report: ONE JIB 2024-036

1. RECOMMENDATIONS

It is recommended that the Board:

1. Confirm that its members have reviewed the Fund Manager Performance Reports for Q1 2024 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 first quarter of 2024, including a brief overview of contributing factors.

The changing outlook for interest rates was the main theme influencing market performance in the quarter. At the start of 2024, markets were preparing for sharp interest rate cuts by central banks, encouraged by comments by the Chair of the US Federal Reserve Bank (Fed). Expectations shifted in response to economic data released during the quarter that showed strong US economic activity, tight labour markets, and persistent inflation. This sharply reduced the market's expectation of interest rate cuts by central banks in 2024. Bond markets were modestly weaker on this development.

Equity markets continued to perform well in the quarter, with the strong equity rally that started in the fourth quarter of 2023 persisting through the first quarter. Global equity markets were up about 9% in the quarter, with strong results from the US, Japanese, and continental European stock markets. ONE Investment equity funds had strong positive returns for the quarter and trailing 12-month period, while ONE's fixed income funds had more modest results.

	Quarter	1 Year
ONE Canadian Equity Fund	7.8%	19.7%
ONE Global Equity Fund	7.0%	17.2%
ONE Canadian Corporate Bond Fund	-0.5%	3.0%
ONE Canadian Government Bond Fund	0.4%	1.9%
ONE Global Bond Fund	0.3%	3.8%

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.

The US economy continues to show strength while improvements in inflation have stalled

Many economists continue to be surprised by the strength of the US economy, which has shown few signs of slowing down despite aggressive rate hikes by the Federal Reserve. Many had anticipated a deceleration of economic activity and the possibility of recession because of the contractionary monetary policy that was introduced in 2022, but the US economy continues to show robust growth. The labour markets continue to be tight, with unemployment rates hovering near 50-year lows and inflation indicators remaining above central bank targets. Inflation peaked at over 8% in mid-2022 and has declined significantly since then, but since June 2023, the inflation rate in the US and Canada has hovered in the range of 3%, showing no clear signs of further improvements. It is not clear when the inflation rate will converge on the 2% central bank targets.

Interest rate expectations changed in the first quarter, with the expectations of significant interest rate cuts in 2024 being curtailed due to strong economic data

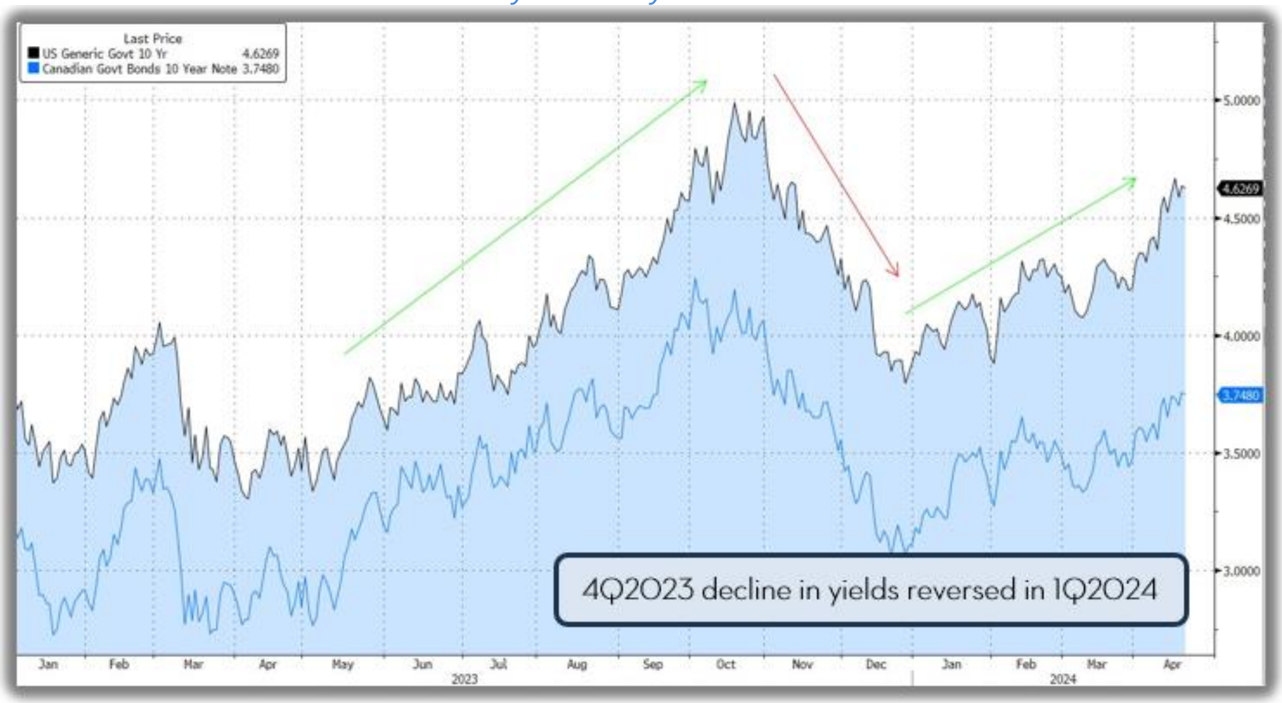
Comments by US Federal Reserve Chairman Powell in the fourth quarter of 2023 indicated that the Fed was becoming more 'dovish', implying that it was pivoting toward easing monetary policy. The market reacted, and interest rate expectations started to discount significant interest rate cuts. At the start of 2024, it was widely expected that the Fed would cut its policy interest rate by 1.75%.

During the first quarter, these expectations were revised as a string of economic data releases indicated that the US economy remained strong, labour markets remained very tight, and inflation improvements had stalled. This diminished the prospects for aggressive interest rate cuts. Market expectations for rate cuts were trimmed significantly, with the market now expecting rate cuts of only 0.50%.

Yields have moved higher since the start of the year offsetting declines experienced in the fourth quarter of 2023

Bond yields have been more volatile in recent months, with large declines in bond yields that occurred in the fourth quarter of 2023 being almost entirely erased by upward movements in yield since the start of the year. In recent months, bond yields have experienced large swings as investors react to changing expectations for central bank rate cuts. In late 2023, yields moved about 1% lower as investors prepared for the Fed and other central banks to start cutting rates in 2024. As signs of US economic strength in the opening months of 2024 dashed hopes of large imminent rate cuts, bond yields largely retraced the movements of late 2023. By April 19, 2024, the US 10-year bond yield was effectively at the same level as it was six months earlier. Chart 1 below shows how changing expectations have influenced bond yields. Movements in Canadian bond yields have echoed the US yield curve, but with somewhat more muted swings over the last six months.

Chart 1 – Recent US and Canadian 10-year bond yield trends



Source: Bloomberg LLP.

The global equity markets continue to rally, with performance uneven across geographies and sectors

Most global equity markets continued to show strength in the quarter as equity markets reacted positively to signs of strength in the US economy and seemed less concerned by the changing outlook for interest rates. US equities were among the strongest globally in the first quarter of 2024, with performance dominated by what has been nicknamed the "Magnificent 7"[1], seven large capitalization technology stocks that collectively have had stellar performance over the last year. In the first quarter, this group of stocks outperformed the rest of the US equity markets by about 10%. Some of the strongest sectors in the quarter included consumer services and the information technology sector, with returns in these global equity markets more than 14%, while the utilities, real estate, and materials sectors lagged, with returns below 5%.

[1] The "Magnificent 7" are Apple, Microsoft, Google parent Alphabet, Amazon, Nvidia, Meta Platforms and Tesla.

Japanese equities were one of the few markets that outperformed US equities in the quarter, boosted by the Japanese central bank announcement that yield curve controls and its negative interest rate policy were being abandoned. This was well received by investors, as it indicated that these policies, which were introduced in 2016 to bolster growth in the Japanese economy and address ongoing deflationary concerns, were no longer required. Japanese equities were up over 20% in the quarter after similar strong returns in the prior quarter. The strength in Japan did not extend to the rest of the region, as ongoing issues in the Chinese economy remain an overhang for Asia ex-Japan equities, which posted low single-digit returns in the quarter.

4. ANALYSIS

The ONE Canadian Equity Fund had returns of 7.8% in the first quarter, after showing similar returns in the prior quarter

The ONE Canadian Equity Fund had strong performance in the first quarter of 2024, with returns of 7.8%, outperforming its benchmark. These returns come on the heels of similarly strong performance in the fourth quarter of 2023, when the fund was up 8.6%. This trend reflects the positive sentiment affecting equity markets globally, as investors seem to be encouraged by surprisingly strong US economic growth.

Stock selection in the fund contributed to the strong results, with the performance of two stocks having a large impact on overall fund returns. The fund has an overweight allocation to Celestica, with a 3.7% allocation. This stock has had spectacular performance since it was added to the fund in mid-2023. In the first quarter, it had returns of 56.8%, with total returns of 219% since the start of July 2023. This holding alone has made a very large contribution to overall fund performance as it has participated in the strength that has surrounded ‘Artificial Intelligence’ (AI) related equities in the US. Another stock that helped performance in the quarter was SNC Lavalin, recently rebranded as “AtkinsRealis”. This stock, which represents 3.4% of the portfolio, rallied 29.9% in the quarter on the back of strong earnings results and a positive outlook for growth.

For the twelve-month period ending March 31st, 2024, the fund had returns of 19.7%, outperforming its benchmark by over 5%. The strength of these results was primarily supported by strong stock selection, but sector allocation also contributed. The fund benefited from an overweight allocation to the Information Technology sector, which has been the best performing sector of the market over the last year with returns of 40%. Some of the fund’s best performing holdings over the 12-month period included Celestica Inc., SNC Lavalin, Cameco, and Fairfax Financial, with returns of 267%, 67%, 66%, and 65%, respectively. The performance of these four stocks made a significant contribution to overall fund returns, helping the fund outperform its benchmark.

The ONE Global Equity Fund had returns of 7.0% in the quarter, as global equities had another quarter of strong returns

The ONE Global Equity Fund had strong performance in the first quarter of 2024, with returns of 7.0%. These results are similar to fund returns in the fourth quarter of 2023, when the Global Equity Fund had returns of 6.9%. For the 12-month period ending March

31, 2024, the fund had strong returns of 17.2%. These returns are reflective of the strength of equity markets, after markets continued to rebound from notable weakness in 2022.This ongoing rally in global equity markets has been supported by a supportive macroeconomic backdrop. Further signs of strong US economic growth have contributed to the positive market sentiment. Strong GDP growth supports demand for goods and services, while inflation pressures may imply pricing power for listed firms. Both factors may have contributed to an environment that is supportive of EPS growth for listed equities.

Fund returns for the quarter and trailing 12-month period were weaker than the fund's performance benchmark, as the investment manager's allocations were not able to fully participate in some of the most favourable themes affecting global equity markets. The fund's exposure to the more defensive consumer staples and healthcare industries had weaker performance than the broader market, which contributed to the underperformance versus its benchmark. There is no expectation that the performance will closely track the benchmark, as the manager's stock selection process and concentrated portfolio are expected to result in patterns of fund performance that may be dissimilar. Long-term outperformance is expected, but over the short term, deviations will occur. It is noted that the 12-month underperformance relative to the benchmark is 5.9%. The magnitude of this merits closer monitoring in future quarters.

Asian equity markets had divergent performance in the quarter, with weaker results from Asia-ex-Japan equities and very strong results from Japanese equity markets. The fund currently has no direct exposure to Asia-ex-Japan equities but does have exposure to Japanese equities via a single holding. The fund has about a 1% allocation to KDDI Corp., a Japanese telecommunications company that announced an acquisition in the quarter. KDDI and the Mitsubishi conglomerate teamed up to fully acquire Lawson, Japan's second-largest convenience store chain. The market did not react well to this announced acquisition, questioning the strategic fit, and KDDI's shares did not participate in the strength of Japanese equity markets in the quarter as a result.

The information technology sector was the best-performing sector in the market during the quarter, extending the leadership role that this sector has played over the last year. The 'Magnificent 7' stocks continued to show strong returns in the quarter as the AI theme pushed these stocks higher. The fund holds two of these seven stocks (Amazon and Microsoft) and has only been able to partially participate in the strength these stocks have experienced over the last year. While other information technology companies have performed well, the fund's underweight exposure to the information technology sector detracted from index relative performance.

The ONE Investment fixed income funds had more modest performance than the equity funds in the quarter as rising interest rates negatively affected performance

Bond markets posted mixed results in the quarter as stronger-than-expected economic growth in the United States led investors to push back their expectations for near-term interest rate cuts by the U.S. Federal Reserve, which led to higher bond yields. The ONE Canadian Corporate Bond Fund had returns of negative 0.5%, while the ONE Canadian Government Bond Fund and the ONE Global Bond Fund had slightly positive returns of

0.4% and 0.3%, respectively, in the quarter. Rising bond yields had a larger negative effect on the performance of the ONE Canadian Corporate Bond Fund and the ONE Global Bond Fund as they had a longer duration. Both funds have a duration statistic of about 5 years, making them more sensitive to movements in bond yields than the ONE Canadian Government Bond Fund. The mandate of the Government Bond Fund was modified in 2023, which reduced its maturity profile, and the fund now has a duration of only 1.4 years.

The performance of the Global Bond Fund was supported by modestly tighter credit spreads. This fund has an allocation of about 18% to high yield bonds, significantly higher than its benchmark, which contributed to fund performance in the quarter.

5. CONCLUSION

The review of manager performance during the first quarter of 2024 did not identify any significant performance issues that were a concern, although it is believed closer monitoring of the performance of the ONE Global Equity Fund is appropriate considering recent performance patterns. The performance of the ONE Prudent Investment Funds were otherwise satisfactory, with all the ONE Investment pooled funds generating positive performance over a 12-month period, and only one fund experienced negative returns in the quarter, which were small in magnitude. The quarterly performance of ONE’s fixed income funds was mixed, with all three funds producing returns that were close to zero. This reflects interest rate trends and should not be seen as a concern. Equity-oriented pooled funds produced strong returns for the quarter as they participated in an ongoing rally in global equity markets. Returns from equity funds over the last 12 months have also been very strong. The macroeconomic backdrop continues to evolve, which has led to volatility in interest rates. More clarity about how central banks will respond to the economic environment will influence the prospects for fixed-income investments.

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