REPORT

To: ONE Joint Investment Board
From: Keith Taylor, Chief Investment Officer, ONE Investment
Date: November 27, 2024
Re: Fund Manager Performance Review Q3 2024
Report: ONE JIB 2024-076

1. RECOMMENDATIONS

It is recommended that the Board:

1. Receive the report.

2. Confirm that its members have reviewed the Fund Manager Performance Reports for Q3 2024 provided in the Resource Library.

2. SUMMARY

This report summarizes the performance of the ONE Investment Prudent Investment Funds for the third quarter of 2024, including a brief overview of contributing factors.

The ONE Investment pooled fund performance produced positive returns in all funds in the quarter with both fixed income and equity markets generating strong returns. All five funds also produced notable investment gains over the last 12 months, with equity funds experiencing significantly stronger returns than fixed income funds. The environment of falling inflation amid signs of moderate economic growth allowed central banks across most developed nations to lower interest rates, helping to push bond prices higher. Equity markets moved higher despite a spike in volatility mid-quarter with interest rate-sensitive sectors like Real Estate and Utilities outperforming.

	Quarter	1 Year
ONE Canadian Equity Fund	9.4%	27.1%
ONE Global Equity Fund	2.8%	17.0%
ONE Canadian Corporate Bond Fund	4.0%	11.1%
ONE Canadian Government Bond Fund	2.3%	6.5%
ONE Global Bond Fund	4.4%	11.1%

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, identifying any issues arising from the quarterly review of the external investment managers. The report is to include a summary of mandate positioning, information on investment performance, and an explanation of the drivers of performance, with commentary to explain the performance and market context.

Most major global central banks cut interest rates in the quarter as inflation pressures continued to decline, augmenting returns for fixed income

As inflation pressures diminished, the inflation rate converged on central bank targets, reducing the need to maintain high interest rates. Signs of labour markets softening and the prospect for slower GDP growth allowed central banks flexibility to lower interest rates.

Bond markets performed well as central banks cut interest rates, helping push bond prices higher. Bond returns in the quarter included a notable capital gains component. While cash and term deposits produced solid returns over the last few years, often outpacing bond returns, this trend was reversed in the quarter with bond returns augmented by significant capital gains. The prospects of falling interest rates also supported equity markets, leading to strength in interest-sensitive market sectors, especially the Real Estate and Utilities sectors.

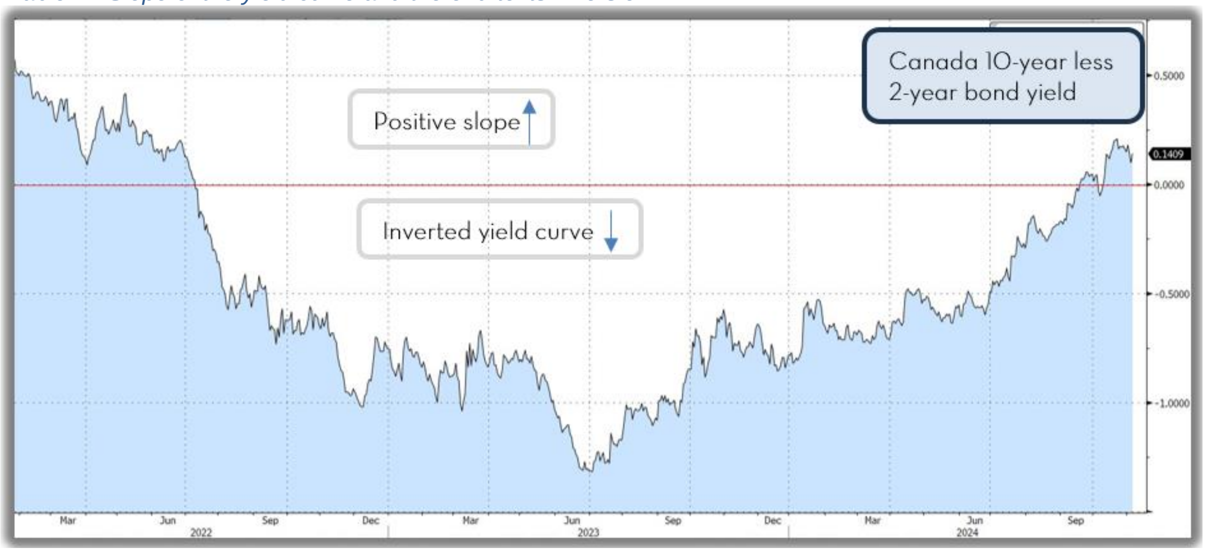
The leadership of large-capitalization technology stocks changed as the 'Magnificent-7' stocks slightly underperformed the broader market in the third quarter

The performance of seven large technology-related companies had a significant impact on overall market performance, but the performance of these companies lagged the broader market for the first time since the start of 2023. These stocks, known as the Magnificent-7 stocks (Microsoft, Apple, Nvidia, Alphabet, Amazon, Meta and Tesla) have had a spectacular performance as investor interest in Artificial Intelligence peaked, leading to returns of nearly 200% for this group of stocks over 21 months. As they collectively represent more than 30% of the S&P 500 index, this made a significant contribution to the overall performance of the index. This has been a prominent feature of market dynamics over the last few years as the strength in equity returns was highly concentrated in a handful of companies. While the US equity markets had a strong rally, the breadth of the market strength was narrow, with most of the smaller companies not fully participating. In the quarter the Magnificent-7 stocks modestly underperformed the broader US equity markets, while small market capitalization companies had strong performance.

Movement in the yield curve saw short-term interest rates fall more than longer-term interest rates

Over the last few years, short-term bond yields exceeded rates available on longer-term bonds, known as an inverted yield curve. This resulted from central banks raising short-term interest rates after the COVID-19 crisis to address inflation pressures. The Bank of Canada started raising interest rates in March 2022 and they have remained elevated since then, with the Bank of Canada's Overnight Interest Rate peaking at 5%. The Bank of Canada started cutting the policy interest rate in June, with the rate dropping to 3.75% by October 2024. The rapid decline in the policy interest rate led to short-term bond yields dropping faster than long-term bond yields. The inversion of interest rates that have persisted since 2022 ended in September 2024. Table 1 shows this, using the spread between the Government of Canada's 10-year bond yield and 2-year bond yield.

Table 1 –Slope of the yield curve and the end to its inversion.



Source: Bloomberg LLP

Volatility spiked mid-quarter as a mini-market meltdown emerged, then quickly abated

The financial markets were affected by elevated volatility in the quarter which affected both equity and bond markets, also creating noise in certain foreign exchange markets. Japan was the focal point of this market event, as the Bank of Japan raised interest rates shortly after weaker US economic data was released. The prospects of the US Federal Reserve lowering interest rates while Japan was raising interest rates created significant dislocations in financial markets. The Japanese equity market (Nikkei 225 index) dropped over 25% between mid-July and early August while the Japanese Yen appreciated versus the US dollar by about 12%. These sharp changes affected other global equity markets, leading to a spike in volatility in equity markets as shown in Table 2 below.

Table 2 –The CBOE VIX index spiked in the quarter as market volatility spiked.

Source: Bloomberg LLP, CBOE Exchange, Inc.

4. ANALYSIS

The ONE Canadian Equity Fund had returns of 9.4% in the quarter, bringing returns over the last year to over 27%

Canadian equity markets were very strong in the quarter, with the ONE Canadian Equity Fund producing returns of 9.4%, modestly underperforming its benchmark in the quarter. The fund's significant underweight exposure to the energy sector, the weakest TSX sector in the quarter, helped fund performance relative to the benchmark, while a significant overweight to the second weakest TSX sector, the Industrial sector, had the opposite effect. Security selection in the Energy and Consumer Discretionary sectors also contributed to underperformance. Over the 12 months ending September 30, 2024, Canadian Equity markets performed very strongly, amidst a strong rally in global equity prices. The fund's returns were 27.1%, broadly in line with the strength in Canadian equity markets over the last year.

Canadian equity markets performed well in the quarter with interest-sensitive sectors performing particularly well. The best-performing sectors included the Real Estate (+23.0%), Financials (+17.0%), and Utilities (+16.6%) sectors, which benefit from a lower interest rate environment. All market sectors had positive performance with the weakest being the Energy sector (+1.9%). Energy sector performance was negatively affected by oil prices moving 16% lower in the quarter. Strength in TC Energy, which was up 25% in the quarter helped the sector produce a small positive return. The fund has always maintained a significant underweight exposure to this sector as returns are highly dependent on commodity prices, which can be highly volatile. The fund typically has half the exposure to commodity-related sectors versus the broader Canadian equity market, which helps to dampen the volatility of fund returns.

The ONE Global Equity Fund returns were 2.8%, with the fund providing returns of 17% over the past year

The ONE Global Equity Fund had returns of 2.8% in the quarter, while the broader global equity markets were up more than 5% in this period. The investment manager's approach, which focuses on a bottom-up security selection process to identify well-managed firms with a sustainable competitive advantage and reasonable valuations is not currently being rewarded by the market, leading to shorter-term underperformance. Over the 12 months ending September 30, 2024, the fund produced returns of 17%, also underperforming its benchmark. It is expected that actively managed investment mandates with positions that reflect manager convictions and concentrated portfolio positions will not always replicate or outperform the market, but the underperformance merits ongoing monitoring.

The fund's sector allocation choices helped performance in the quarter as the fund has no exposure to the Energy sector, which was down over 3% in the quarter due to dropping oil prices. Light exposure to the Information Technology sector also helped as this was the second weakest sector of the market, with returns close to zero.

Fund security selection detracted from performance in the quarter as the stocks that reflect the manager's long-term investment approach were simply not rewarded by the market in the quarter, and market performance was instead driven by other themes. Holdings in BMW were down more than 7% in a market sector that was up 8%. Other weaker holdings included Moderna, which was down 44% due to weakness in demand for COVID-19 vaccines and Novo Nordisk, which dropped 19% in response to increasing regulatory risk concerns and ongoing market share losses to competitors.

The ONE Investment fixed income funds benefitted from the changing interest rate outlook that led to strong returns

The global fixed-income markets performed well in the third quarter of 2024, as most major global central banks cut interest rates. This helped push bond prices higher, allowing all ONE Investment fixed income-oriented funds to generate investment gains that augmented the recurring income generated by bond holdings. The ONE Canadian Corporate Bond Fund, the ONE Canadian Government Bond, and the ONE Global Bond Fund produced returns of 4.0%, 2.3%, and 4.4%, respectively in the quarter. All three funds generated strong returns over the twelve months ending September 30, 2024, with returns of 11.1% for the ONE Canadian Corporate Bond Fund, 6.5% for the ONE Canadian Government Bond Fund, and 11.1% for the ONE Global Bond Fund. The ONE Canadian Government Bond Fund's returns trailed the returns of the other two bond funds due to its shorter maturity profile. When bond yields fall, it tends to have a larger impact on the performance of bonds that have a longer maturity profile.

The ONE Global Bond Fund, which invests in foreign currency-denominated bonds was affected by currency movements in the quarter. The fund has a large allocation to US dollar-denominated bonds with 58% of the fund invested in US bonds. As the US dollar appreciated by about 1% versus the Canadian dollar, this made a positive contribution to returns. The fund typically has currency hedges in place to reduce foreign exchange risk and currently has about 78% of currency exposure hedged back to the Canadian dollar. These currency hedges generated losses in the quarter, offsetting most of the positive effects of the US dollar's strength in the quarter.

5. CONCLUSION

The review of manager performance for the third quarter of 2024 did not identify any significant performance issues of concern, but the underperformance of the ONE Global Equity fund merits continued close monitoring. While there was elevated volatility in financial markets over the third quarter, all ONE Investment Pooled funds generated solid gains and have had very strong returns over the last 12 months.

Markets responded positively to central banks lowering interest rates in most major economies, which has a direct positive effect on bond prices. This environment was also supportive of equity markets, which responded well to moderation in inflation pressures, lower interest rates and relatively stable economic growth.

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