PH&N Core Plus Bond Fund

Fund Performance

Performance Comparison as of March 31, 2022 (%)							
	3 Mo	1 Yr	2 Yr	3 Yr	4 Yr	5 Yr	SI *
PH&N Core Plus Bond Fund	**-6.66**	**-3.76**	**1.02**	**2.26**	**2.98**	**2.82**	**3.94**
FTSE Canada Universe Bond Index	*-6.97*	*-4.52*	*-1.50*	*0.45*	*1.63*	*1.58*	*2.67*
Relative Performance	+0.31	+0.76	+2.52	+1.81	+1.35	+1.24	+1.27

Series O returns. Total returns are gross-of-fee and reported in Canadian dollars. Periods less than one year are not annualized.

* Inception date: June 30, 2013.

Fund Attribution

Attribution as of March 31, 2022 (%)		
	Relative Performance	
	3 Mo	1 Yr
Interest rate anticipation		
Duration & yield curve	0.17	0.25
Real return bonds	0.00	0.06
Foreign sovereign bonds	0.00	0.00
Credit & liquidity		
Provincial & quasi-government bonds	0.04	0.04
Investment grade corporate bonds	0.04	0.21
High yield corporate bonds	0.08	0.16
Mortgages	0.02	0.09
Emerging market debt	-0.02	-0.04
Other	-0.02	-0.01
Total	**+0.31**	**+0.76**

First Quarter Review

Strategy Summary for the Quarter Ending March 31, 2022 (relative contribution to duration exposure)			
Strategy	**Change Over Q1**	**Position Ending Q1**	**Our View**
Duration & Yield Curve	Increased	Slight long duration	Tactical contrarian view based on belief that sentiment and investor positioning are stretched
Real Return Bonds	Decreased	Small position	Long-term market-implied inflation expectations have risen but remain below the BoC's 2% inflation target
Foreign Sovereign Bonds	Unchanged	No position	Monitoring the yield differential between foreign sovereigns and Government of Canada bonds
Provincial and Quasi-Government Bonds	Increased	Medium overweight in provincials; underweight in federal agencies	Valuations more attractive for provincial bonds relative to federal agencies
Investment Grade Corporate	Increased	Medium overweight	Adding exposure opportunistically in areas where we see more compelling valuations and new issue concessions
High Yield	Increased	Medium position	Valuations becoming more attractive; selectively added to Global high yield
Mortgages	Unchanged	Small position	Liquidity premium remains at appealing levels
Emerging Market Debt	Unchanged	Medium position	Reward-for-risk profile remains compelling

- The strong economic recovery continued over the quarter, while inflationary pressures remained elevated, exacerbated by the Russian/Ukraine conflict. As such, the Bank of Canada continued its shift toward a less accommodative monetary policy stance by raising its policy rate and announcing an end to the government bond purchase program. Government of Canada (GoC) bond yields rose sharply over the quarter alongside heightened volatility, resulting in negative bond returns.
- Active positioning within both interest rate anticipation and credit and liquidity strategies resulted in the portfolio finishing the quarter ahead of the benchmark. Overall, the portfolio's risk budget remained focused on credit and liquidity strategies, and we added to the portfolio's credit exposure opportunistically on the back of more attractive valuation levels.
- The portfolio's duration and yield curve positioning was a meaningful contributor to relative performance, with the portfolio ending the quarter with a slight tactical long relative duration position.
- The small out-of-benchmark position in real return bonds was a neutral contributor to performance, as market-implied long-term inflation expectations were unchanged quarter over quarter.
- An underweight position as well as tactical trading within provincial and government agency bonds contributed to relative performance, as spreads moved slightly wider over the quarter.
- The portfolio's overweight to investment grade corporate bonds added value due to conservative positioning toward higher-quality as spreads widened.

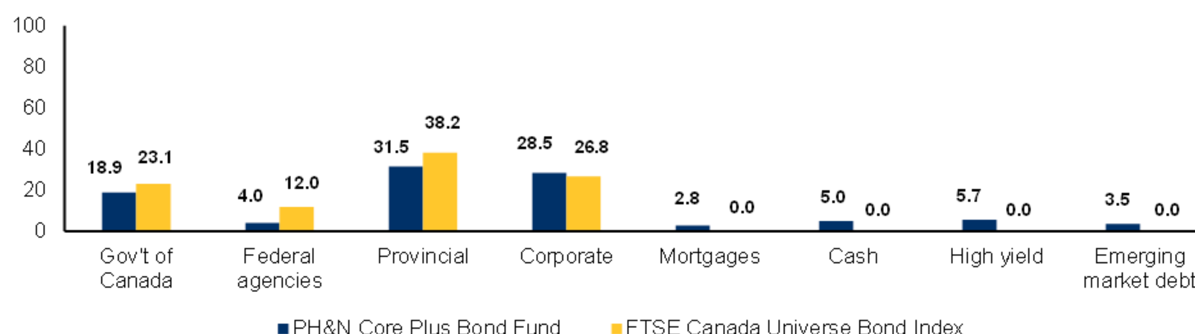
- The out-of-benchmark positions in high yield bonds and mortgages contributed to relative performance, as these asset classes performed well relative to universe bonds over the quarter.
- The portfolio’s out-of-benchmark position in emerging market debt detracted from performance due to the global risk-off sentiment caused by Russia’s invasion of Ukraine.

PH&N Core Plus Bond Fund Portfolio Structure as of March 31, 2022

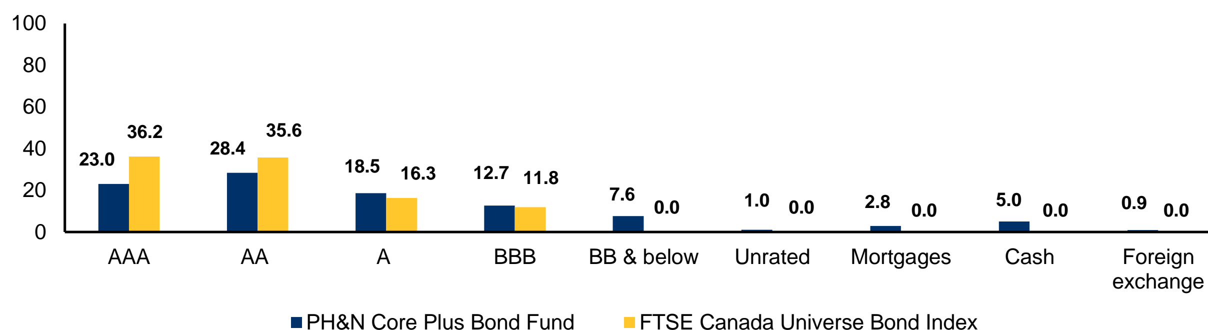
Fund Characteristics

	Modified Duration (Yrs)*	Term to Maturity (Yrs)	Yield to Maturity (%)
PH&N Core Plus Bond Fund	7.86	11.34	3.43
FTSE Canada Universe Bond Index	*7.84*	*10.61*	*3.02*

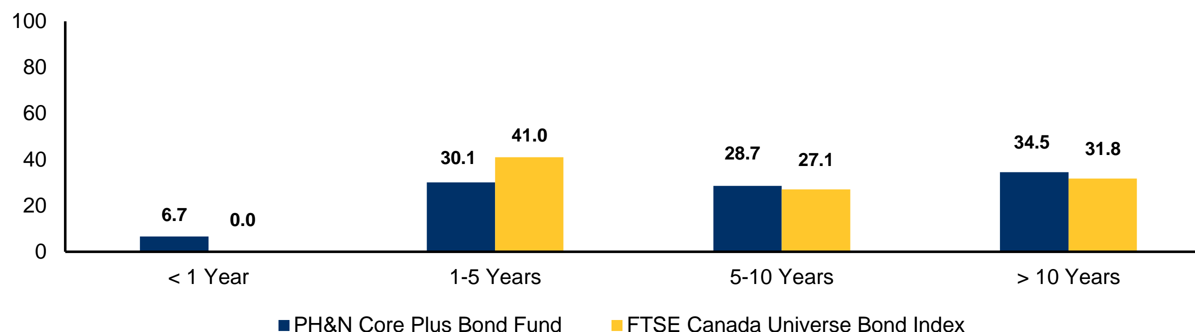
Issuer Analysis (%)



Rating Analysis** (%)



Maturity Analysis (%)



* Duration includes the duration of foreign instruments. Due to the Fund's foreign bonds having a much lower correlation to Canadian interest rates than implied by a conventional duration calculation, the reported duration measure does not correctly estimate true economic sensitivity of the Fund to Canadian base rates.

** Current ratings based on average across rating agencies (DBRS, Moody's, S&P) where available. Ratings at the time of purchase may differ.

Totals may not add to 100% due to rounding.

First Quarter Review

Duration and Yield Curve

The strong economic recovery continued over the quarter with the pandemic-induced economic slack now fully absorbed. Given the surge in cases caused by the Omicron variant and the accompanying public health related restrictions largely behind us, the growth outlook has also improved. Inflation over the quarter remained elevated, as supply chain constraints have proved to be more persistent than previously expected by central banks while also feeding through to a broader range of goods and services. Additionally, the increase in commodity prices as a result of the Russian invasion of Ukraine has further contributed to inflationary pressures. With the above in mind, the Bank of Canada (BoC) continued its shift toward a less accommodative stance over the quarter. It began increasing the policy rate in March and communicated that further increases will be needed moving forward to battle inflationary pressures. These rate increases will be accompanied by an end to the bank’s government bond purchase program. This is expected to be passive in nature, allowing the BoC’s balance sheet to shrink as bonds mature. Bond yields did not change much on this announcement, but we expect that over time this will increase the amount of government debt the market will have to absorb, which will put upward pressure on GoC bond yields. Against this backdrop, GoC bond yields rose sharply over the quarter alongside heightened volatility. Short-term yields rose to a greater extent than long-term yields, as they have a higher sensitivity to future BoC policy rate hike expectations. Overall, the result is a meaningful flattening of the GoC yield curve.

The portfolio’s sensitivity to interest rates was lower than the benchmark at the start of the quarter, as we believed that the modest long-term economic growth and inflation expectations embedded in bond yields were reflecting an overly pessimistic view over the medium term. However, as the quarter progressed and yields increased, we were tactical in increasing the duration of the portfolio relative to the benchmark as the market sentiment and positioning factors we follow shifted. As a result, the portfolio ended the quarter with a slightly overweight duration after being underweight for most of the period. This positioning is a tactical contrarian view based on our belief that sentiment and investor positioning are stretched with the majority of investors being short duration. Overall, in this rising yield environment, the portfolio's duration and yield curve positioning was a positive contributor to relative performance over the quarter.

Government of Canada Yields (%)

	1 Yr	2 Yr	5 Yr	10 Yr	30 Yr
March 31, 2022	1.98	2.28	2.40	2.40	2.38
Forward Curve for March 31, 2023	2.58	2.51	2.46	2.47	2.39
Implied Change (1 year)	**+0.60**	**+0.23**	**+0.06**	**+0.07**	**+0.01**

Source: Bloomberg, RBC GAM (BondLab)

Looking forward, the bond market expects short-term yields to rise to a greater degree than long-term yields over the next year. This is driven largely by market expectations that the BoC will continue to increase policy rates from current accommodative levels. We believe that yields will continue to exhibit heightened volatility in the near term, as a multitude of factors influences the direction and magnitude of yield changes, particularly central bank monetary policy and the outcome of the Russia/Ukraine conflict. This volatility will provide opportunities for value-added through active management.

Real Return Bonds

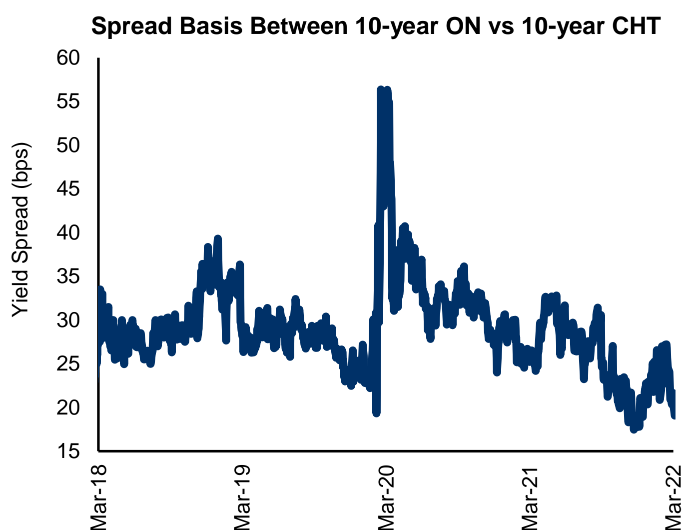
The annual inflation rate, as measured by headline Consumer Price Index (CPI), accelerated to 5.7% in February, which is the highest level since August 1991. The Russian invasion of Ukraine is deeply troubling, injecting new uncertainties and putting upward pressure on commodity prices. This comes atop continued uncertainty about the evolution of COVID-19, even as the world makes its way out of the Omicron variant. Supply chain disruptions persist, distorting the price and availability of many goods. As a result, market consensus is for above-average inflation to continue over the short term.

During the quarter, we trimmed the portfolio's out-of-benchmark real return bond allocation as the bond market's expectations for long-term inflation (estimated as the difference in yield between a nominal and a real return bond) increased before ending the quarter back where they began. Overall, real return bonds were a neutral contributor to relative performance. Over the medium term, we believe inflation expectations are likely to continue moving higher, as they remain below the BoC's 2% midpoint target range, and therefore, the portfolio continues to have a small real return bond allocation.

Foreign Sovereign Bonds

We may choose to hold a tactical position in foreign sovereign bonds, such as U.S. Treasury bonds and U.S. T-Bills, when they are attractively valued and/or because of their diversification benefits. We do not currently have a position in foreign sovereign bonds, but we will continue to monitor this strategy as market conditions evolve.

Quasi-Government Bonds



Source: BMO Sapphire

Alongside broader credit assets, provincial bonds weakened modestly on the back of waning investor risk appetite. Spreads widened across all provinces and terms, although to varying degrees. Unsurprisingly, commodity-sensitive provinces, such as Alberta, Saskatchewan, and Newfoundland, were the most resilient over the quarter, as they benefited from higher oil prices. New issuance slowed in the second half of Q1, as many provinces were hesitant to issue in an uneasy and volatile market environment. Additionally, provincial funding needs have declined as a result of stronger-than-expected revenues and lower-than-anticipated outlays throughout the pandemic, further reducing the need for significant new issuance. Looking forward, we expect the improved fiscal trajectory, coupled with a reduction in borrowing needs, to be supportive for provincial spreads.

Over the quarter, the spread basis between Ontario and federal agency bonds (such as AAA-rated Canada Housing Trust bonds) tightened modestly, and we took the opportunity to upgrade the quality of the portfolio by modestly trimming Ontario bonds in favour of higher-quality federal agency bonds. Simultaneously, we capitalized on improved valuations within British Columbia and Quebec bonds by reducing the portfolio’s underweight exposure to these two provinces, funded through a decrease in federal bonds and commodity-sensitive provinces such as Alberta. Overall, the portfolio has a modest underweight exposure to provincial and quasi-government bonds in aggregate. Within this sector, the portfolio continues to have a meaningful bias toward provincial bonds given their yield advantage over government agency bonds.

The portfolio’s tactical trading within provincial and government agency bonds, coupled with its underweight exposure during a quarter when spreads widened, contributed to relative performance. We will continue to tactically adjust the portfolio’s quasi-government positioning based on the attractiveness of opportunities relative to other segments of the bond market.

Private Placement Corporate Bonds

The portfolio's allocation to private placement corporate bonds is achieved through an allocation to the PH&N Private Placement Corporate Debt Fund (PPCDF). The PPCDF invests in investment grade private placement corporate bonds issued primarily in Canada but also abroad. For bonds unrated by an agency, PH&N will assign an internal rating, which must be of investment grade quality to qualify. One of the benefits of investing in private debt is the opportunity to expand and diversify investment opportunities. While many of the issues are infrastructure related, the private debt market encompasses many industries and sub-industries not available in the "public" markets. In addition, private placements often provide attractive illiquidity premiums for investors because they do not tend to have an active secondary market.

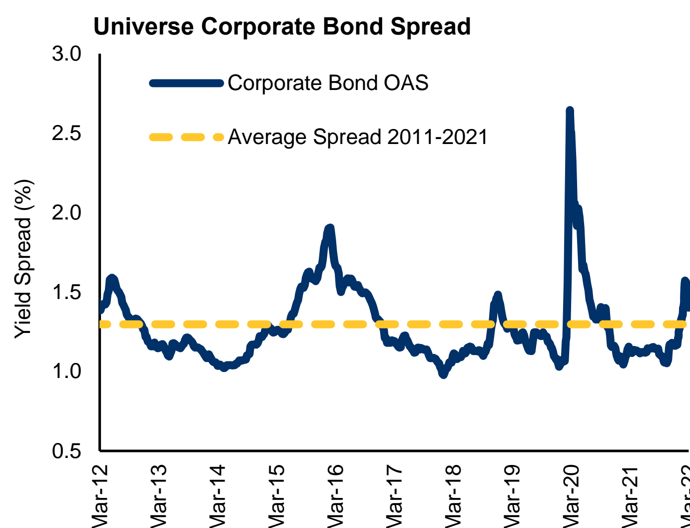
Private placement corporate bond spreads widened by around 10 basis points over the quarter, which was lower than what was witnessed in comparable-term public securities within the broader Canadian corporate bond market. Coupled with lower Government of Canada bond yields over the quarter, the fund returned -8.0%. The extra spread over public corporate bonds provides an ongoing return tailwind.

During the first quarter, the PPCDF participated in a deal from a large domestic construction firm that we are familiar with due to their involvement in the Canadian public-private partnerships (PPP) market. The issuer has a strong business presence in its operating markets, and a good level of diversity by geography, contract type, and client type. It also has a long track record of conservative management and low risk tolerance. This 7-year bond rated BBB was added at an attractive spread relative to Government of Canada yields.

We access investment opportunities for the PPCDF via the private placement desks of bond dealers that are our traditional counterparties in public corporate bond markets. Our expectations for yield enhancement within this sector are in the order of 75–100 basis points over public market opportunities of similar credit quality.

Investment Grade Corporate Bonds

The corporate credit market was marred in volatility during the first quarter, as concerns over the potential impact of soaring inflation and tighter monetary policy on economic growth remained fixtures of the market narrative. Russia's invasion of Ukraine in the last week of February exacerbated investors' uneasiness as commodity prices surged, sanctions were implemented and Russia threatened to default on its debt, which sent investors fleeing from risk assets. Despite the volatile rate and geopolitical backdrop, investment grade corporate bond issuance was still robust in the first quarter with approximately $46 billion of new supply coming to market, up 43% from the same period in 2021 as businesses continued to take advantage of still-accommodative financing conditions. However, the market's ability to absorb the new supply waned as a result of the increased uncertainty, which pushed broad Canadian corporate bond spreads approximately 25bps wider over the quarter, with higher-quality credit faring better than lower-quality credit.



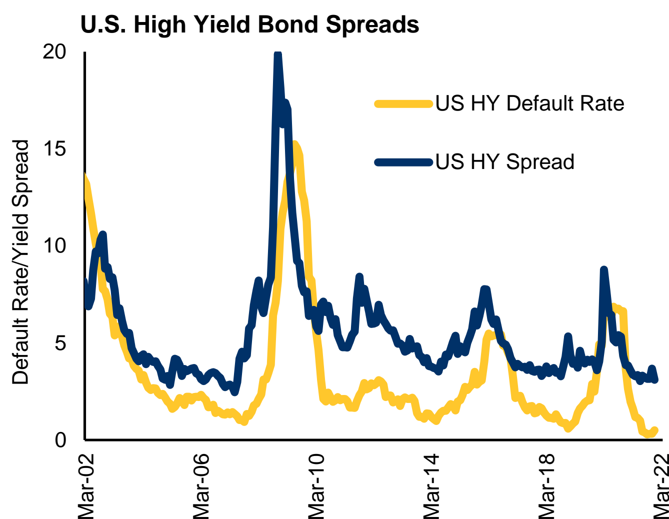
Source: FTSE Global Debt Capital Markets Inc.

From a fundamental standpoint, we remain concerned about increasing debt levels in the Canadian economy among consumers and corporations. Canadian household debt levels are at record levels, largely due to the hot housing market, which has driven more mortgage borrowing. Mortgage debt rose another $44 billion in Q4/2021 and is up over $300 billion from pre-pandemic levels. This, along with a lowering of disposable incomes as government pandemic supports continued to ease, pushed the debt-to-disposable-income ratio to a new record of 186% in Q4 – up 6% from the previous quarter. On the corporate side, a meaningful concern remains the elevated merger and acquisition activity funded by debt as ambitious businesses pursue growth.

We were tactical in managing the portfolio's corporate bond allocation over the quarter, adding some exposure opportunistically where we saw more compelling valuations, such as in the financial and communications sectors. That being said, we are cognizant that market conditions appear to be in the late-stage of the credit cycle, so we continue to favour the higher-quality, less-cyclical areas of the bond market. This bias helped to insulate the portfolio from the spread widening that the broader corporate bond market experienced this quarter, adding meaningful value despite the portfolio's overweight corporate exposure.

High Yield Corporate Bonds

Like most asset classes over the quarter, high yield bonds posted negative returns in the face of rising interest rates and a deterioration in risk appetite. Rising rates had the largest impact, but its effect was more meaningful on government and investment grade corporate bonds due to their longer durations, while the shorter-duration nature of high yield bonds helped soften this impact. High yield spreads began widening from the beginning of the quarter on concerns of increasingly aggressive monetary policy to counteract inflationary pressures, and then widened further upon the Russian invasion of Ukraine. Spreads ended the quarter higher than where they began but below their February peak.



Source: Bloomberg. US High Yield spread represented by ICE BofA Merrill Lynch US High Yield index. US high yield default rate represented by ICE BofA Merrill Lynch US High Yield index to Dec 31 2019, JPMorgan Jan 31 2020 to current

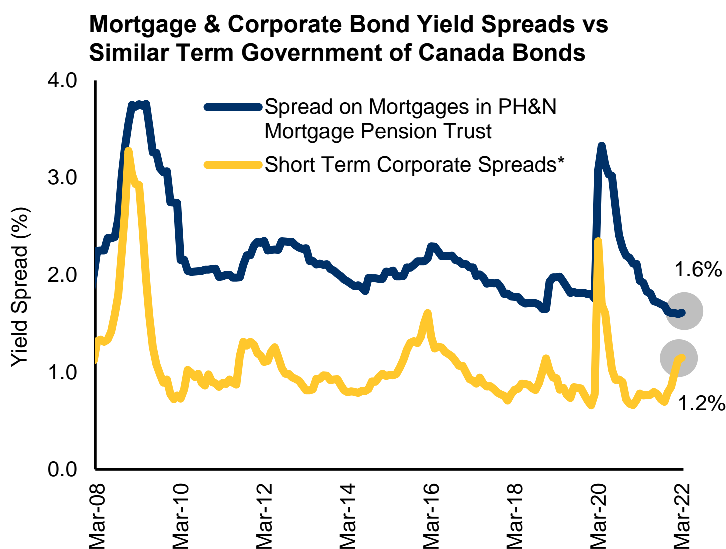
High yield issuance started at a healthy level this year but then quickly dried up as risk-off sentiment began to dominate. Investor demand waned in light of increasingly hawkish commentary from the U.S. Federal Reserve (Fed) and other central banks as well as the escalating conflict in Ukraine. Issuers grew concerned that deals would not be well received amid the uncertainty.

Corporations nonetheless continued to perform well over the quarter, with earnings largely hitting or surpassing targets and management teams mostly optimistic in their outlooks despite valid and growing concerns about inflation levels. Oil prices of above $100/barrel are a double-edged sword for high yield markets – beneficial for oil and gas companies (historically one of the most susceptible sectors); but if prices rise too much, the inflationary and economic consequences can become detrimental. For now, high yield defaults are sparse and expected to remain at negligible levels over the remainder of 2022.

The portfolio's high yield position was modestly increased over the quarter and added slightly to performance. Wider spreads have made valuations more attractive in their own right and compared to investment grade bonds. That said, we are mindful of the growing list of risks, and have accordingly maintained a defensive posture by emphasizing high-quality, less-cyclical issuers and low-duration securities with good diversification across Canadian, U.S. and global issuers. The size of our high yield exposure is moderate and can be dialled up or down from here depending on how the market unfolds.

Mortgages

As of quarter-end, the mortgages had a yield of approximately 160 basis points over similar-term GoC bonds, largely unchanged from the previous quarter. Nevertheless, the commercial mortgage landscape remained competitive. We witnessed high lender competition with a focus on aggressive underwriting terms, which ultimately led to higher loan amounts; this is in contrast to 2021, when lenders focused on offering the most competitive coupon for borrowers. We expect the sharp rise in GoC yields to push the all-in coupons on new lending opportunities higher in the coming quarters.



* FTSE Canada Short Term Corporate Bond Index
Source: FTSE Global Debt Capital Markets Inc. RBC GAM (BondLab)

Many large office tenants are still evaluating their return-to-office policies before making long-term leasing decisions. While it remains unclear how this will drive demand for physical office space, we continue to gain confidence in office lending as more people return to premises. Since the onset of Canada's mass vaccination program, a recovery in retail has been underway, with pent-up consumer demand driving sales for retail businesses. While retail fundamentals have also improved, supply chain difficulties remain a challenge. Despite these headwinds, rent delinquencies remain low; we have experienced no losses to date, and currently have no arrears or deferrals. Multi-residential housing continues to be supported by increased immigration targets, the return of students, the high costs of home ownership, and the undersupply of housing. Unsurprisingly, multi-residential lending opportunities continue to generate strong competition and lenders appear to be offering borrowers more favourable terms. Canada's industrial sector continues to exhibit strong fundamentals, and availability challenges have been particularly acute in the warehouse space, but we remain cognizant that an economic slowdown in the Canadian and/or global economy could lead to a drop in manufacturing and industrial activity.

During the quarter, we funded over $292 million in new loans. Of this, 76% was invested in loans supported by industrial properties and 22% was invested in loans supported by mixed-use retail and office properties. Looking forward, we expect mortgage spreads to widen following the dynamics seen in the corporate bond market, which should provide an additional opportunity for new loans to generate coupons that compensate investors for heightened inflation in the current environment. There are currently 546 mortgages, with conservative weighted average risk metrics of a 1.7x cash flow coverage ratio and a 55% loan-to-value ratio.

Emerging Market Debt (EMD)

We believe that EMD presents a unique opportunity to diversify sources of value-added within the portfolio, given its attractive yield profile, solid credit quality, and lower correlation to Canadian fixed income instruments. EMD encountered a turbulent first quarter owing to increased volatility, which was driven by Russia's war in Ukraine and rising U.S. treasury rates. Consequently, the portfolio's EMD allocation was a modest drag on performance, as hard and local currency sovereign, hard currency corporates, and EMFX all posted negative returns over the quarter. However, it's worth noting that negative performance within EMD had a relatively muted impact on the PH&N Core Plus Bond Fund given EMD returns were only modestly lower than the universe fixed income market.

Hard currency sovereign bonds were the worst-performing EMD sleeve over the quarter, as the sector's longer-duration bias caused it to be more susceptible to rising U.S. treasury yields. Local currency sovereign bonds also struggled on the back of rising local rates. Within hard currency corporates, credit spreads widened as global risk sentiment waned. Finally, although EMFX was the top-performing EMD segment, EM currencies weakened somewhat versus a strengthening CAD, which acted as a slight drag on returns.

The most notable event over the quarter was Russia's invasion of Ukraine. Western countries swiftly imposed severe sanctions on Russia in response to the blatant breach of national borders. Unsurprisingly, liquidity became extremely strained as investors overwhelmingly tried to exit their Russian holdings. Fortunately, our EMD allocation was well positioned for this crisis. Prior to the invasion, we had significantly reduced the portfolio's exposure to both Russia and Ukraine, as we viewed the risk of an invasion as probable. We also had material ESG concerns surrounding Russia, further increasing our conviction to nearly eliminate our holdings to zero. The tactical management of our Russia and Ukraine exposure within our EMD strategies left them faring significantly better than the broader EMD market.

Looking ahead, the outlook for EMD is mixed. Growth and inflation are two key determinants that will influence its performance going forward. While broader fixed income has performed poorly due to rising rates, idiosyncratic events have amplified the negative returns within EMD. Although this is painful in the short term, compelling valuations for the sector should provide support for returns so long as core rates are able to stabilize. Alongside this, higher commodity prices should act as a tailwind for export-driven EM countries. Overall, while the headwinds driven by more hawkish central banks are unlikely to ease in the near term, we continue to see pockets of opportunity across local and hard currency markets. In our opinion, differentiation remains the key to success in EMD.