# PH&N Core Plus Bond Fund

## Fund Performance

| Performance Comparison as of March 31, 2023 (%) | 3 Mo | 1 Yr | 2 Yr | 3 Yr | 4 Yr | 5 Yr | SI * |
|---|---|---|---|---|---|---|---|
| **PH&N Core Plus Bond Fund** | ***3.35*** | ***-1.70*** | ***-2.73*** | ***0.10*** | ***1.26*** | ***2.02*** | ***3.35*** |
| *FTSE Canada Universe Bond Index* | *3.22* | *-2.01* | *-3.28* | *-1.67* | *-0.17* | *0.89* | *2.18* |
| Relative Performance | +0.13 | +0.31 | +0.55 | +1.77 | +1.43 | +1.13 | +1.17 |

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, 2023 (%) | Relative Performance | |
|---|---|---|
| | 3 Mo | 1 Yr |
| Interest rate anticipation | | |
| Duration & yield curve | 0.05 | 0.25 |
| Real return bonds | 0.00 | 0.00 |
| Foreign sovereign bonds | 0.03 | 0.09 |
| Credit & liquidity | | |
| Provincial & quasi-government bonds | -0.04 | -0.05 |
| Investment grade corporate bonds | 0.04 | 0.13 |
| High yield corporate bonds | 0.01 | -0.03 |
| Mortgages | 0.03 | -0.05 |
| Emerging market debt | 0.04 | 0.00 |
| Other | -0.03 | -0.03 |
| **Total** | **+0.13** | **+0.31** |

## First Quarter Review

| Strategy Summary for the Quarter Ending March 31, 2023 (relative contribution to duration exposure) | | | |
|---|---|---|---|
| **Strategy** | **Change Over Q1** | **Position Ending Q1** | **Our View** |
| Duration & Yield Curve | Increased | Slight long duration | Reward for taking significant interest rate risk is not compelling given elevated uncertainty |
| Real Return Bonds | Unchanged | No position | Reduced liquidity given GoC's termination of issuance; sector not currently compelling |
| Foreign Sovereign Bonds | Decreased | Small position | Yield differential between U.S. treasuries and Government of Canada bonds at attractive level |
| Provincial and Quasi-Government Bonds | Unchanged | Moderate overweight in provincials; underweight in federal agencies | Provincial bonds offering better reward for risk relative to federal agencies |
| Investment Grade Corporate | Decreased | Medium overweight | Cautious on fundamentals; selectively taking advantage of compelling valuations |
| High Yield | Unchanged | Moderate position | Mindful of the growing list of risks in the current environment |
| Mortgages | Unchanged | Small position | Liquidity premium remains at appealing levels |
| Emerging Market Debt | Unchanged | Small position | Cautious of potential tail risks despite compelling valuations |

- Inflation continued to edge lower over the quarter, but will likely remain at elevated levels for some time to come. In light of this, central banks continued their efforts to suppress consumer demand by raising policy rates, albeit more modestly than in recent quarters. The Bank of Canada (BoC) increased its policy rate by 25 basis points (bps) over the quarter but signalled a conditional pause to allow time to evaluate the impact of tighter monetary policy. Yields were exceptionally volatile this quarter, but ultimately ended lower, while credit spreads widened as investors' risk appetites waned. Against this backdrop, bond market returns were positive, with the FTSE Canada Universe Bond Index returning 3.2%. The portfolio finished ahead of the benchmark for the quarter with contributions coming from interest rate anticipation and credit strategies.
- In aggregate, tactical management of the portfolio's duration and yield curve positioning was a positive contributor to relative performance as we took advantage of the heightened yield volatility.
- A small tactical position in U.S. Treasuries added slightly to performance. The spread differential versus similar-term government of Canada bonds fluctuated considerably over the quarter, but ultimately ended in line with where it began.
- Exposure to provincial and government agency bonds detracted from relative returns as spreads widened.
- The portfolio's overweight to investment grade corporates was a positive driver of relative performance due to our high-quality bias, despite spreads widening.

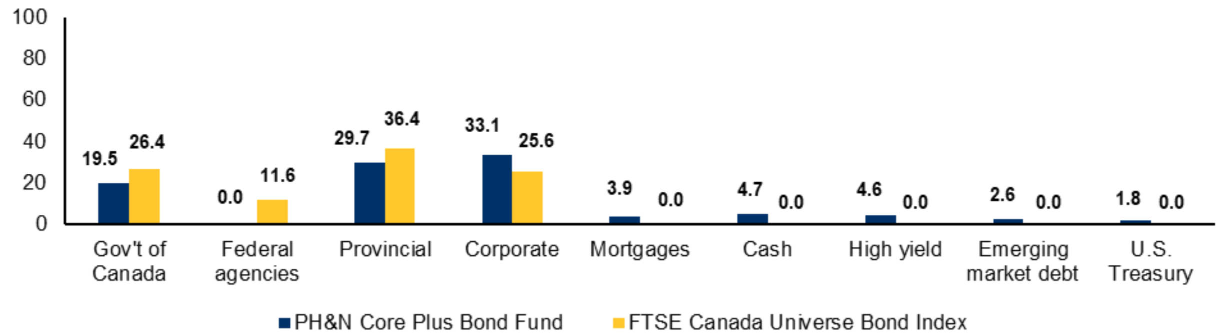
- The out-of-benchmark position in high yield bonds had a largely neutral impact on relative returns.
- The out-of-benchmark allocation to mortgages was additive to returns, driven by modest spread tightening and positive yield accrual.
- The out-of-benchmark allocation to emerging market debt was a modest contributor to relative performance, as the sector proved remarkably resilient amid a period of heightened volatility.
- Overall, the portfolio maintained its medium level of risk over the quarter; however, we remain focused on more liquid, high-quality areas of the market, as recession risk remains prevalent.

# PH&N Core Plus Bond Fund Portfolio Structure as of March 31, 2023

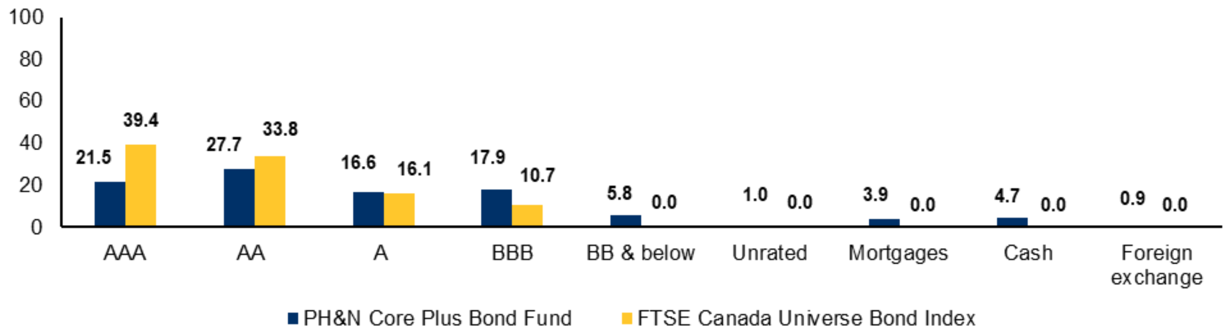
**Fund Characteristics**

| | Modified Duration (Yrs)* | Term to Maturity (Yrs) | Yield to Maturity (%) |
|---|---|---|---|
| PH&N Core Plus Bond Fund | 7.39 | 10.76 | 4.49 |
| *FTSE Canada Universe Bond Index* | *7.31* | *10.06* | *3.95* |

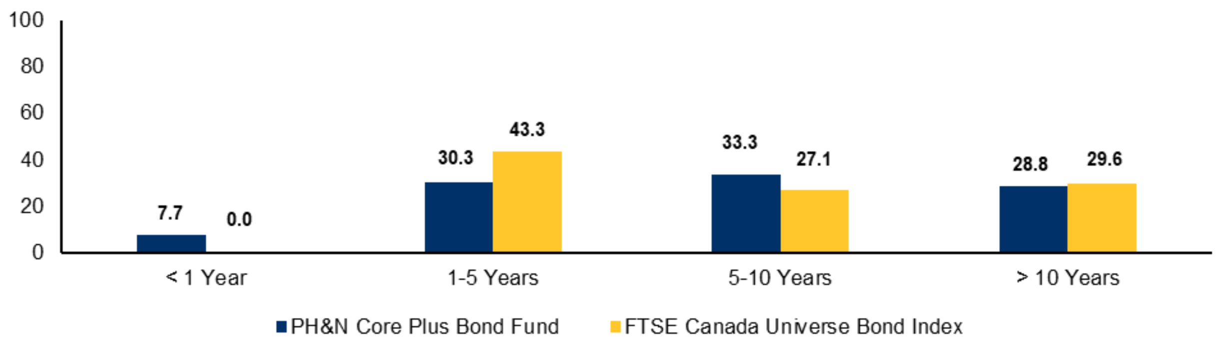
## Issuer Analysis (%)




## 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

A resilient economy combined with inflation well above central bank targets has necessitated the most aggressive policy responses by global central banks in nearly three decades. As a result, the economy is now slowly showing signs of cooling, with consumer price increases also decelerating. One area of continued strength is the very tight labour market, which has consistently surpassed consensus expectations over recent months. Following its 8th consecutive policy rate increase in January – an increase of 0.25% to 4.50% – the Bank of Canada (BoC) announced a pause at its March meeting, conditional on the economy evolving in line with its outlook. The U.S. Federal Reserve (Fed) pressed forward with monetary policy tightening, raising its policy rate by 0.50% over the quarter. Central bank efforts seem to be working, with inflation appearing to have peaked in mid-2022. Since then, in Canada monthly inflation has averaged 0.2% over the last six months, which represents an annualized rate of 2.5%; within the BoC's target band of 1-3%. However, monetary policy acts with a lagged effect, so it will take time before the full extent of previous rate increases are fully absorbed by the economy.

While inflation was top of mind for market participants for most of the quarter, by mid-March the collapse of two U.S. regional banks, along with the fall and subsequent takeover of Credit Suisse by rival Swiss bank UBS, temporarily stole the spotlight as concerns emerged regarding systemic risk in the global financial system. Since then, regulators and policymakers have stepped in, and the fears of broader financial contagion appear to have been stemmed. However, such events serve as a reminder of the market stresses that can materialize from aggressive policy tightening. Against this backdrop, GoC yields were extremely volatile throughout the quarter, but ultimately ended the period lower overall. The yield curve remained significantly inverted at quarter end despite short-term GoC yields falling more than longer-term yields.

Amidst such volatility, the portfolio's sensitivity to interest rates was managed tactically throughout the quarter. We entered the period with a duration position modestly shorter than that of the benchmark, but this position was quickly brought back in line with the benchmark following a sharp move higher in yields to begin the year. A neutral duration position was then maintained until late February, when we took the opportunity to extend the portfolio's duration to slightly longer than that of the benchmark, where it was managed until the end of the quarter. Our view was that a significant amount of positive economic data had already been priced in, and current interest rate levels would be difficult for the Canadian economy to sustain for a prolonged period. The portfolio's yield curve positioning was also adjusted in response to this expectation, but remains partly a function of where we see the most attractive opportunities within credit and liquidity strategies. Overall, the combination of the portfolio's duration and yield curve positioning had a positive impact on relative performance over the quarter.

| Government of Canada Yields (%) | | | | | |
|---|---|---|---|---|---|
| | 1 Yr | 2 Yr | 5 Yr | 10 Yr | 30 Yr |
| March 31, 2023 | 4.40 | 3.74 | 3.03 | 2.90 | 3.02 |
| Forward Curve for March 31, 2024 | 2.97 | 2.83 | 2.57 | 2.79 | 2.94 |
| **Implied Change (1 year)** | **-1.43** | **-0.91** | **-0.46** | **-0.11** | **-0.08** |

Source: RBC GAM (BondLab), Bloomberg.

Looking forward, as of the end of Q1 the bond market is pricing in a meaningful decline in short-term yields, while long-term yields are priced to remain relatively unchanged over the next 12 months. This implies not only the end of the tightening cycle but the expectation that the BoC will cut interest rates in the near future amidst potential economic headwinds. We believe the path for bond yields going forward is uncertain, and that one could posit an unusually broad range of potential outcomes considering competing opinions on how inflation and economic growth unfold. In the near term, we believe yields will continue to exhibit heightened volatility as a result of central bank actions, investor confidence in their ability to rein in inflation, and investor demand for safe haven assets as economic vulnerabilities emerge. Periods of such market volatility provide avenues to add value, and we will continue to look for opportunities to be tactical, while remaining prudent, in our duration positioning.

## Real Return Bonds

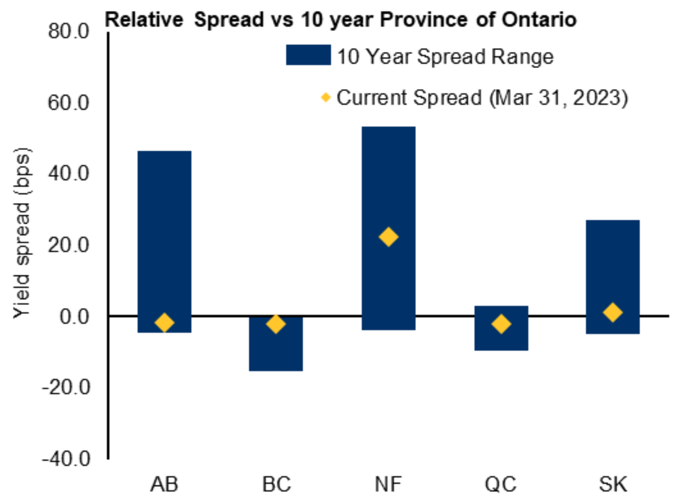
We continue to have zero exposure to real return bonds. The Government of Canada’s decision to cease issuance of real return bonds last November materially impacted liquidity in this market segment. As a result, the compensation that we would require for participating in this strategy has increased, and going forward we anticipate that we will not be as active in this sector. We will continue to monitor inflation expectations and liquidity conditions, but currently we do not consider real return bonds to be a compelling investment opportunity.

## Foreign Sovereign Bonds

We entered the quarter with a long position in a currency-hedged 30-year U.S. Treasury (UST) bond as the difference in yield, or spread, between 30-year USTs and 30-year Government of Canada Bonds (GoCs) remained wider than we thought was justified by economic fundamentals. While we believe there is a case for UST yields to be higher than GoC yields, the speed and magnitude of the initial spread movement late in the third quarter of 2022 suggested that it was being driven by short-term technical factors, which tend to reverse after sudden moves.

Our original trade thesis that the spread between 30-year UST and GoC would narrow did not play out as anticipated as the spread basis fluctuated considerably with no discernible trend. Partway through the first quarter of this year, the spread between the two countries approached levels that were broadly in line with where we initiated the trade, and we took the opportunity to trim our exposure as we had reduced conviction in the trade. Additionally, the trajectory of policy rates in Canada and the U.S. began to diverge in the first quarter, resulting in some justification for the yield divergence between the two countries. We chose to maintain approximately half of our original exposure as it provides risk reduction at the total portfolio level due to the inverse relationship between UST yields and corporate credit spreads during times of market stress. Late in the first quarter we opportunistically added back a small amount to our position after the spread had again widened to attractive levels following the turmoil in the banking sector. Overall, our position size ended the quarter smaller than it began. The spread basis between 30-year UST and GoC bonds fluctuated considerably over the quarter, and despite ultimately finishing broadly in line with where it began, our tactical management resulted in a small positive contributor to relative returns over the quarter.

## Quasi-Government Bonds



Source: BMO Sapphire

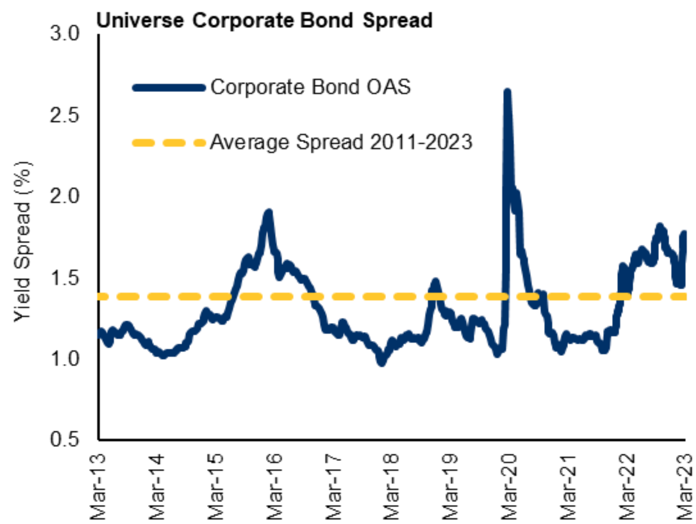
Provincial bond spreads widened slightly across all provinces and terms in the first quarter, albeit to varying degrees. For provincial governments, March 31st marked the end of the 2022-23 fiscal year, during which all provinces collectively achieved 102% of their funding requirements. Closing out the 2022-23 fiscal year, provincial new issuance ended the quarter with approximately $15 billion coming to market, in line with expectations. As provinces unveiled their fiscal 2023-24 budgets throughout March, which are projected to rise to around $95 billion in aggregate, a trend emerged whereby the upcoming year is expected to be characterized by an economic slowdown, less buoyant revenue growth, and residual spending pressures. As a result, if a recession materializes, provincial bonds may experience weakness alongside other risk assets.

Over the quarter, the portfolio’s headline provincial overweight exposure remained largely stable. We did reduce the portfolio’s exposure to the province of Ontario in favour of the province of Quebec. We continue to believe that the province of Quebec is trading at attractive levels given the fundamental backdrop – it has demonstrated considerable success at deleveraging, and its economy is less exposed to interest-rate-sensitive sectors. As a result, the portfolio’s Quebec exposure is now our largest overweight position relative to the benchmark. The portfolio’s second-largest provincial overweight is the province of Ontario, which offers superior liquidity and steady fundamentals relative to the other provinces. The portfolio’s largest underweight is the province of British Columbia, where spreads are lower and we have concerns over its significant exposure to the levered real estate market.

The portfolio's exposure to federal agency bonds, such as AAA-rated Canada Housing Trust bonds, remained unchanged as we continue to have minimal exposure to this segment of the market in favour of higher-yielding credit strategies.  As such, the portfolio remains positioned with a significant underweight exposure to this segment of the quasi-government bond market. In aggregate, the portfolio has an underweight exposure to provincial and quasi-government bonds and maintains a meaningful bias toward provincial bonds given their yield advantage over government agency bonds.

The portfolio's exposure to quasi-government bonds had a negative impact on relative performance over the quarter as spreads widened. We will continue to adjust the portfolio's quasi-government positioning tactically based on the attractiveness of opportunities relative to other segments of the bond market.

## Investment Grade Corporate Bonds



Source: RBC GAM, FTSE Russell

Investment grade corporate credit spreads performed well for much of the quarter amidst a period of strong investor demand driven by historically high all-in yields and moderating levels of new issue supply. However, the rapid pace of rate hikes began to reveal vulnerabilities in the market, culminating in the U.S. and European banking turmoil that emerged in March, fuelling recessionary concerns and denting investor confidence. Unsurprisingly given the heightened volatility, corporate issuance underwhelmed with approximately $23 billion of new supply coming to market, down more than 50% from the first quarter of 2022. Despite the muted primary market activity, broad Canadian corporate bond spreads widened over the quarter as a result of the elevated volatility and risk-off sentiment in the market. Unsurprisingly, the financial sector came under the most pressure over the quarter.

From a fundamental standpoint, high debt levels among consumers and corporations remain a key concern, particularly in an environment of dramatically higher interest rates. Canadian consumer indebtedness remains elevated due to a previously hot housing market, and the cost to service that debt has increased significantly over the past year. Canada's mortgage debt service ratio, which measures the share of income a homebuyer dedicates to their mortgage debt payments, increased to 29% in the fourth quarter of 2022 – up from 12% a year earlier. A household that spends a large portion of its income on mortgage payments (and other debt-servicing costs) is likely more vulnerable to financial stress when confronted with higher interest rates, which could ultimately worsen the impact of a future market downturn. The timing of mortgage renewals coinciding with changing mortgage rates will be very important in this cycle. The biggest additional potential headwind, along with higher financing costs, is sustained high inflation, which may put further pressure on corporate earnings as the economy slows.

We were opportunistic in the primary market this quarter, participating in some attractively priced bonds from issuers with stable fundamentals. However, additions to the portfolio were more than offset by sales in the secondary market (primarily financial sector bonds), resulting in a modest reduction in the portfolio's investment grade corporate bond exposure. We are cognizant of the uncertain market backdrop and that we appear to be in the late-stage of the credit cycle; as a result, along with a decreased overweight exposure relative to the benchmark, we continue to favour the higher-quality areas of the bond market like infrastructure and power generation, which include regulated issuers with stable and predictable cash flows. Over the quarter, our high-quality bias helped reduce the negative impact of being overweight corporate bonds during a period of spread widening. Overall, the portfolio's exposure to corporate bonds contributed to relative performance.

### Private Placement Corporate Bonds

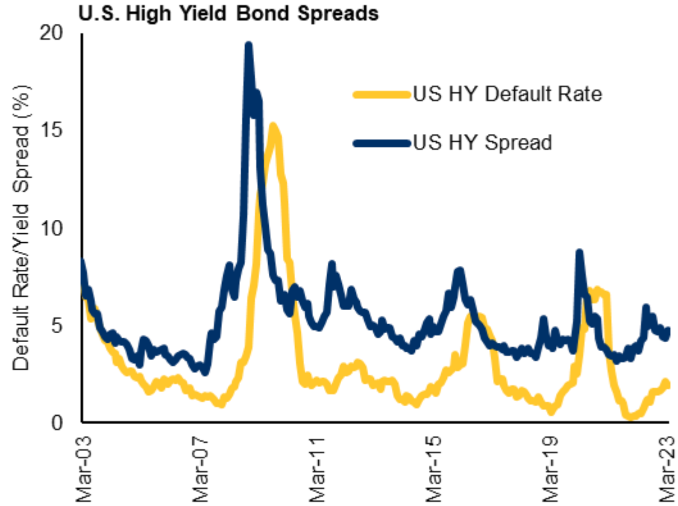
The portfolio's allocation to private placement corporate bonds is achieved through an allocation to the PH&N Private Placement Corporate Debt Fund (PPCDF). The PPCDF invests in investment grade private placement corporate bonds issued primarily in Canada but also abroad. For bonds unrated by an agency, 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 were slightly wider over the quarter, which was similar to 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 portfolio returned a positive 3.8%. The extra spread over public corporate bonds provides an ongoing return tailwind.

The PPCDF did not participate in any new deals over the quarter. With respect to the current pipeline of new opportunities, we are currently engaged with a number of issuers on potential deals related to renewable power and public private partnerships (P3s). 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.

## High Yield Corporate Bonds

High yield bonds finished the quarter with positive performance driven by tighter credit spreads and lower government bond yields. High yield bond spreads trended downwards from January to early March but changed course following the significant shift towards risk aversion among investors as problems emerged within the banking sector outside of Canada. Concerns that began in U.S. regional banking and spread to Credit Suisse became the central focus, adding to worries around systemic risks in the U.S and European financial systems. While the U.S. Federal Reserve emphasized the fact that the U.S. has a sound and resilient banking system, the heightened spread volatility reflects the market's uncertainty about the potential unintended impacts of continued monetary policy tightening. That said, spreads tightened over the last few days of the quarter as actions by governments and central banks alleviated fears of broader contagion from the banking turmoil.



Source: RBC GAM, 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

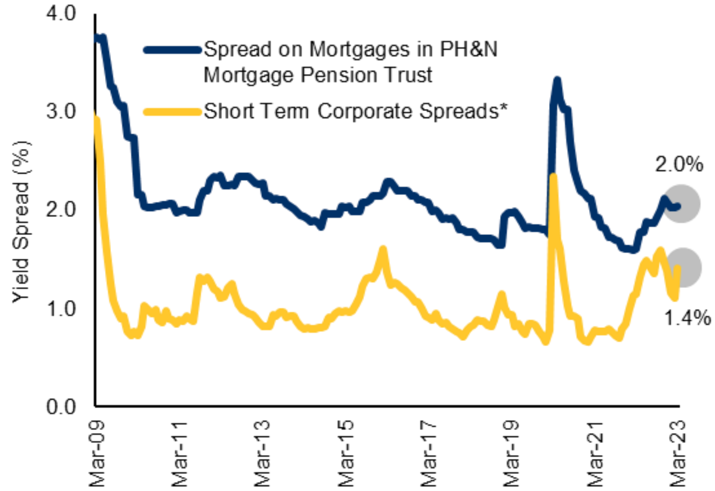
Issuance in the high yield market began 2023 strong but slowed over the course of the first quarter. Though capital market conditions for issuers were robust in early February, a risk-off sentiment began to dominate, and activity faded alongside a surge in yields. Despite a significant number of positive macro surprises impacting the global growth and inflation narrative, optimism faded. Default activity picked up through the first quarter of the year, in contrast to Q4 2022, when there were no defaults. As the high yield distress ratio is rising and default volumes continue to trend upwards, we expect investors to act with a heightened level of caution.

Given the potential for further spread volatility in an economic slowdown, we continue to favour a defensive position from an overall credit quality standpoint. The reward for risk in carefully selected high yield bonds remains compelling, with index yields hovering near 8.5%. Additionally, there are opportunities to collect 6-7% yields in certain investment grade issuers within our high yield portfolios, which we believe are undervalued. The size of our high yield exposure was maintained over the quarter and will be adjusted as necessary depending on how the market unfolds.

## Mortgages

As of quarter-end, the mortgages held in the portfolio had a yield of 208 basis points (bps) over similar-term GoC bonds. Mortgage spreads tightened 2bps over the quarter despite spreads widening in other credit markets. Historically, mortgage spreads have followed the investment grade corporate market on a lagged basis, and we would expect this trend to continue. As such, we expect mortgage spreads to follow suit and expand along with short-term credit spreads over the coming months.

Mortgage & Corporate Bond Yield Spreads vs Similar Term Government of Canada Bonds




* FTSE Canada Short Term Corporate Bond Index
Source: RBC GAM (BondLab), FTSE Russell

Strong leasing activity and a consumer shift toward in-store shopping experience have led to modest rental growth and historically low vacancy levels in the Retail sector. While consumer spending remains stable, there are economic headwinds that could erode consumer balance sheet health, resulting in a decline in discretionary spending and a shift toward the grocery- and other non-discretionary-anchored retail that we focus on. In the Office sector, availability rates continue to climb as employers adapt to the hybrid work environment. However, we have also observed a strengthening return-to-office trend and flight-to-quality, which has mitigated the impact on high-quality office assets. A growing number of large national and international employers are announcing return-to-work mandates, and higher-quality properties are experiencing lower vacancy rates and higher rental growth than their lower-quality counterparts. Industrial continues to be the best-performing sector in the Canadian commercial real estate market and remains tight due to large supply-demand imbalances. We expect this to continue in the near to medium term, as construction activity is inadequate to meet demand; as a result, we see the opportunity for borrowers to bring below-market rents up to market levels. Like the industrial market, there is a large supply-demand imbalance in the multi-residential market. High immigration and deteriorating housing affordability coupled with a lack of supply have created a structurally tight market, resulting in sustained rental growth and occupancy stability for the properties supporting our mortgages.

As we navigate through this uncertain economic environment, our investment approach will continue to support the credit quality of the portfolio. We lend based on the ability of a property to generate sufficient income to support our mortgage payments, and the vast majority of our loans are fixed rate, insulating our borrowers from this rapidly changing interest rate environment. In addition to a proactive approach to servicing our loans, we have recently completed reviews of our exposure to loans maturing in the next year and in sectors that are at higher risk in the current environment. The review showed that all of our loans continue to pay on time, and we do not have any concerns over the ability for our borrowers to refinance but will continue to proactively monitor each loan closely. As of quarter-end, the mortgages held in the portfolio have a weighted average loan-to-value ratio of 56% and debt-service coverage ratio of 1.67x. These metrics demonstrate the conservative nature of the mortgages held in the portfolio and the significant cushion that exists should vacancies increase or property values decline.

## 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.

Despite significant volatility in developed fixed income markets, EMD proved remarkably resilient. Headwinds that challenged EMD in 2022 abated in Q1; namely, central banks appear to be at or nearing the end of their rate hiking cycles, China has reopened its economy and provided support measures for a suffering property sector, Europe navigated the milder-than-anticipated winter without suffering a gas shortage, and Ukraine continues to make progress in the war against Russia. Against this backdrop, all sectors of EMD posted positive returns.

Local currency sovereign was the top-performing sector, supported by positive performance within both foreign exchange (FX) and interest rates. With respect to FX, a depreciating USD resulted in strong positive returns from EMFX. Regarding interest rates, many emerging market countries are well ahead of their developed market counterparts with respect to monetary policy tightening; as a result, EM rates performed well on the expectation that central banks may begin cutting policy rates soon. Hard currency sovereign spreads widened slightly on waning risk appetite, but this was more than offset by positive performance from declining U.S. treasury yields. Spreads also widened within hard currency corporate bonds, although to a milder degree. Positive performance within the hard currency corporate sleeve was driven by the Chinese real estate sector, which continued to rebound on the back of China reopening its economy and announcing additional support measures for the struggling property sector.

Looking ahead, the outlook for EMD is mixed. On the positive side, many of the headwinds that previously challenged EMD have subsided. However, following the recent banking turmoil, it's likely that there will be tighter bank lending conditions which will limit the availability of credit, ultimately subduing growth prospects. That said, we anticipate that emerging markets will prove resilient compared to other credit risk assets, particularly local currency bonds where a more cautious Federal Reserve and high interest rate differential will provide support for the sector. Within EM corporates, the outlook is more cautious given the higher cost of funding that now needs to be absorbed by corporations. That said, fundamentals remain strong. Across both the sovereign and corporate credit markets, we are focusing on idiosyncratic opportunities to generate value add, despite the macro uncertainty.