PH&N Core Plus Bond Fund

Fund Performance

Performance Comparison as of December 31, 2022 (%)							
	3 Mo	1 Yr	2 Yr	3 Yr	4 Yr	5 Yr	SI *
PH&N Core Plus Bond Fund	**0.63**	**-11.22**	**-6.67**	**-0.41**	**1.36**	**1.39**	**3.08**
FTSE Canada Universe Bond Index	*0.10*	*-11.69*	*-7.22*	*-2.20*	*-0.01*	*0.27*	*1.90*
Relative Performance	+0.53	+0.47	+0.55	+1.79	+1.37	+1.12	+1.18

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 December 31, 2022 (%)		
	Relative Performance	
	3 Mo	1 Yr
Interest rate anticipation		
Duration & yield curve	0.16	0.34
Real return bonds	0.00	0.00
Foreign sovereign bonds	-0.02	0.06
Credit & liquidity		
Provincial & quasi-government bonds	-0.02	0.03
Investment grade corporate bonds	0.07	0.14
High yield corporate bonds	0.17	0.04
Mortgages	-0.02	-0.06
Emerging market debt	0.20	-0.05
Other	-0.01	-0.03
Total	**+0.53**	**+0.47**

Fourth Quarter Review

Strategy Summary for the Quarter Ending December 31, 2022 (relative contribution to duration exposure)			
Strategy	**Change Over Q4**	**Position Ending Q4**	**Our View**
Duration & Yield Curve	Decreased	Small short duration	Anticipate that the market is underestimating the potential for sustained higher policy rates
Real Return Bonds	Unchanged	No position	Long-term market-implied inflation expectations in line with our view of fair value
Foreign Sovereign Bonds	Unchanged	Small position	Yield differential between U.S. treasuries and Government of Canada bonds at attractive level
Provincial and Quasi-Government Bonds	Decreased	Moderate overweight in provincials; underweight in federal agencies	Provincial bonds offering better reward for risk relative to federal agencies
Investment Grade Corporate	Increased	Medium overweight	Valuations attractive; selectively taking advantage of compelling opportunities
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	Cognizant of credit risk; however, reward-for-risk profile remains appealing

- 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. The Bank of Canada was no exception, increasing rates by another 100 basis points (bps) over the quarter but alluding to the possibility that the end of the hiking cycle is drawing near. Yields remained volatile but ultimately ended the period slightly higher, while credit spreads recovered as investors anticipated a pause from central banks. Against this backdrop, bond market returns were broadly flat, with the FTSE Canada Universe Bond Index returning 0.10%. Your portfolio finished ahead of the benchmark for the quarter with contributions coming from interest rates and credit strategies.
- For calendar year 2022, bond market performance was meaningfully negative, as a result of the sharp rise in yields experienced through the first half of 2022. However, recall that this means the yield for your portfolio is significantly higher than at the beginning of the year, which improves expected returns going forward.
- In aggregate, the portfolio's duration and yield curve positioning was a positive contributor to relative performance, as the portfolio benefitted from a short duration bias throughout December when yields moved higher.
- A small tactical position in U.S. Treasuries was a neutral contributor to performance, as the spread differential versus similar-term government of Canada bonds did not move meaningfully.
- Exposure to provincial and government agency bonds had a neutral impact on performance.

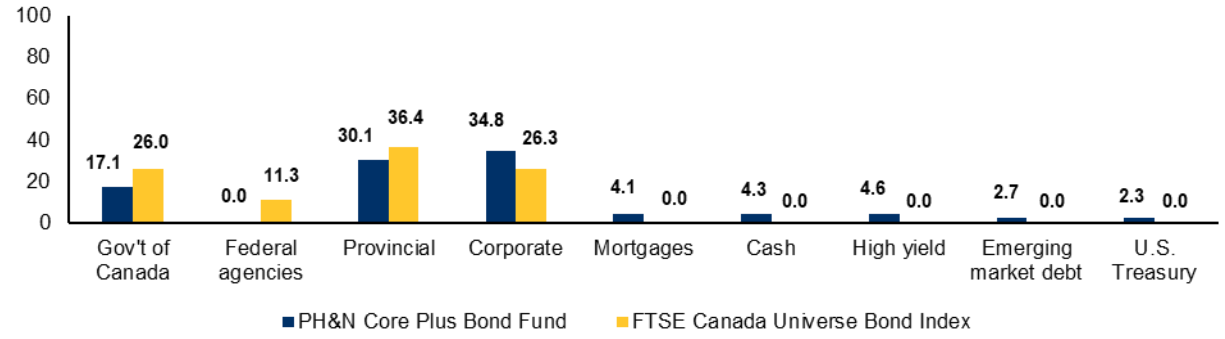
- The portfolio's overweight to investment grade corporates was a positive contributor to relative performance, as spreads continued to recover.
- The out-of-benchmark position in high yield bonds helped to add value from strong yield accrual and a rebound in the asset class over the period.
- The out-of-benchmark allocation to mortgages had a largely neutral impact on performance, as spread widening negated positive yield accrual.
- The out-of-benchmark position in emerging market debt was a meaningful contributor to relative performance, as the sector rebounded significantly over the quarter.
- Overall, the portfolio's risk exposures were increased to a medium level over the quarter in light of compelling valuations; 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 December 31, 2022

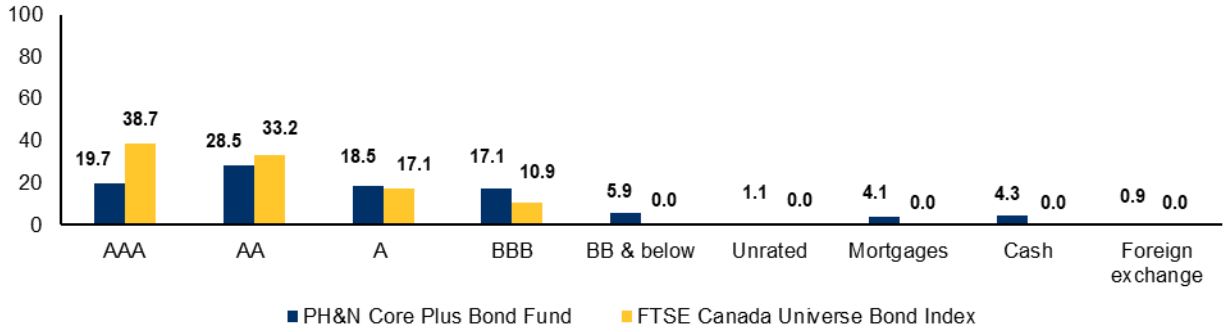
Fund Characteristics

	Modified Duration (Yrs)*	Term to Maturity (Yrs)	Yield to Maturity (%)
PH&N Core Plus Bond Fund	7.09	10.48	4.87
FTSE Canada Universe Bond Index	*7.31*	*10.11*	*4.28*

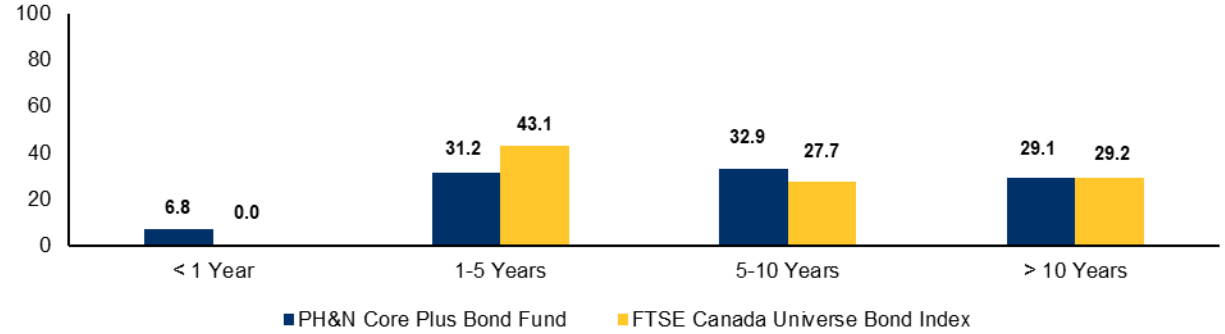
Issuer Analysis (%)



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.

Fourth Quarter Review

Duration and Yield Curve

Inflation, and the policy response by global central banks, remained the primary driving force for sovereign bonds yields over the fourth quarter. However, the momentum of inflation appears to have moderated in the final months of 2022 after repeatedly exceeding market expectations in the prior three quarters. This comes as a small relief to central banks (including the BoC), which have been working to maintain their inflation-fighting credibility since the start of the year. Following an aggressive path of tightening, the BoC surprised markets in October with a smaller-than-expected 0.50% hike but emphasized that while the end of their hiking cycle seems near, policy rates may rise further in the months ahead and that they remained committed to bringing down inflation. Subsequently, in the final meeting of the year, the BoC announced its 7th consecutive rate hike, raising its policy rate by another 0.50% to 4.25%. The statement at the December meeting suggested a more neutral approach with further rate hikes requiring careful consideration. GoC yields moved higher to start the quarter but trended lower throughout November, then reversed course again and moved higher in December, ultimately ending the quarter higher overall. Short-term GoC yields increased more than longer-term yields, resulting in a further inversion of the GoC yield curve.

Amidst a volatile environment for yields, the portfolio's sensitivity to interest rates was managed fairly closely to that of the benchmark for the first two months of the quarter, reflecting our low conviction on the near-term direction of interest rates owing to a wide range of potential outcomes. At the beginning of December we observed that market participants had an overly optimistic view of inflation, discounting the probability that price pressures and, in turn, the BoC's policy rate may remain elevated rather than moving swiftly lower over the medium term. As a result, we took the opportunity to adjust the portfolio's sensitivity to interest rates lower, ending the quarter with a duration position modestly shorter than that of the benchmark. 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
December 31, 2022	4.48	4.05	3.42	3.30	3.28
Forward Curve for December 31, 2023	3.48	3.34	3.04	3.18	3.22
Implied Change (1 year)	**-1.00**	**-0.71**	**-0.38**	**-0.12**	**-0.06**

Source: Bloomberg, RBC GAM (BondLab)

Looking forward, the bond market is pricing in short-term yields to fall meaningfully, 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 2023 in the face of a potential recession. While we foresee a broad range of outcomes for the direction of bond yields in light of competing opinions on how inflation will unfold, our view is that long-term yields have room to move higher, while short-term yields may hover at elevated levels for longer than the market is anticipating. 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 the lag between tightening and its impact on inflation. Periods of such market volatility provide avenues for value added and we will continue to look for opportunities to be tactical in our duration positioning to capitalize on such an environment.

Real Return Bonds

In November, the Government of Canada surprised the market by its decision to cease issuance of real return bonds, effective immediately. This development will have a material impact on the liquidity and supply of real return bonds going forward. Over the quarter, we did not have an exposure to real return bonds. While we may still choose to participate in the strategy as inflation conditions and expectations evolve, we anticipate that we will not be as active in the sector given the reduced liquidity and supply of real return bonds in light of this development.

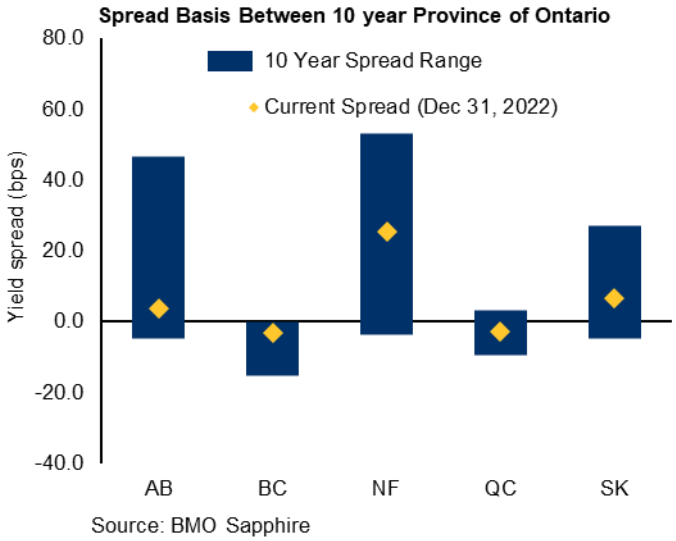
Foreign Sovereign Bonds

Late in the third quarter, we initiated 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) gapped significantly wider in a short period of time. While fundamentally we think there is a case for UST yields to be higher than GoC yields, the speed and magnitude of the spread movement suggested that it was being driven by short-term technical factors. As such, we anticipated that the spread differential will reverse course and return to more normalized levels.

Our foreign sovereign exposure was maintained over the fourth quarter, as our trade thesis remained unchanged. The spread basis between 30-year UST and GoCs bonds fluctuated considerably over the quarter but ultimately ended the period only slightly wider, which had a neutral impact on relative returns over the quarter.

Quasi-Government Bonds

During the quarter, provincial bonds spreads tightened to varying degrees across all provinces and terms on the back of improved investor sentiment. Provincial new issuance ended the fourth quarter with approximately $17 billion coming to market, which is closely aligned with expectations for the current fiscal year. Looking forward, stronger fiscal trajectories, coupled with reduced borrowing needs, should remain supportive for provincial credit spreads. That said, if a recession materializes, provincial bonds may experience weakness alongside other risk assets.

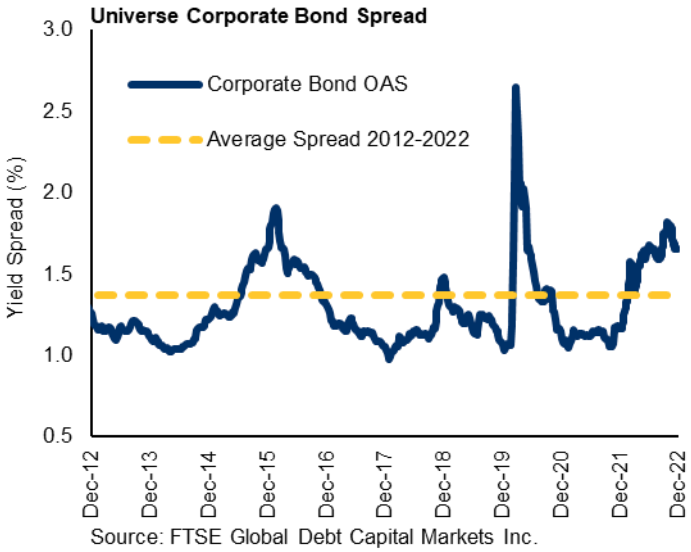


Over the quarter, the portfolio's provincial overweight exposure was reduced. This was largely accomplished by an outright trim to our significant overweight exposure to the province of Ontario. Additionally, we rotated exposure out of Ontario in favour of Quebec. We believe that the province of Quebec 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 overweight relative to the benchmark. That said, the portfolio's largest provincial overweight remains the province of Ontario, which offers superior liquidity and steady fundamentals relative to the other provinces. Conversely, the portfolio's largest underweight is the province of British Columbia, where we have concerns over its significant exposure to the levered real estate market.

During the quarter, we took the opportunity to further reduce the portfolio's exposure to federal agency bonds, such as AAA-rated Canada Housing Trust bonds, in favour of higher-yielding credit strategies. As such, the portfolio remains positioned with an 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 neutral impact on relative performance over the quarter. 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.

Investment Grade Corporate Bonds



After coming under strain for much of 2022, indications that inflationary pressures may be subsiding were supportive for investment grade credit during the fourth quarter. This led to optimism that more dovish central bank policy would return. The market's reaction was positive and came with a healthy appetite for investment grade corporate credit. Corporate treasurers issued $32 billion of new supply, well ahead of the 10-year fourth-quarter average of $23 billion. Notably, we saw the return of some meaningful activity in non-bank issuance, which was significantly underrepresented for the first three quarters of the year (approximately half of 2021 levels). This elevated issuance was easily absorbed by market participants, pulling the broad Canadian corporate bond spreads tighter over the quarter.

From a fundamental standpoint, high debt levels among consumers and corporations remain a key concern of ours, as it relates to the vulnerability of the Canadian economy in an environment of dramatically higher interest rates. Canadian consumer indebtedness remains elevated given the previously hot housing market, while the cost to service that debt has increased significantly over the past year. Canada's household debt-to-income ratio, which is the average share of credit to disposable income, increased to 183% in the third quarter – up from 177% a year earlier. In other words, the average Canadian household owes approximately $1.83 for every $1 they earn in disposable income. High indebtedness could amplify the impact of higher interest rates, and the corresponding lower discretionary spending could also worsen the impact of a future market downturn. On the corporate side, the biggest potential headwind is sustained high inflation, which may put further pressure on companies' earnings as the economy slows.

We were active yet selective in both primary and secondary markets this quarter, opportunistically adding to a number of attractively priced bonds from issuers with stable fundamentals. We are cognizant of the uncertain market backdrop and that we appear to be in the late-stage of the credit cycle, so while we increased the portfolio's overweight exposure to corporate credit relative to the benchmark, we continue to favour the higher-quality areas of the bond market, including regulated issuers with stable and predictable cash flows. High current spread levels provide a compelling reward for patient investors and a substantial cushion against potential future adverse events. Overall, the portfolio's exposure to corporate bonds contributed to relative performance, as credit spreads tightened quarter over quarter.

Private Placement Corporate Bonds

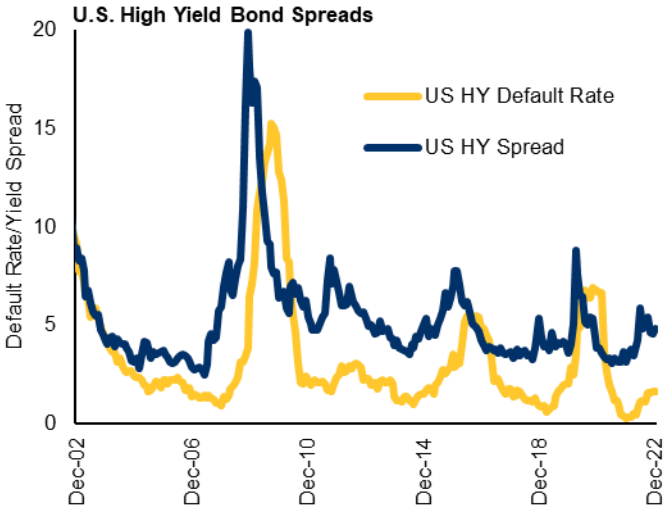
The portfolio's allocation to private placement corporate bonds is achieved through an allocation to the PH&N Private Placement Corporate Debt Fund (PPCDF). The PPCDF invests in investment grade private placement corporate bonds issued primarily in Canada but also abroad. For bonds unrated by an agency, 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 largely unchanged over the quarter, whereas spreads tightened marginally for comparable-term public securities within the broader Canadian corporate bond market. Although Government of Canada bond yields ended higher over the quarter, the fund returned 0.8% due to the extra spread over public corporate bonds providing an ongoing return tailwind.

During the fourth quarter, the PPCDF participated in a deal from **Connect 6ix GP**–a special purpose entity contracted to design, construct, finance, supply, maintain, and rehabilitate the Ontario Line "Rolling Stock, Systems, Operations, and Maintenance (RSSOM)" project. The Ontario Line is Canada's first fully driverless rail line and is a stand-alone, 16km-long rapid transit system that will connect the Ontario Science Centre to the Ontario Place grounds in Toronto. The project is a public private partnership (P3), with Infrastructure Ontario and Metrolinx representing the Province of Ontario. There is an 8.4-year construction phase followed by a 30-year operating phase. We view this issuer favourably due to strong government support, an experienced consortium, low-complexity construction, and a strong financial profile with inflation protections. The newly issued secured amortizing green bond is rated BBB+ by S&P and was added at a spread of 295 bps above Government of Canada yields for a 6.206% coupon over a 38-year term.

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



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 bonds finished 2022 with positive performance over the quarter but negative performance over the full year. The fourth quarter rebound was driven by tighter credit spreads, which was a reversal of the trend from the previous nine months.

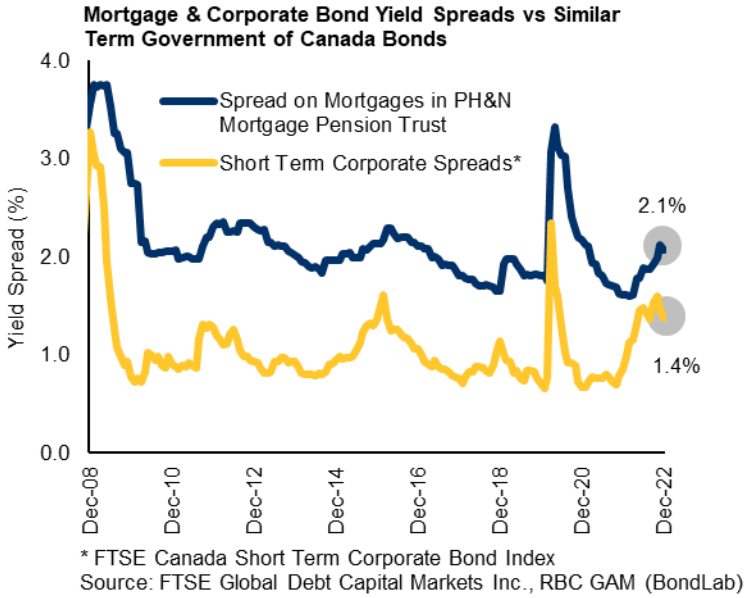
High yield issuance was strong in the first half of the year but slowed dramatically in the second half, as rising yields and recessionary fears drove investors to safety and restrained issuers from issuing bonds into softening demand. The deterioration in risk appetite also stemmed from the ongoing energy crisis resulting from the conflict in Ukraine and a COVID-19 resurgence in China. Across the high yield market, the default rate stalled in Q4 but was higher than the historical low established in February. We think the deceleration in defaults is temporary and expect them to continue rising into 2023's slowing economy. The default rate ended the year at around 1.6%, which is approximately half of its long-term average.

Corporate profits, outside of the mega-cap technology companies, proved resilient throughout 2022. However, we continue to be mindful that the full effects of a hiking cycle tend to take several months to meaningfully slow the economy. We expect this will weigh on earnings next year and that further downward earnings revisions are possible. High yield bond spreads were volatile over the year, reflecting the market's uncertainty about the vigorous pace of monetary tightening in response to the high inflation environment.

The portfolio's high yield position was maintained over the quarter. Despite a potential looming recession, we feel the reward for risk in carefully selected high yield bonds remains compelling, with index yields hovering near 8.5%. We continue to favour a defensive position from an overall credit quality standpoint, through which we are able to achieve attractive yields without taking outsized credit risk.

Mortgages

As of quarter-end, the mortgages held in the portfolio had a yield of approximately 208 bps over similar-term GoC bonds. Mortgage spreads widened by approximately 16 bps over the quarter despite spreads compressing in other credit markets, improving the illiquidity premium offered by commercial mortgage investments relative to comparable quality and term corporate bonds. Mortgage spreads typically follow directional movements in corporate spreads but on a lagged basis. As such, the spread widening experienced during the quarter was indicative of negative market sentiment experienced in credit markets in prior quarters rather than a deterioration in the credit quality of the portfolio.



Strong leasing activity has led to rental rate growth and declining vacancy nationally across all retail property sub-types[1]. While consumer spending appears to be slowing, the grocery- and other non-discretionary-anchored retail that we focus on continues to be well positioned to perform. In the office sector, lower-quality B- & C-class product continue to face challenges, including lower demand and declining rental rates. However, there is some optimism that return-to-office volumes and leasing activity will improve in 2023, particularly given the federal government's recent indication that it wants over 300,000 of its employees back in office two or three days per week[2]. In the industrial sector, while it is generally expected that rental rate growth will begin to decelerate from close to all-time highs, it can take several years for property income to catch up to market levels. As a result, we see the opportunity for borrowers to considerably increase rents in their industrial properties over the next 2–3 years. In the multi-residential market, home ownership affordability issues and a low supply of rental apartments are expected to continue to support rental growth and occupancy stability for the properties supporting our mortgages.

While our lending posture remains focused primarily on the industrial and multi-residential sectors, we have been able to selectively add new mortgages supported by office and retail properties where the return and risk metrics were attractive. As of quarter-end, the mortgages held in the portfolio have a weighted average loan-to-value ratio of 52% and debt-service coverage ratio of 1.6x, a testament to their high quality, which gives us confidence as we manage through what continues to be an uncertain time.

[1] CoStar 2022-Q4 Canada Retail National Report
[2] CoStar 2022-Q4 Canada Office National Report

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. Alongside other risk assets, EMD rebounded significantly over the quarter. Previous headwinds that were challenging the outlook for EMD abated over the quarter: (1) central banks signalled a deceleration in the pace of rate hikes as inflation showed signs of peaking; (2) Ukraine made positive progress in the war against Russia, improving its negotiating power; (3) Chinese authorities moved away from their long standing zero-covid policy, and announced support measures for the beleaguered property sector; (4) the start of winter in Europe proved milder than expected, and gas storage facilities are close to full capacity, reducing the risk of a European energy crisis.

Against this backdrop, all sectors of EMD posted strong positive returns. Hard currency sovereign was the top-performing sector, as spreads tightened over 100 bps on improved risk sentiment. Within this sector, we had a small bias toward high yield, which was advantageous to returns, as lower quality outperformed higher quality. Local currency sovereign bonds also posted very strong returns, driven by the FX component. Asian currencies performed particularly well on the back of China's reopening announcement. Similar to hard currency sovereign, hard currency corporates also benefited from material spread tightening, having narrowed 65 bps over the quarter. Real estate was the main driver of returns, buoyed by China's announcement of additional support measures for the sector. Finally, EMFX posted positive returns and outperformed, as EM central banks are further along their rate hiking trajectories compared to their developed market counterparts.

Looking ahead, the outlook for EMD has improved with many of the headwinds having subsided over the quarter. Alongside this, EMD suffered a material repricing in 2022, resulting in much more compelling valuations today than at the start of the year. Accordingly, the theme within our EMD strategies has shifted from a focus on downside protection to an emphasis on harnessing upside potential. However, we would caution that the market will likely remain volatile in the near term given expectations that default rates will remain elevated in global credit markets as growth slows. Therefore, country and credit selection will remain critical to strong returns going forward.