# Credit Absolute Return Strategy

As of June 30, 2019

## Strategy description

The Credit Absolute Return strategy invests in diversified long and short positions of North American credit securities with an objective to generate positive returns throughout a complete credit cycle. Credit selection serves as the key pillar of strategy, supported by independent fundamental credit analysis. The investment team maintains a diversified and liquid portfolio with reduced interest rate risk exposure and an average credit rating of investment grade. The primary drivers of performance throughout the credit cycle include:

- Leveraged investment grade credit
- Long/short credits
- Arbitrage opportunities

## Why invest?

- An alternative to a traditional fixed income portfolio with strong diversification benefits.
- Credit-driven returns with reduced sensitivity to interest rate risk.
- Ability to generate positive returns throughout a complete credit cycle.

## Portfolio characteristics

| Bond rating (%) | Long | Short | Net |
|---|---|---|---|
| AAA | 35.3 | -84.8 | -49.5 |
| AA | 51.7 | -7.6 | 44.1 |
| A | 34.6 | -14.6 | 20.0 |
| BBB | 91.3 | -14.8 | 76.5 |
| BB | 19.5 | -7.6 | 11.9 |
| B | 0.0 | -3.8 | -3.8 |
| Not rated | 0.7 | 0.0 | 0.7 |
| **Total** | **233.1** | **-133.1** | **100.0** |

| Portfolio exposure (%) | Long | Short | Net |
|---|---|---|---|
| Investment grade | 136.7 | -32.1 | 104.6 |
| High yield | 19.5 | -10.9 | 8.6 |
| Bank loans | 3.7 | 0.0 | 3.7 |
| Cash, short-term investments and other net assets | 63.7 | 0.0 | 63.7 |
| Government bonds | 6.9 | -84.8 | -78.0 |
| Preferred stocks — CDN | 2.0 | -5.4 | -3.4 |
| preferred stocks — USD | 0.8 | 0.0 | 0.8 |
| Options | 0.0 | 0.0 | 0.0 |
| **Total** | **233.1** | **-133.1** | **100.0** |

| Characteristic | |
|---|---|
| Duration | 0.49 |
| Weighted Average Credit Weighting | A+ |
| Gross Leverage | 1.2 X |
| Yield to Maturity | 3.39% |

## Highlights

| | |
|---|---|
| Inception | December 31, 2013 |
| Liquidity | Daily |
| Holdings | 176 |
| Currency | 100% hedged |
| Incentive fee | Yes |
| High water mark | Annual |
| Hurdle rate | 5% |

## Performance

**Compound returns (%)**

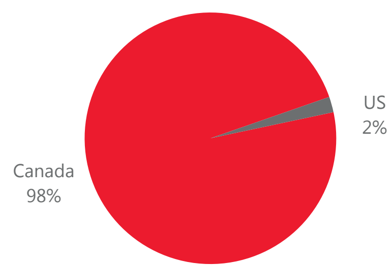
| 1 mth | 3 mth | 6 mth | 1 yr | 3 yr | 5 yr | Inception |
|---|---|---|---|---|---|---|
| 0.00 | 1.31 | 3.27 | 2.84 | 5.38 | 6.77 | 7.52 |

**Calendar year returns (%)**

| 2019 | 2018 | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|
| 3.27 | 0.08 | 7.88 | 6.60 | 12.57 | 11.36 |

| Top corporate issuers (%) | |
|---|---|
| Enbridge Pipelines | 14.3 |
| Enbridge | 13.4 |
| TransCanada Pipelines | 11.6 |
| Canadian Oil Sands | 11.6 |
| OMERS Realty Corp | 5.6 |
| Pembina Pipeline | 5.5 |
| Bank of Montreal | 5.5 |
| Brookfield Property | 5.4 |
| Wells Fargo | 5.2 |
| Choice Properties | 5.1 |
| **Total** | **83.1** |

**Geographic allocation**




## Comparative analysis (since inception)

| | Credit Absolute Return Strategy | FTSE TMX Canadian Universe Bond Index | Barclays High Yield VLI C$ Hedged | S&P / TSX Composite Index |
|---|---|---|---|---|
| Annualized Return | 7.52% | 4.41% | 4.54% | 6.55% |
| Standard deviation | 3.93% | 3.83% | 5.76% | 8.92% |
| Sharpe ratio | 1.49 | 0.72 | 0.50 | 0.55 |
| % of positive months | 80% | 64% | 65% | 64% |
| Max drawdown | -4.45% | -3.55% | -10.64% | -13.77% |
| Yield to Maturity C$ | 3.39% | 2.13% | 6.28% | NA |
| Avg Modified Duration | 0.49 | 8.02 | 3.31 | NA |
| Avg. Credit Rating | A+ | AA | B1/B2 | NA |
| Correlation to Fund | | 0.04 | 0.17 | 0.16 |

Source: Bloomberg, FTSE TMX Global Debt Capital Markets

Scotia Institutional Asset Management™

Performance returns for the Credit Absolute Return Composite ("Strategy") are included to demonstrate how an investment fund with a similar investment strategy performed over the time period indicated. Periods of more than one year are annualized. Portfolio characteristics are of the Scotia Institutional Credit Absolute Return Fund. There is no guarantee that the Strategy would have invested in the same holdings as the Fund, and actual performance would have be different due to differences in underlying holdings and inception periods. The indicated rates of return are reported net of trading expenses but before the deduction of management fees. Past performance is no indicator of future performance.

## Quarterly commentary (as of June 30, 2019)

**Marc-André Gaudreau, CPA, CGA, CFA, Vice President & Senior Portfolio Manager, Fixed Income**

The second quarter saw the Credit Absolute Return strategy rise 1.3%, primarily driven by the leveraged investment grade corporate credit strategy, which benefited from a tightening in credit spreads during the quarter. The strategy's credit arbitrage also added to performance, which benefited primarily from a position in Canadian Oil Sands. Despite being wholly owned by Suncor, Canadian Oil Sands bonds trade at a significant discount to Suncor's bonds, reflecting the fact that Suncor does not provide a guarantee to Canadian Oil Sands bondholders. We believe this discount is too high as Canadian Oils Sands ownership in the Syncrude joint venture is a strategic asset for Suncor. There remains considerable upside potential if Suncor ultimately provides a guarantee for the bonds or if they decide to clean up their capital structure by refinancing the bonds altogether. In the interim, our position continues to provide a positive spread pick-up over Suncor and we are happy to hold for the long-term or until the discount to Suncor closes. The fund's long/short credit strategy was a slight detractor from performance as the tightening in credit spreads repriced the fund's short positions higher.

We remain concerned regarding Canadian consumers taking on excessive leverage in recent years and the high valuations in various real estate markets throughout the country. As a reflection of this view, the fund continues to hold significant short positions targeting the subordinated securities of weaker, less diversified Canadian financials which we believe are highly exposed to excessively leveraged Canadian consumers. The risk/reward of our short positions remains asymmetrically skewed in the fund's favour as we have targeted expensive securities that are structurally limited from further capital appreciation, yet have significant downside potential. Our conviction in this short theme remains strong and was strengthened recently as we received various data points that helped to confirm our view. In particular, we have seen a pickup in Canadian insolvency filings driven largely by increases in Ontario and Alberta, and a significant drop in real estate sales volumes/prices in Vancouver as the spring selling season begins to unfold. We will continue to monitor the strength of Canadian consumers, which recently received much-needed help from lower mortgage rates.

Fund Positioning

We continue to employ a modest amount of leverage at 1.2X and will look to add leverage if valuations support an improved risk/reward relationship. We continue to see no reason to chase returns at current valuation levels and prefer to add exposure when the risk/reward relationship is more skewed in the fund's favour.

## About Scotia Institutional

Scotia Institutional Asset Management provides progressive and innovative investment solutions to meet the challenges facing institutional clients, including pension funds, non-profits, foundations and corporations.

$126 Billion assets under management*

## Fixed Income

The Scotia Institutional Asset Management fixed income team offers a diverse set of fixed income capabilities and solutions, ranging from traditional benchmark-driven to absolute return strategies. We seek to deliver alpha over a full market cycle through the application of a capital preservation philosophy and distinctive investment processes designed to optimize the trade-off between reward and risk.

To complement the skills of our fixed income team, proprietary systems help identify, quantify and manage risks associated with the market. This combination of skills and technologies enables a proactive approach to protecting and growing our clients' capital.

## For more information, please contact:

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* As at March 31, 2019 AUM is for 1832 Asset Management L.P., a limited partnership the general partner of which is wholly owned, directly and indirectly, by The Bank of Nova Scotia and is a manager of mutual funds and investment solutions for private clients, institutional clients and managed asset programs.