October 2018

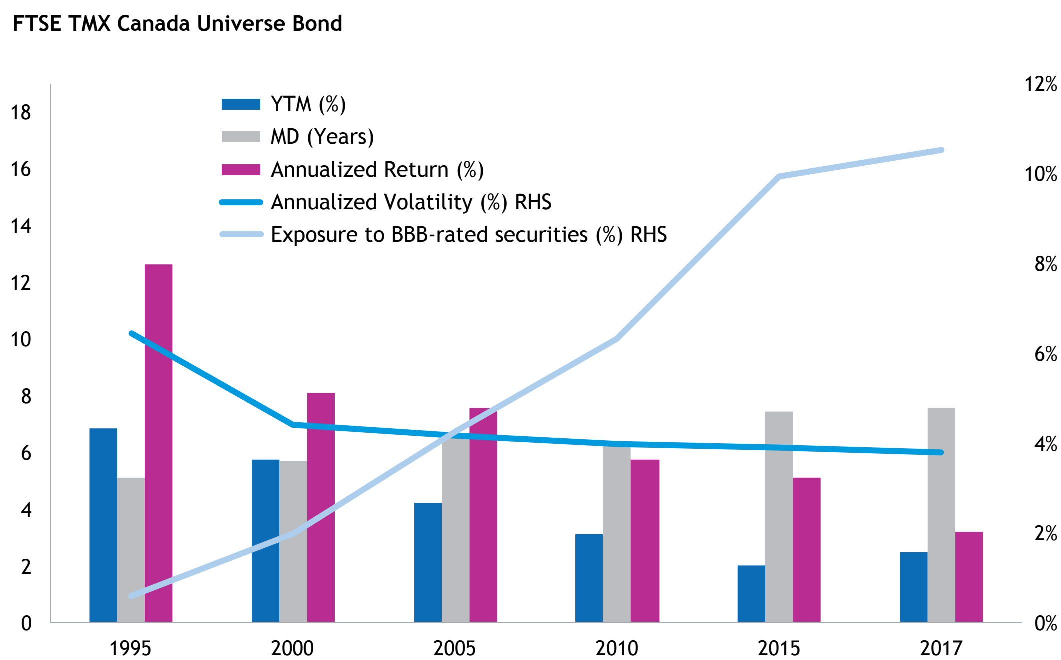
Understanding the "Plus" in CorePlus

Author: Adelina Romanelli, CFA, *Specialist, Product Management*

Are you in a relentless hunt for incremental yield? Relatively low current yields and current expectations for subdued economic growth — relative to historical levels — are leading investors to broaden their horizons. The average yield to maturity (YTM) of the FTSE TMX Canada Universe Bond Index is down to 2.7% from 4.2% ten years ago. In addition, duration is higher[1], which translates into higher interest rate sensitivity as well as potential downside risk in a rising rate environment.

Meanwhile, volatility remains reasonably supressed while exposure to lower-rated debt securities has risen. The outcome is an environment conducive to an opportunistic and forward-looking approach, but not at the expense of a judicious research and portfolio construction process.

Figure 1: Progression of the FTSE TMX Canada Universe Bond Index[2]



Sources: FTSE TMX Global Debt Capital Markets Inc., Addenda Capital

[1] YTM based on August 31, 2018 and August 29, 2008 respectively

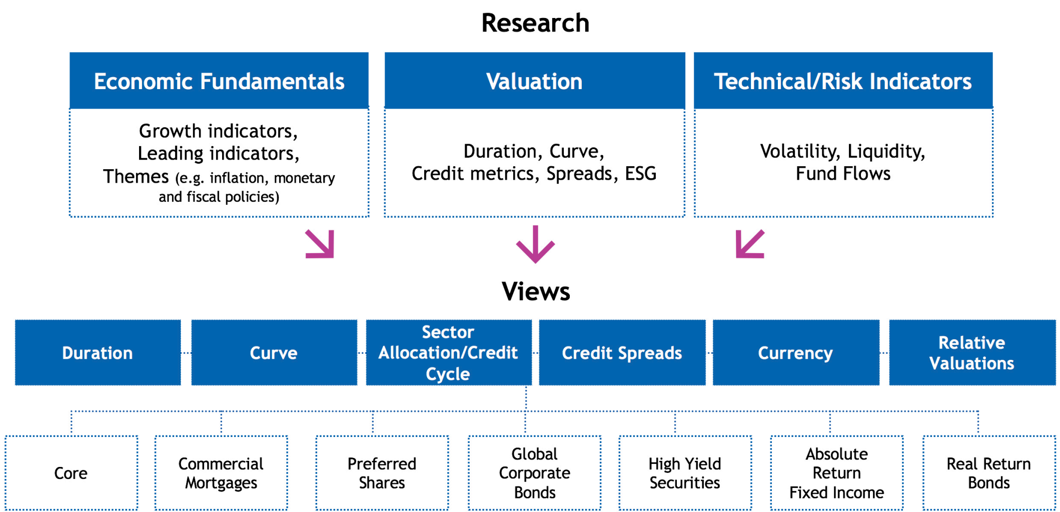
[2] YTM and Modified Duration (MD) are based on the indicated year's calendar year end. Volatility is computed as the annualized standard deviation of daily index returns over 5 years ending the indicated calendar year. Annualized return is based on the 5-year period ending the indicated calendar year. All data is based on the FTSE TMX Canada Universe Bond Index.

A Wider Opportunity Set, Multiple Benefits

The Addenda CorePlus Fixed Income strategy ("the Strategy") has the flexibility to invest opportunistically in a wide range of investments while deploying risk tactically. The Strategy invests outside the benchmark index, in complementary return-enhancing or risk-reducing strategies, seeking to improve the portfolio's longer-term return-risk profile.

As depicted in Figure 2, the Strategy positions its core and "plus" components according to cyclical and secular tendencies, driven by an outlook established by Addenda's investment professionals through deep research on economic fundamentals, valuation metrics as well as technical and risk indicators.

Figure 2: The Power of Macroeconomic Data



Source: Addenda Capital

Using "Plus" to Enhance Returns and Diversification Benefits

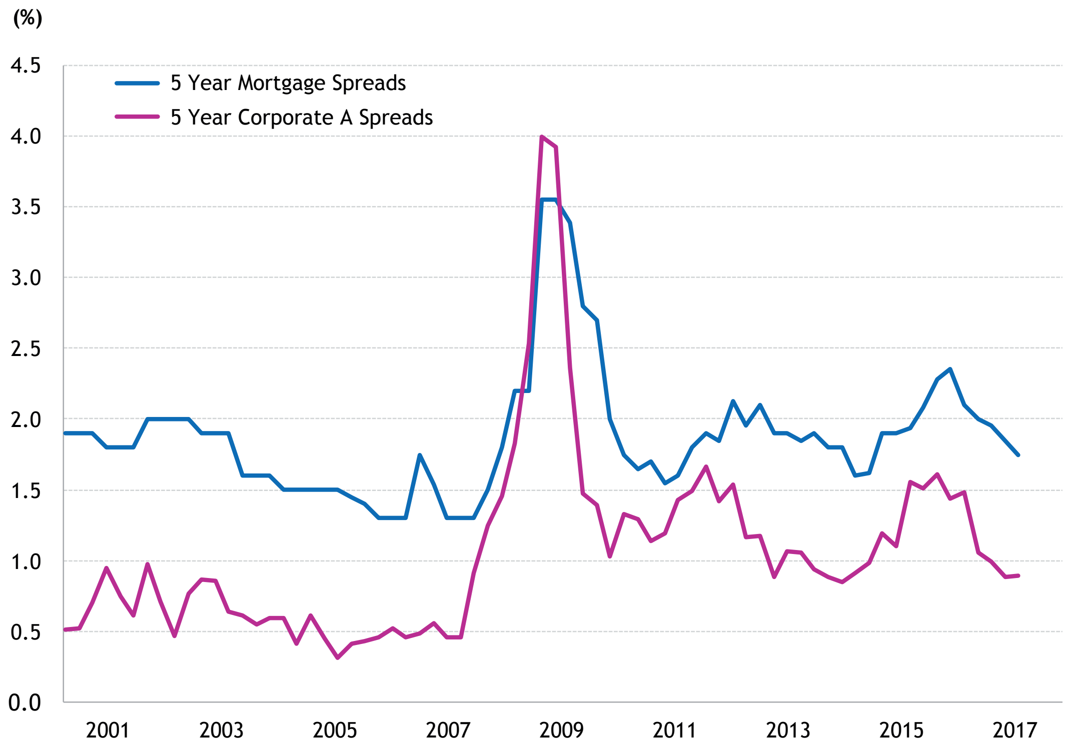
a. Commercial Mortgages

Investing in commercial mortgages[3] typically provides a yield premium over government bonds and corporate bonds of comparable duration and credit quality. Figure 3 below illustrates the yield pick-up over good quality corporate bonds along with the tendency for commercial mortgage spreads to respond more slowly relative to corporate spreads[4].

Their generally smoother return trajectory, in part due to their private nature, is more notable during periods of heightened volatility and particularly notable during the global financial crisis. Moreover, the portfolio's intentional short duration positioning (currently around 2.4 years) enables commercial mortgages to be more resilient against rising interest rates relative to the traditional bond index (and relative to bonds of similar term due to the ongoing payments of interest and principal)[5].

[3] Addenda's Commercial Mortgage portfolio is comprised of mortgages on Canadian commercial properties and/or multi-family residences.
[4] This chart serves as illustrative purposes. Corporate A spreads were selected as a proxy for commercial mortgage spreads for comparison purposes only. The Corporate A spreads are based on an extrapolation using a 5-year (fixed maturity) credit curve (A curve). The analysis is based on quarterly spreads.
[5] Duration is the modified duration of the Addenda Commercial Mortgages Pooled Fund as of June 30, 2018. The duration is based on the Commercial Mortgage component, and thereby ignores cash and money market equivalents.

Figure 3: Gap Between Commercial Mortgage and Corporate Bond Spreads



Sources: National Bank Financial, PC Bond, Addenda Capital

b. Preferred Shares

Preferred shares are hybrid securities. They are issued as equity, provide attractive dividends and tend to depict bond-like characteristics. Preferred share prices are generally influenced by three main factors: interest rates, credit spread changes and market dynamics. The relevance of each factor varies over time and is heavily influenced by the preferred share structure and underlying covenants.

Prices as well as interest rate sensitivity, are influenced by the preferred share structure and underlying provisions. As exhibited in Table 1, their idiosyncrasies have generated returns less correlated with other fixed income segments, deepening portfolio diversification.

Table 1: Preferred Shares Offer Diversification Benefits[6]

	S&P/TSX Preferred Share Index	FTSE TMX Canada Universe Bond	FTSE TMX Canada Universe Corporate Bond	FTSE TMX Canada Short Term Bond	Addenda Commercial Mortgage Composite	Barclays Global Aggregate Credit, unhedged to CAD
S&P/TSX Preferred Share Index	**100.0%**	**0.4%**	**20.9%**	**-3.9%**	**2.3%**	**-24.2%**
FTSE TMX Canada Universe Bond		100.0%	86.8%	82.4%	70.0%	65.9%
FTSE TMX Canada Universe Corporate Bond			100.0%	69.4%	57.0%	48.4%
FTSE TMX Canada Short Term Bond				100.0%	70.0%	67.0%
Addenda Commercial Mortgage Composite					100.0%	49.6%
Barclays Global Aggregate Credit, Unhedged to CAD						100.0%

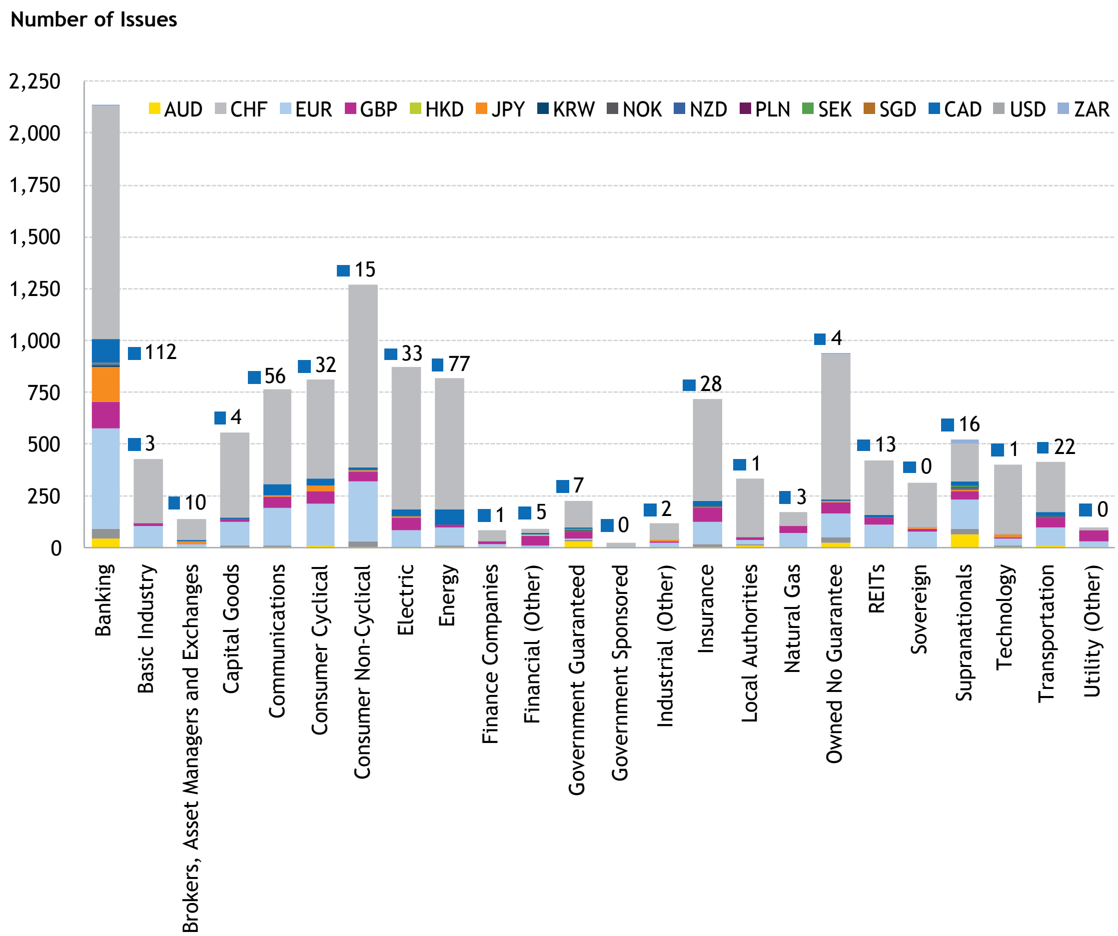
Sources: FTSE TMX Global Debt Capital Markets Inc., Addenda Capital

[6] Correlations were derived using monthly returns, starting September 2008 and ending August 2018. Please contact Addenda Capital to obtain additional information on the Addenda Commercial Mortgages composite and/or associated composite notes.

c. Global Corporate Bonds

The ability to invest in global corporate bonds further broadens the opportunity set. Figure 4 indicates the aggregated number of global credit issues by industry, with country breakdowns. Canadian issues represent less than 4% of the global credit market in both number of issues and market weight capitalization.[7] As such, including global corporate bonds can lead to broader sector, industry and business model diversification. They could also be an opportunity to benefit from diverging monetary policies and various global credit environments.

Figure 4: Broadening the Corporate Landscape



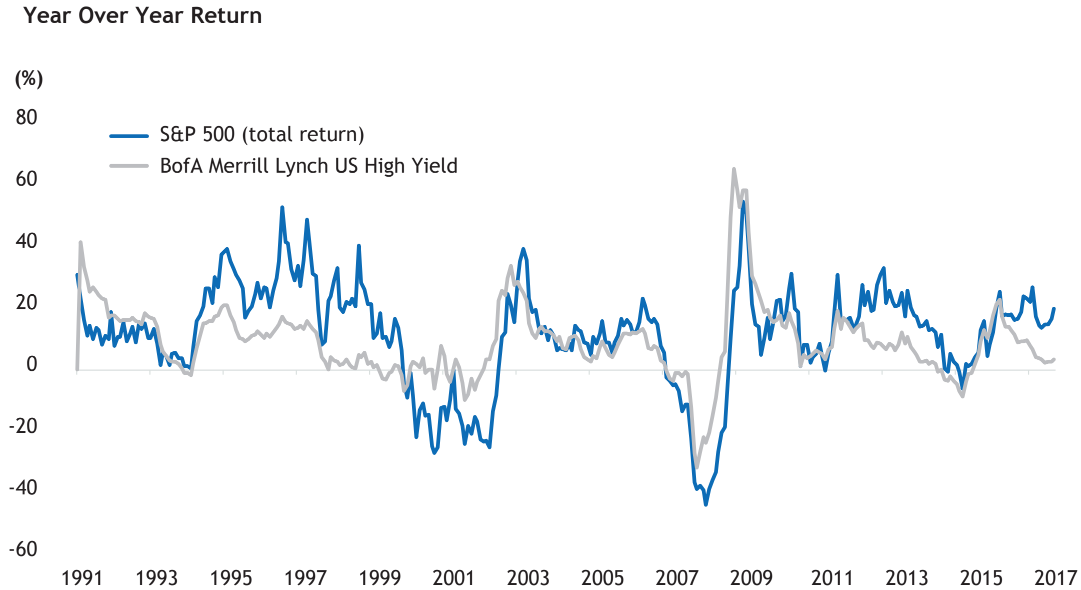
Sources: Allianz Global Investors, Addenda Capital

d. High Yield Securities

High yield (HY) securities[8] provide incremental yield given their lower credit quality. However, they tend to be less sensitive to rates than investment grade bonds while more sensitive to corporate earnings and economic growth. The graph below represents the year over year S&P 500 total return index against the BofA Merrill Lynch US High Yield Index in US dollar terms[9]. As evident from the chart, unlike traditional bond securities, the performance of US high yield securities has been positively corelated with the US equity market. Consequently, adding high yield securities on a selective basis can enhance returns and broaden diversification.

[7] Approximations, based on Barclays Global Aggregate — Credit Index, as of June 2017.
[8] Defined as corporate bonds rated below BBB.
[9] All observations are monthly, for the period beginning December 1991 and ending August 2018.

Figure 5: Deepening Diversification Through High Yield Securities



Sources: Bloomberg, Addenda Capital

e. Absolute Return Fixed Income

Addenda's Absolute Return Dynamic Bond strategy seeks to deliver positive returns regardless of underlying market conditions, interest rate fluctuations and changes in credit spreads by exploiting observed fixed income investment opportunities. The strategy is expected to correlate lowly over time, or offer different return patterns, when compared with traditional fixed income segments. It does so by maintaining a neutral (minimal) duration stance and minimal corporate credit exposure. Since its inception, the Absolute Return Dynamic Bond strategy has had a slight negative correlation coefficient with the FTSE TMX Canada Universe Bond Index, enhancing the CorePlus strategy's efficiency.[10]

Adapt to Change and Seize Opportunities

To summarize, the Strategy's Core and Plus positioning corresponds with views that are purposely and tactically deployed across multiple segments. By navigating changing environments and seizing investment opportunities as they unfold, the strategy seeks to enhance returns irrespective of market conditions and yield levels.

[10] Correlation was based on monthly composite returns of the Addenda Absolute Return Dynamic Bonds strategy for the period commencing October 2014 and ending August 2018. Please contact Addenda Capital to obtain additional information on the Addenda Absolute Return Dynamic Bonds composite and/or associated composite notes.

Appendix

Figure 6: Recap Table: Addenda Fixed Income CorePlus Strategy

The Addenda Fixed Income CorePlus strategy benefits from a large toolkit, with individual components offering unique and often complementary advantages. Some of their features are indicated in the table below.[11]

	Credit Exposure	Diversified Income Source	Generally, Performs Well When…	Generally, Underperforms When…	Characteristics
Core Bonds	●	●	Rates fall or remain "range bound" Credit is favored	Rates rise Credit is disfavored	Active approach positioning to exploit multiple sources of alpha
High Yield Securities	●	●	Strong economic growth Credit is favored	Credit is disfavored Equities underperform	Captures a credit premium
Global Corporate Bonds	●	●	Rates fall or remain stable Credit is favored	Rates rise Credit is disfavored	Captures a credit premium Decisions driven by debt dynamics Foreign currency exposure allows for tactical adjustments
Commercial Mortgages	●	●	Rates fall or remain "range bound"	Fast and unexpected rise rates Rise in defaults	Captures a illiquidity and lending premium Return stability, mostly due to the quality orientation of the strategy
Preferred Shares	●	●	Credit is favoured	Credit is disfavored	Captures illiquidity and structure premium Characteristics vary according to preferred structure Low correlation with traditional bonds
Absolute Return Bonds			Regardless of rate fluctuations Volatility spikes	Suppressed volatility is present Financial repression	Global macroeconomic views Low correlation with traditional bonds

Source: Addenda Capital

[11] The impact of rate changes on returns ultimately depends on the rate level, magnitude of changes and frequency of changes. "Credit is favored" encompasses a variety of factors, including default expectations and investor confidence.

Notes

Offices

Montréal
800 René-Lévesque Blvd. West
Suite 2750
Montréal (Québec)
H3B 1X9

Toronto
110 Yonge Street
Suite 1600
Toronto (Ontario)
M5C 1T4

Guelph
Priory Square
130 Macdonell Street
Guelph (Ontario)
N1H 6P8

Regina
1920 College Avenue
Regina (Saskatchewan)
S4P 1C4

info@addendacapital.com

addendacapital.com

Returns are presented for information purposes and do not guarantee future returns.

Index Disclosures