Credit Absolute Return Strategy

As of September 30, 2018

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	68.8	-132.5	-63.7
AA	69.0	0.0	69.0
A	46.2	-12.4	33.8
BBB	58.3	-13.4	44.9
BB	20.1	-5.1	15.0
B	0.0	0.0	0.0
Not rated	1.0	0.0	1.0
Total	**263.5**	**-163.5**	**100.0**

Portfolio exposure (%)	Long	Short	Net
Investment grade	142.5	-22.4	120.1
High yield	18.1	-4.8	13.3
Bank loans	4.2	0.0	4.2
Cash, short-term investments and other net assets	93.0	0.0	93.0
Government bonds	1.0	-132.5	-131.5
Preferred stocks — CDN	3.5	-3.7	-0.2
preferred stocks — USD	1.3	0.0	1.3
Options	0.0	0.0	0.0
Total	**263.5**	**-163.5**	**100.0**

Characteristic	
Duration	0.31
Weighted Average Credit Weighting	AA-
Gross Leverage	1.4 X

Highlights

Inception	December 31, 2013
Strategy AUM	$226 MM
Liquidity	Daily
Holdings	204
Currency	100% hedged
Incentive fee	Yes
High water mark	Annual
Hurdle rate	5%

Performance

Compound returns (%)

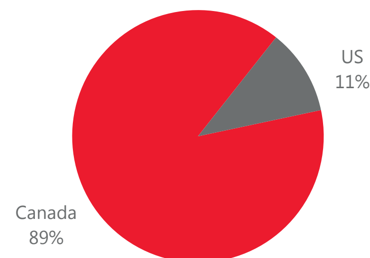
1 mth	3 mth	6 mth	1 yr	2 yr	3 yr	4 yr	Inception
0.29	0.88	1.08	2.42	6.15	7.73	7.77	8.32

Calendar year returns (%)

YTD 2018	2017	2016	2015	2014
1.38	7.88	6.60	12.57	11.36

Top corporate issuers (%)	
Canadian Oil Sands	10.9
CIBC	10.4
TD	9.7
Bank of Nova Scotia	7.7
Royal Bank of Canada	6.2
Toyota	5.9
OMERS Realty Corp	5.4
Wells Fargo	5.4
Choice Properties	5.3
Ford Credit Canada	5.2
Total	**72.1**

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	8.32%	3.35%	4.30%	6.64%
Standard deviation	4.13%	3.86%	5.35%	7.33%
Sharpe ratio	1.63	0.46	0.51	0.69
% of positive months	84%	61%	67%	63%
Max drawdown	-4.45%	-3.55%	-10.64%	-13.77%
Yield to Maturity C$	3.48%	2.91%	6.51%	NA
Avg Modified Duration	0.31	7.40	3.82	NA
Avg. Credit Rating	AA-	AA	B1/B2	NA
Correlation to Fund		0.08	0.14	0.12

Source: Bloomberg, FTSE TMX Global Debt Capital Markets

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

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

The Credit Absolute Return strategy generated a return of +0.88% during the third quarter. Canadian credit markets were largely quiet through the quarter, particularly in short-term credits, and the bulk of the return was generated by positive carry. Canada and the U.S. finally managed to renegotiate NAFTA in the final hours of the third quarter, introducing an element of stability for North American trade. This was followed by the approval of the LNG Canada project in Kitimat B.C. by a Shell-led consortium. The C$40 billion project is the single biggest private infrastructure project in Canadian history and will begin shipping LNG cargoes to Asia towards the middle of the next decade. LNG Canada's proximity to Asia provides a material transportation cost advantage over U.S. Gulf Coast LNG projects. While the project's benefits will not be felt immediately, we believe that this vote of confidence by Shell and its partners will help to reflate severely depressed Canadian energy valuations over time, particularly in the natural gas and oil field services sectors.

As we approach the end of the year and start looking forward to 2019, we thought we would review some of the larger risks we see in the fixed income markets and how we are positioning the strategy to mitigate these risks and capitalize from them.

Higher Interest Rates: With NAFTA negotiations out of the way, the Bank of Canada is running out of excuses to keep rates low and will be forced to follow the Fed higher. We believe the market can likely handle a gradual pace of rising rates, but a spike higher could result in significant stress in risky assets. We note that the yield on the U.S. Treasury 10 year went from 2.86% at the beginning of September to 3.21% in early October which represents a substantial and rapid increase. We want to highlight that the strategy hedges out interest rate exposures and maintains a low duration.

Excessive Corporate Leverage, Especially in BBB Credits: One of the bigger credit stories over the past few years has been the growth in not only the size of the BBB market, but also the increase in leverage incurred by investment grade issuers in the U.S. Much of this capital has been put to work rewarding shareholders through share buybacks and very little has been spent expanding productive capacity or making operations more efficient. From a leverage and rating perspective, the U.S. investment grade market has never been weaker. The strategy has generally avoided the over-levered capital structures of U.S. investment grade issuers and is exploring possible short ideas where valuations reflect an attractive risk/reward profile.

Overleveraged Canadian Consumers: We've discussed this several times in the past and bring it up once more as we continue to see risk in Canadian housing markets and possible spillover effects for consumer spending levels. The material increase in housing prices coupled with extremely low interest rates has encouraged risky behaviour with many Canadian incurring too much debt. In our view, Canadians will increasingly feel the pinch of rising rates which could increase consumer defaults and provide a headwind for economic growth. The strategy has several strategic shorts in subordinated securities of weaker Canadian lenders and other securities correlated to real estate volumes/valuations, which we believe represent an attractive risk/reward profile at current valuations.

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.

$127 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 September 30, 2018. 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.

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