Credit Absolute Return Strategy

As of September 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	35.8	-101.5	-65.7
AA	55.9	0.0	55.9
A	41.9	-8.8	33.0
BBB	82.9	-16.1	66.8
BB	20.7	-7.5	13.3
B	0.0	-3.9	-3.9
Not rated	0.6	0.0	0.6
Total	**237.7**	**-137.7**	**100.0**

Portfolio exposure (%)	Long	Short	Net
Investment grade	135.4	-20.4	115.0
High yield	20.1	-11.0	9.1
Bank loans	0.9	0.0	0.9
Cash, short-term investments and other net assets	77.7	0.0	77.7
Government bonds	2.3	-101.5	-99.2
Preferred stocks — CDN	1.4	-4.8	-3.4
preferred stocks — USD	0.0	0.0	0.0
Options	0.0	0.0	0.0
Total	**237.7**	**-137.7**	**100.0**

Characteristic	
Duration	0.13
Weighted Average Credit Weighting	A+
Gross Leverage	1.2 X
Yield to Maturity	3.17%

Highlights

Inception	December 31, 2013
Liquidity	Daily
Holdings	173
Currency	100% hedged
Incentive fee	Yes
High water mark	Annual
Hurdle rate	5%

Performance

Compound returns (%)

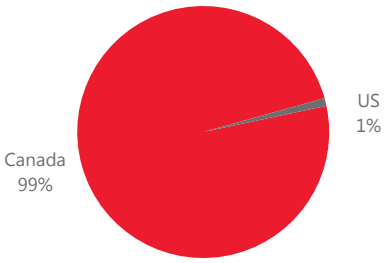
1 mth	3 mth	6 mth	1 yr	3 yr	5 yr	Inception
0.30	0.30	1.61	2.24	4.83	6.64	7.23

Calendar year returns (%)

2019	2018	2017	2016	2015	2014
3.57	0.08	7.88	6.60	12.57	11.36

Top corporate issuers (%)	
Enbridge	15.4
Enbridge Pipelines	12.7
Suncor Energy	11.8
Bank of Montreal	9.6
Pembina Pipeline	6.7
Royal Bank of Canada	5.6
OMERS Realty Corp	5.6
Brookfield Property	5.6
Wells Fargo	5.2
Choice Properties	5.0
Total	**83.2**

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	7.23%	4.43%	4.53%	6.71%
Standard deviation	3.86%	3.83%	5.63%	8.74%
Sharpe ratio	1.44	0.72	0.51	0.58
% of positive months	80%	64%	67%	65%
Max drawdown	-4.45%	-3.55%	-10.64%	-13.77%
Yield to Maturity C$	3.17%	2.12%	6.15%	NA
Avg Modified Duration	0.13	8.10	3.10	NA
Avg. Credit Rating	A+	AA	B1/B2	NA
Correlation to Fund		0.03	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 September 30, 2019)

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

The Credit Absolute Return strategy rose 0.30% during the quarter, benefitting primarily from the levered investment grade corporate debt strategy. Gains from the levered strategy offset losses from the long/short and credit arbitrage positions. In the arbitrage strategy, the Fund's long position in legacy Canadian Oil Sands bonds vs. a short position in Suncor bonds continued to detract from performance. The price spread between the two positions sits at $26 compared to $13 at the end of December 2018. We find this risk neutral arbitrage opportunity very attractive and believe the fair value price spread should be closer to $6.

We have previously highlighted our concerns over the health of Canadian consumers who we view as being excessively leveraged. Canadian insolvency data released in July showed insolvencies picking up with a +16.9% year-over-year increase, led by British Columbia (+35.5%), Ontario (+22.9%) and Alberta (+21.5%), respectively. The growth in insolvencies is alarming and supports our view that Canadian consumer balance sheets are deteriorating. As a result, our credit selection efforts in Canada remain focused on issuers who are less exposed to the health of Canadian consumers (such as pipelines, etc.) or on structures that provide considerable protection from consumer bankruptcies.

The Canadian corporate bond market saw the second busiest month in 2019 and the busiest September on record for new issuance. The new issuance was generally well received as the demand for yield remains strong. Included in September's primary issuance was the largest ever Canadian dollar high-yield deal from Videotron who issued $800mm of 10-year paper at 4.50%. With a rating of BB+, the company is rated one notch below investment grade by rating agencies, whereas Videotron's other Canadian peers (Bell, Rogers, Telus, and Shaw) are all rated higher at BBB- or better. Videotron's 10-year deal came at a spread of 319 bps, while its peers trade materially tighter. We believe the below investment grade rating is unjustified given Videotron's defendable position in Quebec, strategically important media and entertainment business, and strong balance sheet. Consequently, the strategy purchased Videotron bonds in the primary market and benefited from decent spread tightening once the bonds began trading.

Fund Positioning

Being late in the credit cycle warrants caution since timing a market downturn is always a difficult task and debt has grown significantly since the global financial crisis. Investors need to be mindful of increased risk. We continue to employ a modest amount of leverage in the levered investment grade strategy, 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.

$142 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, 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.