Credit Absolute Return Strategy

As of December 31, 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	93.6	-116.2	-22.6
AA	66.0	-26.3	39.8
A	36.0	-14.2	21.8
BBB	59.8	-14.4	45.4
BB	19.9	-6.4	13.5
B	1.0	0.0	1.0
Not rated	1.0	0.0	1.0
Total	**277.5**	**-177.5**	**100.0**

Portfolio exposure (%)	Long	Short	Net
Investment grade	127.5	-50.1	77.4
High yield	19.6	-5.9	13.7
Bank loans	4.3	0.0	4.3
Cash, short-term investments and other net assets	97.1	0.0	97.1
Government bonds	25.6	-116.2	-90.5
Preferred stocks — CDN	2.3	-5.3	-3.0
preferred stocks — USD	1.1	0.0	1.1
Options	0.0	0.0	0.0
Total	**277.5**	**-177.5**	**100.0**

Characteristic	
Duration	0.23
Weighted Average Credit Weighting	AA-
Gross Leverage	1.2 X

Highlights

Inception	December 31, 2013
Strategy AUM	$227 MM
Liquidity	Daily
Holdings	199
Currency	100% hedged
Incentive fee	Yes
High water mark	Annual
Hurdle rate	5%

Performance

Compound returns (%)

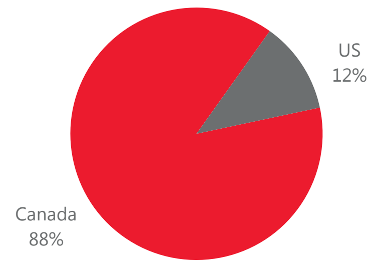
1 mth	3 mth	6 mth	1 yr	3 yr	5 yr	Inception
-0.41	-1.29	-0.41	0.08	4.80	7.61	7.61

Calendar year returns (%)

2018	2017	2016	2015	2014
0.08	7.88	6.60	12.57	11.36

Top corporate issuers (%)	
Canadian Oil Sands	11.7
CIBC	8.0
Toyota	6.0
OMERS Realty Corp	5.5
Choice Properties	5.4
Wells Fargo	5.4
Ford Credit Canada	5.1
Daimler Canada	5.0
TD	4.3
Royal Bank of Canada	4.3
Total	**60.9**

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	7.61%	3.54%	3.01%	4.06%
Standard deviation	4.11%	3.82%	5.47%	8.21%
Sharpe ratio	1.45	0.50	0.25	0.29
% of positive months	80%	62%	63%	62%
Max drawdown	-4.45%	-3.55%	-10.64%	-13.77%
Yield to Maturity C$	3.79%	2.72%	7.92%	NA
Avg Modified Duration	0.23	7.46	4.15	NA
Avg. Credit Rating	AA-	AA	B1/B2	NA
Correlation to Fund		0.06	0.19	0.17

Source: Bloomberg, FTSE TMX Global Debt Capital Markets

Scotia Institutional Asset Management™

Quarterly commentary

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

The Credit Absolute Return strategy declined 1.29% in the fourth quarter as the global selloff in risk assets picked up speed. We saw a dramatic rise in volatility and risk-aversion from investors as market participants became increasingly concerned with aggressive Fed policy, the prospects for continued earnings growth, and escalating Sino-American trade rhetoric. The fund's negative performance during the quarter can be attributed to weakness in long preferred share positions of Enbridge and TransAlta, which under-performed the Fund's short positions in selected banks preferred shares. In addition, the Fund's levered investment grade strategy was also negatively impacted by the general credit spread widening.

In our view, the dominant theme facing investors in 2019 will be the pace of the Federal Reserve's current hiking cycle and its balance sheet normalization activities. The big question facing investors in 2019 is will a market sell-off cause the Fed to blink, or will they remain steadfast and data dependent in their efforts to tighten financial conditions? The current lack of liquidity coupled with the growing influence of passive investing vehicles such as index ETFs could create an environment for increased volatility going forward. In the absence of a pause in the Fed's program to tighten financial conditions, we expect volatility to remain elevated through 2019.

We expect over-leveraged Canadian consumers and depressed commodity prices to weigh on the Canadian economy through 2019. Canadians have borrowed heavily since the Global Financial Crisis and now sport a near record high household debt to GDP ratio. In Alberta, the lack of any clear resolution to pipeline egress issues should keep pricing differentials elevated and result in depressed levels of new investment. While the Alberta government has intervened to cap production levels in the near-term, such policies are not going to encourage new energy-related investments which are critical for job creation. Considering the above noted issues, we expect the Canadian economy to remain challenged through 2019.

Our overall positioning remains defensive with limited exposure to rising interest rates. We have maintained a very low amount of leverage throughout the year, which has helped preserve capital as spreads have widened and positioned the Fund to take advantage of market opportunities as they arise. While Q4's sell-off has been uncomfortable for investors, it has helped improve valuations. We intend to increase risk and leverage in 2019 if we see an improvement in investors' compensation through large new issue concessions.

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 December 31, 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.