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Select Canso Bond Fund Performance in Rising Interest Rate Environments

Introduction

Canso Investment Counsel Ltd. (“Canso”) specializes in the bottom-up security selection of corporate bonds.

While security selection is the major source of “alpha” or value-added for Canso bond funds, **the emphasis on the bottom-up selection of corporate bonds offers considerable protection in rising interest rate environments.**

Corporate bonds have higher yields than government bonds. This means that **over long periods, the extra corporate yield spread will add to the return of corporate bonds and reduce the negative impact of rising interest rates.**

Corporate bond yield spreads (the extra yield above government bond yields) tends to reduce or “narrow” with rising interest rates. This results from an improving economy and therefore better price performance for corporate bond issuers.

Select Canso Bond Funds

Performance of three Canso funds was examined based on Series C units of these funds and from their respective inception dates to February 28, 2021:

- **Canso Corporate Value Fund Series C** (“Canso Corporate Value”)
- **Canso Broad Corporate Fund Series C** (“Canso Broad Corporate”)
- **Canso Corporate Bond Fund Series C** (“Canso Corporate Bond”)

Table 1 and Table 2 below summarize the annualized monthly returns for the Canso funds relative to the FTSE Canada Universe Bond Index (“Universe Index”) and the FTSE Canada All Corporate Bond Index (“Corporate Index”) in both rising and falling interest rate environments.

In order to measure the general direction of interest rates across the government yield curve instead of focusing on the interest rate change at a specific term (i.e. 5-year, 10-year, 30-year), **the rising and falling interest rate scenarios are defined as a monthly change in the yield of the ICE BofAML Canada Federal Government Index.**

Rising Interest Rate Environments

Table 1 shows that corporate bonds have outperformed in periods of rising interest rates as the Corporate Index outperformed the Universe Index over each of the different Canso fund inception periods.

Furthermore, the active management of the Canso funds demonstrated outperformance of passive corporate bonds in periods of rising interest rates – their outperformance of the Corporate Index on an annualized basis since each of their respective inception dates was as follows:

- Canso Corporate Value: **+8.2%** (over 20-years and 2-months)
- Canso Broad Corporate: **+4.1%** (over 10-years and 5-months)
- Canso Corporate Bond: **+0.6%** (over 16-years and 8-months)

Table 1

As of February 28, 2021	↑ Rising Interest Rates
Canso Corporate Value (Inception: Dec 31, 2000)	6.9%
FTSE Canada Universe Bond Index	-4.2%
FTSE Canada All Corporate Bond Index	-1.3%
Canso Broad Corporate (Inception: Sep 30, 2010)	1.6%
FTSE Canada Universe Bond Index	-5.5%
FTSE Canada All Corporate Bond Index	-2.5%
Canso Corporate Bond (Inception: Jun 30, 2004)	-0.5%
FTSE Canada Universe Bond Index	-4.1%
FTSE Canada All Corporate Bond Index	-1.1%

Falling Interest Rate Environments

Table 2 shows that the broad bond market outperformed in periods of falling interest rates, as the Universe Index outperformed both the Corporate Index and the Canso funds since their respective inception dates.

This result is not surprising; the relatively low yield of the Universe Index compared to the Corporate Index lends itself to having a greater level of interest rate sensitivity (i.e. greater duration), thus it is more likely to perform better in a falling interest rate environment.

Even though the Canso funds did not demonstrate the best performance in this scenario, they did however capture the lion's share of the upside performance relative to the best performing Universe Index.

Canso Corporate Value Fund

Canso Corporate Value Fund is neither constrained by duration nor credit quality and focuses on bottom-up security selection. The increased latitude of investment opportunities has resulted in an attractive annualized return of 6.9% in rising interest rate environments compared to -1.3% for the Corporate Index and -4.2% for the Universe Index.

Canso Broad Corporate Fund and Canso Corporate Bond Fund

Canso Broad Corporate Fund and Canso Corporate Bond Fund are duration constrained by +/- 3-years compared to the FTSE Canada All Corporate Bond Index. Furthermore, Canso Corporate Bond Fund has a mandate to remain invested in 100% investment grade securities, while Canso Broad Corporate Fund may invest up to 30% below investment grade rated bonds.

The ability of Canso Broad Corporate Fund to hold below investment grade rated bonds gives it additional scope for security selection and allows it to invest in issues that are not as sensitive to rising interest rates. This is indicated by its 1.6% annualized return in rising interest rate environments compared to the Corporate Index return of -2.5% and the Universe Index return of -5.5%.

While Canso Corporate Bond Fund may only hold investment grade rated bonds, the focus on corporate bonds and prudent security selection has led to considerable outperformance during rising interest rate environments with a -0.5% annualized return compared to -1.1% for the Corporate Index and -4.1% for the Universe Index.

Table 2

As of February 28, 2021	↓ Falling Interest Rates
Canso Corporate Value (Inception: Dec 31, 2000)	11.1%
FTSE Canada Universe Bond Index	15.1%
FTSE Canada All Corporate Bond Index	12.9%
Canso Broad Corporate (Inception: Sep 30, 2010)	11.5%
FTSE Canada Universe Bond Index	13.8%
FTSE Canada All Corporate Bond Index	11.6%
Canso Corporate Bond (Inception: Jun 30, 2004)	12.3%
FTSE Canada Universe Bond Index	14.4%
FTSE Canada All Corporate Bond Index	12.0%

Sustained Periods of Rising Interest Rates

We have also examined the performance of the Canso funds and the comparable benchmarks over sustained periods of rising interest rates. As shown in Chart 1, using monthly data since 2000, there have been 8 periods where interest rates increased over 0.50%.

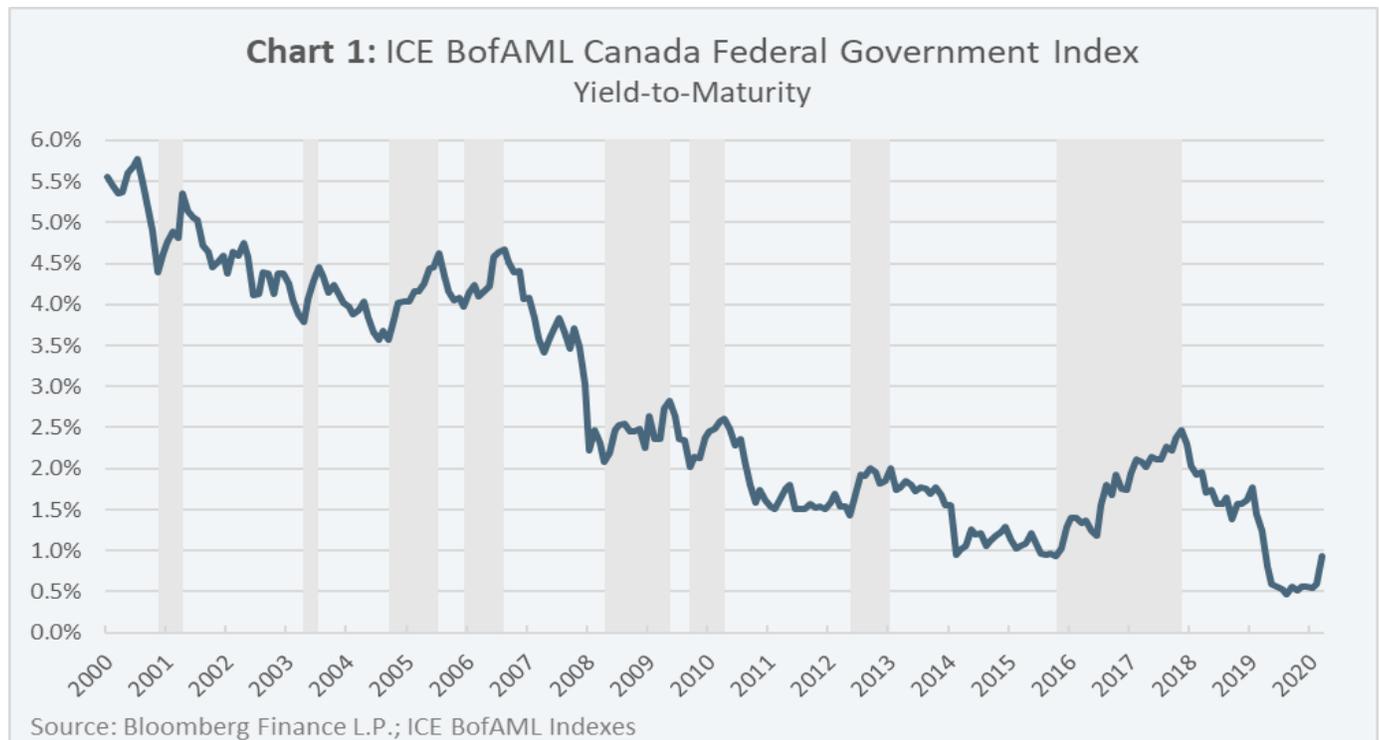


Table 3 shows that these periods lasted on average 8-months and that on average the ICE BofAML Canada Federal Government Index yield increased by 0.84%. **At the same time, the average return of each Canso fund outperformed those of the comparable bond indices.** The stand-out Canso fund over these periods was Canso Corporate Value Fund, which had an average return of 6.5% compared to the -1.0% average return of the Universe Index.

Table 3

Start Date	2001/10/31	2004/03/31	2005/08/31	2006/11/30	2009/03/31	2010/08/31	2013/04/30	2016/09/30	Avg.
End Date	2002/03/31	2004/07/31	2006/06/30	2007/07/31	2010/04/30	2011/03/31	2013/12/31	2018/10/31	
# of Months	5	4	10	8	13	7	8	12	8
Yield Increase	+0.97%	+0.55%	+1.06%	+0.69%	+0.75%	+0.59%	+0.58%	+1.53%	+0.84%
Canso Corporate Value Return	2.5%	0.0%	1.3%	3.0%	31.3%	3.6%	5.9%	3.9%	6.5%
Canso Broad Corporate Return	N/A	N/A	N/A	N/A	N/A	0.4%	1.6%	3.0%	1.7%
Canso Corporate Bond Return	N/A	N/A	-1.4%	-0.9%	13.6%	1.0%	-0.2%	-0.1%	2.0%
FTSE Canada Universe Bond Index	-2.3%	-1.1%	-1.6%	-1.4%	5.1%	-0.3%	-3.0%	-3.0%	-1.0%
FTSE Canada All Corporate Index	-0.8%	-1.1%	-1.3%	-1.6%	14.8%	0.6%	-1.7%	-0.4%	1.1%

Conclusion

The demonstrated defensiveness of the Canso funds in rising interest rate environments results from a variety of sources:

1. The yields of the Canso funds tend to be higher than the Universe Index because of the corporate holdings, the bias towards value, and out-of-favour bond issues;
2. The yield spreads of the underlying bonds in the Canso funds tend to be wider than those in the Corporate Index, which adds to the price appreciation of bonds due to spread compression in a rising rate environment;
3. Canso security selection tends to drive incremental value.

Canso Broad Corporate Fund and Canso Corporate Value Fund also hold securities which tend to be “price based”, meaning they do not react as directly to changing interest rates as bonds with higher credit qualities.

These securities may include:

1. Bonds rated below investment grade;
2. Distressed debt issues;
3. Bank loans;
4. Floating rate issues;
5. Convertible bonds.

While Canso does not actively conduct duration policy changes on an economic or interest rate forecast basis, they do alter the portfolio durations to reflect their views on credit spreads and absolute yields. The Canso valuation and bottom-up security selection style has shown to be very resilient in periods of rising interest rates.

As of February 28, 2021	YTD	1-Year	3-Year	5-Year	10-Year	Since Inception
Canso Corporate Value Fund Series C	3.3%	24.4%	10.0%	8.6%	8.1%	9.3% (Dec 31, 2000)
Canso Broad Corporate Fund Series C	-0.8%	13.4%	8.4%	7.2%	7.2%	6.9% (Sep 30, 2010)
Canso Corporate Bond Fund Series C	-2.3%	7.2%	6.3%	4.8%	5.5%	5.8% (Jun 30, 2004)

Performance for periods greater than 1 year are annualized.

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