DESAUTELS Capital Management
Gestion de capitaux

2023 Q3 REPORT

Honours Investment Management

Fixed Income Fund

McGill

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Fixed Income Fund

Q3 Performance Summary

Overview

The yield on 10-yr U.S. Treasury Securities increased by 78 bps in Q3. The majority of this increase (50 bps) occurred in the month of September. Although the FOMC kept the Federal Funds Rate stable in their September meeting, the committee agreed that the rate policy should remain restrictive for some time. This idea of "higher-for-longer" coupled with strong jobs numbers and a rebound in inflation (U.S. CPI rose 3.7% in August from a year earlier, up from 3.2% in July's 3.2%) drove yields higher.

The Fixed Income Fund has continued its strong outperformance of the benchmark since inception. In Q3 the fund has outperformed the benchmark, with a current net return of (2.66%) where the benchmark has experienced a (2.99%) return. The fund has also outperformed the benchmark YTD, with a return of (1.33%) versus (2.56%) for the benchmark. In general, our performance can be attributed to 2 main factors: our corporate selection and duration positioning. Most of the fund's alpha generation comes from bottom-up fundamental analysis of credit.

A key lever for the fund is our duration strategy. YTD the fund benefited from our shorter duration positioning, as 0.55% of our outperformance came from our duration positioning. With the fund currently positioned with a 5.95 duration compared to the benchmark of 6.64, 0.54% of our Q3 outperformance can be attributed to our duration position.

The Fixed Income Fund did not make any trades during the quarter, with the newest acquisition being Micron Technology 5.327% 2029, purchase at the end of February 2023.

Moving forward, we are continuing to look for strong corporate bond selection based on rigorous bottom-up fundamental analysis while following our duration, credit exposure and currency positioning as discussed in the following sections.

Figure 1: YTD Fund Performance vs Benchmark

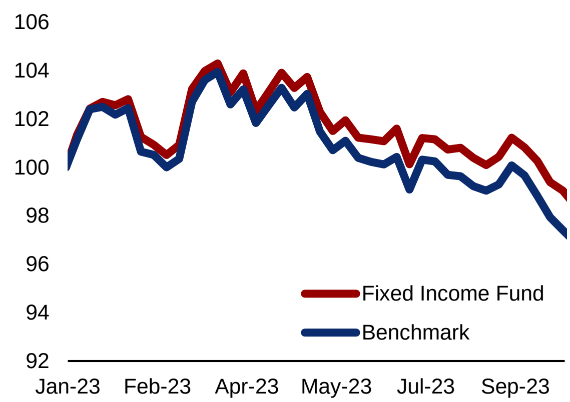

Figure 2: Performance Metrics In 2023

FIXED INCOME METRICS YTD		
	Fixed Income Fund	**Benchmark**
Return	(1.0%)	(2.6%)
Annualized Std Dev	6.1%	6.3%
Annualized Sharpe Ratio	(0.94)	(1.17)
Beta	0.96	
Alpha	1.4%	
Tracking Error	0.12%	

Performance metrics are calculated gross of fees.

Figure 3: Performance Metrics in Q3 2023

FIXED INCOME METRICS Q3 2023		
	Fixed Income Fund	**Benchmark**
Return	(2.5%)	(3.0%)
Standard Deviation	4.7%	4.7%
Sharpe Ratio	(1.57)	(1.64)
Beta	0.97	
Alpha	0.3%	
Tracking Error	0.12%	

Performance metrics are calculated gross of fees.

Sources: Bloomberg, DCM

Fixed Income Fund
Investment Levers Summary

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Duration Outlook

The Fixed Income Team carefully examined the key inflation levers and central bank policies to form a view on interest rates and duration strategy. Most of our recent outperformance was due to our having a shorter duration position than our benchmark. Our industry overview stance was that a softer labour market, a weakening of the consumer, and a deteriorating growth outlook would lead to a more dovish FED cut than what was being priced in by the market. We anticipated yields to surprise on the downside and thus determined a longer-duration stance would be beneficial. Our analysis recognized the highly levered Canadian residential real estate market and the recent surge in mortgage rates. Due to most Canadian homeowners possessing mortgages that are refinanced every 5 years, 2024 will see a large wave of refinancings with mortgages rates nearing 8%. Already, 20% of mortgages from TD, BMO, CIBC are negatively amortizing, meaning loan balances grow as monthly payments no longer cover all the interest owed. This weakness in the Canadian economy could lead to the BoC acting even more dovish than the FED. The Fixed Income Fund has taken the view of being long duration, with greater duration difference in our CAD holdings. Our duration view impacted will impact our screening process for bond positions and will be acted upon via the reallocation of ETF position to increase the fund's duration.

Credit Exposure Outlook

Our findings indicate for more opportunities in the IG segment. First, pertaining the HY space, we remark that: 1) limited HY issuances (due to rising borrowing costs) have kept spreads low; 2) default percentages remain low, but are rising, leading to more uncertainly in the space. The overall mismatch in supply and demand combined with increased risk has led us to believe there to be limited opportunities in HY.

Thus, we turned to examining the IG space. The team regressed the OAS of all credit rating buckets against leading GDP indicators and market volatility metrics. The model displayed an R^2 of 0.69 and our findings indicated that the highest rated securities, AAA corporate bonds, were the most attractive securities in terms of actual versus implied OAS. We ran a similar regression for AAA-rated government and corporate bonds, this time with an R^2 of 0.70, and found that government bonds had a larger potential for OAS compression compared to similarly rated corporate bonds. Thus, we believe the IG space offers attractive risk-adjusted returns.

Currency Strategy

Last term, we took the position of being overweight USD. This decision was based on relative central bank policies, the commodities market, and the indebtedness of Canadian households. We believed that the US federal reserve would be more hawkish when compared to the Bank of Canada. We highlighted the overall higher rate of indebtedness of Canadian households versus their American counterparts as a key vulnerability in the Canadian economy. The large wave of variable mortgage refinancing in 2024 at significantly elevated interest rates should be on the minds of the BoC members and adds to our belief that the central bank will be more dovish than the Fed. As for the commodity market, oil is an important driver of CAD, thus the team analyzed the correlation between the two. We believed that unique circumstances, including recent geopolitical conflicts, had led to an uncertain position between CAD and oil, however, an overall pessimistic view on oil prices added to our overweight USD stance.

Sources: Bloomberg, Federal Reserve, FRED, Globe and Mail

Fixed Income Fund

Select Holdings Update

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Micron Technology, Inc.

MU 5.327% 2029

In Q1 2023 the Fixed Income Fund initiated a position in Micron's 6.750% bond maturing in 2029. Originally pitched during November of 2022, the Fixed Income Fund believed that the company's forecasted cash flows were being overly punished by the market leading a mispricing of the bond's risks. Specifically, the Fixed Income Fund believed that the diverse end market of Micron's DRAM products would support the company's top line numbers during a market downturn.

The bond was pitched with a target OAS of 39 bps above the S&P Corporate Bond Index. While it was trading at 102 bps above the index in November 2022, it now trades around 44 bps above the index, closing in on our target spread. Since our purchase, the Micron bond has been one of the funds top performers. However, Q3 proved to be harder on Micron, the bond returned (2.22%) with OAS compression of 4.43% compared to 5.73% for the S&P500 Corporate Bond Index.

The Toronto Dominion Bank

TD 1.943% 2025

We initiated a position in TD 1.943% 2025 in Q4 2021, after screening for a high quality and shorter duration holding among the largest Canadian banks. We noted that the bond's higher OAS vs peers with similar duration and rating is unwarranted.

TD has consistently posted among the highest CET1 ratio, NIM, spread, and liquidity coverage among both our Canadian and American comps. Credit agencies have recently raised the concern of the adverse impact which a housing downturn may have on consumer-related loans. We believe TD is the best positioned among peers to navigate such an environment.

Q3 proved to be a strong quarter for our TD holding. OAS compressed by 11.73% and the bond returned 0.54% and was our only corporate holding to have a positive return while the fund and benchmark returned (2.5%) and (3.0%), respectively.

The Goldman Sachs Group, Inc.

GS 2.013% 2029

We initiated a position in GS 2.013% 2029 in Q4 2021, at an OAS of 66 bps, with a conviction in the bank's well-balanced business portfolio and robust risk management processes. In 2022, the tightening macroeconomic conditions led to a slowdown in GS' major flagship segments. Consequently, our bond's credit spread expanded materially in response to the Bank's heightened revenue volatility coupled with cost structure inflexibility.

In 2021, Goldman Sachs purchased the fintech lending company GreenSky for $1.7 billion dollars in an effort to diversify their business and get into consumer banking. GreenSky provides home improvement loans to consumers. In Q2 2023, Goldman Sachs was forced to write down $504 million of goodwill related to GreenSky. As reported by Reuters on September 19, 2023, a consortium led by Sixth Street Partners, and investment firm, has entered exclusive talks to acquire GreenSky.

Previously, we considered the rising rates environment a catalyst as it helps expand the bank's Net Interest Margin (NIM). As the Fixed Income Fund now expects rates to stop rising, we see NIM expansion coming to an end. During Q3 the bond's OAS compressed by 5.78% compared to 5.73% for the S&P500 Corporate Bond Index and the bond returned (1.43%) over the period. The Fixed Income Fund has been closely monitoring the holding and may look to sell the position in Q4 2023.

Sources: Bloomberg, DCM, Reuters

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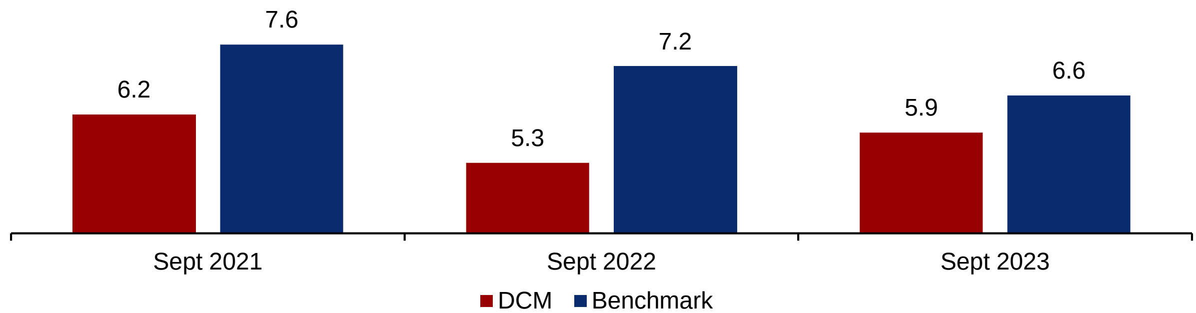
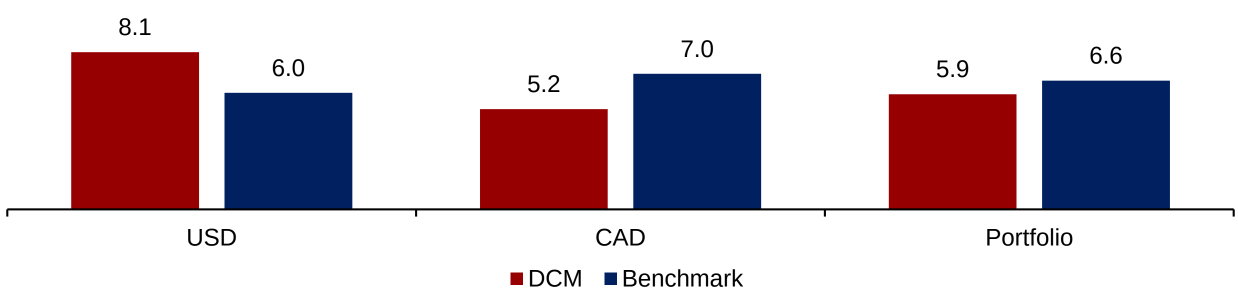
Fund Overview

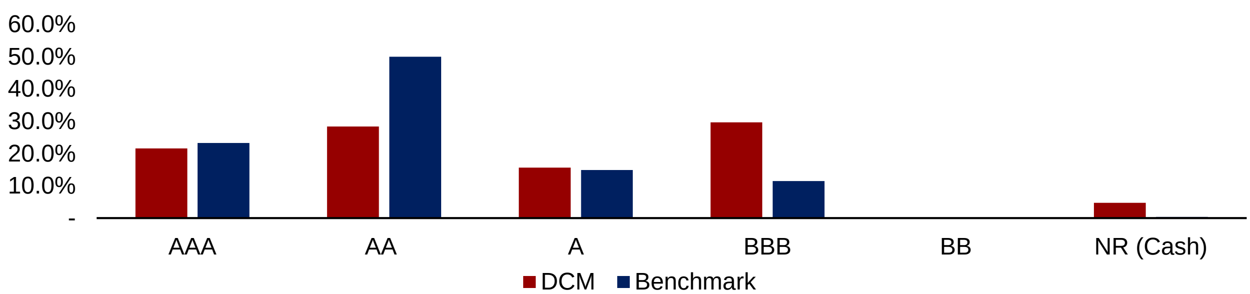
Fixed Income Fund Duration vs. the Benchmark



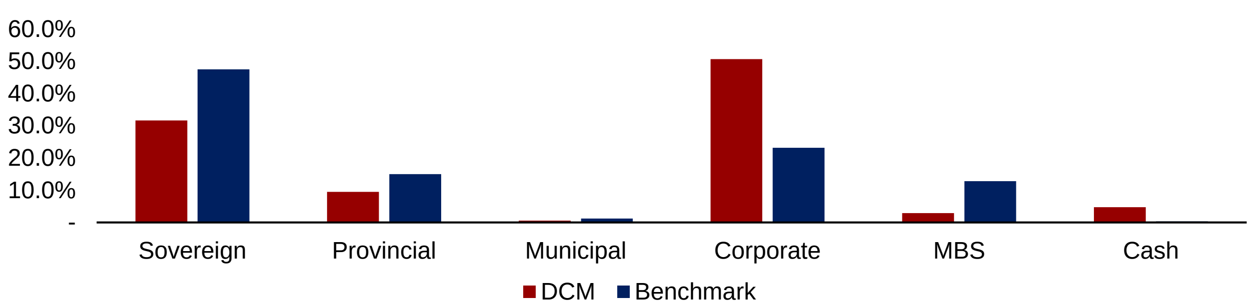
Duration Breakdown: Fixed Income Fund vs. the Benchmark



Fixed Income Fund Credit Rating Exposure vs. the Benchmark



Fixed Income Fund Sector Allocation vs. the Benchmark



Sources: DCM

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