Fixed Income

HIGHLIGHTS

FIXED INCOME	5 years	2018
$94.3 B Net assets as at December 31, 2018	4.2% Annualized return	2.1% Return
	$16.7 B Net investment results	$1.9 B Net investment results

5 portfolios

Rates

Credit

Short-Term Investments

Long-Term Bonds

Real Return Bonds

Benefits

Diversifies the overall portfolio's risk

Enables clients to match their assets and liabilities

Provides a substantial source of liquidity

As at December 31, 2018, the **Fixed Income** portfolio represented 31% of la Caisse's overall portfolio. It is comprised of:

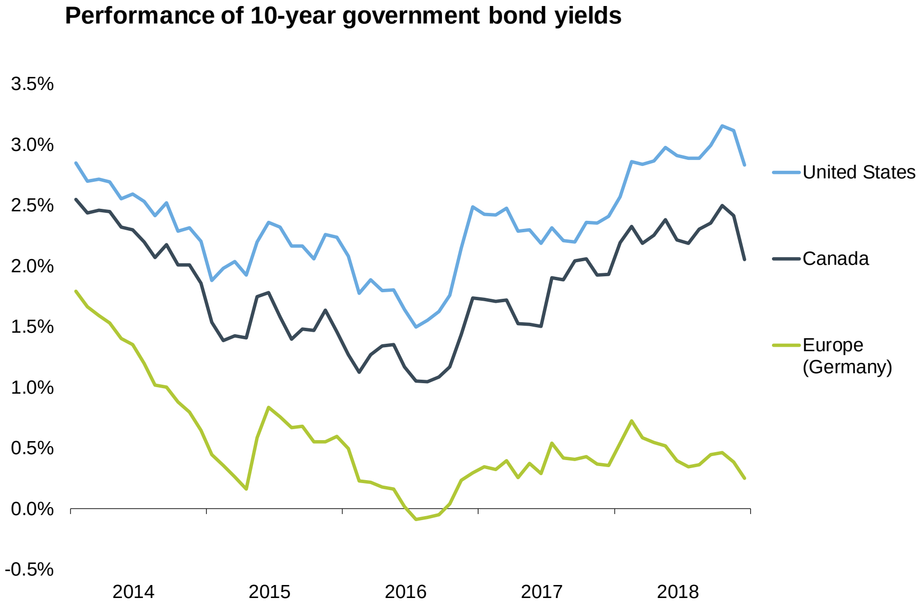
- Two actively managed portfolios:
  - **Rates,** which includes more traditional government bonds and represents la Caisse's primary source of liquidity;
  - **Credit,** which contains corporate debt, real estate debt, sovereign credit and specialty finance mandates.
- Three indexed portfolios:
  - **Short-Term Investments, Long-Term Bonds** and **Real Return Bonds**

Exposure to assets with less risk plays a critical role in la Caisse's portfolio construction. The level of return for the Fixed Income asset class therefore reflects its role in balancing the overall risk profile.

Market conditions

Over the last five years, government bond yields for developed countries evolved in two phases. From the beginning of 2014 until around the middle of 2016, we saw a downward trend that pulled yields to historical lows. This is due to:

- Key rates being held at levels close to 0%, coupled with the conciliatory tone of central banks and massive injections of liquidity that some of them enacted through government bond purchase programs;
- Fears of deflation in Europe and Japan;
- The sharp fall in oil prices from the second half of 2014 to the beginning of 2016;
- The high level of uncertainty that prompted investors to seek the safety of high-quality bond markets.



From the second half of 2016 to the end of 2018, we saw an upward trend. This coincides with the beginning of monetary policy normalization by the U.S. Federal Reserve (the Fed), followed by the election of Donald Trump as president of the United States, who promised to stimulate the economy and markets through various policies. The subsequent acceleration of growth and gradual hikes in the federal funds rate pushed U.S. 10-year bond yields to their highest level since 2011. For 2018 as a whole, the 10-year yield increased 28 basis points. The pullback recorded at the end of 2018 is partially explained by rising uncertainty caused by the tone of the Fed's statements, which diminished expectations of rate hikes, all with the backdrop of a rising threat of a trade war with China.

Canadian bond yields generally followed the trend in U.S. yields over the last five years, even though their spreads widened and narrowed at times. In 2018, the Canadian 10-year yield was flat. On one hand, it was stimulated by three 25-basis-point hikes in the Bank of Canada's key rate, and on the other, was driven down by the deceleration of the Canadian economy and the decline in the U.S. yield at the end of the year.

German bond yields remained significantly weaker than U.S. and Canadian yields throughout the 2014–2018 period. The 10-year yield even dipped below 0% in 2016. The main causes are the various political and debt crises that are hitting some in the euro zone, significant surplus supply and the low inflation rate. These factors prompted the European Central Bank (ECB) to adopt a very expansionist monetary policy, including a major securities purchasing program in 2015. The ECB ended this program at the end of 2018.

Portfolio returns

In 2018, the strategy applied to the Rates and Credit portfolios generated the expected benefits. La Caisse's results benefited from the decision to diversify sources of return for this asset class, which translated into greater exposure to more profitable market segments, as seen in the growth of the Credit portfolio, which reached $56.4 billion in 2018.

RATES

In addition to representing a significant source of liquidity, this portfolio plays a fundamental role in managing risk. It invests in bond securities issued by the governments of Canada and its provinces, mainly Québec, and other developed countries presenting excellent credit quality. It has two primary activities: rate management and sovereign debt.

	5 years	2018	
$33.0 B Net assets as at December 31, 2018	This portfolio was created in 2017.	2.3% Return	2.1% Index

$751 M
2018
net investment results

2018 Return

Since its creation in 2017, the mandate has delivered net investment results of $1.4 billion, including $751 million in 2018. Its return of 2.3% for one year is primarily due to the current yield of the bonds. The effect of rate changes is nearly neutral for the overall year, despite the volatility observed in the markets, rates remained stable. In fact, the generally favourable environment of the Canadian economy led to a progressive increase in rates over the first three quarters. However, uncertainty in markets at the year's end sparked a generalized decline in yields and a widening of the credit spreads of provincial bonds. The value added since this portfolio's launch results from certain strategies put into place by la Caisse, which benefited from rising short-term key rates and stability in long-term maturities in 2017 and 2018.

CREDIT

This portfolio's objective is to generate higher returns than the more traditional bond market and to diversify sources of value. It includes a broader range of instruments with fixed income characteristics. The investment activities are divided into four main mandates: corporate credit, real estate debt, specialty finance and sovereign credit, which targets sovereign securities in growth markets.

$56.4 B Net assets as at December 31, 2018	5 years	2018	
	This portfolio was created in 2017.	2.3% Return	0.3% Index

$1.1 B
2018 net investment results

2018 Return

The portfolio generated net investment results of $1.1 billion. Its 2.3% return outpaces that of its index by 2.0%, representing $1.0 billion in value added. This result is mainly due to the higher current yield earned by the real estate debt and specialty finance mandates, and by the return from bonds in growth markets managed internally. Widening credit spreads represent another factor that contributed to value added due to the credit quality of portfolio securities. However, this weighed on the absolute return, especially in the fourth quarter.

Among the portfolio's mandates, real estate debt posted the best performance thanks to a high current yield specific to this type of activity. Specialty finance, which includes project finance, also delivered a solid performance, as well as the strongest value added thanks to a rigorous selection of high-yield financing securities. For sovereign credit, despite the volatility of growth market bonds in 2018, the pronounced decrease of yields in countries such as Brazil and India was particularly beneficial for returns.

In addition, la Caisse continued to implement its strategy to expand its credit activities through several large transactions in 2018, including:

- Tillman Infrastructure: With AMP Capital, an investment of US$500 million, which could double depending on the company's growing needs, to finance the construction of telecommunication towers across the U.S.;
- SSQ Assurance: Financing of up to $150 million so the company, which is one of the largest in the insurance and investment sector in Québec, can optimize its capital structure and pursue the execution of its strategic plan;
- ContourGlobal: A loan of $150 million for the acquisition of solar energy assets in Spain through this growth platform that targets long-term-contract-backed energy assets.

SHORT-TERM INVESTMENTS

This indexed portfolio consists of short-term liquid investments in the Canadian money market. It aims to preserve capital and maintain a high degree of liquidity while providing a return comparable to 91-day Canadian Treasury Bills.

	5 years		2018	
$0.9 B Net assets as at December 31, 2018	0.9% Annualized return	0.8% Index	1.5% Return	1.4% Index

$172 M
5-year net investment results

Returns

The portfolio recorded an annualized return of 0.9% over five years, reflecting the environment of low rates characteristic of recent years. It produced net investment results of $172 million. Its value added stems from a selection of securities that performed better than Canadian Treasury bonds.

In 2018, the Bank of Canada's key rate increases resulted in raising the current yield of assets. As such, the portfolio earned a return of 1.5%.

LONG-TERM BONDS

This portfolio consists primarily of long-term provincial bonds. It is managed using an optimized index approach. Consequently, not all of the index's securities are held in the portfolio. However, the selected securities replicate the index's various risk factors such as duration, spread change or exposure per issuer.

	5 years		2018	
$2.9 B Net assets as at December 31, 2018	6.4% Annualized return	6.4% Index	0.0% Return	0.0% Index

$702 M
5-year net investment results

Returns

Over five years, the portfolio generated an annualized return of 6.4% and $702 million of net investment results. It benefited from the significant current yield of securities, stable over time, as well as a favourable price effect due to the decrease in long-term rates in Canada and Québec over the period.

Sharp rate volatility in 2018 had an unfavourable effect on the portfolio due to its long-term maturity. This resulted in a negative market effect, which completely erased the current yield of securities over one year, translating into a neutral yield.

REAL RETURN BONDS

This indexed portfolio aims to protect la Caisse's overall portfolio against rising Canadian inflation rates. The portfolio is also intended, for those clients who choose to allocate capital to it, to better match their assets with their liabilities, which are sensitive to rising inflation.

	5 years		2018	
$1.2 B Net assets as at December 31, 2018	3.8% Annualized return	3.8% Index	-0.1% Return	0.0% Index

$193 M
5-year net investment results

Returns

Rising inflation in Canada allowed the portfolio to obtain a 3.8% annualized return over five years. It also benefited from a favourable market effect, as rates fell slightly over the period. Net investment results therefore totalled $193 million for the period.

In 2018, despite a positive inflation effect, the portfolio posted a slightly negative return. This is due to an unfavourable market effect resulting from the increase in real rates in the wake of the Bank of Canada's key rate hikes.

Investment results table for Fixed Income portfolios

As at December 31, 2018		5 years			2018		
Specialized portfolios	Net assets	Net investment results[1]	Return	Index	Net investment results	Return	Index
	$M	$M	%	%	$M	%	%
Rates	32,985	1,416	N/A	N/A	751	2.3	2.1
Credit	56,378	3,395	N/A	N/A	1,134	2.3	0.3
Short-Term Investments	867	172	0.9	0.8	15	1.5	1.4
Long-Term Bonds	2,863	702	6.4	6.4	(2)	(0.0)	0.0
Real Return Bonds	1,192	193	3.8	3.8	(1)	(0.1)	(0.0)
Fixed Income	**94,285**	**16,695**	**4.2**	**3.5**	**1,897**	**2.1**	**0.9**

1. Total includes the history of closed portfolios.