Caisse de dépôt et placement du Québec

# Fixed Income

## HIGHLIGHTS

| FIXED INCOME | 5 years | 2019 |
|---|---|---|
| $102.9 B<br>Net assets as at December 31, 2019 | 4.3%<br>Annualized return | 8.9%<br>Return |
| | $18.6 B<br>Investment results | $8.2 B<br>Investment results |

### 5 portfolios

**Rates**

**Credit**

**Short-Term Investments**

**Long-Term Bonds**

**Real-Return Bonds**

#### Benefits

Diversifies the overall portfolio's risk

Enables depositors to match their assets and liabilities

Substantial source of liquidity

As at December 31, 2019, the **Fixed Income** portfolio represented a little more than 30% of CDPQ's overall portfolio. It is comprised of:

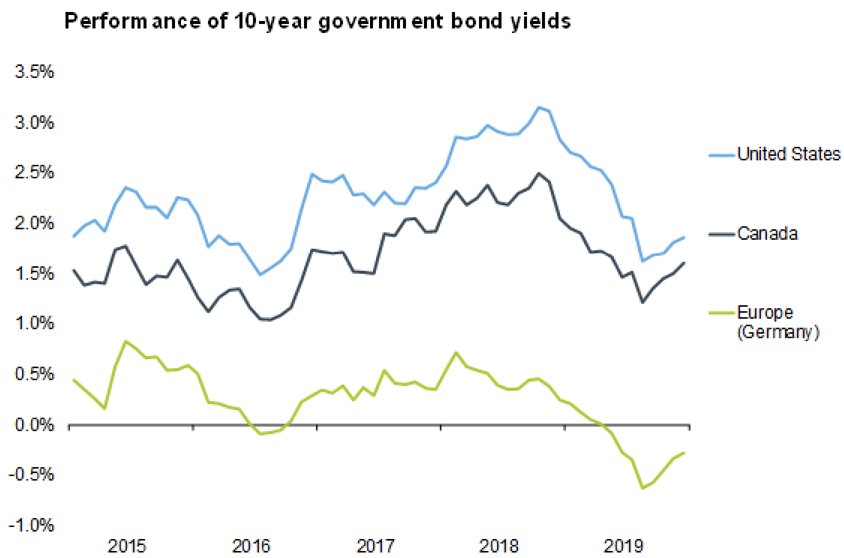
- Two actively managed portfolios:
  - **Rates,** which includes more traditional government bonds and represents CDPQ's primary source of liquidity.
  - **Credit,** which includes corporate credit, real estate debt, specialty finance and sovereign credit mandates.
- Three indexed portfolios:
  - **Short-Term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

Exposure to assets with lower risk plays a critical role in CDPQ's portfolio construction, including in managing liquidity, and in generating stable and predictable long-term income.

## Market conditions

At the end of 2019, 10-year U.S. and Canadian government bond yields were below their levels from five years ago. In Europe, yields were sharply below the levels at the end of 2014, especially in Germany, where they were in negative territory. The change in yields over the last five years can be divided into three phases.

The first corresponds with a decrease in yields from mid-2015 to the end of 2016, which stems from the interruption in economic recovery due to China's unexpected slowdown in 2014. That triggered a contraction in global manufacturing activities, a decrease in the price of risky assets and the collapse of oil prices, with negative repercussions on the U.S. and Canadian energy sectors. At the time, Chinese authorities adopted major budgetary and monetary stimulus measures while many developed economies implemented more accommodating monetary policies.




The second phase, from the end of 2016 to the end of 2018, featured synchronized global economic recovery, stimulated by monetary easing measures and favourable financial conditions around the world.

In the United States, growth was also boosted by lower taxes, which supported household income and risky assets in 2018. This environment allowed the central banks of developed countries to consider normalizing their monetary policy. As such, the U.S. Federal Reserve (the Fed) and the Bank of Canada embarked on a cycle of key rate hikes. The Fed also began reducing its balance sheet, and the European Central Bank (ECB) ended its quantitative easing policy. In this context, U.S. bond yields exceeded the 3% mark in 2018.

The third phase was marked by bond yields ceasing to rise toward the end of 2018 and by a sharp decline in yields in 2019 resulting from several factors:

- The Fed putting monetary tightening on hold, in light of sharply deteriorating financial conditions, followed by three interest rate decreases in 2019.
- Rising uncertainty due to the situation with U.S. trade policy.
- The risk of a no-agreement Brexit and the political environment in Europe, which added uncertainty.
- The absence of a lasting signal of rising inflation in a majority of developed economies.

At the end of 2019, signs of stabilizing economic conditions and easing uncertainties on world trade put an end to falling sovereign bond yields.

In Canada, bond yields largely followed the direction of U.S. yields over the last five years. In August 2019, the 10-year yield plummeted to a low. In Europe, yields fell to historic lows in 2019, with German 10-year bond yields having settled into negative territory. The decline of the economic environment in the euro zone and the expectation that the ECB would adopt new monetary softening measures drove yields down in 2019.

# Portfolio returns

Over five years, Fixed Income portfolios have posted an annualized return of 4.3% and generated investment results of $18.6 billion. This represents $3.9 billion of value added compared to the benchmark index. This performance demonstrates the merits of CDPQ's strategic shift in recent years, which aims to diversify sources of return through increased exposure to global markets and segments with more attractive profiles. Today, credit activities count for nearly two thirds of the asset class and contribute significantly to the return. Together, the five portfolios delivered results that greatly exceeded expectations in 2019, surpassing $100 billion in net assets.

## RATES

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

| $31.2 B<br>Net assets as at December 31, 2019 | 5 years | 2019 | |
|---|---|---|---|
| | This portfolio was created in 2017. | 4.8%<br>Return | 5.2%<br>Benchmark |

$1.5 B
2019 investment results

**Return since its creation**

Since 2017, the portfolio has generated $2.9 billion of investment results, more than half of which were generated in 2019. It created $140 million in value added compared to its benchmark index.

**2019 return**

The portfolio recorded a 4.8% return, which was attributable to the current yield of stocks and the change in rates. The decrease in yields during the year was a major performance driver, as was the narrowing of credit spreads, which helped provincial bonds. However, the return of accommodative monetary policies around the world and the downtrend in long-term yields slightly curbed the portfolio's performance, given its positioning. In Canada, the decrease in yields was driven by weak economic growth and the returning risk of recession.

## CREDIT

This portfolio targets higher returns than the more traditional bond market by diversifying sources of value. It includes a broader range of instruments with fixed income characteristics. As at December 31, 2019, the activities were divided into four main mandates: corporate credit, real estate debt, specialty finance and sovereign credit, which targets sovereign securities in growth markets.

| 66.4 B<br>Net assets as at December 31, 2019 | 5 years | 2019 | |
|---|---|---|---|
| | This portfolio was created in 2017. | 10.9%<br>Return | 9.3%<br>Benchmark |

$6.2 B
2019 investment results

**Return since its creation**

Since 2017, the portfolio has generated investment results of $9.6 billion and value added of $2.5 billion compared to its benchmark index.

**2019 return**

The return was 10.9%, amounting to investment results of $6.2 billion. This performance is the result of the quality of the assets in the portfolio, on the one hand, and decreasing yields and narrowing credit spreads across the various markets, on the other. The main management mandates all contributed to the portfolio's performance, particularly corporate credit and sovereign credit.

Corporate credit drew on its strong exposure to high-yield securities and a favourable allocation to investment grade securities. Sovereign credit benefited from the compression of credit spreads and falling sovereign yields in growth markets. Specialty finance – which includes project finance activities – and real estate debt also contributed to the performance, notably through the high current yield specific to this kind of asset.

In 2019, CDPQ continued to expand its credit activities, conducting major transactions, including:

- La Coop fédérée: $300 million in financing, alongside Fonds de solidarité FTQ, Fondaction and Desjardins Capital, to fund the acquisition and real estate investment projects of the largest agri-food company in Québec.
- Lightsource BP: A £150 million loan to this world leader in its industry that finances, develops and operates solar energy projects over the long term, to create a solar asset financing platform.
- Medavie Inc: A $75 million subordinated private debt investment, which could be increased to $100 million, to support the advancement of the strategic objectives of this Canadian non-profit that operates Medavie Blue Cross.

## 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 | | 2019 | |
|---|---|---|---|---|
| $0.9 B<br>Net assets as at December 31, 2019 | 1.0%<br>Annualized return | 0.9%<br>Benchmark | 1.7%<br>Return | 1.6%<br>Benchmark |

$128 M
5-year investment results

**Returns**

Over five years, the portfolio recorded an annualized return of 1.0%, which demonstrates the low-yield environment during the period. It produced investment results of $128 million.

In 2019, the portfolio posted a 1.7% return, which is entirely due to the current yield of securities. That yield remained stable during the year, given that the Bank of Canada held the key rate steady in conditions of economic and geopolitical uncertainty.

## 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 | | 2019 | |
|---|---|---|---|---|
| $3.1 B<br>Net assets as at December 31, 2019 | 5.4%<br>Annualized return | 5.3%<br>Benchmark | 12.6%<br>Return | 12.5%<br>Benchmark |

$722 M
5-year investment results

**Returns**

The portfolio's annualized return was 5.4% over five years, representing $722 million in investment results. This performance mainly stems from the current yield of securities, as well as a price effect due to the decrease in long-term rates in Canada and Québec over the period.

The portfolio generated a return of 12.6% in 2019, as long-term rates declined over the year, benefitting securities with long maturities.

## REAL-RETURN BONDS

This indexed portfolio aims to protect CDPQ's overall portfolio against rising Canadian inflation rates. For clients who choose to allocate capital to it, the portfolio is also intended to better match assets with liabilities, which are sensitive to rising inflation.

**$1.3 B**
Net assets as at December 31, 2019

| 5 years | | 2019 | |
|---|---|---|---|
| 2.8% Annualized return | 2.8% Benchmark | 8.0% Return | 8.0% Benchmark |

**$166 M**
5-year investment results

### Returns

The portfolio generated an annualized return of 2.8% over five years, adding $166 million to investment results. This performance is mainly due to rising inflation over the period, whereas real rates decreased. The current yield of securities also contributed, but to a lesser extent, due to the low interest rate environment.

In 2019, the portfolio posted an 8.0% return, primarily the result of lower real rates. The consumer price index, which is used to calculate inflation, increased 2.2% over the year.

## Investment results for Fixed Income portfolios

| As at December 31, 2019 | 5 years | | | | 2019 | | |
|---|---|---|---|---|---|---|---|
| Specialized portfolios | Net assets $M | Investment results[1] $M | Return % | Benchmark % | Investment results $M | Return % | Benchmark % |
| Rates | 31,241 | 2,872 | N/A | N/A | 1,456 | 4.8 | 5.2 |
| Credit | 66,413 | 9,629 | N/A | N/A | 6,234 | 10.9 | 9.3 |
| Short-Term Investments | 882 | 128 | 1.0 | 0.9 | 15 | 1.7 | 1.6 |
| Long-Term Bonds | 3,072 | 722 | 5.4 | 5.3 | 362 | 12.6 | 12.5 |
| Real-Return Bonds | 1,282 | 166 | 2.8 | 2.8 | 98 | 8.0 | 8.0 |
| **Fixed Income** | **102,890** | **18,640** | **4.3** | **3.4** | **8,165** | **8.9** | **8.0** |

1. The total includes the history of closed portfolios.