Sun Life Opportunistic Fixed Income Private Pool

FUND COMMENTARY | Q4 2020

Opinions and commentary provided by Wellington Management.

Portfolio review

Global fixed income sectors generated positive returns over the fourth quarter of 2020. Encouraging vaccine developments propelled market confidence despite growing global COVID-19 infections and the U.K.'s formal exit from the European Union. Most fixed income spread sectors outperformed as global credit spreads tightened, U.S. presidential elections concluded and major central banks enacted policies aimed at mitigating economic risks. Sovereign yield curves generally steepened outside Europe as easy central bank policies anchored front-end yields, while the prospect of additional fiscal stimulus lifted inflation expectations. The U.S. dollar (USD) weakened versus most currencies.

The portfolio was generally positioned to take advantage of the Q4 market environment, realizing positive performance from all three of the strategy's performance drivers: strategic sector, market neutral and tactical. The unprecedented events of 2020 certainly stress-tested the Fund's framework, highlighting the value of active management and dynamic sector rotation. The Fund's strong results in Q4 support the portfolio manager's belief that the Fund's construction offers an optimal blend of high conviction ideas drawn from insights of Wellington's credit, macro, and sector-specialist teams, while still offering the "anchor to windward" desired from bonds.

In Q4, strategic sector positions were the strongest contributor. The emerging market opportunities theme, which combines exposure to emerging markets external and local debt, provided the largest positive impact, as declining yields and underperformance of the U.S. dollar fueled a 9% total return from this asset class. Also contributing positively to performance were holdings in the dislocated credit (U.S. high yield) and activist government themes (inflation-linked bonds), as the conclusion of the U.S. election and expectations for larger fiscal and monetary stimulus led to a rally in risk assets and a 43 basis point rise in U.S. 5-year breakeven spreads.

Market neutral strategies modestly contributed to returns for the quarter and the Fund realized positive contributions from a number of currency strategies. Long positions in the Australian dollar (AUD) and Swedish Krona (SEK) contributed favorably after gaining 4.8% and 4.2%, respectively, versus the U.S. dollar.

The AUD was the best-performing G-10 currency. Strong economic data and rising commodity prices offset concerns over COVID-19. The SEK outperformed as economic data continued to surprise to the upside. Partially offsetting these results were long U.S. dollar positions implemented in anticipation of weakening U.S. economic data relative to the rest of the world.

Tactical strategies also contributed favorably, led by exposures to bank loans, convertibles and high yield, as non-IG sectors significantly outperformed higher quality credit for the quarter. The Fund's ~9% exposure to bank loans contributed to returns as the sector returned 1% in December, according to the S&P/LSTA Leveraged Loan Index. The trailing 12-month loan default rate by par amount ended December at 3.8% and the portfolio manager believes there may be further improvement as continued fiscal and monetary stimulus, along with a gradual vaccine-enabled reopening in the second half of 2021, should all help to ease pressure on many businesses.

Portfolio positioning

The portfolio manager believes recessions can wipe the slate clean and potentially lead to new investment and consumption patterns. In the portfolio manager's view, the dominant theme of the last cycle from the global financial crisis (GFC) to the COVID-19 pandemic was likely the market embracing global secular stagnation – the idea that productivity, growth and inflation will all remain perpetually low. The portfolio manager believes U.S. credit – and particularly investment grade credit – has been the sector that has benefitted most from this environment. For the decade, investment grade credit returned an average of 5.4 per annum with 5.1% volatility – which is considered an attractive return/risk combination.

Looking into 2021 and beyond, the portfolio manager believes there are initial signs that the secular stagnation narrative of the last ten years may not hold in the coming decade. Though there are many longer-term causes of secular stagnation, like demographics, three of the most important sources – the global savings glut, monetary policy focused on reducing inflation and lack of investment spending – are all seemingly beginning to reverse.

- ***Global savings glut*** – For the past 20 years, consumption has been suppressed. First, current account surplus countries were trying to grow their manufacturing capabilities. Then, after the GFC, consumers globally focused on balance sheet repair. The COVID-19 crisis changed both conditions. The largest current account surplus countries are now focused on rebalancing their economies toward domestic consumption. Housing markets are also thriving, which has the potential to give consumers the confidence to draw down savings now that balance sheets are repaired.
- ***Monetary policy*** – Over the last 40 years, monetary policy was dedicated to bringing inflation down to 2%. This has meant that the U.S. Federal Reserve has hiked interest rates whenever wage inflation started to rise. But the Fed's recent policy statement revision seems to mark a shift in its monetary policy. The Fed is now seeking to purposely lag inflation, stating plans to keep the policy rate at zero until the unemployment rate is at levels consistent with full employment and inflation is above its target.
- ***Investment spending*** – Over the past 20 years, the U.S. economy has seen a dearth of non-residential investment spending – the most important factor in productivity growth. In the aftermath of COVID-19, additional fiscal spending is expected to focus on infrastructure and other green investments that could lift structural growth rates. Biden's selection of Pete Buttigieg as the Secretary of Transportation and other climate-related appointments speak to the importance of this spending to the new administration.

How we can adapt

While the portfolio manager does not anticipate a substantial increase in yields for 2021, they believe several of the decades-long forces that allowed U.S. fixed income and equity assets to outperform the rest of the world may now be reversing. Consistent with the Fund's philosophy and process, the portfolio manager believes the following factors are important considerations for positioning the Fund in this new environment: go global, look at niche asset classes, and embrace absolute-return investing.

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Go global

U.S. Treasuries and corporates are trading at negative real yields (i.e., adjusted for inflation expectations). In the next downturn, it is unclear whether core fixed income will offer its same historical benefits – a source of total return and an anchor to windward in times of stress. The portfolio manager believes 'going global' is important in addressing this uncertainty. Within the Fund's strategic sectors allocation, the Core Challenges theme, which seeks to find global government bond markets such as Israel, China, Singapore, and South Korea that might perform these traditional fixed income functions.

Additionally, as the long-term disinflation trend may be reversing, the portfolio manager increasingly favors global inflation-linked bonds as part of the activist governments theme.

Explore niche opportunities

The 60/40 U.S. equity/bond portfolio had one of its best decades ever. However, given current valuations, the portfolio manager believes there are opportunities in less traditional sectors that may offer higher total returns. The Fund's EM opportunities theme looks for EM countries with high local real yields and that have broken the structural back of inflation. EM local bonds were the worst performing fixed income sector of the last decade and, the portfolio manager believes, history doesn't often repeat itself.

Similarly, given increased dispersion in credit and the low recovery rates on defaulted bonds in this cycle, the portfolio manager believes this may be the time to rethink credit allocations. The Fund is focusing on COVID-19 recovery stories with good industry structures, dislocated credit where asset coverage well exceeds debt, and bank loans (as it is the one U.S. credit market not to benefit over the past decade, and valuations are currently attractive). Finally, in the TALF Trickle-down allocation, the strategy favors structured products that were left behind by the Fed's emergency programs.

Embrace absolute return

With yields declining over the past 40 years, absolute return allocations or long/short investing has not been a consideration for many fixed income investors, as most fixed income sectors' returns exceeded expectations. However, the COVID-19 crisis demonstrated how quickly volatility can spike and the limited capacity for markets to accommodate flows in time of stress. The portfolio manager continues to view absolute return strategies as both a return enhancer and a portfolio diversifier. The Fund has also favored currency strategies recently, as the portfolio manager anticipates volatility and dispersion might make its way into currency markets in 2021, as most policy rates globally are stuck at or near zero.

Bottom line

The events of 2020 demonstrated that this cycle could be unlike anything the markets have faced before. It is portfolio manager's belief that strategies that can dynamically tilt allocations to attractive areas of the market are particularly relevant in this rapidly evolving environment.

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Fund performance

COMPOUND RETURNS %[1]	Since Inception[2]	3 Year	1 Year	Q4
Sun Life Opportunistic Fixed Income Private Pool - **SERIES A**	0.9	2.2	6.9	2.3
Sun Life Opportunistic Fixed Income Private Pool - **SERIES F**	1.9	3.3	7.9	2.6
Bloomberg Barclays Global Aggregate Bond Index (C$ Hedged)	3.4	4.6	5.3	0.8

[1]Returns for periods longer than one year are annualized. Data as of December 31, 2020.
[2]Partial calendar year. Returns are for the period from the fund's inception date of June 6, 2016 to December 31, 2016.

On May 24, 2019 Sun Life Opportunistic Fixed Income Fund, previously Sun Life Multi-Strategy Return Fund, changed its name and underwent a change in investment objective to seek exposure to diverse global fixed income strategies; it is structured as an alternative mutual fund. The sub-advisor assumed portfolio management responsibilities at that time. On February 26, 2020 Sun Life Opportunistic Fixed Income Fund was renamed to Sun Life Opportunistic Fixed Income Private Pool.

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While Series A and Series F securities have the same reference portfolio, any difference in performance between these series is due primarily to differences in management fees and operating fees. The management fee for Series A securities also includes the trailing commission, while Series F securities does not. Series A securities of the fund are available for purchase to all investors, while Series F securities are only available to investors in an eligible fee-based or wrap program with their registered dealer. Investors in Series F securities may pay a separate fee-based account fee that is negotiated with and payable to their registered dealer.

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