The Nexus Report

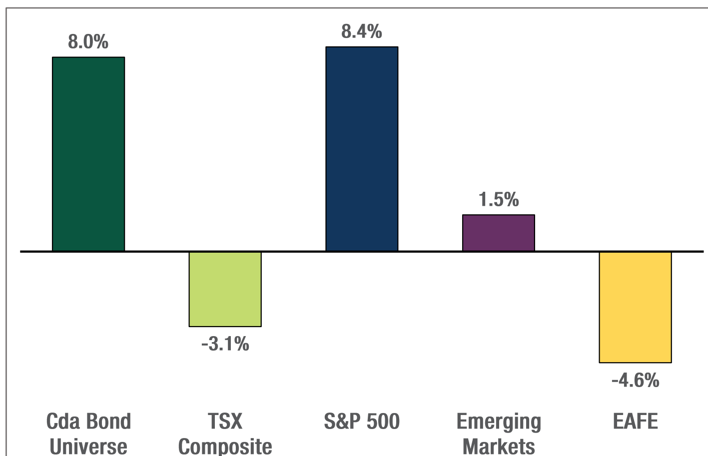
Third Quarter, 2020

Investment Outlook 1
Asset Class Review 3
Pooled Fund Reports 5

Investment Outlook

Further Gains on Wall Street

Stocks around the world recorded solid gains over the last quarter. In Canada, the TSX Composite gained 4.7%.[1] The S&P 500 in the U.S. was even better as it rose 6.6% in Canadian dollar terms, a strong gain in the face of headwinds from a weaker U.S. dollar (it was up 8.9% in U.S. dollar terms). International markets were also good as stocks in developed international markets (EAFE) returned 2.6% and emerging markets jumped 7.2%.



2020 Year-to-Date Total Returns (C$)

The strong gains of the last two quarters go a long way to repairing the damage inflicted on investment portfolios in late February and March as the COVID-19 pandemic swept the world and shut down economies. Nonetheless, despite a remarkable recovery over this period, both the TSX and EAFE remain in negative territory over the full nine months of 2020: the TSX was down 3.1% and EAFE was down 4.6%.[2]

Emerging markets managed to generate a year-to-date gain, but only a modest one of 1.5%.[2] The outlier in global markets has been the strength of the U.S., with the S&P 500 providing a total return of 5.6% in U.S. dollar terms (8.4% in Canadian dollars). Over the last six months, the S&P had its strongest two-quarter advance since 2009 and is now up 51.8% from the March 23 low.[3] Also remarkable over the first nine months of 2020 has been the Canadian bond market. The FTSE Canada Universe Bond Index generated an 8.0% return[2] as bond yields fell to previously unimaginably low levels.

While the TSX Composite's strong recent performance has brought the Index back from its depths, the experience of most investors is not as good as the Index overall. The Canadian stock market has been supported by a few star performers in 2020: technology company, Shopify, as well as the major gold mining stocks. Together, these few companies contributed over 1,000 points to the TSX Index. Thanks to this contribution, the TSX Index level was down only 5.5% in the first 9 months of 2020. Excluding these few stocks, the rest of the TSX was down 12.9%.[4]

Caution Lingers on Main Street

For many investors, there is a disconnect between the strength of the recovery enjoyed on "Wall Street" and the strength of the recovery experienced by the average citizen on "Main Street". The former is a lot more robust than the latter. Moreover, three months ago there was a lot of debate over what letter of the alphabet the shape of the economic recovery would most resemble: would it be a quick recovery in the pattern of a "V"? A more gradual one like a "U"? A see-saw one like "W"? We hope it will not be shaped like an "L". Recently, it seems like the recovery might most resemble a "K" – some businesses have rebounded like gangbusters while others have

[1] All returns are total returns expressed in Canadian dollars in this paragraph.
[2] Total returns in Canadian dollars.
[3] Total return in U.S. dollars.
[4] Returns excluding dividends. Excluded stocks are Shopify and six gold company stocks.

languished. In general, goods-producing businesses have recovered nicely while service businesses have struggled.

On the positive side, there has been an epic home sales boom on both sides of the border. In the U.S., new home sales topped a one million unit annual rate in August, the strongest month since 2006.[5] In both Canada and the U.S., buyers are looking for more space to accommodate an indefinite work-from-home scenario. Many also realize that the suburbs may be more attractive if proximity to city centres is not as important as it used to be. Buyers also are taking advantage of ultra-low mortgage rates.

There is also lots of anecdotal evidence to suggest consumers are not being shy with their wallets. General Motors reports huge demand for light trucks and SUVs as it frantically tries to replenish inventory to keep up with better-than-expected sales. U.S. discount chain, TJ Maxx, reported more traffic in its stores as it re-opened this summer than it had last year at the same time. Consistent with this, in September, the Conference Board in the U.S. reported the biggest month-over-month surge in consumer confidence since 2003. Also in September, the U.S. Institute of Supply Management manufacturing survey came in at 55.4. While this is lower than the survey in August, it is still comfortably above 50, the level that portends economic expansion in the months ahead.

Notwithstanding a number of these positive trends, investors are worried the recovery may be running out of steam. Most prominent in the data reflecting a slowdown is the U.S. labour market report for September. While 661,000 new jobs were created in September, this was almost 200,000 fewer than expected and fewer than half the 1.4 million new jobs created in August. While the unemployment rate fell more than expected – to 7.9% – it did so mostly because a large number of Americans left the work force, itself a worrisome trend.

Perhaps the most significant concern about the U.S. labour market is that, of the 22 million jobs lost in March and April, the U.S. economy has recovered only 11.4 million. Nearly 11 million Americans remain out of work. It may take years, not months, to recover the remaining jobs. Moreover, in recent weeks, some of the temporary layoffs that occurred early in the lockdown appear to be becoming more permanent. Disney announced it was eliminating 28,000 jobs in its theme parks. United Airlines and American Airlines cut more than 32,000. Defense contractor, Raytheon, reduced headcount by 15,000.

In Canada, the recovery also appears to be decelerating. Hotel occupancy in mid-September was down 53% year-over-year, the weakest level since July. Domestic air travel was 21% lower than it was four weeks earlier.[6] The recently reported Canadian trade figures disclosed that exports fell 1% in August after strong positive growth in June and July. Imports were down 1.2%. The velocity of trade, a critical contributor to Canadian prosperity, is clearly slowing.

Market Outlook

Investors have a lot to digest in the coming months. Will a second wave of COVID infections result in more economic lockdowns? When will a vaccine be widely available? When will there be more effective testing or treatments for the disease? Will the U.S. election on November 3 produce a timely and orderly result? Will Britain and the EU agree on terms for Brexit before the December 31 deadline? How will countries around the world – Canada included – deal with growing tensions with China?

Most of this uncertainty will be resolved. We don't know how long it will take to roll out an effective vaccine, but we are confident that the COVID beast eventually will be tamed. The U.S. election will be resolved, one way or the other. Through this uncertain period, governments and central banks are doing their best to keep the economy and markets stable. According to Bank of America analysts, global central banks are buying $1.5 billion of bonds *per hour* in pursuit of this goal.[7]

Thankfully, we don't need to predict what twists and turns these many issues will take over the next few months. Our investment approach is focused on the long term, so our attention is concentrated on the impact that these issues will have on the long-term prospects for companies in which we are invested, and ones in which we are considering investing. For certain, some things will change. COVID and the attendant economic lockdown accelerated the development of eCommerce, a trend well established but now much more advanced. While we believe that most offices eventually will get re-populated, there seems little doubt that office routines will become more flexible and work-from-home options more available. While these are two of the more obvious trends arising from the turmoil of 2020, it is easy to see that some companies are positioned to benefit from them and others will be more challenged.

We have commented frequently over the last couple of years that bonds are likely to provide little in the way of investment returns over the years ahead. While they do still provide the important attribute of stability, many investors will want to re-think how much they really need committed to this traditional asset class. If appropriate, taking on a little more equity risk is likely to serve most investors well over the long term. With a patient and disciplined approach to choosing high quality stocks, we are as confident as ever that good long-term returns can be achieved.

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[5] *Barron's,* September 25, 2020.

[6] *The Globe & Mail*, September 30, 2020.

[7] *The Globe and Mail*, September 29, 2020.

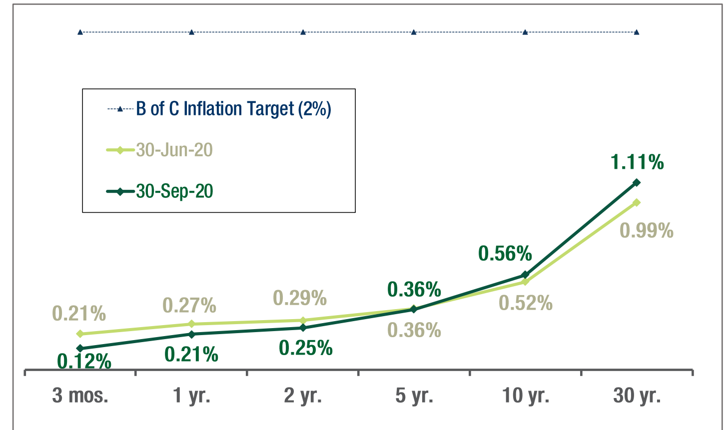
Asset Class Review

Fixed Income

Interest rates remained low and were little changed last quarter. As we said in our last report, there is not much room for policy rates such as the Bank Rate or Fed Funds Rate to fall further because interest rates are at what economists call the “lower bound” of monetary policy settings. But that doesn’t mean that central banks are out of tools to continue to support markets. They continue to buy assets in the markets (and they could do more) as well as communicate a policy of forward guidance that extends investor expectations of how long the current extraordinary intervention will continue.

In the U.S., Fed Chairman Powell used the annual Jackson Hole Conference to describe a new approach to inflation targeting. Because inflation has consistently undershot a target of 2% for many years, the Fed has adopted a new approach that would delay any tightening of monetary policy until inflation had made up, on some average basis, the cumulative shortfall of prior low inflation. This means that as the economy recovers, and we get a cyclical pick-up in demand, the Fed will not be withdrawing stimulus as quickly as it has historically. In Canada, things are a little different, but the messaging to markets is similar. At the end of the quarter, new Bank of Canada Governor, Tiff Macklem, gave an extensive interview to *The Globe and Mail* in which he provided Canadians some insight into his thinking. To paraphrase, if he learned anything from past crises, it was that timid responses were a mistake. When confronted with a crisis, the best response is to “Crush it.“[8] Nexus will take both these men at their word and assume that monetary policy will remain exceptionally easy for a considerable time.

Especially in Canada, these explicit commitments to ultra-easy monetary policy are meant to deflect concern that one day the supply of debt will overwhelm demand and that interest rates will be forced higher to attract capital. We are sympathetic to that point of view, but not consumed by it. For now, we accept that the Bank of Canada can serve as a cornerstone buyer of the debt that arises from the rapid expansion of our deficit. However, the worry of how government debts will eventually be repaid is of secondary concern to the basic unattractiveness of investing at rates below inflation. (See chart) Accordingly, the core of our holdings is in bonds of shorter maturity that will not fall in value the way longer-term bonds will if rates rise. The duration of our portfolio is 3.8 years as compared to the FTSE Canada Universe Bond Index of 8.4 years. On the credit front, almost 90% of our holdings are rated AA or better and we hold no BBB-rated securities.[9] It is a portfolio designed for liquidity and capital safety.



Government of Canada Yield Curve

The third quarter was a busy one for new issuance and we used the opportunity to make refinements to our holdings. Demand for new issues was strong and credit spreads continued to narrow. An index of investment grade corporate bond spreads narrowed from 1.60% at the end of June to 1.38% at the end of September.[10] Because over half the portfolio is invested in highly-rated corporate securities, we enjoyed some lift to assets values from this continued trend. While the general level of interest rates didn’t change much, there was a slight steepening of the yield curve. Two-year yields fell 4 basis points (from 0.29% to 0.25%), while ten-year yields rose 4 basis points (from 0.52% to 0.56%).[11]

The bond return in our Income Fund was 1.1% for the quarter, while the FTSE Canada Universe Bond Index returned 0.4%. Over the last 12 months, our bond holdings returned 6.0%, which trailed the index’s 7.1% return.

[8] “Crush It: Bank of Canada Governor Tiff Macklem Says a Crisis is No Time For Half Measures”, *The Globe and Mail*, October 2, 2020.

[9] Returns and credit information are for the bond portion of the Nexus North American Income Fund, which serves as the model for all bond portfolios at the firm.

[10] Bloomberg Barclay Canadian Aggregate Corporate Average OAS Spread Index.

[11] A basis point is one-hundredth of one percent.

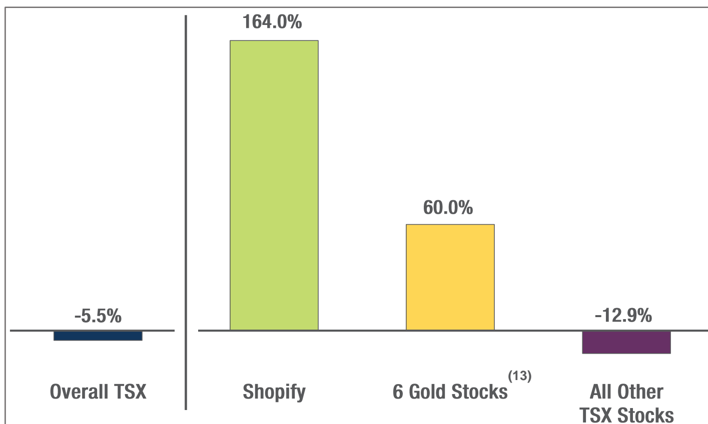
Equities

Last quarter, markets continued to recover from the COVID-19 bear market. The Equity Fund was up 3.3% in the quarter and now has a slight positive return of 0.4% for the 12 months.[12]

Our equities lagged the blended benchmark in the quarter, which was up 5.3%, and lagged over the full 12 months, with the blended benchmark up 7.2%. Our U.S. and international equities performed strongly over the 12 months, so all the lag stemmed from our Canadian stocks. The underperformance, explained more fully below, is largely driven by the strong performance of a handful of stocks in Canada that we don't own as they don't fit with our investment approach. In addition, we hold some Canadian equities that, although they are quality stocks at reasonable valuations, are struggling in COVID. As an active manager with a "quality companies with a reasonable valuation" investment approach, we are invested differently than the overall markets. As such, periods of under-performance (such as occurred in the 2000 tech bubble) and out-performance are inevitable. COVID-19 has been unusual as it has favoured some companies that are normally cyclical, and substantially hurt other quality companies that will eventually recover. We are carefully monitoring all of our holdings and remain comfortable with their business prospects.

Canadian Equities

Nexus's Canadian stocks returned 1.5% in the quarter, but are down 15.6% for the last 12 months. By comparison, the TSX was up 4.7% and flat over the same periods.



Year-to-Date (to Sept 30, 2020) Price Return of TSX Stocks

To explain our Canadian underperformance, the chart shows the year-to-date return of various segments of the TSX Index. The overall TSX Index's price return (excluding dividends) is down 5.5% year-to-date, but seven stocks have had a strong positive effect on the TSX. Without these, the rest of the TSX stocks have fared poorly, with a weighted price return for the other 217 companies of minus 12.9%.[14]

Shopify, a software company that provides services to online merchants, is up 164% this year. It is the largest company in the TSX by market capitalization, but has yet to report an annual profit. The returns for the top 6 gold stocks in the TSX average 60% year-to-date. Given our investment philosophy of buying quality stocks at a reasonable valuation, Shopify doesn't fit our investment criteria for profitability or valuation. While the gold companies have periods of strong performance, they have been poor stewards of investors' capital and poor performers over the long term.

Several of our Canadian holdings, such as Metro, Alimentation Couche-Tard, Toromont and Brookfield Infrastructure, have been resilient year-to-date, but others are struggling. These include our energy, pipeline, and real estate holdings, as well as CAE (which serves the pilot training market) and ATCO (an Alberta utility). These are quality companies trading at reasonable valuations, which have strong recovery potential beyond COVID.

U.S. Equities

Our U.S. equity portfolio increased 4.1% last quarter (the S&P 500 returned 6.6%) and 16.6% over the past 12 months, slightly outperforming the S&P 500 which rose 16.0%.[15]

In the quarter we had several strong performers, such as Facebook and General Motors, and especially UPS. Several stocks fell, including two value tech names (Cisco and Western Digital), as well as Gilead and Citigroup. Given particularly strong valuations, we trimmed Microsoft and sold Apple. We added two new medical device holdings, Medtronic and Boston Scientific, which are quality healthcare companies with favourable trends from an aging population but, with the deferral of elective surgeries during COVID, both have traded down to appealing valuation levels.

Other Equity Investments

We remain invested in two externally-managed pooled funds, which add international exposure and diversification to our Funds.[16] Both have performed strongly, adding to our overall equity returns and outperforming their respective international indices. For the quarter, EQIT (international developed market equities) returned 4.9% and EMEC (emerging market equities) 11.2%. For the 12 months, their returns were 6.8% and 18.9% respectively. For more information on EQIT and EMEC, please see the Nexus International Equity Fund section of this report.

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[12] All the return data in this section are total returns for the Equity Fund. Equity returns within the Balanced Fund were similar. For specific performance, please refer to the Fund reports that follow or your client-specific report.

[13] Simple average return of the six precious metals stocks that contributed the most to the TSX's overall return.

[14] This occurs because the TSX Index is market capitalization weighted, so the largest companies have an outsized effect on the overall index return.

[15] Except where indicated, all foreign returns are measured in Canadian dollars.

[16] Both are managed by teams from JPMorgan Asset Management in the U.K. and are held in our Equity and Balanced Funds.

Pooled Fund Reports

Nexus North American Equity Fund

The Nexus North American Equity Fund delivered a second consecutive quarter of gains, rising 3.3% in the third quarter. This advance built on the even stronger returns achieved last quarter. Performance in both quarters reflects optimism that a recovery remains underway. Third quarter corporate earnings and economic data were generally supportive of this optimism, while incremental progress on COVID-19 treatments and vaccines also helped underpin confidence in a recovery.

Our performance over the last 12 months was slightly positive, but with mixed results beneath the surface. We had solid gains in our U.S. holdings which were almost entirely offset by a very challenging period for our Canadian stocks. For a more detailed discussion of our Canadian performance, please refer to the Canadian Equities section earlier in this report.

More detail on the Fund's performance is presented in the table below.

In Canada, our holdings gained 1.5% in the quarter but trailed the TSX which advanced 4.7%. Our lagging performance is due to several stocks with exposure to the aerospace and energy sectors, which continue to be weighed down by pandemic uncertainty. We anticipate that the uncertainty will pass and these stocks will thrive in the post-pandemic period.

Our U.S. holdings produced solid gains, rising 4.1% in the quarter. Several of our stocks performed particularly well, including UPS, General Motors and Facebook. Others fell, including two value tech companies (Cisco and Western Digital), as well as Gilead and Citigroup. We made several changes to the portfolio, including trimming Microsoft and selling Apple due to high valuations. We also added two new medical device holdings, Medtronic and Boston Scientific, which are quality healthcare companies with favourable trends from an aging population. With the deferral of elective surgeries during COVID, both have traded down to appealing valuation levels.

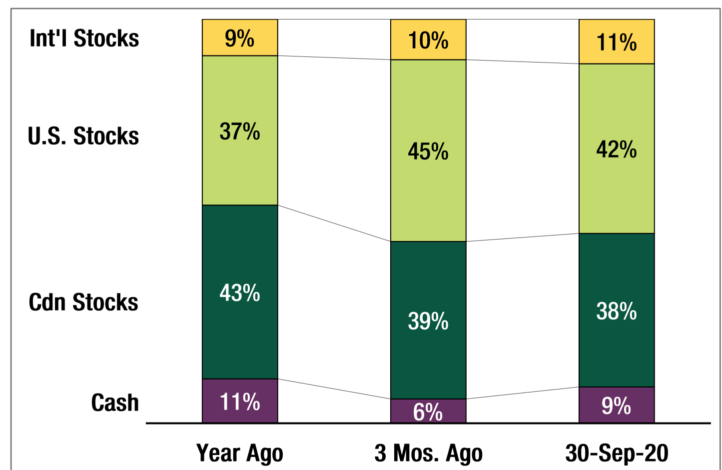
Our international holdings also delivered good results. The developed markets fund, EQIT, rose 4.9% in the quarter and the emerging markets fund, EMEC, rose 11.2%.

At the end of the third quarter, the Fund's cash position was 9%. Our allocation to Canadian stocks was 38%, while U.S. stocks represented 42% of the mix. We have maintained an allocation of 11% to markets outside North America and remain confident that this will provide important diversification to our North American investments.

	Equity Fund	Cdn Stocks	U.S. Stocks	Int'l Stocks
Quarter				
Fund	3.3%	1.5%	4.1%	7.6%
Benchmark	*5.3%*	*4.7%*	*6.6%*	
One Year				
Fund	0.4%	-15.6%	16.6%	12.3%
Benchmark	*7.2%*	*0.0%*	*16.0%*	

Returns are presented before deduction of management fees. Benchmarks are (a) for the Fund: 5% FTSE Canada 91 Day TBill, 50% TSX, and 45% S&P 500 (in C$) (rebalanced monthly); (b) for Cdn Stocks: TSX; and (c) for U.S. Stocks: S&P 500 (in C$).

Investment Returns – As at September 30, 2020



Equity Fund Asset Mix

Nexus North American Balanced Fund

The Nexus North American Balanced Fund generated a gain of 2.9% in the third quarter, with positive contributions from both bonds and stocks during the period.

Over the last 12 months, the Fund has returned 3.5%, comprised of strong gains in our bonds, U.S. stocks and international holdings, but offset by significant weakness in our Canadian stocks. For a more detailed discussion of our Canadian performance, please refer to the Canadian Equities section earlier in this report.

More detail on the Fund's performance is shown in the table below.

Fixed income markets rose slightly during the quarter and our bond holdings produced a 1.2% gain.

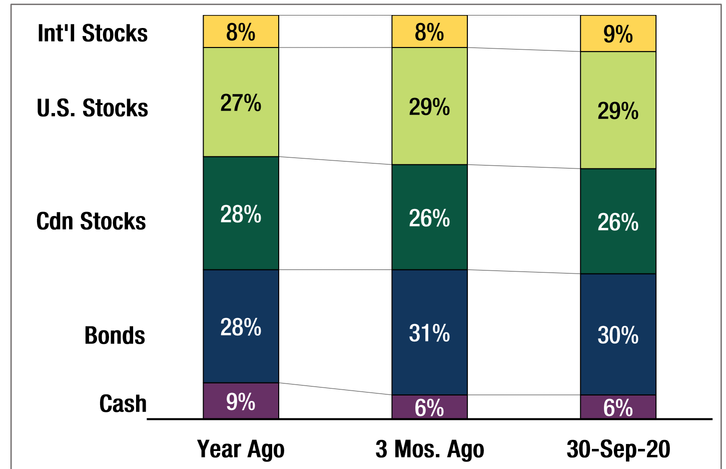
The equity holdings in the Balanced Fund generated positive returns in Q3 in both the U.S. and Canada. We made several changes to the portfolio, including trimming Microsoft and selling Apple due to high valuations. We also added two new medical device holdings, Medtronic and Boston Scientific, which are quality healthcare companies with favourable trends from an aging population. With the deferral of elective surgeries during COVID, both have traded down to appealing valuation levels. Our international stocks also delivered good 3Q results. The developed markets fund, EQIT, rose 4.9% in the quarter and the emerging markets fund, EMEC, rose 11.2%.

At the end of the quarter, cash represented 6% of the Fund's asset mix, bonds were 30% and stocks accounted for the remaining 64%. These asset allocations remain close to the Fund's long-term guideline.

	Balanced Fund	Bonds	Cdn Stocks	U.S. Stocks	Int'l Stocks
Quarter					
Fund	2.9%	1.2%	1.8%	3.9%	7.6%
Benchmark	*3.7%*	*0.4%*	*4.7%*	*6.6%*	
One Year					
Fund	3.5%	6.4%	-14.6%	17.6%	11.8%
Benchmark	*6.5%*	*7.1%*	*0.0%*	*16.0%*	

Returns are presented before deduction of management fees. Benchmarks are (a) for the Fund: 5% FTSE Cda 91 Day TBill, 30% FTSE Cda Universe Bond, 40% TSX, and 25% S&P 500 (in C$) (rebalanced monthly); (b) for Bonds: FTSE Cda Univ. Bond; (c) for Cdn Stocks: TSX; and (d) for U.S. Stocks: S&P 500 (in C$).

Investment Returns – As at September 30, 2020



Balanced Fund Asset Mix

Nexus North American Income Fund

The Nexus North American Income Fund rose 1.3% during the third quarter, a period in which interest rates remained low and largely unchanged. In the last 12 months, the Fund has generated a total return of 3.2%.

More detail on the Fund's performance is displayed in the table below.

Our fixed income portfolio is designed with liquidity and capital safety in mind. About half the portfolio is invested in highly-rated corporate securities, which received a lift last quarter from the narrowing of credit spreads during the period. The portfolio also prioritizes safety by focusing on shorter-maturity bonds which have limited downside sensitivity if interest rates rise. With rates largely unchanged in in the last three months, this was not a meaningful factor in our performance this period.

For further details on our bond performance, please refer to the Fixed Income section earlier in this report.

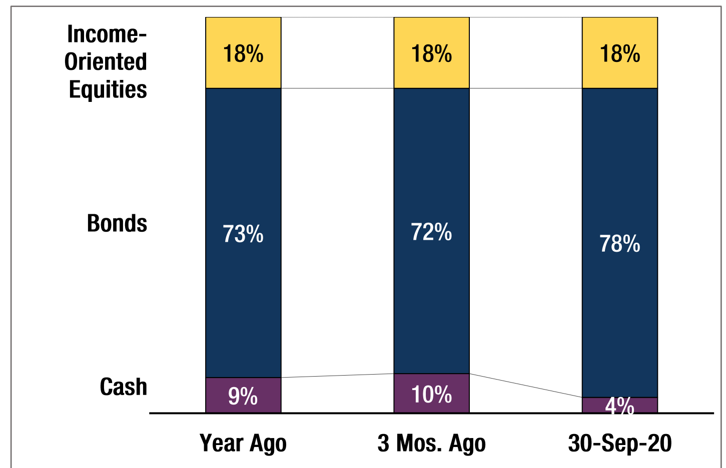
Our holdings of income-oriented Canadian and U.S. equities were positives this quarter, with a small gain in Canada and a 5% return for our U.S. stocks. Over the 12-month period, results have been much more mixed, with strong gains in the U.S. offset by losses in Canada. Over time, our allocation to equities has added significant value to the Fund. But in the current, more volatile 12-month period, the short-term return from equities has detracted from performance.

At the end of the third quarter, the Fund's cash position was 4%, income-oriented equities accounted for 18% and the balance, 78%, was in our core bond holdings.

	Income Fund	Bonds	Cdn Stocks	U.S. Stocks
Quarter				
Fund	1.3%	1.1%	0.8%	5.0%
Benchmark	*0.4%*	*0.4%*		
One Year				
Fund	3.2%	6.0%	-12.7%	9.0%
Benchmark	*7.1%*	*7.1%*		

Returns are presented before deduction of management fees. Benchmarks are (a) for Fund: FTSE Canada Universe Bond; (b) for Bonds: FTSE Canada Universe Bond. In addition to bonds, up to 20% of the Fund's portfolio may be invested in equities.

Investment Returns – As at September 30, 2020



Income Fund Asset Mix

Nexus International Equity Fund

The Nexus International Equity Fund ("NIEF") holds two underlying funds: EQIT (invested in international developed market equities) and EMEC (invested in emerging market equities).[17]

International equity markets extended their gains last quarter, building on the strong rebound achieved in the previous quarter. The key driver for these continued gains is the unprecedented fiscal support from various governments, which has helped both households and companies regain some of the ground lost since the depths of the COVID-19 crisis.

NIEF benefitted during this period of recovery, rising 7.5% in the quarter. EQIT produced a 4.9% gain and the recovery in EMEC was even stronger at 11.2%.

More detail on the Fund's performance is presented in the table below.

International developed markets advanced as re-opening efforts – although far from perfect – have shown some modicum of success. All eyes are on the prospect of second waves and renewed lockdowns in Europe but, so far, investors' worst fears have been avoided. Critical issues including Brexit and global trade relations seem no closer to positive resolutions. For now those concerns are taking a back seat to the perception of modest progress in handling COVID.

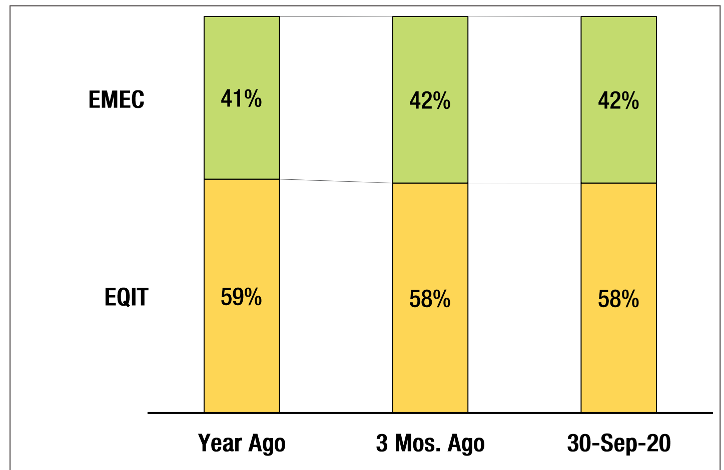
Many emerging market (EM) economies have proven more resilient than observers had anticipated at the onset of the crisis. This has helped propel many EM stock markets higher. In addition, investors appear to be looking into the post-COVID period, when many of the long-term tailwinds benefitting EM economies – young populations, rising incomes and growing industries – will resume.

At the close of the third quarter, the International Equity Fund's investment in EQIT accounted for 58%, while EMEC accounted for 42%.

	International Equity Fund	EQIT	EMEC
Quarter			
Fund	7.5%	4.9%	11.2%
Benchmark	*3.8%*	*2.6%*	*7.2%*
One Year			
Fund	11.7%	6.8%	18.9%
Benchmark	*3.8%*	*1.2%*	*11.3%*

Returns are presented before deduction of management fees. Benchmarks are (a) for Fund: 75% MSCI EAFE (in C$) and 25% MSCI Emerging Mkts (in C$) (rebalanced monthly); (b) for EQIT: MSCI EAFE (in C$); and (c) for EMEC: MSCI Emerging Mkts (in C$).

Investment Returns – As at September 30, 2020



International Equity Fund Asset Mix

[17] International developed markets or "EAFE" includes Europe, Australasia and the Far East. Emerging markets include 26 developing countries. EQIT and EMEC are managed by JPMorgan Asset Management in the U.K. The Nexus Balanced and Equity Funds have held EQIT and EMEC for some time and continue to do so.