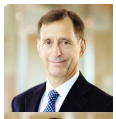
Ninepoint Fixed Income Strategy

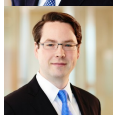
December 2020 Commentary

*Monthly commentary discusses recent developments across both the **Diversified Bond** and **Credit Income Opportunities Funds**.*

Investment Team



Mark Wisniewski,
Partner, Senior Portfolio Manager



Etienne Bordeleau-Labrecque, MBA, CFA
Vice President, Portfolio Manager

Macro

What a year it has been; starting with the euphoria induced by the US -China trade deal (remember that?), the depth of the Covid-19 health crisis in March and April, central banks deploying the largest arsenal ever seen, fiscal stimulus of a scale only matched by the New Deal, riots on the streets in the summer, the US presidential election, vaccines and the "reopening trade". All this while most of us worked from home, in what has felt like the longest running Groundhog Day.

Before going into the year's recap and our outlook for 2021, we would like to thank our clients for their continued trust and support, along with the multiple stakeholders with whom we interact with everyday to make all this possible. It has been a very challenging year at multiple levels, and we would not have been able to achieve the same level of client service and performance without everyone's support.

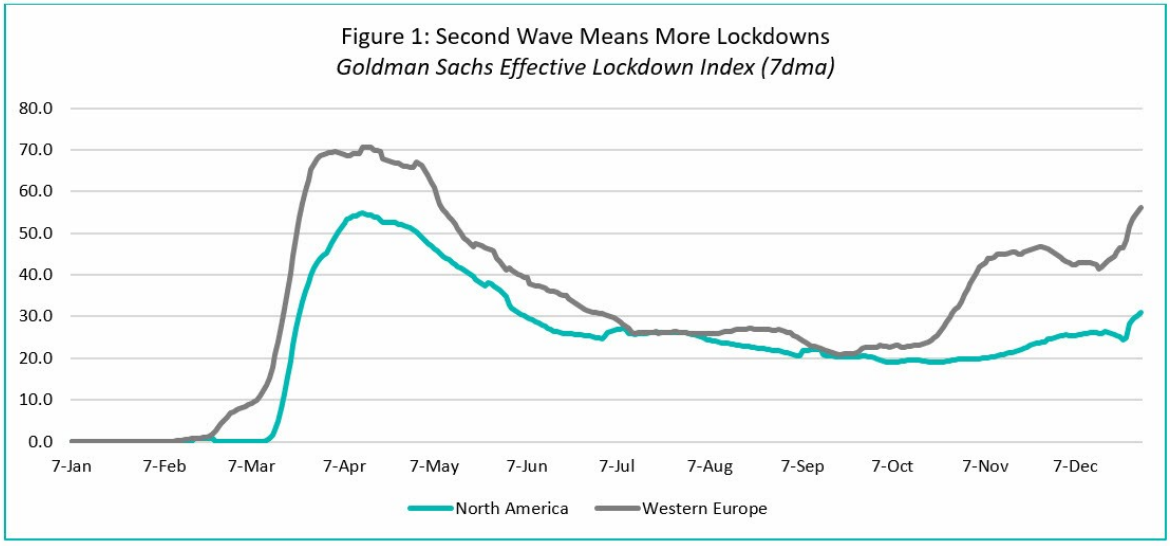
As most of our readers know, going into 2020, we were defensively positioned across our mandates. The decelerating global growth environment in 2019, which led to rate cuts by many central banks and triggered important signals such as yield curve inversion, set the stage for what we thought was the last inning in the cycle. Accordingly, we had reduced credit risk (less high yield, lower credit duration, and higher quality corporates) and increased government bond exposure. This, fortunately, allowed us to act from a position of strength. While markets were completely gummed up, even trading government bonds was a challenge, we had plenty of liquidity on hand to take advantage of the market dislocation. Eventually, the extraordinary support provided by central banks backstopped the markets, providing much needed liquidity and a return of normalcy.

By the time August rolled in, equity markets were making new all-time highs and credit spreads had narrowed very quickly. Market participants exhibited a clear sense of complacency about the risks of a second wave of Covid-19, the fiscal cliff in the US, the presidential election, etc. At that point, we did take profits on some credit positions that had done exceptionally well, anticipating a bit more volatility in the Fall.

While we did get some volatility around those events, there was a relentless optimism in the market and any dip was quickly bought. The market euphoria continued on. Nonetheless, from our perspective, 2020 was an ideal environment for our investment process. Our drawdowns were shallow, the rebound in performance was strong and we maintained the discipline and rigour that our investors have come to expect.

Going into 2021, things are looking a bit more promising, the vaccines are here, and the end of the pandemic is somewhere in sight. However, while there is glowing light at the end of the tunnel, the road to get there will likely be bumpy. We have two new strains/mutations of the virus, one from the UK and

the other one from South Africa, which seem to be spreading much faster than the original virus. It is yet unclear how those will react to the existing vaccines or if the vaccines will have to be modified, adding an additional layer of complexity to an already very challenging problem and forcing governments to tighten restrictions (Figure 1).



Source: Bloomberg

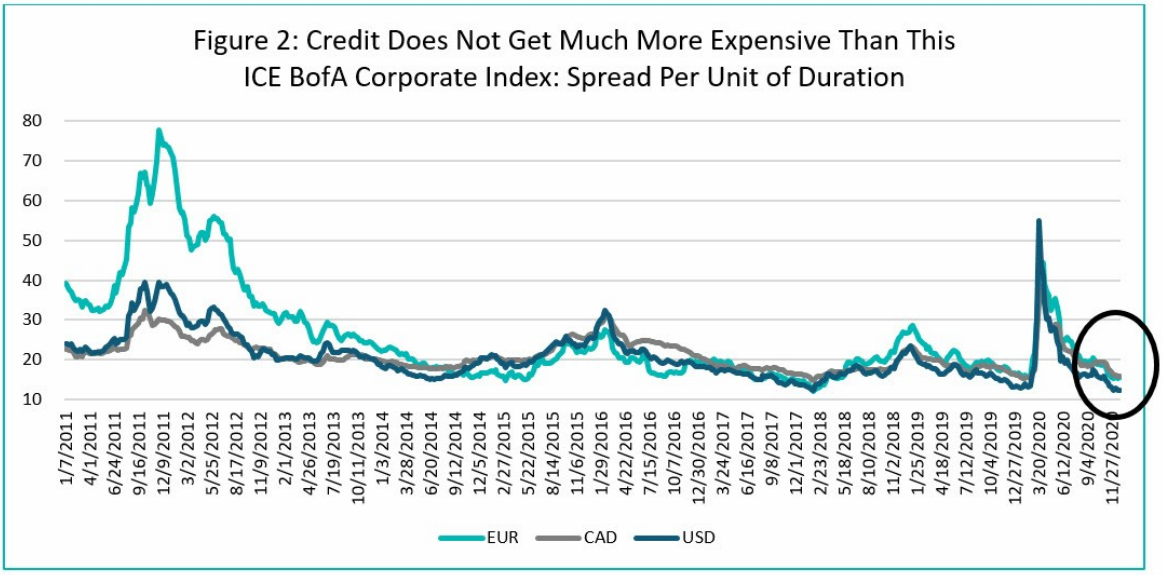
Also, unfortunately, so far, the vaccine rollouts have been very slow. We hear of wasted doses and distribution issues. For example, the US was forecasted to achieve 20 million vaccinations before the end of 2020, the last figures we have seen point to only 3 million. Hopefully, the pace of vaccinations will pick up in the new year, but in the near term, these challenges should force market participants to reconsider the expected pace of the "return to normal".

So, for the foreseeable future, we are waiting for better spread levels to increase credit exposure. Across both mandates, we have added liquidity, and a good inventory of shorter dated opportunities that generate above market yields, so we can afford to be patient. We have started to take down our government bond exposure (and hence overall duration), which should help lower volatility.

We are entering the year defensively positioned with lots of dry powder, so when the conditions are right, we will look to add positions to the funds that should be accretive to yield/performance.

Credit

We will not dwell on how expensive corporate credit is, we have beaten this topic to death. Let us simply reiterate that, accounting for credit quality and duration, the global credit indices (CAD, US, EUR) are currently trading at their richest levels of the last 10 years (Figure 2). Given the extraordinarily low level of interest rates and unprecedented amount of unconventional monetary policy, credit spreads could definitely go tighter in the future. For this to happen, we would need to see an end to the current second wave of the virus, and more progress on administering the vaccination. Consequently, we view the level of credit spreads to be slightly rich relative to the current risks to the economic recovery. As such, we currently prefer to take a wait and see approach, as opposed to increasing risk to reach for yield.



Source: Bloomberg

One topic that we think is worthy of mention, looking into 2021 is the Limited Recourse Capital Notes, or LRCN for short. LRCNs are essentially preferred shares, packaged in a clever way to achieve a more liquid, scalable, and cost-effective outcome for the issuer and investors. For the banks that issue these instruments, the main advantage is that the coupon payments on the notes are tax deductible, as opposed to preferred shares, which are paid out of net income. Additionally, by targeting the institutional market (as opposed to retail investors), banks can issue larger amounts of those notes, which in turn increases liquidity for end investors.

To be clear, similar instruments to LRCNs were already in circulation in many other markets, often called AT1 in the USD or "COCOs" in the EUR markets. But because of the Canadian tax code and regulatory rules, banks had yet to design a security that offers all these advantages in $C, until August 2020, when Royal Bank first came to market with their inaugural LRCN note. Most banks followed suit, and we fully expect that by the end of 2021, most if not all Schedule 1 banks will issue at least one LRCN.

This market innovation has created a new opportunity set for investors. For one, we can now buy these notes, which carry much higher coupons, than typical bank debt, with the (near) certainty that we, investors, will be able to sell them at a reasonable market price if need be, a feature that was not always guaranteed with preferred shares.

Also, as the banks work through their capital stacks and call the most expensive of their preferred shares to replace them with LRCNs, those callable prefs become very attractive "money market like" securities. So, while a 3-month T-Bill might yield only 7bps and even longer dated (1-3y) investment grade corporates yield under 1%, quite often these called (or very likely to be called) preferred shares can be bought with a yield to call of about 2-3%.

Finally, we know that OSFI (the Canadian regulator) is reviewing a similar structure for insurance companies (another large issuer of preferred shares). We know that insurers, just like the banks, would like to have access to this more efficient source of capital and that several of the most expensive insurance preferred hares are very likely to get called, once OSFI approves the structure. We have been slowly building positions in several of those insurance companies preferred shares, that we consider the most likely to be called, often at current yields of 4 to 5%. To be clear, this is not something we would invest 10% of the funds in, but even at a small weight it is certainly accretive to the portfolios' yield and carries fairly low risk.

Diversified Bond Fund (DBF)

2020 was a solid, yet unexpected, year for the DBF, returning 6.6% with minimal volatility. Unfortunately, we do not think that 2021 will be any easier an environment to navigate. Interest rates on government bonds are extremely low, with negligible income and very limited potential for capital appreciation. Credit, although spreads are narrow, will be the only way to generate income for investors. We are encouraged by many of the new types of higher yielding credit securities and structures we have been reviewing. We are working away on getting more yield into the portfolio and fine tuning our asset mix for 2021. Given the complexity of the virus, there will of course be many challenges to this year's investing environment but, given recent history, that is nothing new.

Diversified Bond Fund Portfolio Characteristics

	Limits	Dec 2017	Mar 2018	Jun 2018	Sept 2018	Dec 2018	Mar 2019	Jun 2019	Sept 2019	Dec 2019	Mar 2020	June 2020	Sept 2020	Dec 2020	Outlook
Government Bonds	**100%**	-2%	0%	-4%	2%	1%	7%	22%	28%	13%	9%	9%	14%	**8%**	↓
Investment Grade	**80%**	37%	56%	66%	73%	76%	72%	58%	61%	58%	78%	80%	71%	**74%**	↔
High Yield	**40%**	32%	24%	17%	16%	13%	14%	9%	7%	6%	13%	11%	12%	**11%**	↓
Emerging Market Governments	**10%**	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	**1%**	↔
Preferred Equities	**10%**	6%	6%	6%	6%	2.5%	0.7%	0%	0%	0%	0%	0%	2%	**4%**	↔
Common Equities & ETFs	**10%**	0%	0%	0%	1.5%	1.5%	4.3%	2.4%	-1.3%	0%	0%	-6%	-5%	**-2%**	↔
Derivatives	**+/- 2.5%**	-0.1%	+0.5%	-0.1%	-0.05%	0.0%	0.0%	-0.2%	0.0%	0.2%	0%	0%	0.1%	**0%**	**N/A**
Cash and Equivalents		28%	14%	15%	1.5%	6%	2%	9%	6%	22%	0%	6%	6%	**5%**	↑
Total		100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	**100%**	
Duration	**1 to 8 years**	2.4	2.1	2.3	1.0	2.4	3.4	5.4	6.5	4.3	3.8	5.9	6.2	**5.3**	↓
Spread Duration		-	-	-	3.4	2.9	3.0	2.3	3.1	3.0	2.2	4.1	3.8	**3.9**	↑
Unhedged FX Exposure	**20%**	0%	0%	0%	0%	0%	0%	6%	5%	3%	3%	5%	6%	**6%**	↓

Source: Ninepoint Partners

Credit Income Opportunities Fund

The Credit Income Opportunities fund had its best year in the fund's history, returning 14.58% net of fees; 2020 was truly an exceptional year for credit if you were positioned on the right side. Our low leverage, high quality portfolio and ample liquidity meant we could take risk when it really mattered. We are in the process of reviewing numerous new and innovative types of hybrid fixed income securities for the portfolio. Although, liquidity on most of these instruments is limited, the return they generate relative to their volatility is very encouraging. As discussed, 2021 will not be without its challenges, but we have lots of ideas and new opportunities to explore, so we're up for the challenge!

There were not many changes made to the portfolio in December; the table below shows the most recent fund characteristics. The 2020 recap and outlook for 2021 were discussed in the previous sections.

Credit Income Opportunities Portfolio Characteristics

	Limits	Oct 2018	Dec 2018	Mar 2019	June 2019	Sept 2019	Dec 2019	Mar 2020	June 2020	Sept 2020	Dec 2020	Outlook
Government Bonds	**100%**	0%	0%	6%	0%	18%	0%	0%	0%	0%	**0%**	↔
Investment Grade	**100%**	58%	55%	58%	53%	68%	64%	72%	65%	77%	**64%**	↑
High Yield	**40%**	29%	24%	19%	16%	10%	6%	22%	28%	26%	**26%**	↔
Private Loans	**10%**	3%	3%	2%	3%	2%	2%	4%	7%	6%	**6%**	↔
Preferred Equities	**10%**	4%	4%	0.5%	0%	0%	0%	0%	0%	0%	**5%**	↑
Common Equities & ETFs	**10%**	0%	0%	0%	0%	-7%	-7%	-10%	-15%	-13%	**-8%**	↔
Derivatives	**+/- 2.5%**	0%	0%	0%	-0.4%	0%	0%	0%	1%	0%	**1%**	**N/A**
Cash and Equivalents		6%	14%	15%	28%	8%	32%	12%	8%	2%	**3%**	↔
Total		100%	100%	100%	100%	100%	100%	100%	100%	100%	**100%**	
Duration	**0 to 5 years**	2.5	2.1	2.9	2.2	2.9	1.7	2.6	3.3	5.1	**3.8**	↓
Leverage	**0-4x**	0.7x	0.7x	1.0x	1.0x	0.77x	1.04x	0.87x	1.67x	1.15x	**1.04x**	↔
Unhedged FX Exposure	**<25%**	0%	0%	0%	2.7%	5.1%	-3.2%	0%	0.3%	0%	**2%**	↔

Source: Ninepoint Partners

Conclusion

Thank you again for your continued support. We wish everyone and their families a happy and prosperous 2021 and look forward to interacting with as many of you as possible this coming year.

Until next month,

Mark & Etienne
Ninepoint Partners

NINEPOINT DIVERSIFIED BOND CLASS - COMPOUNDED RETURNS[1]
AS OF DECEMBER 31, 2020 (SERIES F NPP221)

	1M	YTD	3M	6M	1YR	3YR	5YR	INCEPTION
Fund	0.2%	6.4%	0.7%	2.2%	6.4%	3.5%	4.4%	4.7%

NINEPOINT DIVERSIFIED BOND FUND - COMPOUNDED RETURNS[1]
AS OF DECEMBER 31, 2020 (SERIES F NPP118)

	1M	YTD	3M	6M	1YR	3YR	5YR	10YR	INCEPTION
Fund	0.2%	6.6%	0.8%	2.3%	6.6%	3.7%	4.5%	4.5%	4.6%

NINEPOINT CREDIT INCOME OPPORTUNITIES FUND - COMPOUNDED RETURNS[1]
AS OF DECEMBER 31, 2020 (SERIES F NPP507)

	1M	YTD	3M	6M	1YR	3YR	5YR	INCEPTION
Fund	2.3%	14.6%	5.6%	11.7%	14.6%	6.3%	6.6%	5.8%

[1] All Ninepoint Diversified Bond Fund/Class returns and fund details are a) based on Series F units; b) net of fees; c) annualized if period is greater than one year; d) as at December 31, 2020 [1] All Ninepoint Credit Income Opportunities Fund returns and fund details are a) based on Class F units (closed to subscriptions); b) net of fees; c) annualized if period is greater than one year; d) as at December 31, 2020.

The Risks associated worth investing in a Fund depend on the securities and assets in which the Funds invests, based upon the Fund's particular objectives. There is no assurance that any Fund will achieve its investment objective, and its net asset value, yield and investment return will fluctuate from time to time with market conditions. There is no guarantee that the full amount of your original investment in a Fund will be returned to you. The Funds are not insured by the Canada Deposit Insurance Corporation or any other government deposit insurer. Please read a Fund's prospectus or offering memorandum before investing.

Ninepoint Credit Income Opportunities Fund is offered on a private placement basis pursuant to an offering memorandum and are only available to investors who meet certain eligibility or minimum purchase amount requirements under applicable securities legislation. The offering memorandum contains important information about the Funds, including their investment objective and strategies, purchase options, applicable management fees, performance fees, other charges and expenses, and should be read carefully before investing in the Funds. Performance data represents past performance of the Fund and is not indicative of future performance. Data based on performance history of less than five years may not give prospective investors enough information to base investment decisions on. Please contact your own personal advisor on your particular circumstance. This communication does not constitute an offer to sell or solicitation to purchase securities of the Fund.

Ninepoint Partners LP is the investment manager to the Ninepoint Funds (collectively, the “Funds”). Commissions, trailing commissions, management fees, performance fees (if any), other charges and expenses all may be associated with mutual fund investments. Please read the prospectus carefully before investing. The indicated rate of return for series F units of the Fund for the period ended December 31, 2020 is based on the historical annual compounded total return

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