Davis Rea

INVESTMENT COUNSEL

# Davis-Rea Fixed Income Fund

## Annual Management Report of Fund Performance

For the year ended December 31, 2018

# Davis-Rea Fixed Income Fund

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This Annual Management Report of Fund Performance contains financial highlights, but does not contain the audited annual financial statements of the Davis-Rea Fixed Income Fund. You can get a copy of the audited annual financial statements of the Davis-Rea Fixed Income Fund at your request and, at no cost, by calling Davis-Rea Ltd. at (416) 324-2200 or at (877) 391-9929, by writing to us at 79 Wellington Street West, Suite 3535, P.O. Box 239, Toronto, Ontario, M5K 1J3, or by visiting our website at www.davisrea.com or SEDAR at www.sedar.com.

Securityholders may also contact us using one of these methods to request a copy of the Davis-Rea Fixed Income Fund’s proxy voting policies and procedures, proxy voting disclosure record, and/or quarterly portfolio disclosure.

# Management Discussion of Fund Performance

## Investment Objective and Strategies

The investment objective of the Davis-Rea Fixed Income Fund (the "**Fund**") is to preserve capital while providing income and some capital gains by primarily investing in bonds and other fixed income securities with a strong credit rating.

The fixed income investments held by the Fund may include government securities, corporate securities and bonds issued by foreign governments and issuers. Usually, we will not invest the Fund in such investments unless they have a credit rating of B or higher. The duration of any fixed income investment held by the Fund will also vary depending on our assessment of the direction of interest rates. At our discretion, the Fund may also hold cash and/or short-term money market instruments, preferred shares and convertible debentures.

## Risk

The Fund is subject to a number of risks that have not changed over the last year. These risks include the Fund not being able to obtain its investment objective, general economic conditions, interest rate fluctuations and liquidity constraints. See the prospectus of the Fund for a full description of the risks that the Fund may be exposed to. The Fund also has a risk rating of low.

## Results of Operations

For the full year, the Fund achieved a positive return of 0.22% compared to 1.08% for the iShares Core Canadian Universe Bond Index ETF over the same period. The Fund continued to focus on keeping its duration short for 2018, and maintained its focus on corporate bonds, which remained attractively valued for 2018. Over the course of 2018, we focussed on increasing the quality of the Fund and maintaining a relatively short term-to-maturity, without too big a decline in the yield. We did this in anticipation of a moderation in economic and earnings growth in 2019 against a backdrop of rich corporate bond valuations. Changes in the Fund's holdings in the fourth quarter continued within this framework.

Currently, 20% of the portfolio will mature in the next twelve months. Almost half of that will mature by the end of April, generating considerable funds that can potentially be invested in the corporate bond market at more attractive valuations. We have seen corporate spreads move wider throughout the fourth quarter of 2018 and are seeing opportunities in 2019 as spreads continue to drift wider. Combined with the increase in government yields, we are seeing corporate issuance resume at higher yields, and more attractive levels.

## Recent Developments

The bond market lost a little ground in the first quarter of 2018 as Government of Canada bond yields edged up by 2 to 10 basis points across the maturity spectrum. In sharp contrast, U.S. Treasury yields rose by 30 to 40 basis points, in spite of weak and volatile equity prices, as concerns about rising short-term interest rates and potential inflation risks started to set in. The Federal Reserve ("**Fed**") raised the Fed funds rate by a quarter-point to a 1.50-1.75% range in March as was unanimously expected, and restated its view that additional, but gradual rate hikes were likely. Canadian short-term rates also rose in the quarter, with the Bank of Canada ("**BoC**") increasing the overnight rate from 1.00% to 1.25% in mid-January. BoC officials, however, outlined a cautious approach to any further rate hikes due to uncertainty related to ongoing NAFTA negotiations. Like equities, corporate bonds also struggled in the first quarter and underperformed their government counterparts.

Rising government bond yields were a headwind for fixed income returns in the second quarter of 2018. Improving global economic conditions caused many central banks to start shifting away from the extraordinary measures they took in response to the global financial crisis. Much of that action had occurred in North America with both the BoC and the Fed pushing short-term interest rates upward and the Fed shrinking the size of its balance sheet. The Fed has been more aggressive on this front than the BoC, and short-term U.S. rates have risen more than their Canadian counterparts. This trend continued in the second quarter and was reflected in U.S. Treasury yields rising by more than Government of Canada yields. The Fed increased the Fed funds rate target by 25 basis points to 1.75-2.00% and signaled more increases to come this year and next. In contrast, the BoC kept the overnight rate steady at 1.25% during the quarter, but indicated that it was disposed to increasing it in July. Expectations of higher short-term interest rates caused two-year bond yields to rise more than ten-year yields. Fears of U.S. trade actions that will hurt Canadian exports will keep the BoC on a slower trajectory of interest rate increases than the Fed.

The favorable economic backdrop in the second quarter was positive for corporate earnings, which gave corporate bonds a lift and helped them outperform their government counterparts. This was an important factor helping the Fund in the second quarter, given its higher weighting in corporate bonds. The rise in bond yields also supported the Fund's heavier weight in shorter-term bonds. As a result, the Fund returned 1.56% in the quarter, versus the index return of 0.82%. The yield on the Fund edged up to 4.00% from

3.86% on March 31, largely reflecting the general increase in yields through the quarter. There were no changes in the Fund's average credit rating or duration, but its allocation to government bonds was trimmed slightly in favour of a larger weight in higher-yielding corporate bonds.

Rising government bond yields continued to be a headwind for fixed income return in the third quarter of 2018. Global economic conditions continued to remain strong, causing central bankers to back away from their accommodative monetary policy settings. The real action occurred in North America, where short-term interest rates continued to rise. Both Canada and the U.S. hiked rates by 25 basis points, bringing Canada's overnight rate from 1.25% to 1.50% in July, and the U.S. Fed funds rate to 2.00%-2.25% in September. Government bond yields rose in tandem with the rate hikes, with short term rates rising more than their longer-term counter parts-flattening the yield curve in both Canada and the U.S. Continued strength in corporate earnings helped corporate bonds perform better than their government counterparts. Alongside rising bond yields, this helped the Fund in the third quarter, given its relatively heavy weightings in corporate and shorter-term bonds.

The fourth quarter of 2018 was very challenging for corporate bonds, with worries about the economy and earnings driving investors into the safety of government bonds. Economic concerns have also caused markets to stop discounting any further short-term interest rate increases but the Fed and the BoC. All of this caused a sizable 32 to 46 basis point decline in both the U.S. and Canadian government bond yields. Investor uncertainty also caused Canadian and U.S. corporate bonds to considerably underperform their government counterparts. Declining government bond yields meant that longer term bonds posted better returns than shorter-term bonds.

The Fund underperformed its benchmark in the fourth quarter, given the outperformance of longer-term government bonds, and the Davis-Rea Ltd.'s bias toward shorter-term corporate bonds. That bias had been positive for performance for most of 2017 and 2018. Our high yield positions underperformed in the "risk-off" environment of the fourth quarter. The yield on the Fund increased in the fourth quarter to 4.43% from 3.90% as corporate bond yields rose. The Fund's average credit rating was steady at BBB+ and duration at 3.9 years. The maturation of approximately 20% of the Fund over the next year will generate considerable funds to be invested in the corporate bond market at more attractive valuations. As corporate spreads have widened throughout the fourth quarter of 2018, we see continued opportunity for investing at more attractive levels in 2019 as yields continue to drift wider.

## Related Party Transactions

Davis-Rea Ltd. (the "**Manager**") is the manager and portfolio adviser for the Fund. The Manager is responsible for managing the day-to-day activities of the Fund and providing or arranging for all required administrative services of the Fund. In consideration for such services, certain classes of units of the Fund pay the Manager a monthly management fee based on the net asset value ("**NAV**") of the applicable classes of units of the Fund, calculated daily. As no Class A, Class B or Class F units of the Fund have yet been issued, the Fund has not yet incurred any management fees. Each holder of Class O units of the Fund pays their management fee directly to us pursuant to their Class O investment management agreement. The Class N units of the Fund do not pay a management fee and may only be bought by another Davis-Rea Mutual Fund.

The Manager has also created an independent review committee ("**IRC**") to review and provide impartial judgment on conflict of interest matters. The IRC reviews potential conflicts of interest referred to it by the Manager and makes recommendations on whether a course of action is fair and reasonable for the Fund. The IRC prepares an annual report of its activities for interested parties. A copy of the IRC's report for 2018 will be available at www.davisrea.com at the end of March, 2019.

## Management Fees

The table below outlines the Fund's annual management fees and the trailer fees, if any, that the Manager pays to dealers who distribute units of the applicable class of the Fund (i.e., a percentage of the daily NAV of such class). The Manager is paid an annual management fee by each unitholder who invests in Class O units of the Fund pursuant to a Class O investment management agreement, which will not exceed the management fee that we receive from Class A units of the Fund. The Class N units of the Fund do not pay a management fee and may only be bought by another Davis-Rea Mutual Fund.

| | Class A* | Class B* | Class F* | Class O | Class N |
|---|---|---|---|---|---|
| Management Fee | 1.75% | 2.00% | 1.50% | Negotiated | N/A |
| Trailer Fee (maximum rate as a percentage of management fees) | N/A | 0.50% | N/A | N/A | N/A |

* No Class A, Class B or Class F units were issued as of December 31, 2018.

## Class O Units

### Financial Highlights

The following tables show selected key financial information about the Class O units of the Fund* and are intended to help you understand the Fund's financial performance for the past five years ended December 31.

| The Fund's Net Assets per Unit | Dec. 31, 2018 | Dec. 31, 2017 | Dec. 31, 2016 | Dec. 31, 2015 | Dec. 31, 2014 |
|---|---|---|---|---|---|
| **Net assets - beginning of period[1]** | $68,735,614 | $76,675,247 | $76,240,541 | $70,380,281 | $74,948,033 |
| ***Increase (decrease) from operations:*** | | | | | |
| Total revenue | $2,417,048 | $2,749,692 | $2,886,635 | $3,789,790 | $3,326,234 |
| Total expenses | $138,313 | $153,662 | $167,756 | $145,456 | $183,244 |
| Realized gains (losses) for the period | ($808,088) | ($164,203) | ($1,160,945) | $1,114,839 | $961,397 |
| Unrealized gains (losses) for the period | ($1,382,511) | $172,407 | $2,785,355 | $4,357,860 | ($5,195) |
| **Total increase (decrease) from operations[2]** | $88,137 | $2,259,418 | $4,343,289 | $395,232 | $4,099,193 |
| ***Distributions:*** | | | | | |
| From net realized gain on investments | $0 | $0 | $0 | $1,890,827 | $903,672 |
| From net investment income | $2,316,786 | $2,628,115 | $2,770,460 | $2,912,062 | $3,172,380 |
| From return of capital | $0 | $0 | $0 | $0 | $0 |
| **Total Annual Distributions** | $2,316,786 | $2,628,115 | $2,770,460 | $4,002,890 | $4,076,052 |
| **Net assets - end of period** | $57,766,838 | $68,735,614 | $76,675,247 | $76,240,541 | $70,380,281 |
| ***Ratios and Supplemental Data*** | | | | | |
| Total net asset value[1] | $57,766,838 | $68,735,614 | $76,675,247 | $76,240,541 | $70,380,281 |
| Number of units outstanding[1] | 6,106,942 | 7,011,631 | 7,772,031 | 7,873,825 | 6,920,381 |
| Management expense ratio | 0.20% | 0.21% | 0.19% | 0.18% | 0.22% |
| Management expense ratio^ before waivers or absorption (%)[2] | 0.20% | 0.21% | 0.19% | 0.18% | 0.22% |
| Trading expense ratio (%)[3] | 0.02% | 0.00% | 0.02% | 0.01% | 0.04% |
| Portfolio turnover rate (%)[4] | 42.14% | 80.05% | 147.65% | 142.8% | 84.1% |
| **Net asset value per unit** | $9.46 | $9.80 | $9.87 | $9.68 | $10.17 |

* Class O units of the Fund were first offered by prospectus on March 18, 2013 and were offered on an exempt basis since June 19, 2011. For explanatory notes, please refer to "Explanatory Notes to Financial Highlights" at the end of the section.

** Class A, Class B and Class F units of the Fund are offered by prospectus, but as at December 31, 2018, no units of any of these classes had yet been issued to the public.

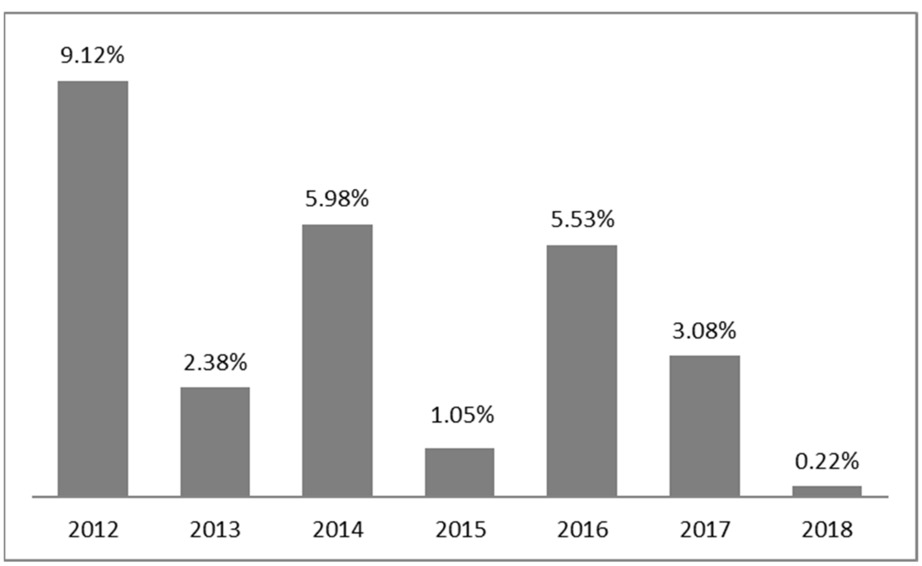
^ Each investor enters into a Class O investment management agreement with the Manager and pays a management fee to the Manager directly.

## Past Performance

The following information does not take into account any Class O management fees, which are paid to the Manager pursuant to a Class O investment management agreement. The past performance indicated below assumes that all distributions made by the Fund in the periods shown were re-invested in additional units of the applicable class of the Fund. In addition, the past performance results shown below does not take into account sales, redemption, distribution or other optional charges that would have reduced returns or performance, finally, past performance does not necessarily indicate how the Fund will perform in the future.

## Year-by-Year Returns

The bar chart below shows the Fund's performance for Class O units in each of the years shown. It illustrates how the Fund's performance has changed from year to year. In percentage terms, the bar chart shows how much an investment made at the beginning of the period has increased or decreased by the end of the period.



## Annual Compound Returns

The following table shows the annual compound total returns for the Class O units of the Fund for the last year, three years, five years, and since inception (i.e., June 19, 2011). The annual returns are compared to the returns of the iShares Core Canadian Universe Bond Index ETF.

| | **Since Inception (June, 2011)** | **1 Year** | **3 Year** | **5 Year** |
|---|---|---|---|---|
| Davis-Rea Fixed Income Fund | 4.16% | 0.22% | 2.92% | 3.15% |
| iShares Core Canadian Universe Bond Index ETF | 3.58% | 1.08% | 1.75% | 3.45% |

The above comparison demonstrates how the Fund has generally achieved its investment objective of preserving capital and providing income to unitholders. For example, since inception, the performance of the Class O units was 0.58% above the return of the iShares Core Canadian Universe Bond Index ETF.

## Class N Units

### Financial Highlights

The following tables show selected key financial information about the Class N units of the Fund* and are intended to help you understand the Fund's financial performance for the past five years ended December 31.

| The Fund's Net Assets per Unit | Dec. 31, 2018 | Dec. 31, 2017 | Dec. 31, 2016 | Dec. 31, 2015 | Dec. 31, 2014 |
|---|---|---|---|---|---|
| **Net assets - beginning of period[1]** | $6,705,832 | $7,603,969 | $6,853,033 | $5,962,044 | $4,951,634 |
| ***Increase (decrease) from operations:*** | | | | | |
| Total revenue | $233,395 | $275,197 | $255,989 | $315,600 | $272,631 |
| Total expenses | $13,481 | $15,398 | $14,932 | $12,187 | $15,520 |
| Realized gains (losses) for the period | ($79,561) | ($16,370) | ($103,619) | $91,483 | $80,166 |
| Unrealized gains (losses) for the period | ($133,642) | ($19,064) | $238,498 | $383,668 | ($26,867) |
| **Total increase (decrease) from operations[2]** | $6,711 | $224,363 | $375,936 | $40,990 | $310,410 |
| ***Distributions:*** | | | | | |
| From net realized gain on investments | $0 | $0 | $0 | $161,272 | $79,741 |
| From net investment income | $223,353 | $261,210 | $249,589 | $248,220 | $270,051 |
| From return of capital | $0 | $0 | $0 | $0 | $0 |
| **Total Annual Distributions** | $223,353 | $261,210 | $249,589 | $409,492 | $349,792 |
| **Net assets - end of period** | $5,844,043 | $6,705,832 | $7,603,969 | $6,853,033 | $5,962,044 |
| ***Ratios and Supplemental Data*** | | | | | |
| Total net asset value[1] | $5,844,043 | $6,705,832 | $7,603,969 | $6,853,033 | $5,962,044 |
| Number of units outstanding[1] | 618,940 | 685,401 | 709,144 | 709,144 | 587,393 |
| Management expense ratio | 0.21% | 0.21% | 0.19% | 0.18% | 0.23% |
| Management expense ratio before waivers or absorption (%)[2] | 0.21% | 0.21% | 0.19% | 0.18% | 0.23% |
| Trading expense ratio (%)[3] | 0.02% | 0.02% | 0.02% | 0.01% | 0.04% |
| Portfolio turnover rate (%)[4] | 42.14% | 80.05% | 147.65% | 142.82% | 84.1% |
| **Net asset value per unit** | $9.44 | $9.78 | $9.85 | $9.66 | $10.15 |

* Class N units of the Fund may only be purchased by another Davis-Rea Mutual Fund. For explanatory notes, please refer to "Explanatory Notes to Financial Highlights" at the end of the section.

## Explanatory Notes to Financial Highlights

### Net assets per unit:

(1) This information is derived from the Fund's audited annual financial statements. In the period the Fund or a class of units of the Fund is established, the financial information is provided from the date of inception to the end of the period.

(2) Net assets and distributions are based on the actual number of units outstanding at the relevant time. The increase (decrease) in net assets from operations is based on the weighted average number of units outstanding over the fiscal period. This table is not intended to be a reconciliation of opening and closing net assets per unit.

### Ratios and Supplemental Data:

(1) This information is provided at the end of the period shown.

(2) Management expense ratio is based on total expenses for the stated period and is expressed as an annualized percentage of daily average net asset value during the period.

(3) The trading expense ratio represents the total commissions and other portfolio transaction costs expressed as an annualized percentage of net asset value during the period.

(4) The Fund's portfolio turnover rate indicates how actively the Fund's investments are traded. A portfolio turnover rate of 100% is equivalent to the Fund buying and selling all its investments once in the course of the relevant period. There is not necessarily a relationship between a high turnover rate and the performance of the Fund.

# Summary of Investment Portfolio

## Davis-Rea Fixed Income Fund – as at December 31, 2018

| | % of NAV |
|---|---|
| **Canadian Bonds** | |
| **Corporate Bonds** | |
| AG Growth International Inc., Convertible, Callable, 4.50%, 2022/12/31 | 1.56% |
| Air Canada, Callable, 4.75%, 2023/10/06 | 3.19% |
| Alcanna Inc., Convertible, Callable, 4.70%, 2022/01/31 | 1.37% |
| Alimentation Couche-Tard Inc., Callable, 3.06%, 2024/07/26 | 0.76% |
| Allied Properties REIT, Series 'C', Callable, 3.64%, 2025/04/21 | 3.03% |
| Artis REIT, Series 'A', 3.75%, 2019/03/27 | 1.58% |
| Brookfield Asset Management Inc., Callable, 3.95%, 2019/04/09 | 1.58% |
| Brookfield Infrastructure Finance ULC, Callable, 3.45%, 2022/03/11 | 3.14% |
| Brookfield Infrastructure Finance ULC, Callable, 3.32%, 2024/02/22 | 1.54% |
| Brookfield Infrastructure Finance ULC, Callable, 4.19%, 2028/09/11 | 1.17% |
| Brookfield Renewable Partners ULC, Series '10', Callable, 3.63%, 2027/01/15 | 2.26% |
| Cameco Corp., Series 'D', Callable, 5.67%, 2019/09/02 | 2.40% |
| Canadian Imperial Bank of Commerce, Variable Rate, Callable, 3.00%, 2024/10/28 | 1.57% |
| Canadian Natural Resources Ltd., Callable, 3.42%, 2026/12/01 | 0.76% |
| Canadian Natural Resources Ltd., 2.05%, 2020/06/01 | 1.24% |
| Cominar REIT, Series '7', 3.62%, 2019/06/21 | 0.79% |
| Crew Energy Inc., Callable, 6.50%, 2024/03/14 | 3.98% |
| Dollarama Inc., Series '3', Floating Rate, Restricted, 2.48%, 2021/02/01 | 1.16% |
| Dollarama Inc., 2.34%, 2021/07/22 | 0.77% |
| Fairfax Financial Holdings Ltd., Callable, 6.40%, 2021/05/25 | 3.38% |
| Fairfax Financial Holdings Ltd., 4.50%, 2023/03/22 | 0.81% |
| Fiera Capital Corp., Convertible, Callable, 5.00%, 2023/06/30 | 1.27% |
| Ford Credit Canada Co., Floating Rate, Restricted, 2.93%, 2020/12/01 | 0.77% |
| Ford Credit Canada Co., 2.45%, 2020/05/07 | 0.58% |
| Keyera Corp., Callable, 3.93%, 2028/06/21 | 1.55% |
| Kruger Products L.P., Callable, 6.00%, 2025/04/24 | 1.13% |
| Lightstream Resources Ltd., Callable, 8.63%, 2020/02/01 | 0.00% |
| Manulife Bank of Canada, Floating Rate, Callable, 2.53%, 2020/01/27 | 0.78% |
| Mattamy Group Corp., Callable, 6.50%, 2025/10/01 | 0.74% |
| Morguard Corp., Series 'B', 4.01%, 2020/11/18 | 4.74% |
| Nissan Canada Financial Services Inc., 1.58%, 2019/10/07 | 1.56% |
| Nuvista Energy Ltd., Callable, 6.50%, 2023/03/02 | 1.12% |
| Osisko Gold Royalties Ltd., Convertible, Callable, 4.00%, 2022/12/31 | 1.56% |
| Parkland Fuel Corp., Callable, 5.75%, 2024/09/16 | 1.54% |
| Parkland Fuel Corp., Callable, 5.63%, 2025/05/09 | 0.90% |
| Pembina Pipeline Corp., Callable, 2.99%, 2024/01/22 | 1.53% |
| Precision Drilling Corp., Callable, 7.13%, 2026/01/15 | 1.84% |
| RioCan REIT, Series 'V' , 3.75%, 2022/05/30 | 1.59% |
| Rogers Communications Inc., Callable, 3.00%, 2023/03/15 | 4.21% |
| Royal Bank of Canada, 1.40%, 2019/04/26 | 1.57% |
| Royal Bank of Canada, 1.58%, 2021/09/13 | 3.05% |
| SNC-Lavalin Group Inc., Series '2', Floating Rate,Restricted, 2.60%, 2019/03/04 | 1.57% |
| SNC-Lavalin Group Inc., Series '5', Floating Rate, 2.61%, 2019/06/06 | 0.79% |
| Suncor Energy Inc., Series '5', Callable, 3.00%, 2026/09/14 | 0.76% |
| Suncor Energy Inc., Series '5', Callable, 4.34%, 2046/09/13 | 1.26% |
| Superior Plus L.P., Callable, 5.25%, 2024/02/27 | 0.74% |
| Toronto-Dominion Bank (The), Variable Rate, Callable, 3.59%, 2028/09/14 | 0.78% |
| Toronto-Dominion Bank (The), 2.45%, 2019/04/02 | 0.94% |
| Toronto-Dominion Bank (The), 2.05%, 2021/03/08 | 0.78% |
| Toronto-Dominion Bank (The), 1.68%, 2021/06/08 | 1.16% |
| Toronto-Dominion Bank (The), 3.01%, 2023/05/30 | 1.58% |
| TransCanada PipeLines Ltd., Callable, 3.39%, 2028/03/15 | 0.76% |
| Vesta Energy Corp., Callable, 8.13%, 2023/07/24 | 0.74% |
| **Total Corporate Bonds** | 81.95% |

| | |
|---|---|
| **Provincial and Municipal Bonds** | |
| Municipal Finance Authority of British Columbia, 2.95%, 2024/10/14 | 0.80% |
| Province of Quebec, 2.75%, 2025/09/01 | 1.59% |
| **Total Provincial and Municipal Bonds** | 2.38% |
| **Total Canadian Bonds** | 84.33% |
| | |
| **Foreign Bonds** | |
| Apple Inc., Callable, 2.51%, 2024/08/19. | 3.06% |
| Aroundtown SA, Callable, 4.63%, 2025/09/18 | 0.78% |
| Bank of America Corp., Floating Rate, 3.27%, 2019/04/01 | 0.65% |
| McDonald's Corp., Callable, 3.13%, 2025/03/04 | 1.55% |
| United States Treasury Bond, Inflation Indexed, 0.75%, 2045/02/15 | 5.16% |
| Walt Disney Co. (The), 2.76%, 2024/10/07 | 1.55% |
| **Total Foreign Bonds** | 12.74% |
| | |
| **Total Investments** | 97.07% |
| **Other Assets and Liabilities, Net** | 2.93% |
| **Net Assets** | 100.00% |

The Fund's summary of investment portfolio set out above will change due to ongoing portfolio transactions. A quarterly update is available on request.

# DAVIS-REA FIXED INCOME FUND

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