December 31, 2013

LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Increased acceptance of the Fed's mantra that "tapering is not tightening" renewed investor interest in the yield carry trade during Q4, causing corporate yield spreads to tighten by an average of 10 basis points over the period. The move can most aptly be described as aggressive, given investors extended both out the credit curve and across the credit spectrum amidst a backdrop of relatively stagnant fund flows and a steeper underlying government yield curve.

With market conditions and dynamics remaining supportive for primary market activity, the quarter saw a robust $21.3 billion in new issues come to market. Notable issuance emerged from banks ($8.8 billion), telecom ($1.8 billion), auto ($1.8 billion) and securitization ($1.6 billion). New issuance activity only temporarily pressured spreads in the active sectors and names with the exception of shorter-term senior bank debt and cross border issues, which saw uncharacteristically strong secondary demand from foreign buyers.

For the quarter, short-, mid-, and long-term corporate yield spreads tightened by 7, 11 and 12 basis points respectively, resulting in respective absolute returns of 1.01%, 0.92% and 0.67% according to the DEX Corporate Bond Index. On an absolute basis, the modest bull flattening of the credit curve (longer term yield spreads narrowed more than shorter-term yield spreads) was unable to mitigate the adverse effects of the steepening government yields curve.

Across the yield curve, the best spread and absolute performance was generally reserved for lower rated, higher yielding, higher beta sectors: energy generation and real estate in the short-end of the yield curve; and telecom and retail in the mid and long ends. Insurance also performed uniformly well across the curve with favorable rates and equity environments. Securitization underperformed as a result of supply pressures. On a ratings basis, relative performance reflected investor preference for risk, as lower-rated BBB debt modestly outperformed across the credit curve.

Portfolio Activity

In anticipation of rising rates and a steepening yield curve a decision was made to reduce overall duration and exposure to the middle of the yield curve. The position in CDP Financial (AAA-rated quasi-provincial) was sold and shorter-dated subordinated bank debt purchased. Prior to the purchase, strong foreign demand for short-term senior bank debt (which acts as a corporate proxy) pushed the senior versus subordinated yield spread basis to the widest levels of the year.

What Worked In The Quarter

Performance benefited from the portfolio's overweight in higher-yielding telecom/cable issues, which continued their "relief" rally due to a lack of foreign participation in the upcoming 700 MHz spectrum auction and investors reach for yield.

What Didn't Work In The Quarter

Relative to the index, the portfolio was more conservatively structured with a shorter duration and a defensive sector bias, resulting in a lower overall yield relative to the index.

Outlook & Strategy

Investors continue to be predisposed to the yield carry trade. However, with market dynamics tilting back towards normalcy after a period of insatiable demand for credit from both traditional and non-traditional investors, we feel that investors are increasingly becoming complacent on a risk/reward basis in their zealous reach for yield.

From a credit quality perspective, the sector impacts of higher rates will be muted, as yields are merely transitioning from an ultra-low to a low interest rate environment. In terms of corporate fundamentals, we feel that we have passed the credit cycle peak; although in the short-term we do not expect any significant degradation in the general quality of credit as corporate fundamentals such as leverage, liquidity and profitability still remain sound.

The portfolio is structured defensively and has minimal exposure to sectors or issuers that are negatively impacted by higher interest rates. We are well positioned to capitalize on relative value and yield enhancement.

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