LORICA | INVESTMENT COUNSEL INC.

# Focused Corporate Bond

## Market Highlights

Amidst a backdrop of supportive monetary policy, the grab for yield was evident in risk assets globally. Domestic investment grade corporate bonds were further buoyed by seasonal cash flows and the typical increase in investor risk appetite at the outset of a new year. As a result, domestic investment grade spreads tightened by 14 basis points in Q1. Although the rally stalled into quarter-end (NB: the Cyprus crisis), corporates displayed a remarkable resiliency during this period of duress. Recent earnings and guidance, which aside from concerns over future margins and increased rhetoric on shareholder friendly initiatives, have been innocuous from a credit perspective. Significantly, instances of earning misses, rating downgrades, lowered guidance and aggressive dividend increases or share buybacks did not result in a material change to the respective issuer's credit spreads.

Robust demand and favorable market tone resulted in primary issuance of $22.3 billion, which, while down modestly from the $22.6 billion issued in Q4, was an improvement from the $17.5 billion priced in Q1 of last year. Significant issuance emerged from domestic banks in the form of fourteen deposit note deals (totaling $11 billion), telecom ($2.7 billion) and credit card ABS ($1.4 billion).

For the quarter, short, mid and long-term corporate yield spreads tightened by 12, 18 and 13 basis points respectively, resulting in absolute returns of 1.29%, 2.25% and 1.32% respectively according to the DEX Corporate Bond Index. The middle part of the curve credit curve outperformed due to the steep roll down in that part of the curve, alpha driven investors cautiously assuming greater duration risk and retail RRSP interest. Long end returns were impacted by the overall weakness of long bonds.

Across the yield curve the best spread and absolute performance was reserved for higher yielding, higher beta sectors and securities. Insurance, real estate, telecom and bank hybrid debt were the best performers. While defensive sectors such as infrastructure, pipelines and utilities modestly underperformed. Relative performance on a rating basis reflected the sector moves as higher yielding, lower rated BBB rated debt outperformed across the curve.

## Portfolio Activity

Positions in Bank of Nova Scotia 2.242%/2018, Laurentian Bank 3.12%/2017, HSBC Bank Canada 3.86%/2015, Canadian Western Bank 2.531%/2018 and Quebec 3.0%/2023 were established and positions in HSBC Bank Canada 3.86%/2015, SNC-Lavalin 6.19%/2019, 407 International 5.96%/2035. GTAA 7.1%/2031 and TD Bank 5.48%/2015 were eliminated. Tactically, the moves took advantage of the tight spread differential between bank senior and subordinated debt (senior bank debt supply pressured spreads), reduced exposure to long-term corporates issues that were overvalued, and increased exposure to the belly of the yield curve.

## What Worked In The Quarter

Shorter and mid-term issues were concentrated in higher beta sectors and instruments which outperformed across the credit curve. The portfolio was additionally overweight telecom/cable and insurance and underweight retail issuers.

## What Didn't Work In The Quarter

The portfolio is structured conservatively relative to the index. With investor's biased to reach for yield through lower rated, less liquid securities this hampered performance.

## Outlook

We feel that investors are increasingly becoming complacent on a risk/reward basis in their reach for yield and that a certain level of caution is still warranted as significant headwinds both in respect to the North American economy and European sovereign crisis remain.

We do not expect any significant degradation in the general quality of credit as corporate fundamentals which in terms of leverage, liquidity and profitability remain sound. However, we note that corporate spreads have narrowed substantially and interest in corporates is at an extreme. At current yield spread levels any change in investor sentiment could have a noticeable impact on spreads.

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