LORICA | INVESTMENT COUNSEL INC.

# Focused Corporate Bond

## Market Highlights

Corporate yield spreads began 2011 with a strong tightening bias however were pressured in March by indigestion from near record issuance and a rout of risk aversion as exogenous concerns weighed. In all, corporate spreads managed to close the quarter 4 basis points tighter on average. Sentiment at quarter end however would best be described as weary.

New issuance was strong with $20.7B in new issues versus $15.9B and $7.1B in Q1 2010 and 2009 respectively. Jumbo issuance emerged from the Canadian banks ($7.1B) and the telecom/cable sector ($3.5B). Elsewhere, issuance was a hodgepodge of issuers, many of which took advantage of a backdrop that was favourable for higher-yielding, non-financial or infrequent issuers, as there continues to be a premium attached to name diversification.

For the quarter, corporate yield spreads tightened by an average of 4 basis points resulting in absolute returns of 0.52%, 0.56% and -0.44% for the short, mid and long corporate indices respectively. Higher beta sectors (e.g. real estate and financials) generally outperformed early in the quarter but relinquished most if not all of this return (particularly in the long-end) as risk aversion escalated. The best spread performance was reserved for third generation Tier 1 hybrid financials (on the back of the OSFI decision on financial hybrids) and insurance, which continues to recuperate from summer spread widening. The telecom/cable sector was the worst performer, as it suffered from heavy issuance and increasing fundamental risks.

## Portfolio Activity

Jan 21- Sold position in Aeroports de Montreal 5.67/37 and established new position in Enbridge Pipelines 6.62/18. Reduction of long-term corporate exposure in anticipation of credit curve steepening.

Jan 21- Sold position in GE Capital Canada 5.29/12 and established new position in GE Capital Canada 5.53/17. Extension along steep GE Capital credit curve (flattened by quarter end).

Mar 9- Increase weight in GTAA 7.1/31 and GE Capital Canada 5.53/17. Portfolio duration brought to neutral relative to the index. Attractive relative valuation.

## What Worked In The Quarter

Driven by an improvement in equity markets, interest rates and an increased pace of hedging activity, insurance issues outperformed. The portfolio is overweight the sector on both a percentage and duration weighted basis.

Escalating competition, revenue mix shifts coupled with issuance concerns pressured telecom/cable spreads across the curve. The portfolio is significantly underweight telecommunication.

## What Didn't Work In The Quarter

The portfolio continues to be structured with a more conservative, defensive bias relative to the index and as a result has a lower running yield (3.74% vs.3.91%).

The portfolio is underweight bank credit which outperformed as a whole. This underperformance however was somewhat offset by the composition of the portfolio's bank holdings which are subordinated and older generation hybrid issues. These issues rallied (relative to senior notes) on scarcity premium and also indirectly on OSFI's regulatory event decision.

## Outlook & Strategy

Although there are still many areas of economic uncertainty, domestic corporate bond market returns will be more impacted by supply, regulatory events and exogenous events, than a significant degradation in the general quality of credits. We feel that the insatiable appetite for credit as of late has been met and if the near record levels of supply continue, spreads will be materially pressured.

We are increasingly concerned with the possibility of more shareholder friendly initiatives particularly via share buybacks and increased dividends. Dividend yields in many cases are much higher than after-tax debt costs. Boards are incentivized to reward shareholders their "just deserts" for years where debt concerns where of foremost concern.

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