June 30, 2011

LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Corporate yield spreads widened 10 basis points on average during Q2 as exogenous risks such as European sovereign concerns and weaker macro data weighed on investors. Liquidity was also pressured as domestic corporate trading volumes dropped 20% from Q1 and bid/ask spreads moved wider in sympathy with the general pullback in risk.

Deteriorating market conditions were reflected in the consecutive monthly declines of new issuance ($5.5B in April, $4.6B in May and $3.4 in June). The $13.5B in fixed rate issuance during Q2 was a significant drop from Q1 issuance of $20.7B and $17.2B in Q2 of last year. Jumbo issuance emerged from credit card securitizations ($2.6B), telecom and cable ($2.2B) and P3 private placements ($1.8B). Noticeably absent were the big five banks, whom have been tapping the Yankee market in lieu of the domestic market this year and additionally were met with an unfavourable issuance environment post-earnings blackout when bank supply typically emerges.

For the quarter, short, mid and long-term corporate yield spreads widened by 8, 14 and 7 basis points respectively, resulting in absolute returns of 1.68%, 2.70% and 3.61% respectively. The belly consistently underperformed the rest of the credit curve (which is the spread between credit and Government of Canada yield curve) during the quarter. Credit curve bear steepening may have been more pronounced if it were not for the demand for long defensive credit by asset-liability managers in need of alpha. Across the yield curve, the best spread performance was reserved for defensive sectors: utilities, infrastructure, pipelines, and instruments: short and mid-term bank covered and deposit notes. Worst yield spread performers included media (YPG), telecom and cable (overhang of heavy issuance), retail (margin compression, foreign entrants and all constituents are BBB rated), and mid and long-term tier 1 hybrids (high beta and lingering par call concerns). Performance of corporate BBB debt trailed higher rated debt in most parts of the curve due to escalating risk aversion to higher beta names and sectors, and a dearth of higher rated financial supply.

Portfolio Activity

May 16 – Established new position in Bell Canada 4.95/21. Attractive relative valuation. Reduced underweight position in telecom space post-supply driven spread widening. Appealing new issue concession.

May 17 – Reduced position in Telus 5.0/13. Telecom curve steepening. Spread contraction post issuance. Portfolio duration brought to neutral relative to the index.

June 29 – Increase weight in Bell Canada 4.95/21. Attractive relative valuation. Increased portfolio duration and telecom weight.

What Worked In The Quarter

The portfolio was optimally structured with higher yielding, higher beta short-term issues (subordinated financials) and more defensive long-term debt (regulated utilities, pipelines and infrastructure issuers with unfettered rate setting ability).

On both a market weighted and duration weighted basis, the portfolio was significantly underweight the sectors with the poorest performance, namely media, cable, telecom and retail.

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 (3.52% vs. 3.70%).

Outlook & Strategy

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. At current spread levels and a saturated investor and dealer base, we fell there is little catalyst for significant spread tightening. 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.

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