September 30, 2011

LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Negative macro developments pushed domestic investment grade spreads (DEX Universe All Corporate Index) out an average of 38 basis points in Q3. Liquidity was pressured and bid/ask spreads moved wider in sympathy with the general pullback in risk. Selling pressure was met with little resistance as neither an investor base that is heavily overweight corporates, nor a dealer base that, as bank year ends approach, is in balance sheet preservation mode had considerable appetite to take on additional credit. Credit spreads closed the quarter at the widest levels seen since the summer of 2009.

Amidst the price volatility and liquidity deterioration, the primary market stalled. Bond issuance of $8.8B during Q3 ($5.8B in July, $690M in August and $2.3B in September) was a significant drop from Q2 issuance of $13.5B and $15.7B in Q3 of last year. On a quarterly basis, Q3 was the slowest pace of fixed rate issuance (floating rate issuance was $4B) since the depths of the credit crisis in Q4 2008 at $2.8B. Jumbo issuance emerged from three domestic bank deposit deals ($4.3B) and two P3 private placements ($1.5B). Predictably, high yield issuance dried up, with only two issues totaling $265M coming to market, as the category performed poorly and cross over investors stepped aside – the DEX High Yield index returned a lowly -8.3% in Q3.

For the quarter, short, mid and long-term corporate yield spreads widened by 45, 47 and 23 basis points respectively, resulting in absolute returns of 1.76%, 4.06% and 8.19% respectively (DEX Bond Indices). Long corporates consistently outperformed corporates of shorter maturities due to the low concentration of underperforming higher beta names in that part of the yield curve. Long defensive credit continues to be in demand by asset-liability managers who are in need of duration and yield pick-up. Across the yield curve, the best spread performance was reserved for defensive sectors such as utilities, infrastructure and pipelines. Escalating risk aversion resulted in underperformance of media (YLO), real estate, and financials.

Portfolio Activity

Aug 29: Established new position in Telus 5.05/19 and sold Telus 5.0/13. Telus credit curve steepening and attractive sector relative value. Telus credit curve flattened into quarter-end.

Sep 28: Established new position in Aeroport De Montreal 5.67/37 and increased position in Terasen 6.0/37. The position in in Sun Life 5.7/19 was sold. Underweight in long-term corporates was reduced. Exposure to life insurance was trimmed due to deteriorating fundamentals.

What Worked In The Quarter

The portfolio was optimally structured with a more conservative, defensive bias relative to the index. Long and mid-term issues continue to be concentrated in defensive sectors such as 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, real estate, and retail.

What Didn't Work In The Quarter

In anticipation of yield spread widening opportunities, the portfolio's overall duration was held an average of 20 basis points shorter than that of the index. Although corporate spreads widened significantly, this was more than offset by the fall in absolute yields.

Outlook & Strategy

We believe that the corporate bond market will continue to be impacted more by exogenous events and supply, than a significant degradation in the general quality of credits. Increasing risk premiums and a volatile macroeconomic backdrop provide little catalyst for significant spread tightening, and hence we are not yet ready to lose our defensive bias. However, with the potential for increased volatility and event risk, we feel this presents an opportunity to capitalize on relative value and yield enhancement.

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