LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

During Q1, the grab for beta - or the more dysphemistic, “dash for trash” - was evident in risk assets globally. Domestic investment grade spreads were no exception, as they tightened on average by 28 basis points. While the reach for yield (given expectations for an extended period of low rates) continued to underlie demand, it was further buoyed by seasonal cash flows and the typical increase in investor risk appetite in the outset of a new year.

Robust demand, historically low rates, and the smallest new issue concessions in the past six months, led to a fury of opportunistic issuers coming to market, particularly in January and February which saw record issuance of $7.4B and $8.4B respectively. The rapid pace of activity, however, waned into March as a light maturity schedule coupled with significant pre-funding and continued Yankee covered bond issuance, led to only $1.7B of new deals – the slowest March since 2003. Sizeable issuance emerged from the banks ($7.7B in deposit/senior notes), autos ($1.4B), real estate ($1.2B) and last year’s unloved sector, insurance ($1.3B).

For the quarter, short, mid and long-term corporate yield spreads tightened by 28, 34 and 24 basis points respectively, resulting in absolute returns of 0.85%, 2.11% and 2.00% respectively according to the DEX Corporate Bond Index. The credit curve steepened on the back of demand for higher beta short-end issues (subordinated bank debt) and retail RSP driven demand, that is typically focused on mid and short-term credit. Conversely, longer-term credit underperformed on a relative basis as it has less exposure to riskier sectors (insurance, real estate and financials) and spreads were at levels that were somewhat unattractive versus provincials/municipals and on a stand-alone risk/reward basis.

With the risk rally in full mode it was no surprise that across the yield curve the best spread and absolute performance was reserved for higher beta sectors and instruments. Insurance, financial services, retail and bank subordinated and hybrid debt, which lagged last year, were the best performers. Alternatively, defensive sectors such as infrastructure and utilities underperformed. On a credit rating basis, BBB rated credit outperformed across the yield curve.

Portfolio Activity

Positions in Aeroports de Montreal 5.67/37 and Scotiabank Cap Trust 6.282/13 were sold. Positions in CDP 4.6/20 and City of Montreal 5.45/19 were established. Trades provided attractive sector relative value, reduced the underweight in overall duration, and increased exposure to the belly of the yield curve.

What Worked In The Quarter

On both a market weighted and duration weighted basis, the portfolio’s term structure was overweight mid and short-term credit and underweight long-term credit.

What Didn’t Work In The Quarter

The portfolio was 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. The portfolio was underweight insurance, real estate and financial issuers.

Outlook & Strategy

Corporate fundamentals in terms of leverage, liquidity and profitability remain sound. In the near term we do not expect any significant degradation in the general quality of credit or any significant deviation from conservative corporate policies.

We feel that despite the recent (and not unexpected) uptick in tolerance for risk displayed by the credit markets, a certain level of caution is still warranted. Recent economic data has buoyed optimism, yet significant hurdles, both in respect to the European sovereign crisis and the North American economy remain. One can’t ignore the eerie parallels of this recent rally to the credit rallies in 2010 and 2011, when credit spreads narrowed to the tightest levels of the year in March, only to subsequently widen on the back of macro concerns and Europe’s sovereign debt crisis. The corporate bond market will continue to be impacted more so by exogenous events and supply than fundamentals. However, we feel the potential for increased volatility and event risk presents an opportunity to capitalize on relative value and yield enhancement.

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