LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Persistent European sovereign debt concerns, a deteriorating global macro outlook and supply pressures caused corporate yield spreads to widen by an average of 18 basis points during Q2. The spread widening was reminiscent of the credit rallies in 2010 and 2011, when credit spreads narrowed to the tightest levels of the year in March, only to subsequently widen thereafter. In conjunction with the general pullback in risk, market liquidity remained pressured (secondary volumes and trade counts were both down from Q1 2012 and Q2 of last year), and bid/ask spreads drifted wider.

Despite the problems in the secondary market, primary issuance volumes remained resilient. There was $19.5B in new deals in Q2 ($4.8B, $9.8B and $4.9B during April, May and June respectively), supported by a heavy maturity schedule, large coupon flows, attractive spread concessions and issuers motivated to lock in record low financing. Significant issuance emerged from domestic banks ($6.5B), telecom/cable ($2.1B) and real estate ($2.5B), with the latter placing an unprecedented 11 issues.

For the quarter, short, mid and long-term corporate yield spreads widened by 18, 19 and 18 basis points respectively, resulting in absolute returns of 0.96%, 2.18% and 3.09% respectively (according to the DEX Corporate Bond Index). In terms of maturity, the best performance amongst shorter dated issues was reserved for generally higher beta sectors and instruments (e.g. bank hybrid debt) having relatively wider yield spreads and larger coupons. The tolerance for risk did not extend to mid and longer dated issues where defensive sectors (utilities, pipelines and infrastructure) outperformed, and the worst performance was reserved for communications and real estate (both sectors were hit by supply pressures), insurance (poor fundamentals), and bank deposit notes (supply pressures). (In Canada, deposit notes tend to be the most liquid proxy for credit and hence their spreads are responsive to yield spread widening.)

Portfolio Activity

Positions in National Bank 5.55% 15-Nov-13, Epcor Utilities 5.8% 31-Jan-18, CIBC 5.15% 1-Feb-13, RBC Capital Trust 5.812% 31-Dec-13 and TransCanada Pipelines 5.1% 11-Jan-17 were sold. Positions in National Bank 3.261% 11-Apr-17, Rogers Communications 4.7% 29-Sep-20, CIBC 3.15% 2-Nov-15, RBC 3.18% 2-Nov-15 and SunLife 5.7% 2-Jul-19 were established. The trades were largely implemented near the widest credit spread levels of the quarter. Tactically, the moves provided attractive relative values in the respective sectors, reduced the underweight in overall duration, raised overall portfolio yield, and increased exposure to the belly of the yield curve.

What Worked In The Quarter

The portfolio was structured with a more conservative, defensive bias relative to the index. Shorter-term issues were concentrated in higher beta sectors and instruments, whereas long and mid-term issues were concentrated in defensive sectors such as regulated utilities, pipelines and infrastructure issuers. The portfolio was underweight insurance, real estate and communication issuers, and senior bank debt.

What Didn’t Work In The Quarter

In anticipation of yield spread widening opportunities, the portfolio’s overall duration was held an average of a third of a year shorter than that of the index. Although corporate spreads widened significantly, this was more than offset by the decline in underlying government yields (47 basis points) during the quarter.

Outlook & Strategy

The corporate bond market will continue to be impacted more so by exogenous events and supply than corporate fundamentals, which 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.

Increased volatility and event risk present an opportunity to capitalize on relative value and yield enhancement. However, we feel that investors are increasingly becoming complacent on a risk/reward basis in terms of their reach for yield. We believe a certain level of caution is still warranted, as significant headwinds, both in respect of European sovereign debt problems and the U.S. economy remain.

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