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LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Amidst a backdrop of supportive global monetary policy and sanguine corporate earnings, the grab for yield was evident in risk assets globally. Domestic investment grade bonds were no exception as investors, be it traditional domestic, retail, equity crossover or foreigners, plowed cash into corporate bonds. The demand driven rally resulted in a tightening of investment grade spreads by an average of 26 basis points during the quarter.

There was $14.9B in new deals priced in Q3, which was significantly higher than the $8.8B priced in the crisis ridden Q3, 2011, but less than the $15.7B issued during the third quarter of 2010. Robust demand resulted in some non-financial new issues being 5 times oversubscribed during the quarter. Non-financials generally did not feel the need to opportunistically re-finance upcoming maturities early or augment their already hefty cash stockpiles. However, significant issuance did materialize from the domestic banks ($8.1B), utilities ($1.7B), and Maples ($2.0B), the latter being the highest level of issuance since Q2, 2011. Also notable was the unprecedented number of ultra-long deals (>30YR) from utility and pipeline issuers whom were motivated to lock in historically low financing.

For the quarter, short, mid and long-term corporate yield spreads tightened by 26, 26 and 15 basis points respectively, resulting in absolute returns of 1.44%, 2.51% and 3.18% respectively according to the DEX Corporate Bond Index. The credit curve steepened (shorter term yield spreads fell relative to longer term spreads) as investors expressed a preference for shorter-term credit. Currently, long-term credit spreads appear unattractive relative to provincials and municipals, and on a standalone risk/reward basis.

On a sector basis, the best performance was reserved for insurance – sector offered good relative value and recent earnings presented few negative surprises; telecom – dearth of issuance; and banks – sector is most liquid credit proxy. Defensive sectors and lower-rated and less liquid sectors such as real estate and retail underperformed. On a ratings basis A-rated debt outperformed in the short-end of the credit curve, whereas BBB's marginally outperformed in the mid and long-end.

Portfolio Activity

The portfolio was optimally structured and thus trading was limited. The position in GECC 5.53/17 was sold and a position in City of Toronto 3.5/21 was established. Tactically the move provided attractive sector relative value, 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's short and mid-term holdings were concentrated in higher beta sectors and instruments which proved to be the best risk/reward proposition for hesitant corporate bond investors. The overweight in communication and insurance sectors and underweight retail and real estate issuers also added value during the quarter.

What Didn`t Work In The Quarter

Long-term issues were concentrated in defensive sectors such as infrastructure and utilities which underperformed higher beta sectors. However, the negative performance impact to the overall portfolio was somewhat mitigated as underperformance of defensive sectors was less pronounced in the long-end of the credit curve.

Outlook

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, while we do not expect any significant degradation in the general quality of credit or any significant deviation from conservative corporate policies, we do feel credit ratings may come under pressure.

We also feel that investors are increasingly becoming complacent on a risk/reward basis in their reach for yield, and that a certain level of caution is still warranted as significant headwinds both in respect to the European sovereign crisis and North American economy remain.

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