LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Surrounded by an environment of central bank easing, equity volatility and sanguine economic data, investors continued to shift assets into the domestic corporate bond market in a reach for yield. The resulting supply/demand disequilibrium led credit spreads to tighten by an average of 6 basis points during the quarter.

Buoyed by robust demand for product, $22.6 billion of investment grade supply was issued in Q4, which was a significant improvement from the $13.3 billion and $18 billion placed in Q4 of 2012 and 2011 respectively. Lower rated, opportunistic issuers such as Cameco, Alimentation Couche-Tard and Reliance LP were active and managed is launch issues at their lowest all-in yields to date. Significant issuance also emerged from the domestic banks in the form of six deposit note deals totaling $5.8 billion, and via four sub-debt issues from RY ($2.0 billion), Bank of Nova Scotia ($1.75 billion), Canadian Western Bank ($250 million) and Laurentian Bank ($200 million). The sub-debt issues were noteworthy as it was the last opportunity for banks to pad their Tier 2 capital levels using the current subordinated structure, before 2013 when only non-viability contingent capital sub debt will qualify for issuance.

For the quarter, short, mid and long-term corporate bond yield spreads tightened by 7, 7 and 5 basis points respectively, resulting in absolute returns of 0.62%, 1.08% and 0.92% according to the DEX Corporate Bond Index. The corporate yield curve steepened as a result of waning relative demand for long-term corporates early in the quarter – the byproduct of a backup in underlying long-term government yields and the relative unattractiveness of corporates (particularly for riskier sectors) versus provincials and municipals.

On a sector basis, the best performance was reserved for lower rated, higher yielding sectors and instruments (insurance, subordinated bank debt and telecom), whereas defensive sectors (utilities, infrastructure) underperformed as many issues traded near or through provincial and municipal credits. On a ratings basis, A-rated debt such as bank capital securities and insurance issues marginally outperformed in the short-end, whereas BBB-rated debt outperformed in the mid and long-end.

Portfolio Activity

A position in Westcoast Energy 3.12/22 (Spectra Energy Corp's indirect wholly-owned subsidiary and large natural gas firm) was established and a position in BMO Capital Trust 5.47/14 was sold. Tactically, the move 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

Short and mid-term issues were concentrated in higher beta sectors and instruments which outperformed across the credit curve. The portfolio was also overweight telecom/cable and insurance sectors and underweight the weaker performing retail sector.

What Didn`t Work In The Quarter

The portfolio is structured conservatively relative to the index. With investor's biased to reach for yield through lower rated securities this hampered performance.

Long-term issues were concentrated in defensive sectors such as infrastructure and utilities. The negative performance impact 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 the demand/supply disequilibrium than corporate fundamentals which in terms of leverage, liquidity and profitability remain sound. In the medium term, we expect the Canadian economy to muddle along with greater while we do not expect any significant degradation in the general quality of credit, we do feel that a more upbeat economic outlook has the potential to mitigate further corporate spread tightening through a rotation into equities or a significant deviation from conservative corporate policies.

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 North American economy and European sovereign crisis remain.

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