September 30, 2013

LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Amidst a backdrop of rising yields, heavy corporate bond issuance and muted secondary trading activity, corporate yield spreads widened by 3 basis points, on average, during the quarter. At this stage of the rate cycle corporate bonds continue to perform atypically – despite healthy earnings and solid balance sheets (albeit bother deteriorating), higher beta issues continue to underperform on a risk-adjusted basis. The weaker performance highlights the extent to which supply-demand imbalances created by QE have distorted valuations.

With higher rates on the horizon, issuers were in a rush to term out bank debt, pre fund upcoming maturities and refinance callable bonds. A record $21.8 billion came to market during Q3 with notable issuance emerging from banks ($5.6 billion), retail ($2.9 billion), securitization ($2 billion) and real estate ($1.5 billion). As a result of generous spread concessions, sector spreads traded heavily.

For the quarter, short, mid and long-term corporate yield spreads widened by 3, 3 and 2 basis points respectively, resulting in absolute returns of 0.68%, 0.48% and -1.12% respectively according to the DEX Corporate Bond Index. In contrast to the steepening of the government yield curve (2-30's widened 21 basis points), the credit curve experienced a parallel shift wider. Investors modestly extended along the credit curve while avoiding migration across the credit spectrum. The long-end of the credit curve continues to see steady demand from asset/liability managers looking to pick up cheaper issues on the backup of underlying government yields.

Across maturities the best yield spread and total return performance was reserved for insurance issues (sustained backup in yields would ease pressure on discount rates) and bank covered bonds and deposit notes (heavy foreign funding reduced domestic supply concerns). Alternatively, retail (M&A activity driven issuance) and real estate (supply overhang and credit metrics negatively impacted by higher rates) sectors underperformed. On a rating basis, after lagging for most of the quarter, BBB rated credit debt marginally outperformed across maturities. The late quarter move was due to the dual surprises of no tapering announcement by the Fed, and no foreign participation in the upcoming spectrum auction which caused a rally in the cable/telecom sector.

Portfolio Activity

Consolidation and shareholder friendly initiatives pressured retail sector spreads through the summer. Despite stable credit metrics, due to our concerns over event risk, the portfolio had no exposure to the retail sector. Once retail spreads hit their widest levels, Loblaw was added to the portfolio and City of Toronto sold – municipals had outperformed all other sectors in the DEX universe during the quarter.

What Worked In The Quarter

Performance benefitted from a concentration in the top performing sectors of municipal and short-term financials, and a lack of exposure to the poor performing sectors of real estate and retail.

The portfolio was structured with an overweight in the belly (5-10 years) of the yield curve in lieu of long bonds, as the 10–30 curve steepened by 7 basis points over the quarter.

What Didn't Work In The Quarter

The portfolio's sector exposure was more defensive and conservative than the benchmark resulting in an overall lower yield.

Outlook & Strategy

Investors continue to be predisposed to reach for yield; however, with the prospect of tapering on the horizon, they appear less inclined to do so through higher beta sectors and issues, which, during the recent rise in yields, have notably underperformed.

From a credit quality perspective, the sector impacts of higher yields will be muted, as we are merely transitioning from an ultra-low to a low yield environment. From the perspective of corporate fundamentals, we feel that we have surpassed the credit cycle peak. However, in the short-term, we do not expect significant degradation in the general quality of credit, as corporate fundamentals, in terms of leverage, liquidity and profitability, still remain sound.

The portfolio is structured defensively and has minimal exposure to sectors or issuers that are negatively impacted by higher yields. Therefore, we are well positioned to capitalize on relative value and yield enhancement opportunities as they present themselves.

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