



**LORICA** | INVESTMENT  
COUNSEL INC.

### Market Highlights

For the most part, bond market volatility was subdued in Q2 reflecting investor uncertainty over the exaggerated weather effects of the first quarter and geopolitical events that had the potential to spiral out of control. Towards the end of the quarter, depressed sovereign yields in Europe and lofty US equity markets tempted some investors into taking profits and deploying capital into North American bond markets. For the quarter, 10-year Treasuries and Government of Canada yields fell 0.19% and 0.22% respectively. In the FTSE TMX Canada Universe Bond Index returns were 1.48% for Canada's, 2.80% for provincials and 1.79% for corporates, while the index returned 1.99% overall for the quarter.

During the quarter, both the Fed and the Bank of Canada kept monetary policy on course despite evidence from the most recent data of economic improvement and higher inflation. With neither central bank ready to signal a change in course, bond investors were reluctant to respond in any sustainable fashion to the better data preferring to side with the weak economic news from the consumer and more significantly, from economies outside North America.

In the corporate bond market short-term spreads widened by 3 bps whereas mid and long-term spreads tightened by 4, and 1 bps respectively. Spread compression was greatest in the mid-part of the credit curve as a result of its high concentration of BBB issues (representing roughly half of all mid-term corporates) and investors modestly adding duration risk to increase yield pick-up. On an absolute basis, overall returns were predominately driven by the flattening of the underlying government yield curve.

### Portfolio Activity

Late in the quarter and in anticipation of yield curve bear steepening (a back-up in the yield curve with longer term yields rising by more than

## Focused Fixed Income

shorter-term yields), we seized the opportunity to reduce the portfolio's long bond and cash position and shift the exposure into short-term bonds. The short duration stance of the portfolio relative to the index was maintained. Additionally, on the back of provincial spread weakness the relative underweight in provincial bonds was reduced.

### What Worked In The Quarter

The portfolio had an overweight corporate exposure relative to the index with a concentration in higher yielding short-term financials and telecom/cable issues which outperformed. Corporate yield spreads tightened on average by one basis point during the quarter.

### What Didn't Work In The Quarter

The portfolio is structured with a short duration via a concentration in the short-end of the yield curve in lieu of maturities 10 years and longer. For the quarter 5, 10 and 30 year yields fell by 18, 22, and 18 basis points respectively, whereas 2-year yields fell by 1 bps. The portfolio underperformed on this bull flattening move of the yield curve.

### Outlook & Strategy

We expect the bond market to respond to the stronger economic news and moderate increase of inflation expectations with higher bond yields in the second half of the year. Investors have been reluctant to fight monetary policy, but we expect the beginnings of a shift from both the Fed and the Bank of Canada.

The portfolio has been positioned for higher bond yields and a steeper yield curve since the beginning of the year, which will continue to be the case in Q3. We expect the climate for credit to remain benign and hence will maintain the overweight exposure in the portfolio to corporates and provincials. However, the portfolio is structured conservatively and has minimal exposure to sectors or issuers that would be negatively impacted in the event of higher interest rates.



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## Focused Fixed Income

### Firm Overview

Lorica is an investment counsellor, committed to providing an entire investment service including management, administration, communication and compliance. Lorica's investment team and process is characterised by stability, security and consistency and an ongoing commitment to delivering superior results.

### Philosophy

Underpinning Lorica's investment philosophy is a belief that value can be added through active management in all market environments. We believe a comprehensive range of core bond market competencies can be used effectively to manage within a central risk management paradigm. Economies and markets are dynamic and we have learned they call for an adaptive, subjective approach to forecasting. However, construction of diversified, yet targeted portfolios is ideally suited to our proprietary computer-based models and algorithms.

### Investment Strategy

An actively managed core fixed income strategy investing in government and investment grade corporate bonds. The investment strategy includes: duration and yield curve management; and sector, industry, issuer and individual security selection; with an emphasis on duration and credit risk management.

### Managers

#### Gary Morris, CFA

President, Lorica Investment Counsel Inc.

#### Thomas Gomes, CPA, CFA

Portfolio Manager, Lorica Investment Counsel Inc.

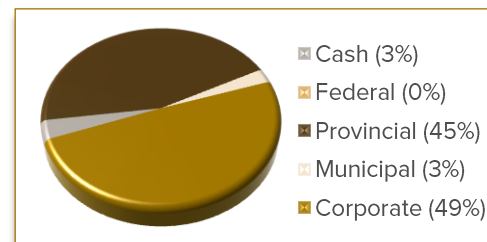
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**Inception:** January 1, 2011  
**AUM (Mandate):** \$620 M

### Asset Mix



### Risk Profile

	Lorica	Universe Index*
Yield to Maturity	2.10	2.44
Average Term	4.63	10.12
Modified Duration	4.05	7.10
Coupon	3.20	3.93
Credit Rating (%)		
AAA	5.25	43.21
AA	34.05	23.28
A	44.33	24.05
BBB	16.38	9.46

### Constraints

No. of Securities	10 – 25
Duration	-4/+2 years of Universe Index
Sectors	
Gov't of Canada	0 – 100%
Provincials	0 – 50%
Corporates	0 – 50%
Max Corporate Security Weight	10% (5% BBB)

### Historical Performance

Annualized Returns	1 Month	3 Months	1 Year	2 Years	3 Years
Lorica Focused Fixed Income	0.19	1.32	4.30	1.96	4.85
Universe Index*	0.25	1.99	5.33	2.55	4.81
Annual Returns	YTD	2013	2012	2011	
Lorica Focused Fixed Income	3.28	-1.12	4.44	10.57	
Universe Index*	4.82	-1.19	3.60	9.67	

Source: FTSE TMX Global Debt Capital Markets & Lorica Investment Counsel Inc., as at June 30, 2014.

\*FTSE TMX Canada Universe Bond Index