September 30, 2014

LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

The domestic corporate debt market adopted a cautious tone in Q3 as escalating geopolitical risks overshadowed generally improving North American macroeconomic data. Periods of strength (as in early September) were fleeting due to supply pressures and investors' attempts to shed risk when opportunities arose. Overall, corporate spreads widened by 6 basis points on average for the quarter. However strains were more evident in bid-ask levels, particularly for higher beta issues, which materially widened.

Despite muted secondary trading activity, primary issuance remained healthy at $16.3 billion. However, waning risk appetite was evident as lower rated issues (WestJet, Reliance) underperformed in post-deal secondary trade. Sizeable issuance emerged from domestic banks ($6.2 billion), telecom ($2.4 billion) and real estate ($1 billion) sectors. Of the bank issues, most notable were the inaugural Basel III compliant non-viability contingent capital (NVCC) subordinated debt issues from RBC and BMO. Unlike existing subordinated debt, this new instrument, upon the occurrence of a trigger event (as set out by OSFI's capital adequacy requirements) will be converted into common shares as a means to recapitalize the bank.

For the quarter, short, mid and long-term corporate yield spreads widened by 5, 7 and 6 basis points respectively, resulting in absolute returns of 0.41%, 0.67% and 1.76% respectively according to the FTSE TMX Canada All Corporate Bond Index. The parallel movement of the credit curve reflected heightened risk aversion. On an absolute basis, overall returns were predominately driven by the bull flattening of the underlying government yield curve – longer term yields fell by 10 basis points more than shorter-term yields.

Across the yield curve, the best spread and absolute performance was reserved for more defensive, higher rated infrastructure and regulated utility issues. Senior and legacy subordinated bank debt also performed well as they were supported by a paucity of supply, the release of a bail-in debt consultation paper, and the launch of successful NVCC deals. Alternatively, lower-rated and less liquid issues in real estate and industrial services (Enercare, Teranet) underperformed. Supply pressures also weighed on telecom/cable issues in the mid and long-term area of the yield curve. Relative performance on a ratings basis reflected the more cautious investor tone as AA-rated debt (predominately bank debt) led in the short and mid-term area of the credit curve, whereas A-rated debt (utilities) outperformed in the long-end.

Portfolio Activity

We opportunistically increased exposure to higher-yielding, shorter-dated issues in the auto, media and life insurance sectors which have solid fundamentals and should outperform in a rising rate scenario. Of note, the position in a Tim Horton's bond maturing in 2019, which has a $101 put in the event of a change of control and a downgrade to non-investment grade (likely to be triggered with the acquisition by Burger King Corp), was sold as it was trading at a sizeable premium above its pre-announcement level.

What Worked In The Quarter

The portfolio's sector exposure distribution was optimal as short-term, higher-yielding bank and insurance issues outperformed in that area of the credit curve, while issues with more defensive characteristics (utilities) outperformed in the mid and long-term areas. The long-term Suncor bond was a notable outperformer as it was upgraded to A- by S&P near quarter-end.

What Didn't Work In The Quarter

Relative to the index, the portfolio was more conservatively structured with a shorter duration and an overweight in the mid area (5-10 year) of the yield curve in lieu of long bonds. For the quarter, underlying 5, 10 and 30 year government yields fell by 0, 9, 11 basis points respectively.

Outlook & Strategy

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 any significant degradation in credit metrics. We do feel that an upbeat economic outlook has the potential to mitigate corporate returns through asset class rotation or a deviation from conservative corporate policies. That said, the portfolio is structured conservatively and additionally has minimal exposure to sectors or issuers that would be negatively impacted in the event of higher interest rates. We therefore are well positioned to capitalize on relative value and yield enhancement opportunities.

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