December 31, 2014

LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Canadian corporate yield spreads were buffeted by a plethora of negative catalysts during Q4: a weakening global macro backdrop, declining oil prices, deflation concerns and shareholder friendly initiatives, which resulted in spread widening of 12 basis points, on average. The guarded tone towards corporates persisted through periods of market strength with investors attempting to shed risk when the opportunity arose. As a result market liquidity was strained with bid-ask levels (particularly for higher beta issues) materially wider by quarter-end.

Amidst reduced risk appetite, primary market issuance of $14.2 billion was considerably lower than the $21.3 priced in Q4 of last year. Issuance was dominated by higher rated issuers in the bank ($7.6 billion) and utility ($1.6 billion) space. CIBC issued a $1 billion Basel III compliant non-viability contingent capital (NVCC) subordinated debt issue – it's first, in what was perhaps the most noteworthy financing of the quarter. Other notable deals emerged from infrequent issuers such as Metro Inc., Suncor and Saputo, which timed their (heavily oversubscribed) deals to exploit the embedded demand stemming from the December 1st coupon payments and resulting index extension.

For the quarter, short, mid and long-term corporate yield spreads widened by 13, 12 and 12 bps respectively, resulting in absolute returns of 0.90%, 2.17% and 3.78% respectively according to the FTSE TMX Canada All Corporate Bond Index. The parallel movement of the credit curve credit reflected heightened risk aversion. In absolute terms, overall returns were predominately driven by the bull flattening of the underlying government yield curve.

The cautious tone in the corporate market translated into industry and term performance as higher-yielding issues in the industrial and telecom/cable sector marginally outperformed in the short-term area of the credit curve; whereas, more defensive, higher rated issues in utilities and infrastructure generally outperformed in the mid and long-term area of the yield curve. Underperforming areas of note included legacy bank debt capital securities (subordinated debt, Tier 1 and Tier 2A hybrids), whose loss absorption terms may not be grandfathered under the final bail-in capital framework for domestic systemically important banks, and the pipeline sector which was pressured by the shareholder friendly restructuring by Enbridge Inc.

Plummeting oil prices also had a significant negative impact on investment grade oil and gas producers with sector spreads out by 25 bps during the quarter. The greatest impact was seen in the Canadian high yield space (energy and oilfield services comprise 40% of the FTSE TMX High Yield Index) where a number of smaller producers that borrowed heavily to fund development have raised default concerns. The High Yield Energy sub-index returned -11% for the quarter.

Portfolio Activity

With the weakening in corporate spreads, the portfolio opportunistically increased exposure to regulated utilities and pipelines via a reduction in longer-dated provincial debt (monetizing outperformance). Higher coupon short-dated bank sub debt (<2 years) was also sold to purchase 5 year senior bank debt which had widened in sympathy with corporate bonds.

What Worked In The Quarter

Risk-off sentiment continued to benefit the portfolio's municipal and long provincial holdings, which saw spreads tighten (2-5 basis points) during Q4. For the year, municipals and provincials (particularly Quebec based issuers) were the top performing sectors in terms of both spreads and absolute returns.

What Didn't Work In The Quarter

Relative to the index, the portfolio is more conservatively structured with a shorter duration and an overweight in the belly (5-7 year) of the yield curve in lieu of long bonds. For the quarter, underlying 5, 10 and 30 year government yields fell by 29, 37 and 34 bps 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. Corporate spread levels currently represent nearly half of all-in-yields (higher end of post-credit crisis range) and thus provide good relative value. 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.

Gary Morris, CFA
President

Thomas Gomes, CPA, CFA
Portfolio Manager

T. 647.776.8111 E. info@loricaic.com www.loricaic.com