First Stop on the Road to Recovery – Income Opportunities

After being frozen last fall, the credit markets are now on a much more stable footing. This turnaround was led by a remarkable resurgence in the corporate debt market, as record yield spreads attracted investors, allowing corporations to issue securities and shore up their balance sheets.

These developments had the welcome effect of bringing greater confidence to other credit markets, the broader equity markets and the global financial system as a whole.

Now that we are on the road to recovery, where are the opportunities for investors, especially income investors? Those people who fled to the safety of government bonds, GICs, "higher" interest savings accounts and money market funds are receiving minimal returns. And, with shorter-term interest rates unlikely to rise substantially in the near term, it's inevitable that the search for higher yields will intensify.

The credit crisis has wreaked havoc, but has also created excellent investment opportunities. This is especially true in the higher-yielding asset classes, as so many of these sectors – notably real estate and infrastructure – are distressed due to their dependence on high levels of leverage.

At Signature, we are taking advantage of these opportunities through our funds, with Signature High Income Fund offering the greatest exposure to a variety of higher-yielding asset classes. CI Investments also plans to launch this fall an even more diversified fund, which will represent Signature's best high-yield investment choices from around the world.

Signature is well placed to manage this fund, with our extensive resources and a highly experienced income team, consisting of eight investment professionals. Four portfolio managers and analysts are dedicated exclusively to high-yield corporate bonds and other high-yield asset classes.

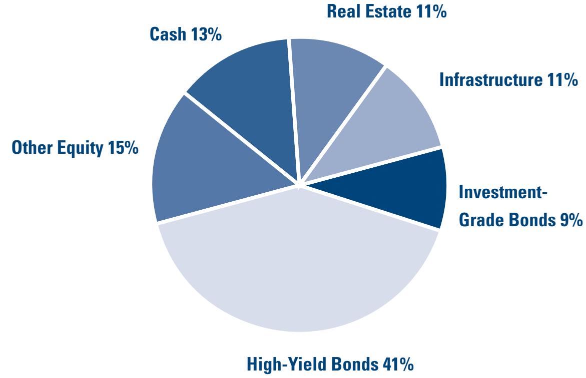
The new fund will be very timely, as we believe that high-yield securities offer the potential for excellent risk-adjusted returns. Here's how these opportunities have come about. The credit crisis had a devastating effect on the values of corporate debt, real estate and infrastructure. Because they often feature very stable cash flows, owners of these assets tend to finance their purchases with high amounts of debt. Over the past decade or more, easy access to affordable credit inflated the value of the underlying assets, creating a false sense of collateral safety. This led to a positive feedback loop of even greater lending and higher asset values over time. The credit crisis abruptly burst that bubble, leaving owners without the means to refinance their debt and a wake of indebtedness that has dramatically devalued assets.

An example of this phenomenon can be seen in the U.K. real estate market, where the credit-induced meltdown has created seldom-seen entry points. At the recent peak, a typical prime City of London office tower with a market value of $100 million provided about $5 million in cash flow each year – a yield of 5%. Following the credit crisis, investors now demand a yield of 7.75%, so the property's actual cash flow now warrants a property price of $73 million – a decline of 35.5%. If the owner made his purchase using $40 million in equity and a $60 million mortgage, his equity has declined to $13 million – down 67.5%. This shows the brutal effects of the feedback loop working in reverse, when leverage was used to buy assets at the top of the cycle. It's reflected in the U.K. property index, which fell 74% from its peak in January 2007.

At Signature, we believe that this type of painful de-leveraging process is well underway, and presents a rare opportunity to invest selectively and prudently in these valuable asset classes at deflated prices. Yields are at their highest levels in years, while lending rates remain structurally low, luring large investors such as pension and mutual funds away from government debt. Credit markets, meanwhile, are healing, and are increasingly opening up the financing mechanisms necessary for owners to restructure or sell their assets, rather than fall into insolvency.

Signature High Income Fund provides diversified exposure to several high-yielding asset classes (See Chart 1). The fund pays a monthly dividend yielding 7.5% annually, a premium of about four percentage points over the yield of Government of Canada 10-year bonds. Over the long term, the fund has outperformed the S&P/TSX Composite Index, with only 60% of the volatility. Other funds in the Signature family offering significant exposure to these securities include Signature Income & Growth Fund and Signature Corporate Bond Fund.

Signature High Income Fund Asset Allocation



Source: CI Investments, as at July 31, 2009

Chart 1: Signature High Income Fund offers diversified exposure to high-yielding areas of the capital markets.

Let's take a closer look at each asset class:

Corporate Bonds

Credit spreads for U.S. high-yield bonds peaked at 20 percentage points (or 2,000 basis points) at the height of the credit crisis, and have since settled back to about 11 percentage points – still at record levels (See Chart 2). Though the High Yield Index recorded its best gain ever in the second quarter, these spreads mean there is still the potential for capital appreciation, along with generous yields. We anticipate total returns in the low teens for high-yield bonds over the medium term. Defaults are hovering at about 8% and are likely to climb, but we believe they are adequately priced into the market. Even in the event of bankruptcy, however, corporate bonds present the opportunity to recoup up to about 25% of the original investment. High-yield and investment-grade bonds currently make up about half of the Signature High Income Fund portfolio.

The High-Yield Opportunity

U.S. Investment-Grade and High-Yield Debt Spreads

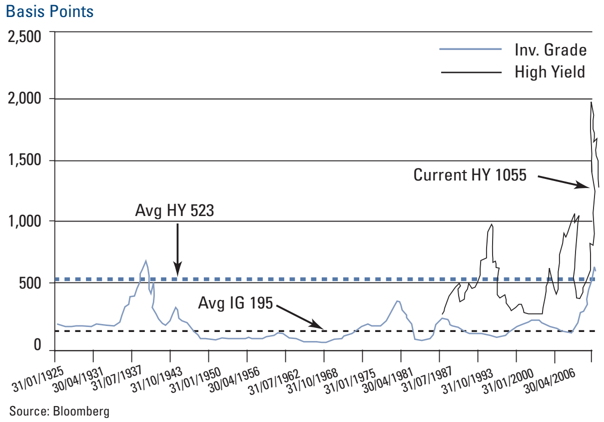


Chart 2: The yield spreads on investment-grade and high-yield bonds (the yield premium over government bonds) jumped during the recent credit crunch, with the high-yield spread reaching a record level of 2,000 basis points.

A Vicious Property Correction in the U.K.

Commercial Property Values

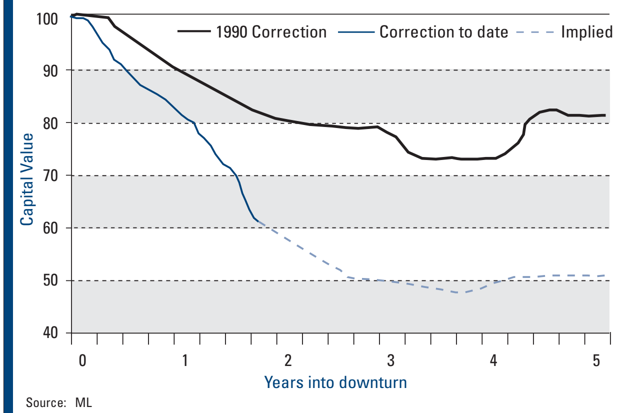


Chart 3: The downturn in the British commercial property market has been fast and vicious, with values falling 40% in less than two years. In the 1990s crash, property values declined 27% over a four-year period.

Real Estate

As our London office tower example indicates, the correction in the commercial property markets has been both fast and vicious (See Chart 3). Now, property companies must reduce their leverage. For example, we estimate that the U.S. REIT market needs to boost its equity by approximately US$50 billion to $80 billion, either through asset sales or equity issues. This presents a significant opportunity for pension funds, private equity, healthy REITs, mutual funds and other large investors looking for valuable assets with long-term, stable yields. Canadian REITs generally yield about 8.5%, compared to about 3.3% for 10-year Canada bonds, while even better yields are available globally.

Infrastructure

Similar opportunities are available in this asset class, where the credit crisis has forced the same price corrections as in real estate. In addition, actions taken by governments and central banks over the past several months to cushion the impact of the financial crisis have ushered in a new era of government deficits. We expect this will give rise to a massive wave of privatizations over the next few years, as state and national governments struggling with their debts – California being the most prominent example – look to sell or lease high-quality, income-producing assets such as pipelines, utilities, toll roads, airports and stadiums. These assets match well with the objectives of institutional investors requiring long-term, inflation-protected income streams to match their liabilities (See chart 4).

Our focus is not on the companies that build infrastructure. Rather, we are more interested in companies that hold the assets, benefit from the steady cash flow, and pass those proceeds along to investors. An example of the type of company we seek is Great Lakes Hydro, the largest owner of hydroelectric facilities in North America.

Income Trusts

The need for yield can be a powerful force, having given rise to the Canadian income trust market more than a decade ago. While income trusts are less important to Signature with the approach of the 2011 deadline for taxing trusts, we maintain positions in a number of blue-chip business, royalty and infrastructure trusts.

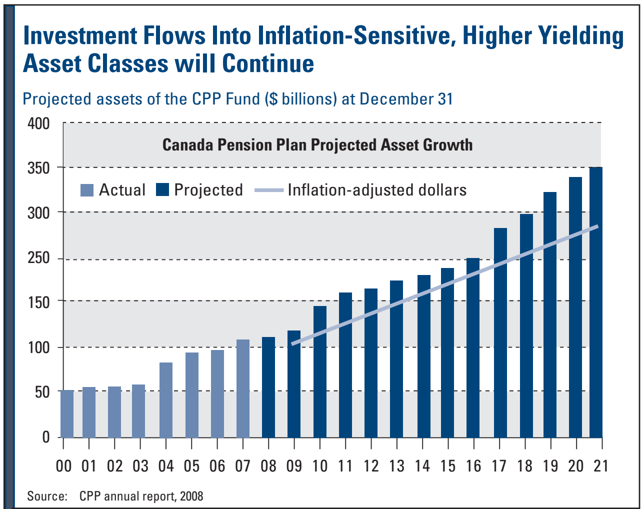


Chart 4: The assets of pension plans, such as the Canada Pension Plan, are expected to continue to grow significantly, and these plans will be seeking investments with stable, long-term yields.

In conclusion, we believe that spiralling deficits, stubbornly high unemployment, and the de-leveraging of Western economies could constrain growth for several years. In such an environment, earnings growth and capital gains from equities may be challenged, so a large component of total returns will depend on investment and dividend yields.

In many cases, yields on corporate bonds, REITs and infrastructure securities have reached levels that are comparable to traditional equity returns. Adding even modest amounts of capital appreciation (which we think is likely), the total return for these asset classes is attractive on an absolute and risk-adjusted basis.

We are also prudently managing the foreign currency exposure of these investments in order to protect our investors from changes in the Canadian dollar relative to other major global currencies.

Improvements in the bond and equity markets, and the support of tens of billions of dollars in funds flow from income-hungry investors, are setting the stage for multi-year outperformance of these asset classes. While opportunities clearly abound, the road will not be smooth because many problems persist, contributing to short-term volatility. We are slowly identifying and adding positions in companies that are industry leaders, have the strongest balance sheets, and can best capitalize on the opportunities turned up by the credit crisis.

Eric Bushell
Chief Investment Officer
Signature Global Advisors

Ryan Fitzgerald
Senior Research Analyst
Signature Global Advisors

CI INSTITUTIONAL ASSET MANAGEMENT

2 Queen Street East, 20th Floor, Toronto, Ontario M5C 3G7
www.ciinstitutional.com

For more information on CI Institutional Asset Management:
Please call 1.866.760.5274 Or e-mail ciinstitutional@ci.com

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