Market Commentary

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High-yield bond market update

Geof Marshall
Vice-President and Portfolio Manager
Signature Global Asset Management

High-yield bond spreads were a one-way trade from the beginning of the year to about May 8, with prices for riskier securities steadily rising. Through this period we did not find a lot of value in the market. We bought in spots, or participated selectively in the new issue calendar, but in general the high-yield bond portfolio was shrinking. We have a target weight of 60% in high-yield bonds within Signature Corporate Bond Fund. This allocation hit a low of 52% and is now about 54%, on our way back to 60%. The high-yield bond portfolio shrank as bonds were called and new inflows reduced the weight of high yield in the fund. As I mentioned during the May Signature roadshow, the 2013 vintage new high-yield issues with coupons like 3.75% for Ba1/BB+ rated Constellation Brands 2021 bonds, or 4.25% for B1/BB- rated Heinz 2020 bonds were unattractive to us. Those are not the type of coupons I associate with high-yield bond investing.

Spreads on high-yield bonds started the year at 526 basis points over government bonds and tightened to +428 on May 8. Similarly, yields on high-yield bonds started at 6.1% and decreased to 5.0% by May 8. Spreads have since backed up to +509 and yields to 6.12% on the fear of a sell-off induced by the possibility that the U.S Federal Reserve's third round of quantitative easing would be phased out. Investment-grade bonds experienced a similar change over this period.

We continue to favour a short duration, high quality and off-index strategy in the portfolio. The portfolio is short duration and floating rate issues because while I believe the historical negative correlation between spreads and rates will return, I do not want to put all my eggs in that basket, especially given how low yields are. This is because a small move in price could wipe out a full year's worth of interest. We have continued to add floating-rate loans to the fund (about a 2% weight) and hybrid securities in the financials sector where we are seeing better value. We are also buying Canadian dollar-denominated private placements like Centric Health 8.625% and Canadian International Oil Corp. 8% cash pay/3% payment-in-kind securities, where we can structure strong covenants and get compensated for the lack of secondary trading liquidity. We will continue to add to these allocations and have begun to buy more "main street" high-yield bonds at the margin in this weak market. A lot of the weakness is induced by exchange-traded fund outflows and indiscriminate forced sellers, and many of the low-coupon, high-duration new issues we shied away from are down five basis points. These bonds have demonstrated a positive correlation to rates, whereas over the history of the asset class, high-yield bond spreads have been negatively correlated to rates. I expect correlations to flip back to their normal relationship over the intermediate term. This is the most important message I can convey and why I believe, on top of the yield pick-up, there is a diversification benefit to remaining invested in Signature Corporate Bond Fund.

Given that the capital markets are still open, economic growth is likely to remain subdued but positive (meaning a recession-induced default cycle is not in the cards) and issuers generally do not need to borrow (issuers have been opportunistically refinancing early at lower and lower yields), all is right in the corporate credit market. Just now in June, things are looking interesting again.