Market Commentary
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Signature High Income Fund & Signature Diversified Yield II Fund Update

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What to expect when you expect rates to rise

The yield for the Canadian 10-year government bond stood at 1.80% in December 31, 2012, just 22 basis points above its all-time record low of 1.58% seen in July of that year. Twelve months later, the bond yield had risen a full 1% to 2.80%, a big move when measured against such a low base. The U.S. 10-year Treasury bond yield rose even more, from 1.76% to 3.0% over the course of the year. The spike in bond yields was driven by the U.S. Federal Reserve's decision to scale back – or "taper" – its quantitative easing program. The stock market greeted the anticipated rise in rates with enthusiasm as it coincided with improving economic data, and tapering was viewed as another signal of a normalizing U.S. economy. The back-up in yields translated into negative total returns during 2013: Government of Canada bonds with near 10 years to maturity saw a -5% total return, while 10-year U.S. Treasuries lost about 7%, the first negative year since 2009 and only the fourth negative year in the last 20 years.

Income fund performance varied dramatically in 2013. Many funds have high structural exposures to common stocks – they are basically equity-heavy balanced funds with a high distribution payout. Signature Income & Growth Fund can be counted in this group. A second category of income funds are what we consider to be "pure income," in which most of the distribution is funded not by capital gains from stocks but by the interest and dividend income of the underlying securities in the portfolio. These funds, which include Signature High Income Fund and Signature Diversified Yield II Fund, hold securities that have both equity and bond-like characteristics, such as income trusts, REITs, utility stocks, and high-yield bonds.

The common stock-tilted income funds were clear winners in 2013. Signature Income & Growth Fund solidly outperformed Signature High Income Fund and, among our global fund offerings, Signature Global Income & Growth Fund outperformed Signature Diversified Yield II Fund.

While returns lagged global equity markets, Signature High Income and Signature Diversified Yield II recorded high single-digit to low double-digit gains in 2013, considerably outperforming several of our core asset classes. Despite the rates headwind, high-yield bonds posted a return of 7.4%, the best in fixed-income. However, the rise in bond yields abruptly halted, and then reversed, several years of outperformance of some other yield securities. U.S. REITs, for example, currently trade 16% below their May highs and underperformed the S&P 500 Index by a whopping 30% for the year. Canadian REITs are also down about 16% from their highs and recorded their first negative total return since 2008. The S&P

500 utilities sub-index posted positive returns, but was up less than half that of the broader U.S. market. And the fledging Asian trust market got its first taste of rising bond yields, with many names down 20% from their spring highs.

What is the outlook for Signature High Income and Signature Diversified Yield II?

Relative valuations between equities and fixed income are far more balanced than a year ago. This makes predicting the future more difficult than usual. A useful exercise is to consider how Signature's income funds might perform under a few different scenarios:

1. **U.S. economic growth continues, unemployment comes down, and rates rise moderately, although still anchored at historically low levels by Fed policy. Europe plods along without incident and emerging market troubles remain contained to their respective geographies.**

   This scenario is positive for equity markets and, judging by funds flow data, is probably close to consensus thinking. This is also largely Signature's base case, although our enthusiasm is tempered by possible sovereign debt problems in Europe and new funding problems for select emerging market companies and governments.

   In this scenario, stock markets continue their ascent, although returns are more subdued than in 2013 given the higher starting point. Government bond yields drift higher but credit spreads tighten, allowing high-yield bond prices to hold up. High-yield bonds are thus again likely the best performing fixed-income asset with mid-single-digit returns. Similarly, REITs and infrastructure stocks would likely be flat on a price basis but offer decent yields. This probably means a repeat of 2013 relative fund performance whereby equity funds (and equity-tilted income funds) outperform Signature High Income and Signature Diversified Yield II. Here we expect subdued but positive returns in the mid-single digits for the funds.

2. **A withdrawal of quantitative easing and the resulting rise in rates causes economic growth to stall.**

   While perhaps not the consensus view, many market participants believe this to be the most likely outcome. Our best guess is that equities go down in this scenario. Why do we say "best guess"? In our policy-driven world, sometimes bad news is good news. The market could interpret a growth stall as a good thing if it meant more money printing by the Fed. But we would expect the stock market to go down, considering equities are at (or close to) all-time highs.

   Here, Signature's income funds should produce very good returns compared to equities. In this scenario, investors could well assume bond yields have peaked for the time being. If the economy is more sluggish than currently believed (but not in recession), our core asset classes – real estate, high-yield bonds and infrastructure, which generally do not require strong economic growth to support valuations – would post solid, high single-digit returns against the backdrop of a lacklustre equity market.

3. **Growth takes off, inflation picks up and the Fed is forced to withdraw stimulus more quickly.**

   This third scenario is outside consensus thinking since there are virtually no signs of inflation in the global economy. In fact, some regions, such as Europe, are flirting with deflation. However, if inflation did come

back with a vengeance, the resulting rise in interest rates would be bad for underlying securities in the funds and we would expect a negative total return. We suspect, however, that equity markets would not escape unscathed. The rapid rise in rates would likely derail the economic recovery, and the stock market, which is currently looking for earnings growth, could react negatively.

4. **Stock markets go down for some reason unrelated to monetary policy.**

   Perhaps it is a problem in European sovereign debt markets, perhaps it is an emerging market default, or perhaps earnings growth fails to materialize. Whatever the reason, an external shock to the market that results in a loss should positively showcase the downside protection of Signature High Income and Signature Diversified Yield II. In a negative year we expect that the funds would be down less than half of the broad equity market, as has been the case in the past.

Fund positioning

All of our core asset classes are sensitive to interest rates over the long term, yet there were large divergences in performance in 2013. High-yield bonds, for example, held up very well, starting the year with a wider-than-historical spread that compressed to a narrower-than-average spread today. At year-end, the average high-yield bond spread in the Bank of America Merrill Lynch High Yield Bond Master Index was 412 basis points, lower than the historical average of approximately 490 basis points. The high-yield bond market is thus forecasting one of two things: either (1) interest rates are set to drop, thereby restoring the average spread or, (2) an improving economy will result in lower defaults, thereby justifying a lower than average spread. Clearly, it is the latter scenario that is driving high-yield and investment-grade bond markets currently.

Conversely, Canadian REITs had a rough go in 2013 and at year-end traded at a wider-than-historical spread. A further rise in rates is already at least partially priced in. On the other side of the globe, the beaten down Asian trusts do not have a historical context on which to measure spread; however, 6% to 8% dividend yields seem very high to us when compared to 10-year bond yields of 2.38% in Hong Kong and 2.58% in Singapore.

We are seeking to deploy cash into the equity side of the funds, focusing on our core sectors of trusts, real estate, and infrastructure securities. Our cash levels are high (upwards of 18% when including short-term investment-grade bonds) as we sat on the sidelines for much of last year as our core sectors weathered the back-up in yields. High-yield bond exposure is quite low (35% in Signature High Income and 33% in Signature Diversified Yield II) and will probably continue to be so. Within the high-yield portfolio, we will continue to favour credit risk over duration risk.

AIMCO

An example of our approach can be seen with our recent purchase of AIMCO in Signature Diversified Yield II Fund. AIMCO is a U.S. multi-family REIT that we originally purchased about a year ago. After it

fell almost 10% from our original purchase price, we recently added to the position, making it the largest real estate investment in the fund.
In addition to the rise in interest rates that impacted all REITs during 2013, apartment stocks were doubly hit with fundamental negatives. Investor fears include: (1) new supply coming on stream that could pressure rent growth, (2) Fannie Mae and Freddie Mac, traditionally sources of cheap financing in the sector, will likely withdraw their lending activities over the next decade. The result could be higher borrowing costs that reduce apartment values, and (3) the recovery in the U.S. single-home market could turn renters into first-time home buyers and dampen demand for apartment units.

We think in turn all three of these concerns are overblown. While new construction is increasing, it is being measured off a historically low level and aggregate new stock is still nowhere near historical averages. Second, Fannie Mae and Freddie Mac will withdraw their funding slowly and other traditional apartment lenders, namely pension plans and insurance companies, are eager to deploy capital into the sector. Lastly, the single family home market recovery draws on an entirely different demographic than the apartment dweller. There has been a massive shift in the attitudes of 20-something professionals. Saddled with student debt, marrying later, and wanting an urban lifestyle are all established trends that favour apartments over single-family suburban homes.

Specific to AIMCO, the once second-tier company has made enormous strides in correcting its past indiscretions. Amid the noise in the sector, these accomplishments are going unnoticed in our opinion. The company has reduced debt dramatically, exited almost all of its undesirable non-core businesses, reduced the portfolio footprint to focus exclusively on top U.S. cities, and embarked on a very profitable development pipeline. We value the company at $35 per share and recently added approximately one million shares at $25.40. The dividend yield is fairly low at 4.3% (based on 2014's projected payout) but we expect very good dividend growth in the coming years as the deleveraging process matures and developments add to cash flows.

Emerging markets
Emerging markets were key, albeit indirect, beneficiaries of quantitative easing, but got sideswiped as U.S. bond yields rose. Patient investors can now make investments in sectors such as utilities, telecommunications and real estate at mid- to high single-digit dividends yields. We recently initiated such a position in the Signature Diversified Yield II Fund by investing in the IPO of True Telecommunications Infrastructure Fund, a Thai trust that houses the incumbent telco's tower assets. In our opinion, the deal was priced competitively to yield 8.8% in 2014. As it turns out, most investors are leery of investing in a country that appears of be on the verge of a military coup. Needless to say, our position is small and we have plenty of room to add if tensions continue to increase and we feel our long-term investment thesis is intact. We hope to do more in emerging markets equities and debt in the upcoming year and envision up to 5% of the fund being invested in these geographies if prices are right.

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Financial fixed-floater preferred shares
While our high-yield bond weights are low, there are select opportunities on the fixed-income side of the funds. Leverage benefits shareholders and therefore deleveraging benefits bondholders as credit risk decreases. Corporations and households began reducing debt in 2009 and are now largely finished this process. In fact, many corporations are now proactively adding debt to satisfy shareholder demands for large share repurchases. However banks, and to a lesser extent insurance companies, are still reducing debt as regulators and politicians globally demand safer, less levered banks. Nowhere else in the credit markets do investors enjoy this tailwind. Hence, in the high-yield component of the funds, we are increasing our weight in the deeply subordinated "Tier 1" debt and preferred shares of banks and insurance companies. We see this as the cheapest part of the entire fixed-income market. These are typically "fixed-floater" hybrid perpetual securities, meaning they pay a fixed coupon for the first 10 years and then, if they are not called by the issuer, pay a floating rate in perpetuity. The added nuance is that these securities are considered by regulators to be favourable equity capital during the "fixed" period but punitive debt capital once they float. As a result, these securities tend be called at the early redemption date, mitigating the interest rate risk associated with a perpetual maturity. Given this hybrid structure and credit ratings that straddle high yield and investment grade, these securities are priced, and need to be priced, competitively to attract buyers.

Some of these securities were issued at the peak of bond market frothiness in May and June 2013 and, as rates backed up, have fallen significantly in price. We have purchased names like the Ba1/BBB-rated Tier 1 JP Morgan 6% perpetual fixed-floater at five basis points below par. At a current price of 96, this preferred yields 6.57% to its likely call (redemption) in 2023. Given that government bond yields have already increased 100 basis points, we believe there will be less duration risk in this class of securities going forward as prices decline and as high-yield bond investors, who care more about price than duration risk, gravitate towards these securities.

In the insurance sector, a bond we have been held for a number of years is the Baa3/BBB-rated Lincoln National 7% fixed-floating rate bond, due in 2066. It pays 7% until May 2016, at which time it floats at LIBOR+235.75 basis points if it is not called. That translates into a yield of 6.19% to the 2016 call, or 6.50% if it is left outstanding until 2066 – which we view as unlikely. Investing in this part of the bond market is tricky as each jurisdiction has its own regulations and capital requirements. The new "additional Tier 1" Credit Suisse 7.5% fixed-floaters we purchased for the funds in December are written down if the bank's Tier 1 capital ratio (i.e. core capital) falls below a certain level. "Written down" is a polite way of saying this class of preferred equity is wiped out, thereby acting as a shock absorber if bank losses are sufficiently large enough to undermine the viability of the bank. While not ideal, we feel this is a very unlikely event in an environment where banks are going to be safer and more heavily scrutinized than ever before. As a result, we feel the yields are enough compensation for this credit risk.

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Final thoughts

Investors rotating into developed market equities today are betting that continued improvement in the U.S. economy, coupled with rising, but still very low interest rates, will propel stock markets higher. In other words, they foresee a continuation of 2013. This bull thesis can be extended further to include a positive feedback loop that traces its path from Wall Street to Main Street and back again. Here, the substantial increase in household wealth achieved over the last several years, driven by rising equity and housing markets, translates into increased consumer and business confidence. At this point, participants begin to spend and the Holy Grail of quantitative easing will be achieved – maybe.

The truth is no one knows if there will be negative side effects associated with the unprecedented monetary stimulus. Further, no one can predict what the Fed might do in reaction to the various scenarios that may unfold. In such a policy-driven environment, predicting the direction of the market requires investors to accurately forecast these four future variables (in addition to the usual myriad of factors):

1. What are the consequences of adding approximately US$3.7 trillion to the U.S. money supply in the span of five years?
2. How will other central banks respond to these consequences?
3. Will the market respond favourably or unfavourably to these new central bank actions?
4. Has the market already accurately predicted the first three variables and thus priced them into security valuations?

Our base case of a 2014 return of approximately 5% might sound uninspiring, but against the backdrop of uncertainties listed above and a fairly priced equity market, we think that the funds still have a solid place in investors' portfolios for two reasons. First, with rising yields continuing to be a severe headwind to bonds, 5% will stand up very well when compared to almost any fixed-income alternative. Second, if the base case does not come to pass and equities are headed for a correction Signature High Income and Signature Diversified Yield II should have the potential to provide valuable downside protection.

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