# Signature sound bites
# June 2012

Signature GLOBAL ADVISORS

## The global yield story lives

*by Geof Marshall*

May was a good example of why the global yield trade still has legs. During the month, high-yield bonds were down 1.2% compared to a 6% decline in stocks. High yield is going to continue to outperform in down markets but could underperform in rising markets. This trend should continue unless there are problems specific to the high-yield market, such as excess leverage. But that is unlikely since we are in a global de-leveraging trend.

Valuations are mixed, with the average bond currently trading at $99. Yields are a little low by historical standards at 7.8%, but spreads are wider than average at 690 basis points over U.S. Treasuries and 129 bps over investment-grade bonds. Additionally, aggregated leverage (debt over cash flow) is 3.2X, also low by historical comparison. High-yield valuations seem well supported at current levels. Signature's high-yield portfolio is currently yielding 7.8% with an average credit quality of BB- to B+. The majority of the holdings (90%) are rated single B or higher.

**New holdings**

Telesat Canada term loan B – Telesat Canada is the satellite communications business that was spun out of BCE five years ago. The company has very high margins. This holding is a loan, not a high-yield bond. High-yield bonds are usually unsecured with a fixed coupon. By comparison, loans are secured and have a floating rate coupon. The rate is based on Banker's Acceptances, plus 375 basis points, with a 125 bps floor, for a yield of 5%. We purchased the loan below par at $99, which increases the equivalent yield to 6%. Rated Ba3/BB-.

Gibson Energy term loan B – Signature has been involved with Gibson Energy for about five years on the debt side and one year on the equity side. The company has energy infrastructure assets in Alberta. The loan is based on LIBOR plus 375 bps, with a 100 bps floor. We purchased the loan at $99.50. It is yielding 5.5% on a floating rate basis. Rated Ba2/BB-.

Inmet Mining high-yield bond, 8.75%, due 2020 – This Canadian copper company is a first time issuer in the high-yield market, but Scott Vali, Signature's resource specialist, has known it for years. Rated B1/B+.

Allied Nevada high-yield bond, 8.75% in Canadian dollars, due 2019 – Allied Nevada is a Canadian gold producer. Rated B3/B.


2 Queen Street East, Twentieth Floor, Toronto, Ontario M5C 3G7 | **www.ci.com**

CI Investments

| Head Office / Toronto | Calgary | Montreal | Vancouver | Client Services |
|---|---|---|---|---|
| 416-364-1145 | 403-205-4396 | 514-875-0090 | 604-681-3346 | English: 1-800-563-5181 |
| 1-800-268-9374 | 1-800-776-9027 | 1-800-268-1602 | 1-800-665-6994 | French: 1-800-668-3528 |

The floating rate loans and the exposure to gold act as portfolio insurance if there is inflation and/or higher interest rates.

Cash is 15% in Signature Diversified Yield Fund and slightly lower in Signature High Income Fund. High yield is favoured in Signature's income funds, making up 37% of Signature High Income and 42% of Signature Diversified Yield.

## Big Pharma 2.0 model will lead to a re-rating

*by Rui Cardoso*

At Signature, we believe there is a turnaround coming in health care, especially in pharmaceutical stocks. The sector has de-rated for a decade and we think it is poised for healthy returns. As such, we are overweight. It is a very defensive sector; stocks are cheap, pay good dividends, have relatively clean balance sheets and expectations are low – classic ingredients for generating excess returns.

### Food and Drug Administration approvals

In 2004, the Food and Drug Administration pulled Vioxx, a drug produced by Merck, off the market for safety issues. There was a lot of backlash from Congress and the public. From 2004 to 2007, the focus of the FDA shifted from efficacy of new drugs to a "safety first" mentality, which led to a sharp decline in drug approval levels. As a result, Big pharma had to re-invent its pipelines and shift focus from "me-too" drugs to innovative products where safety profiles were well understood. After a few years in the wilderness, in 2008-2009, new drugs from revamped pipelines started filtering through the process. We are now starting to see approvals return to the level of 2002.

We don't believe that the equation of "Rational FDA + Smarter Big Pharma = More Approvals" has been factored into the price of pharma stocks. Pharma companies had big gaps in their portfolios and those gaps are leading to a "patent cliff''. But it takes time to rebuild the pipelines. While we expect revenues for pharma companies to decline or move sideways for the next couple of years, current valuations don't reflect a bounceback in R&D productivity once these new drugs come on stream. Instead, they reflect higher levels of investment, lower returns on investment, and terminal declines. In addition to a retooling of R&D at some pharma companies, the sector has also gone through a massive restructuring of its cost base, especially in SG&A – gone are the armies of salespeople targeting the same doctors with undifferentiated drugs. Innovative drugs can command higher prices and sell on their own merits with smaller specialty salesforces.

# Signature sound bites
# June 2012
#

**Turnaround in Big Pharma**

Our biggest holding is Eli Lilly, predicated largely on improving R&D productivity and unappreciated growth potential in its core diabetes franchise. For example, Eli Lilly had four phase three drugs in 2006-2007. Now it has 12. On a relative basis, its 12 phase three drugs compare favourably to Pfizer's 12 phase three assets, despite the fact that Pfizer is three and a half times larger than Lilly. (Pfizer's market cap is US$170 billion compared to Lilly's $48 billion).

Currently, diabetes treatments account for 25% of Lilly's business and is expected to account for about 45% to 50% in four to five years. The World Health Organization expects the incident rate for diabetes to double between 2010 and 2020. There are more diabetics in China than there are in the developed world. It's a massive market that is underserved and undertreated. Globally, three major insulin manufacturers have a combined 90% market share – Sanofi, Lilly and Novo Nordisk. Insulin remains an attractive growth business, with high barriers to entry.

China is a big untapped market. It now spends 5.5% of GDP on health care. The government has expanded the access to health care and has spent the last decade building hospitals and clinics in rural areas. There are 5.5 million diabetic patients currently receiving treatment in China compared to 75 million diabetics. Lilly grew its insulin business in China 40% over the last few quarters and has excellent prospects to continue at a high rate of growth.

We are bullish on the potential for drug pipelines because expectations remain very low on approval success rates and market potential. We value pharma companies with a limited value for pipelines. Based on the core business the companies are cheap – we are essentially getting low-cost options on their drug pipelines. And, while we wait for the market to realize Lilly is not in terminal decline, we are getting paid a 4.7% dividend.

**Emerging markets**

Fleury SA is a diagnostic lab business in Brazil. Brazil has government-funded health care, but it spends only 5.5% of GDP on health care. (By comparison, the U.S. spends 16%.) Private insurance has been steadily growing in Brazil because of the gaps in government health care. As a result, there will be growth in the number of tests and the types of services that Fleury provides. In addition to organic growth from increased access to care, Fleury can accelerate growth through acquisitions and increased operating scale. Fleury is the second-largest diagnostic company in the country, but it has only 6% of the market. Dasa, the largest company, has just 10%. The rest of the market is very fragmented. On the basis of increasing access to insurance and new tests and services, we believe Fleury can grow 10% to 15% annually over the next five to 10 years. If it acquires more companies, growth could be in the 30% range. It is a well-run company with professional management, and trades at attractive valuations relative to fundamentals.

# Signature sound bites
# June 2012
#

**Core holding**

Amgen is a leading biotech company with a focus on drugs for the dialysis, osteoporosis and cancer markets. Its current operations are relatively stable as more mature dialysis drugs are offset by new drugs in osteoporosis and cancer. In addition, there are a few interesting assets in the pipeline that, in our view, are not factored into current valuation levels. It has a solid balance sheet and generates a lot of excess cash. The company just bought back 20% of its shares and it has the ability to keeping buying back 10% a year. The company produces a 10% free cash flow yield annually. As long as management keeps doing the right thing (i.e. buying back its own stock at low valuations), we are very comfortable holding the stock.

In Signature Select Canadian Fund, health care is just under 10% of the portfolio – that is about the same weighting as in the MSCI World Index, but substantially higher than what can be found in the S&P/TSX Index.

*Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. This commentary is provided as a general source of information and should not be considered personal investment advice or an offer or solicitation to buy or sell securities.*