

Canadian Fixed Income

Q2 2010

Investor profile: Suited to the investor whose objectives are income and capital appreciation over the medium term.

Objective: The portfolio's objective is to provide interest income with the potential for capital appreciation by investing primarily in Canadian fixed income securities, including government securities and corporate income producing securities.

Investment Strategy: Laketon's active investment style is designed to continually capture incremental gains relative to the portfolio's benchmark. The manager adds value through yield curve and duration management, sector allocation and individual security selection.

Investment performance

	Annualized rates of return (%)					
	Quarter	YTD	1 Year	2 Years	3 Years	5 Years
Canadian Fixed Income	3.28	4.84	7.57	7.21	7.12	5.08
DEX Universe Bond Index	2.93	4.22	6.88	6.95	6.90	4.92
<i>Value Added</i>	<i>0.35</i>	<i>0.62</i>	<i>0.69</i>	<i>0.26</i>	<i>0.22</i>	<i>0.16</i>

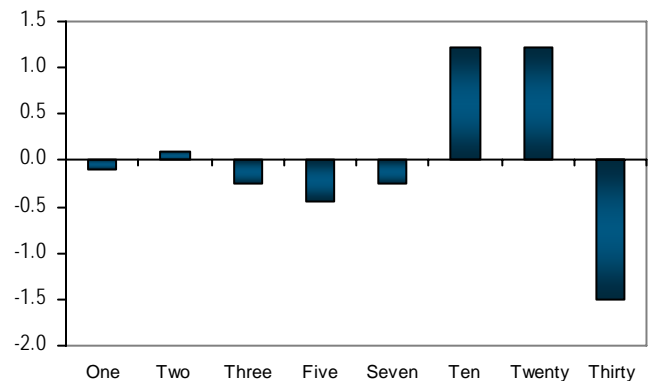
Returns shown (which are gross of fees) reflect the performance of the model portfolio. Actual returns experienced by an investor may differ from those shown.

Portfolio Characteristics

	Portfolio	DEX Universe Index
Running Yield	3.37%	3.08%
Modified Duration* (years)		
Canada	1.70	2.44
Provincial	2.88	2.09
Corporate	1.28	1.46
Municipal	0.22	0.10
Total	6.07	6.09

*duration contribution indicates the level of spread exposure

Duration Contribution vs DEX Universe Bond Index



Top 10 Holdings

	Portfolio (%)
Canada 3.8% 01-Jun-19	18.9
Ontario 6.5% 08-Mar-29	14.0
Canada Housing Trust 3.6% 15-Sept-13	8.9
Nova Scotia 4.2% 25-Nov-19	5.0
Quebec 6.3% 01-Jun-32	5.0
407 International 4.7% 20-Jan-12	4.5
GE Capital Cda Fund 4.4% 28-Sept-12	4.1
GTAA 6.3% 30-Jan-12	4.0
Bank of Nova Scotia 5.0% 08-Apr-13	3.8
Thomson Corporation 5.2% 01-Dec-14	3.3
Total	71.6

Sector weights* & quality diversification

	Portfolio (%)	DEX Universe Index (%)
Federal	30.26	47.28
Provincial	27.16	24.79
Corporate	39.67	26.52
Municipal	2.91	1.41
AAA	33.40	52.44
AA	27.23	22.06
A	37.16	19.50
BBB	2.21	6.00

*weight indicates the level of credit exposure

Market Review

- The second quarter caught the majority of bond investors off guard, and off side; as fears of inflation were quickly replaced with fears of sovereign debt problems and fears of a double dip.
- 10-Year Government yields in what investors consider the relatively safest of countries found their lows previously seen in the fall of 2009; e.g. U.S. – 2.93%, Germany – 2.51%, and Canada – 3.08%.
- In contrast, those countries deemed to be sovereign debt problems, saw their yields rise; e.g. the Club Med countries such as Portugal – 6.27%, Greece – 12.43% and Spain – 4.88%.
- Somewhat ominously, the widening in weak sovereign spreads translated into a widening of interbank lending levels, swap spreads and credit spreads, eliciting broad fears of a second credit crisis.
- We have been talking about sovereign debt problems for some time; but with the debt problems of the PHIIGS (Portugal, Hungary, Italy, Ireland, Greece, Spain), and potential debt problems of certain Anglo economies, the market focus has turned squarely to sovereign debt.
- Perhaps the most telling response to the issue of sovereign debt has come from the G20 Summit in Toronto and the leader's commitment to cut Debt/GDP levels in half by 2013.
- However, as always, there is no free lunch; cutting debt levels means cutting budget deficits, and consequently reducing the main catalyst for developed country growth – government spending. Investors are keenly aware of this dynamic, which has contributed to the decline in certain government yields.
- But the ramifications of mounting sovereign debt are not the only issues worrying the market. U.S. economic data, which had been more convincingly positive in the first quarter, began to take on more troubling tone in Q2 with declining retail sales and troubling housing data.
- And China – ever the wild card, has been sending signals that it would take steps to reign in its over-heated housing market, thereby impacting a main engine of global growth.
- The upshot, government returns in Canada were a stellar 3.67% (DEX Canada Index) with particularly strong contributions from the front end of the yield curve - the Short, Mid and Long Canada indices returned 1.81%, 4.29% and 6.90% respectively.
- Corporate returns were more disappointing at 2.27% for the corporate component of the Universe resulting in an overall bond market return of 2.93%.
- Despite the rush of companies to issue debt ahead of the rate hike, corporate bond issuance had its fits and spurts during the second quarter. Total issuance in H1 was a healthy \$39 billion but is expected to slow as profits and retained earnings have increased. In comparison, issuance in H1 2006 and 2007 was 43.4 and 46.4 billion respectively.
- Investors did see some new, or not seen in a while, issuers come to the market, particularly in the municipal and infrastructure spaces. Names such as City of Toronto, Peel Region, and 407 International were generally well received, albeit at slightly wider yield spreads than issuers would have looked for just a quarter earlier.

Portfolio performance attribution

Positive performance factors in the second quarter

- The portfolio benefited from the duration extension in March and April of one-half of a year greater than that of the benchmark. Following May's rally, the portfolio duration was brought back to neutral. Additionally, the portfolio's concentration in 10 year bonds proved to be reasonably good positioning in the recent curve flattening as 10 year yields rallied by 20 basis points and the 2-10 yield curve flattened by 32 basis points over this period.
- On a duration weighted basis the portfolio's corporate exposure was approximately one-quarter of a year shorter than that of the index which was positive as corporate spreads widened by 28 basis points on average for the quarter. Additionally, the portfolio's mid and long-term corporate holdings are primarily defensive names which outperformed.
- The running yield of the portfolio is much higher than that of the index (3.37% versus 3.08%) as a result of our overweight in higher-beta short corporates (32.6% versus 15.6%) and the concentration in 10-Year Government bonds.

Portfolio performance attribution

Negative performance factors in the second quarter

- Coincident with corporate spread widening, provincial and municipal spreads also widened, but to a much lesser degree. For the quarter, mid and long-term provincial spreads widened by 7 and 17 basis points respectively. The portfolio is approximately three quarters of a year overweight provincial credit relative to the index on a duration weighted basis.

Outlook & strategy

- Following May's rally, the duration of the portfolio was brought back to neutral on May 31st. Although yields rose, it was only temporary, and now bond yields are back to the lows for the year. We believe longer term yields are at the lower end of a trading range, but will continue to manage the portfolio's duration from a neutral to long position.
- We believe the Bank of Canada has embarked on a tightening cycle that will be very dependent upon incoming economic data. In the banks spring Monetary Policy Report we thought the Bank was on a clear path to normalising rates, which we interpreted as a series of hikes to about 2%. In our view, recent events have caused the Bank to shorten its projection horizon, creating more policy uncertainty over the medium term. Consequently, we expect short term rates to be more volatile.
- The concentration in 10-year bonds, has given the portfolio more running yield, reasonable positioning in the recent flattening, and good performance in the second quarter rally. We expect the 10-year part of the yield curve to stay out of trouble, and hence we will retain the portfolio's overweight.
- The recent underperformance of corporate and provincial bonds has presented an opportunity to increase the portfolio's running yield at attractive yield spreads. We have begun this process and will continue to look for further opportunities. We expect credit spreads to remain at heightened levels, until there is further clarity on the PHIGS situation.
- Although we have not been immediately concerned about the North American sovereign debt situation, we have noted that the situation in the U.S. was something to be watched. However, we believe that the trouble with European sovereign debt will likely provide a longer window for the U.S. to address its issues.
- The first risk to our outlook would be the spread of sovereign debt problems. If these concerns translate in a more significant way to the banking sector, the result could be widespread credit concerns and the risk of a repeat credit crisis.
- The second risk is that governments' enthusiasm to reduce debt/GDP levels proves to be too aggressive and/or too early. A policy misstep could ultimately prove too much for recovering developed economies, resulting in a second recession. Although, we would question whether there would be resolve amongst governments to carry out austerity plans should there be signs of failing growth.