

Canadian Corporate Bonds

Q3 2010

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

Objective: Laketon's approach places its primary emphasis on achieving a reasonable level of yield-pick up while avoiding credit risk.

Investment Strategy: Laketon employs rigorous credit analysis and valuation techniques to select individual securities required for the optimal portfolio structure. The result is a well diversified portfolio of liquid, investment-grade instruments with credit quality that does not differ significantly from the corporate universe. The portfolio seeks to mitigate risk through the use of a variety of tools, including: issuer quality, term-to-maturity, seniority, capital structure ranking, options, conversion privileges and ultimately the securities overall weight within the portfolio.

Investment Performance

	Rate of return (%)		
	Quarter	YTD	1 Year
Canadian Corporate Bonds	3.5	7.5	8.2
Benchmark	3.2	7.8	8.9
<i>Value Added</i>	0.3	-0.3	-0.7

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 management team

	Years of experience	Years with Laketon
Gary Morris, CFA	23	18
Thomas Gomes, CFA	14	10
Siek Djoe, CFA	16	5
Jenny Wan	7	6

Portfolio information

Benchmark:	DEX All Corporate Index	
Total Holdings:		25
	Portfolio	Benchmark
Yield	3.29%	3.50%
Modified Duration	5.59	5.62

Top 10 stock weights

	Portfolio (%)
SNC Lavalin Group Inc. 6.2% 3-Jul-19	4.8
RBC TruCS 5.8% 31-Dec-13	4.8
BNS Capital Trust 6.3% 30-Jun-13	4.7
Capital Desjardins 5.5% 1-Jun-16	4.7
Manulife Financial 5.2% 26-Jun-15	4.6
EPCOR Utilities Inc 5.8% 31-Jan-18	4.6
Thomson Reuters Cor 5.7% 15-Jul-15	4.6
Toronto-Dominion Bk 5.5% 2-Apr-15	4.5
Nat Bank Of Canada 5.6% 15-Nov-13	4.5
GE Capital Cda Fund 5.3% 17-Aug-12	4.5
Total	46.2

Sector diversification

	Portfolio (%)	Benchmark (%)
<i>Sector Breakdown:</i>		
Financials	49.42	51.94
Infrastructure	16.75	13.97
Energy	13.65	12.88
Securitization	0.00	3.95
Communication	11.02	9.76
Industrial	4.83	6.25
Real Estate	0.00	1.24
Cash	4.33	0.00
Total	100.00	100.00
<i>Duration Weight by:</i>		
AAA/AA	0.77	1.35
A	3.78	2.76
BBB	1.04	1.51
Total	5.59	5.62

Market review

- Corporate bond performance in Q3 was volatile. July saw corporate yield spreads tighten on the back of relatively positive earnings reports but widen back out again in August as equity markets took a tumble and growing anticipation of new supply in September. September's supply ended up coming in on the light side of expectations and spreads performed extremely well throughout the month. Overall yield spreads tightening by 3 basis points on average for the quarter. Amongst this volatility, market participants continued to deploy cash into corporate bonds, albeit with some level of trepidation as yields approached historic lows.
- Corporate issuance in Q3 was brisk with 42 issues totaling \$16.3 billion. On a year-to-date basis, total issuance has reached \$55 billion but this growth is expected to slow going into year-end as there are fewer maturities. Also, many of these upcoming maturities are bank debt, which may not be refinanced domestically due to lower financing needs and the Big Five's recent preference to issue in the Yankee market (\$11.2 billion in Q3). Beyond the banks, a number of the remaining maturities have already been refinanced as issuers opportunistically prefunded amid the backdrop of a rallying bond market.
- For the quarter, short-term and long-term corporate spreads tightened by 8 and 3 basis respectively whereas mid-term corporate spreads widened by 2 basis points. This resulted in absolute returns (which accounts for changes in the yield curve) of 2.02%, 3.55% and 5.42% respectively. Underperforming sectors for the quarter were financials (particularly "par call" Tier 1 bank and insurance issues) and telecom/cable (due to deals and rumours of upcoming supply) whereas long defensive sectors (i.e. utilities, infrastructure and pipelines) outperformed.

Fund performance attribution

Positive performance factors in the third quarter

- Investors had a need to extend duration but were only willing to do so through higher quality sectors (i.e. infrastructure and energy). This resulted in long infrastructure (i.e. utility and transportation) and energy (i.e. pipelines, generation, distribution) as the best performing segments within the corporate Universe. This was positive for the portfolio as it is overweight longer-term infrastructure and energy names.
- The financial yield spread curve steepened significantly over the quarter as short-term yield spreads tightened by 14 basis points whereas mid and long-term spreads widened by 3 and 16 basis points respectively. The portfolio's positioning in financials benefited on two fronts. First, the portfolio is underweight financials. Secondly, the financials we do hold are almost exclusively shorter-term debt which experienced spread tightening.
- Noteworthy during the quarter was the announcement of new Basel guidelines, leading to significant spread widening on new or third generation high coupon "par call" innovative Tier 1 bonds. While negative for these specific issues, the news was positive for other existing subordinated debt and older generation Tier 1 hybrid issues. Under the new reforms, both of these structures will be phased out and replaced by securities that have contingent capital provisions. This resulted in a scarcity premium being attached to the grandfathered issues and a positive for the portfolio as it holds a number of them. On average, 5-year subordinated bank debt tightened by 17 basis points relative to deposit notes. We would note that we have always limited our exposure to Tier 1 hybrids from older generation series with holder exchange features.
- Escalating competition, the ramifications of Bell's convergence play coupled with large new issuance (Rogers, Bell Aliant) and rumours of further supply (BCE, Shaw) pressured telecom/cable spreads across the curve. This was positive as the portfolio is underweight telecommunication.

Negative performance factors in the third quarter

- Dismal earnings from Manulife followed by a large new – \$900M (upsized from \$500M) 5-year issue pushed its spreads wider. It is worth noting that despite the deal coming at a hefty 185 basis points over the curve, representing a 30 basis point concession over secondary market levels, the 4.079% coupon was still well below the 4.896% paid when Manulife last came to market in May 2009 with a similar \$1.0 billion 5-year bond (+230 basis points).
- The portfolio continues to be structured with a more conservative, defensive bias relative to the index and as a result has a lower running yield (3.29% vs. 3.50%). This acted as a drag on relative performance during the quarter.

Outlook & strategy

- Canadian corporate spreads have held up well year to date but the general direction of spreads remains tied to global equity markets as fundamentals continue to take a back seat. We believe that the recent relative underperformance of the domestic corporate bond market had more to do with supply concerns than a significant degradation of economic fundamentals or the general quality of credits. Although there are still many areas of

economic uncertainty, our expectation for policy support – both fiscally and monetarily, should keep yield spreads well supported. The recent underperformance of corporate bonds is presenting an opportunity to increase the portfolio's running yield at attractive yield spreads.

- Market participants have cash to invest and we are witnessing a desire to move toward longer duration mandates; these combined pressures should help to push yields lower, although not without a high level of trepidation. In this environment, we would expect the credit curve to flatten. Additionally, we expect that if there is no significant selloff in the equity market and there are no unexpected negative surprises on the economic front that there will be issuance, particularly from higher beta sectors and Maple issuers. We also continue to see a backdrop that is favourable for non-financial or infrequent issuers, as there continues to be a premium attached to name diversification.