LAKETON

Laketon Fixed Income

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Milos: Hello and Happy New Year !!! to all of our listeners tuning in to the first in a new series of audio commentaries for 2009. These commentaries can be found on the Laketon website at www.laketon.com and feature Laketon portfolio managers in discussion regarding financial markets as well as the particular fund portfolios they manage.

My name is Milos Kostich, and as VP Sales, Strategic alliances, it is my pleasure to have with me today Gary Morris, Director of Fixed Income….Welcome Gary..

Gary: Well, thank-you Milos. It's a pleasure to be here.

Milos: Gary, the capital markets, like the equity markets have experienced unprecedented upheaval and turmoil in 2008. Investors are wondering what they can expect in 2009 and beyond in terms of some sort of stability and predictability regarding capital markets, and furthermore I think they are also wondering whether all of the proposed stimulus packages promised will have real and immediate effects on the problems at hand.

Gary, Can you give the listeners a sense of where we have been and in your view what lies ahead in the capital markets in the shorter to medium term?

Gary: I think a good starting point is really about 18 months ago, looking at around June/July 2007 that really coincides with when we started to see the problems at Bear Sterns surface. Essentially there were problems with a couple of their mortgage funds. Subsequently, we saw sale of Bear Sterns to JP Morgan in March 2008. In 2007, at that time, we saw the ABCP collapse which many listeners will be familiar with, and really that was the starting point of the credit crisis that emerged in 2007 and I think I wouldn't say ended, but certainly culminated or reached a nexus with the collapse of Lehman Brothers in Sept of 2008. And really that is kind of a backdrop of where we have seen this crisis come from.

So it has been ongoing credit crisis that has morphed into an economic crisis if you will. The banking sector hasn't really recovered and certainly the stock market was another casualty in the fourth quarter of last year. In response to that what we are seeing today is extreme and extensive government involvement in response. Globally central banks have been very very active in terms of monetary policy. What's ahead is much more fiscal policy, I think we have seen perhaps the limits that monetary policy can be effective in this environment, and so we are going to see a lot of government spending and that is going to really occupy a lot of the discussion going forward. The U.S .has been the leader, and will be continue to be the leader. Their economy is certainly one of the biggest sufferers at the moment, but the Canadian government will also be active and I think in Canada we can expect to see our government spend between 1 to 1.5% of GDP in terms of tax breaks and infrastructure spending so that's kind of what lies ahead, its going to have great implications for how capital markets behave both domestically but in the global context as well.

Milos: With all of the talk regarding gov't stimulus packages, gov't deficits are a certainty I think. This raises the spectre of higher inflation going forward. Do you feel this poses serious challenges for the bond market as a whole, and could we see bond returns at risk as a result?

Gary: Well, I think you have to be careful when you talk about deficits and inflation. Because I think there is certainly the view point that government spending will be inflationary, and so, that in itself is not necessarily a product of the deficit. So I am going to separate the response in two parts.

The deficit side of things will be a problem. Governments to spend will have to incur significant deficits and to offset some of that deficit they will be borrowing significantly in the capital markets, there will be a lot of government bond supply, and that should be a problem for bond yields. Hopefully offsetting that I think will be the kind of savings we are likely to see from the consumers and some of those will flow into government bonds.

On the other hand, you have the government spending implications on inflation. My feeling is that really what you are talking about here is less about government spending and really much more about supply side economics. So, traditionally the monetarists would say that injecting all this money in the economy should be inflationary, and I would counter that with the fact that if you look right now, there is significant excess capacity in all aspects of the economy, and it is likely to be some time before that capacity gets diminished. So likely if anything, it’s going to be much more of a deflationary environment than a inflationary environment.

Milos: Looking at both government and corporate bonds in 2008, yield spreads had widened considerably between the 2 sectors. Can you give our listeners a sense of why these yield spreads are important and how they affected the returns in both the government and corporate bond sectors in 2008.

Gary: Well, Milos investors have historically looked for some sort of compensation for taking additional risks, of owning corporate bonds or debentures versus government bonds. If you look back to the 2004 - 2007 time frame, you will see that in hindsight, investors were not seeking enough compensation, and we know that today because you have seen a significant widening of corporate spreads. For example, if you look back to the middle of 2007, 5 year Canadian bank senior deposit notes are basically 200 basis points wider, at the peak of the yield spreads in Dec of 2008. So that was some 200 basis point widening or four times the amount of spread that the investors were being compensated a year prior. So really what it has meant is that the owners of the government bonds in 2008, far outperformed owners of corporate bonds during that period.

Milos: With many pundits now hailing the "BIG" opportunity in corporate bonds, why aren't we seeing some spread tightening. What risks lie ahead that people may not have considered?

Gary: Well, in fact Milos we actually have seen spread tightening. Perhaps not consistent with or on the scale with the exposure that the corporate market has received, but we have seen spread tightening thus far this year. Perhaps some of the problem that the corporate market is still facing, would include a lot of balanced funds that have to still to be rebalanced, they have had their equity losses being outstripped their bond loss, hence now overweight the equity market and they hadn’t rebalanced last year. A lot of investors are overweight corporate bonds on the institutional side so there really isn’t a deep appetite for more corporate bonds. The intermediaries aren’t playing their role in the corporate bond market which makes it more difficult for corporate bonds at this juncture, and then finally the issuers really been on hold since last year, so that there is a queue of issuers that investors are aware of. Perhaps one last point I’d make is that the economic picture is still very uncertain at this point, so it makes it very difficult for the investors to really want to gobble up corporates in a big way.

Milos: In your mind what is the big opportunity that lies ahead in the corporate market?

Gary: Put simply there is enormous yield pick-up and pretty great break-even protection in corporate bond market. Certainly historical context that I've observed and so that really is big big opportunity. At some point spread will move in (we live in a capitalist driven society and they ultimately grow), and so the corporate yield spreads at this level really inhibit that. So I would suggest that some point, you going to see capital appreciation as well in the corporate market.

Milos: Gary, Given your outlook and commentary regarding the capital markets as a whole, can you comment on how you have positioned the portfolio for the Canada Life/Laketon Fixed Income Fund (S19)?

Gary: Well, we currently have a neutral duration, or average term versus the benchmark index which is DEX Universe benchmark, and that would put the duration at around 6 years. We believe there will be an opportunity for us to extend the duration; we have seen a significant recent sell-off in the government bond market, fears of inflation and funding concerns for the government as well as the sort of widely talked about "*Treasury bubble"* have certainly put some concern or fear in the government bond market at this time. So we think we can capitalize on that. And then finally, we are overweight corporate bonds, and we see an opportunity for the corporate bond market to outperform going both on a yield pick up basis and as well as on a capital appreciation basis.

Milos: Gary, we've seen exceptional returns recently in the Canada Life Laketon Int'l bond fund. Can you give our listeners a short overview of the fund and what factors have played positively in regards to this portfolio?

Gary: The fund has been part of the Canada Life platform for many years, and is has been conservatively run throughout that time with large exposure to global government bond markets. Historically, it has only had a relatively small exposure to the Canadian dollar and the Canadian bond market and that has somewhat reflected Canada's weight in the global government bond context. And simply, if you look at the most recent 12 month period, we had a significant decline in the Canadian dollar and significant out performance in government bonds, both of those factors were very pivotal in generating outsize performance for that portfolio.

Milos: Thank you Gary for joining us today, I know that you have definitely shed some light on the issues at hand, and I hope that our listeners can leave today with a better understanding of the both the challenges and opportunities to be found with investing in the fixed income market…

I would like to remind our listeners that the quarterly fund reports for all of the Laketon funds available on the Canada Life Generations shelf are now available on the Laketon website and these reports are available quarterly.

Thank you once again for tuning in…..