Market Commentary
CI Digital Roadshow

Signature's Fixed-Income Solutions Meeting the Challenge
Summary of a presentation by Signature Global Asset Management
September 20, 2016

Eric Bushell, Chief Investment Officer

- Signature manages about $30 billion in fixed-income securities.
- Developments in the corporate credit and government bond markets have dominated capital markets activity in 2015 and 2016, and have relevance for equity market participants because of the interconnectedness between the asset classes.
- For the past few years, our concern about the potential for deflation driven by secular and cyclical forces resulted in advising investors to stay balanced and to stay long on bond duration, which can act as a hedge against deflation. We saw a potential deflationary shock building in the commodity markets and emerging economies.
- Bonds sold off in 2013 when the U.S. Federal Reserve began to taper its quantitative easing programs. Many investors abandoned duration in favour of shorter-term corporate credit, floating rate paper and less conventional bond strategies. That was unfortunate as we entered into one of the biggest duration rallies in history. Long duration government bonds were up 60-100%, driven by weak fundamentals and central bank easing policies. This progressed right up until the Brexit vote in late June.
- We now believe the pure duration bet is coming to a close. Cyclical and commodity price deflation are moderating, we are seeing green shoots of new growth, and inflation expectations are stabilizing. So we are a little less government-bond focused. Today we are advocating a more diversified approach to fixed income, requiring significant broad capability from fixed-income managers.

Kamyar Hazaveh, Vice-President and Portfolio Manager

- We have expanded the Signature rates team to cover money market, Canadian government bonds, emerging market bonds and global developed market government bonds, including more specialized products such as inflation-linked bonds and mortgage-based securities.
- Because yields have fallen so low (many bonds offer negative yields), even investors with longer duration are challenged to get reasonable returns. Our solution is diversification. There is yield in corporate credit, emerging market bonds and mortgage-backed securities. Signature Tactical Bond Pool pulls all of the levers to deliver investors' fixed-income goals such as diversification, liquidity, income and inflation protection. It's nimble and has the flexibility to tap into the best yield opportunities.

- Weak growth and deflationary forces, as well as the surprise Brexit result, have helped bonds in 2016, with most developed market indexes yielding about 2% and having risen 4-6%. Cyclically, however, we are seeing a recovery in real growth and uptick and inflation. Neither of these forces are bond-friendly, so we have a defensive view on government bonds, particularly long duration.

John Shaw, Vice-President and Portfolio Manager

- Signature has expanded its investment-grade credit capabilities to cover more markets around the world, including the top 100 corporate global bond issuers.
- We firmly believe we are in the latter stages of the credit cycle. We are seeing more shareholder-friendly activity at the expense of bondholders, company leverage is rising, top line revenue is flat, and net earnings have been falling. Merger and acquisition activity has picked up, mostly financed with debt. Spreads have tightened since February. We are growing more cautious on the market as a whole and some sectors in particular.
- Our corporate bond investment framework looks at factors like credit fundamentals, technical factors and investment sentiment. Over past six months, central bank-fuelled liquidity has trumped fundamentals.
- The European Central Bank's program to buy US$5-7 billion in corporate credit per month has had significant consequences for investment-grade markets since March. It has been a huge tailwind, along with rising energy prices, the Bank of Japan's easing policy and the Fed's decision to delay a rate increase. Spreads have tightened in both Europe and the U.S. corporate bond market.
- U.S. bank capital bonds (equivalent to preferred shares in Canada) offer a very good risk/reward opportunity and have been one of our favourite investments since the financial crisis of 2008. Regulators have worked to create a more robust U.S. banking system that can withstand financial shocks on its own without relying on public bailouts. Regulatory changes are resulting in better business quality and credit quality and limiting risks. Capital payouts are more secure. This has supported the preferred share market globally and has resulted in good returns. Yields have declined in the last few years and now hover around 5%, which is still an improvement over Canadian corporate bonds.
- Besides financials, we are finding good value in the energy sector, which includes pipelines as well as oil and gas. Management teams are taking positive steps to support their share prices and improve credit quality despite lower commodity prices. The portfolios were overweight energy for the past six months but we have recently begun to sell these bonds at a profit.

Geof Marshall, Senior Vice-President and Portfolio Manager

- The Signature high-yield investment team understands the unique risk/reward nature of the high-yield bond market. It is very easy to lose money in high yield when a bond defaults, and far more difficult to double your investment as high-yield bonds that are performing well are often called early so that companies can re-finance. Many investors do not understand the risk.

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- We are focused on avoiding losses, resulting in a high active share for our high-yield bond portfolio. We undertake very deep due diligence to understand the company, industry, end markets, bond structure and the company's capacity to repay. We are built on a sector specialist model like the equity teams at Signature and co-ordinate extensively with the investment-grade team.
- The high-yield market was overbought in 2013-2014 and swung to oversold last year and early this year. The pain was concentrated mainly in the metals and energy bond markets, where prices went from above par to about 60 cents on the dollar and defaults rose from about 2% to 5.5%. Since then central bank easing policies and the weakening of the U.S. dollar have helped the market to begin to recover.
- We have seen issuers begin to repair their balance sheets with equity issuance, reduced costs and asset sales, sometimes at the expense of shareholders.
- The markets now appear to be fairly priced. We have seen the market recover since February; spreads have tightened from 850 basis points to 530, so prices are up about 13.5% from the bottom. This is in the context of a growing U.S. economy and lower volatility in the foreign exchange and rates markets. We are likely to see more spread tightening. Default rates have room to fall from 5.5%.
- The Signature high-yield portfolios are overweight metals, financial and energy names where we see de-leverage happening. We have upgraded the portfolio with companies like Cenovus, EnCana, Seven Generations and some Permian basin producers like Endeavour. Other floating rate bonds we own include Formula One, Amaya, Cirque du Soleil and Xplornet. We also like certain private placements that offer more alpha in exchange for a bit of liquidity risk.

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