Market Commentary
First Quarter 2018

Signature Diversified Yield II Fund

The first quarter of 2018 started on the right foot with equity prices higher, and spread compression in corporate bonds more than offsetting the gradual move higher in U.S. Treasuries. Markets soon turned lower, however, after concerns about higher inflation related to strong U.S. economic data. This sparked an increase in both interest rate and equity volatility near the beginning of February that continued into the end of the period. Two of the five asset classes represented in Signature High Income Fund performed reasonably well given market conditions, with high-yield bonds delivering essentially flat results, while currency effects added slightly to returns. Other asset classes including real estate, infrastructure and other income equities, however, underperformed in local currency terms and detracted from overall performance.

Fixed income

Corporate bond market performance across ratings was commensurate with credit risk, with lower-rated issues outperforming, as would be expected in a spread-tightening environment. However, in the first quarter this was correlated with duration as U.S. credit yields increased, despite the equity volatility. Typically, duration falls in line with credit ratings, but the first quarter was anything but typical. Cross-asset correlations and volatility spiked as U.S. government bond yields moved higher.

The fund carried a slight overweight allocation to high-yield bonds and fixed-floating preferred shares which delivered flat returns.

High-yield bond spreads widened slightly as U.S. Treasury yields backed up in the quarter, pushing index returns negative. One of the small positive contributors to fund performance was Getty Images; we own the 7% bonds due 2020 and the L+350 term loan due 2019. Detracting from relative performance was our position in Teck Resources 6% bonds due 2040. While the U.S. yield curve flattened significantly in the quarter, the long-end ended 23 basis points higher; this was enough to cause a price drop in long-dated corporate bonds. We view Teck Resources as a near-term upgrade candidate to investment-grade and believe the ensuing spread compression will more than mitigate any further increases in long-term rates.

During the quarter we added a new position in Boyne Resorts 7.25% bonds due 2025. Boyne is the owner and operator of ski resorts in Canada and the U.S., including Cypress Mountain just outside of Vancouver. Our previous experience in the term loan of Intrawest and the equity of Whistler-Blackcomb and Vail gave us additional confidence in the cash flow characteristics and asset value of the business model.

The fund uses a tactical hedge ratio, meaning that a portion of the assets held in U.S. securities are exposed to currency fluctuations. As the Canadian dollar depreciated against the U.S. dollar in the first quarter, currency effects added slightly to performance.

Equity: Infrastructure, energy, real estate

Signature Diversified Yield II held a slight overweight in infrastructure equity over the quarter, (18.87% of the fund), but this asset class detracted from performance, returning -9.6% in local currency terms within the first quarter. Prices for the fund's holdings in midstream and energy infrastructure companies, including Enbridge, Pembina Pipeline and Williams Companies, slid despite stronger oil prices (WTI crude was up 7.5% in the quarter). On the plus side, the dividend yields now range from 5.5% for Williams Cos. to 6.8% for Enbridge.

Sentiment for midstream energy companies has suffered based on concerns about the sustainability of growth and unfavourable regulatory developments. In particular, Enbridge and Williams have been affected by a ruling that will disallow tax breaks on pipeline rates. Our analysis suggests the share price reaction is overdone, and that the market is not recognizing the growth potential for both companies. We believe valuations will recover as new projects come on line and the resulting free cash flow drives strong dividend growth, more than offsetting the impact of the tax ruling. Although Enbridge also appears over-leveraged following its acquisition of Spectra, we believe the company has numerous assets it can monetize to pay down debt, including Western Canada gas gathering and processing assets and its joint venture interest in DCP Midstream in the U.S. Some of the fund's transportation infrastructure names – Macquarie Atlas Roads, Sydney Airport and Transurban – also weighed slightly on performance due to perceived interest-rate sensitivity.

The fund was significantly underweight real estate equity, where we expect opportunities to continue to arise. At current pricing, we view continued short-term volatility as an opportunity, as U.S. REITs appear cheap relative to corporate bonds and equities. We have been adding select real estate companies to the portfolio, buying on the dips, and anticipate that the weighting in the fund will continue to rise.

One of the real estate names we added is Prologis. Whereas most property fundamentals are slowing with supply increasing some markets and demand waning in others, industrial property seems to continue to be supported by structural tailwinds. Prologis is transitioning from being a provider of industrial space to a key piece of infrastructure in the logistics chain. The stock features strong growth potential and the returns on the underlying asset class look good relative to other property types.

The biggest single real estate detractor was Colony. We took a positive view last year after the company acquired Northstar in late 2016; however, it turned out the assets it acquired were struggling more than anticipated. To preserve capital, Northstar cut its dividend in the first quarter of this year, resulting in a drop in the stock price that detracted from fund performance. We exited the position as well as several others that fit into the "value" camp in real estate.

It is important to note that we believe the real estate asset class remains strong. We also believe that a repricing of the asset class since its all-time highs in the summer of 2016 is completely normal, and healthy. However, while REITs are cheap, the underlying property is going through a slight price correction of its own, therefore we are not allocating capital to any REIT trading at a discount to net asset value (there are many). Instead, we believe that strong property types with abilities to push rents are offering opportunities.

The other large detractor was Hudson's Bay Company, where the stock was down 20%. The board has assured us it is working on some transformational ideas, but it has yet to come up with anything. The board has taken some strong action in selling the Lord & Taylor Flagship store, and bringing in WeWork and Rhone as partners, and this should help to significantly de-lever the company's balance sheet. It is also marketing its Vancouver store, which could also fetch several hundreds of billions. The company recently hired a new CEO who has yet to articulate a plan for the company. Monetizing real estate is a good strategy, however the risk is that the company takes this money and dumps it into its failing retail business. We think the most important catalyst will be when Land and Buildings (the activist investor) reaches the end of its standstill in the company after the annual general meeting (likely in June). At this point, Land and Buildings has agreed to support the company as it integrates the WeWork deal and the new CEO. After that, we think the activist investor has every reason to get loud again and push for change.

Non-core equity: Overweight 12.9% of fund

Other equities – financials, consumer staples and energy – were a slight drag on performance. The biggest difference between the Signature income funds and competing funds is the high active share strategies used by Signature. While the Canadian banks are a large part of our benchmark, it has been some years since we owned a Canadian bank given valuations compared with global alternatives. Our position in Wells Fargo represents 2.41% of the fund. While that dragged on performance, this was equal to the drag on performance had we owned the Canadian banks.

Our newest position here is Manulife Financial. Manulife is Canada's most global financial listing with compelling growth franchises in Asia, complemented by strong insurance and wealth businesses in North America. The market has recently ignored the benefits that the company enjoys from U.S. tax reform, higher interest rates, ongoing strength in its Asian franchise and simple currency benefits from a weak loonie. In contrast, the market appears to be extremely concerned with Manulife's legacy U.S. businesses, especially Long-Term Care (LTC) following GE's recognition that its LTC reserves were deficient by billions of dollars. Currently it seems that the market is discounting reserve charge risk to extreme levels. Manulife's franchise has continued to strengthen in recent years and we currently view diversification from Canadian households as desirable. This feature, combined with the market excessively discounting reserve charge risk, supports an attractive investment opportunity.

Outlook

Although valuations for many of the fund's income asset classes declined to levels seen in 2016, risk levels have improved since then. In the first quarter of 2016, the U.S. Federal Reserve had just begun to increase interest rates, despite weak commodity prices and softening global growth. In the most recent quarter, the Fed's intentions to raise rates are priced into valuations and bond market fears are abating after volatility in January. Many investors may turn back to these income asset classes again after the recent decline in technology and growth stocks, much like the early 2000s. Valuations are starting to look more attractive, especially when we take a longer-term view based on how low interest rates could fall in the next downturn.

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Class F Returns (in %) as at March 31, 2018	Year-to-date	1 year	3 year	5 year	Since inception	Inception date
Signature Diversified Yield II Fund	-4.1	-1.7	0.6	4.9	6.0	2/15/2011

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