Market Commentary
October 2015

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Signature High Income Fund and Signature Diversified Yield II Fund

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Signature High Income Fund and Signature Diversified Yield II Fund experienced a higher-than-normal downdraft through the third quarter of 2015 and have underperformed in their category for the year-to-date. This commentary will explain some of the reasons for the underperformance, how the portfolios are positioned and the outlook going forward. But jumping straight to the conclusion, valuations are now at very reasonable levels and our three-year outlook for these funds is more positive than it has been in several years.

The yield demand feedback loop

In an often repeated story, unusually low interest rates cause capital to flow into riskier asset classes, geographies and securities. To the extent that investors do not have the means to access these higher-yielding destinations, investment dealers are always at the ready to facilitate investment with new structures, products, and IPOs. The inbound capital represents cheap financing for some company, sector, or geography that quickly creates a "reflexive" feedback loop where the cheap money works to improve earnings, thereby attracting even more cheap money.

Relatively recent memory provides two excellent examples of this yield-driven reflexive relationship between the market and Main Street. The first was the Canadian income trust market. Low rates caused capital to flow out of traditional fixed income and into trusts, thereby causing unit prices to rise. Companies issued trust units at their fancy new valuations to finance acquisitions that, in turn, drove earnings and dividend growth. This growth incited yet more capital into the sector that took unit prices even higher, allowing for more acquisitions, and so on. As the cycle progressed, the quality of IPOs became more dubious, and valuations detached further and further from real asset values. The Canadian government eventually stepped in and shut down the market, thus robbing us of the market-based conclusion to the story.

A similar, but far larger story played out in the U.S. through the creation of the sub-prime mortgage market. There, yield-seeking capital flowed into the new bonds which, in turn, financed the housing boom. The cheap financing boosted home prices, which improved the credit quality of borrowers and allowed even more bonds to be issued. We all know how painfully this story ended.

Whose turn is it this time?

Following the financial crisis, central bankers and policymakers embarked on a series of unconventional monetary policies such as quantitative easing that brought bond yields even lower than in the previous cycle. So where did the yield-seeking capital flow this time around? And are we currently living with the resulting economic distortions that will eventually have to be unwound in a painful manner? We believe that the equity market sell-off experienced in August and September represents a partial unwinding of this cycle's yield-driven excesses.

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Once the dust settled on the financial crisis and investors regained their nerve, capital once again began to flow into a variety of asset classes and geographies in search of higher yields. While many markets, geographies and securities were recipients of these flows, none were larger beneficiaries than the emerging markets (EM). Yields on offer in places such as Brazil, Columbia and Malaysia were too tempting to ignore compared to the near-zero yields available throughout the developed world.

This cycle's yield feedback loop took place as EM capital flows drove an economic boom that propelled currencies higher relative to the U.S. dollar. This encouraged investors to leverage their trades by borrowing in U.S. dollars at cheap rates to invest in higher-yielding EM assets. Emerging market corporations, not wanting to miss out on the fun, mimicked financial investors and borrowed heavily in U.S. dollars in order to fund their domestic investments. The EM carry trade, as it is known, measures in the *trillions of dollars.*

Distorted capital flows will eventually distort real economies and now, on script, boom has turned to bust throughout the emerging world. Overproduction and oversupply loom everywhere, which is perhaps not surprising considering the six years of ultra-cheap money that led to it. Currencies have responded, this time creating a negative feedback loop, a mirror reflection of the positive loop described above. Declining EM economies result in declining currencies, which cause capital to repatriate back to the United States, spurring yet more currency depreciation and more capital flight, and so on.

The commodity and high yield tie-in

Even though we have minimal exposure to emerging markets, volatility from the asset class hit Signature High Income Fund and Signature Diversified Yield II Fund in several ways. The post-financial crisis emerging market boom fuelled massive demand for commodities. Investors, with lenders happily in tow, chased the second derivative of EM strength, funnelling capital into digging more copper mines in Panama and Zambia, excavating more iron ore in Brazil and Australia, building more shopping malls in China, and drilling more oil wells in Alberta and Texas. In a classic example of a commodities crunch, the supply response in mining and energy finally came on stream just as growth began to slow. On the energy side, the supply response was magnified by huge leaps forward in hydraulic fracturing technology and OPEC's decision to defend its market share in lieu of prices.

On the equity side of the funds we owned no mining companies and had less than 1% of the portfolio exposed to upstream oil producers, thus avoiding some of the most extreme wreckage. We did, however, have exposure to energy infrastructure companies that got hit very hard. As a proxy, the U.S. MLP Index (Master Limited Partnership), a sector that holds U.S. energy infrastructure, was hit hard, declining approximately 23% during the third quarter and down almost 40% since mid-April.

In the vast majority of cases, the dividends of energy infrastructure companies are safe, owing to the contracted nature of the cash flow. Even underlying profitability should see little deterioration. So many investors may wonder why the re-rating was so violent. We believe that the answer lies in growth expectations.

On the odd occasion when a yield investment has substantial growth, fireworks can happen. In a low rate, low growth world, the favoured investment is an asset with a high dividend *that grows*. This occurred in the energy infrastructure space in recent years. Not only did the solid and predictable dividends warrant a high share price on their own owing to near-zero bond yields, but those dividends grew rapidly as companies built out their systems

to accommodate non-conventional oil production (growth component). Future growth is now clearly in question since upstream energy development is slowing dramatically. Therefore, the growth component of the "income and growth" valuation has been taken out of share prices, a painful adjustment that we think is mostly over.

The correction also produced some other surprising developments. For example, we had exposure to two U.S. "yieldco" companies that usually own contracted renewable power assets. These companies are often structured in such a way to provide growth through acquisition. The sector, however, was affected by the energy sell-off, despite the fact that it has almost nothing to do with the price of oil. We believe this was due to the cross-ownership of institutional MLP investors who came under redemption pressure and were forced to liquidate their holdings – including renewable yieldco's. The ensuing damage to share prices unravelled the acquisition story (since companies could no longer issue attractively priced shares) and created a downward valuation spiral. During the correction we sold our position in one yieldco and added modestly to the other.

Otherwise, the equity portfolio performance generally tracked the performance of the overall equity markets, which was not great. Defensive sectors such as REITs held up a bit better through the correction, but performance was still disappointing considering they had been under pressure since the spring due to concerns about interest rate increases. Importantly, the non-energy equities exhibited very few duration characteristics, and thus did not provide the usual low-beta hedging characteristics that we have come to expect.

Unfortunately, large parts of the fixed-income portfolio also tracked the poor performance of the overall equity markets, which was unusual. Four months of negative returns in high-yield bonds – the first such stretch since 1994 – culminated in the worst month and quarter for credit since the European banking crisis broached the market's consciousness in 2011. Weakness in the commodities markets over the past 12 months has effectively closed access to the high-yield bond market for issuers in those sectors, and this will be the epicentre of defaults over the next 12-24 months. While these sectors have been weak for some time, the market began to worry this weakness could spread. In September, valuations in cable/telecommunications and health care, two historically defensive sectors, broke down and the threat of contagion grew significantly. Impaired market liquidity and investor fatigue (to the extent that metals and energy, which comprise about 15% of the market, has been demanding 90% of investors' attention) contributed to these sectors selling off. In cable/telecom, two large re-leveraging transactions forced about $11 billion of new bonds into the market with material pricing concessions. At the same time, the credit rating of one of the bellwether U.S. wireless operators was downgraded. In health care, Congressional attention on aggressive orphan drug price increases meant the risk to Valeant had to be re-priced and the bonds sold off alongside the stock. This dragged the entire sector lower. Like cable/telecom, technical factors overwhelmed fundamentals, there was nowhere to hide and these sectors traded with a 2x beta to the market in September.

Defensive fund positioning in U.S. financial preferred shares worked well, and, while we largely avoided the supply-induced re-pricing in the cable/telecom sector and we do not have any exposure to Valeant, we are overweight in metals. Portfolio activity was focused on inter- and intra-sector swaps where we could reduce dollar exposure. While this tends to also reduce yields, it is a barbell strategy aimed at both mitigating further downside risk and capturing upside price gains as future returns tend to be driven more by price moves than yields.

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The fallacy of yield support

Yield support refers to a security valuation that is higher than normal due to a high dividend or coupon. In an environment of benign fundamentals this means that companies choosing to pay out a higher portion of their free cash flow will be rewarded by the market with a higher valuation than their lower-payout peers. When fundamentals weaken, yield support means that a declining stock price will eventually bottom out and find support when the dividend yield becomes high enough to attract yield investors.

In our experience, yield support is fleeting and cannot be relied upon when thinking about valuations. Remember, many investors in higher-risk/higher-yielding securities are not really supposed to be there in the first place. They are investors who have traditionally bought government bonds and GICs but, because of low yields in these securities, have been pushed into riskier asset classes in search of higher yields. While these investors are likely aware that they are taking more risk at the outset, many will quickly abandon their new strategy at the first hint of capital loss. When fundamentals become so challenged as to throw dividend sustainability into question, the high dividend yield becomes meaningless in the context of attracting new investors. Think of a troubled sector such as mining. It seems unlikely that conservative yield investors are buying Rio Tinto in order to capture the attractive 6.0% dividend yield. The dividend yield could be 12% and yield-seeking investors would not budge. Some investors are indeed buying that stock every day, but we would venture that they are deep value contrarian equity investors who may not particularly care one way or the other about dividend yield.

We saw this dynamic play out in the third quarter and we think that it represents a shift in the yield investing landscape. For example, the free cash flow spread of Canadian REITs over 10-year government bonds (ie: the extra yield investors get to assume the extra risk for buying REITs over bonds) is at a high not seen since the late 1990s when yield investing was deeply out of favour. (We have eliminated the distortion of the credit crisis from this analysis.)

An abnormally heightened spread ultimately means that yield investors are staying away from the sector despite very attractive dividend yields in a super-low rate environment. This is most likely due to investors, for the first time in years, worrying about the sustainability of company cash flows in a challenging Canadian economy. In other words, investors are focusing on credit risk of their yield investments. Credit analysis was largely an afterthought throughout the last five years.

Higher bond spreads mean investors have re-assessed the sustainability of those cash flows not to pay dividends, but to service debt (i.e. credit risk). Defaults will be higher over the next 12-24 months, but in our view, we are being compensated for that risk. Yields are 250 basis points higher than the lows seen in early 2013 and average bond prices about 10 points lower. The bonds of companies likely to default are already trading much lower. Current yields at 7.5% imply the market is pricing in a default rate above 7% for the next 12 months, even after making some adjustments for impaired trading liquidity.

Given the resiliency of the U.S. economy, we think a 7% default rate is too pessimistic. Yes, capital has become more expensive and we are increasingly wary of debt-financed roll-up strategies in slow-growth industries like cable or parts of health care. However, outside of commodities, credit quality trends are good. Our “lower-for-longer” interest rate outlook is premised on U.S. growth remaining low, but positive, and the performance of credit securities is not as reliant on growth as it is for equities. Importantly, to put September’s fears to rest, while

we carefully assess credit availability as a leading indicator of broad financial and economic risk appetite, we do not believe at this time that the commodity contagion has infected other sectors.

While this changing investor landscape contributed to underperformance in the third quarter, it is without question a good thing when considering future opportunities and returns. At Signature we have the ability to do the deep research necessary to analyse credit quality and, with some yield investors essentially on strike, there are already excellent opportunities to invest at very reasonable prices with yields in excess of 6% in both the equity and fixed-income components of the funds. Multiple compression or spread tightening (i.e. improved valuations) could drive returns of many securities into the double-digits.

Longer term

Is it possible that the aforementioned 6% yields become 8% yields, indicative of yet more downside to share prices? Anything is possible in the short term. The excesses in EM, commodities, and credit will not be cured in one quarter, so it is possible that volatility will persist. However, with a three-year view, we think that current valuations are at least very well supported and possibly have upside capital gains potential.

It is important at such a confusing juncture to take a step back and think about the underlying drivers of yield demand. They are the same that they have been since the income trust days got going in the early 2000s; that is, an aging demographic, extremely low interest rates on traditional fixed-income investments, and a growing aversion to general equity investing. These pillars are not going away any time soon and we believe that once the dust settles in the markets, and a certain period of calm reasserts itself, that yield demand will come roaring back. It is a story and theme that we have been living with for 15 years and we believe will be with us for 15 more, with or without quantitative easing. It is important to remember that the entire income trust market was built without QE, with 10-year bond yields above 4%, and with a demographic that was 10 years younger than it is today.

A note on currency

The move in the U.S. currency over the last three years, and especially this year, helped fund performance but hurt relative performance relative to our peers.

Both Signature High Income Fund and Signature Diversified Yield II Fund have slipped in their quartile rankings within the Global Neutral Balanced category, largely due to our currency hedging policy. Signature High Income Fund was originally launched as a Canadian income product to be used by conservative Canadian savers who may withdraw monthly distributions to help fund Canadian goods and services. As the fund's profile became more global over time we instituted a high hedge ratio policy of between 60-100% against any individual currency. The thinking was that the vast majority of investors had not originally bought a global fund, and so had not signed up for currency risk. When Signature Diversified Yield Fund was launched at the end of 2009 we put the fund on the same high hedge ratio program, mostly in response to client demand at the time.

It appears to us that most of our peers in the Global Neutral category have unhedged U.S. dollar exposure through either an active or passive policy. Our own Signature Global Income & Growth Fund falls into this category, having been unhedged through an *active* call.

Our high hedge ratio policy has hurt relative performance in recent years but especially so in the third quarter when the underlying asset classes of the funds displayed a higher amount of volatility than expected. As

mentioned previously, we expect that volatility and credit risk will be larger feature of yield investing going forward than it has been over the last six years. We therefore need all of the portfolio management tools at our disposal in order to give investors as smooth a ride as possible and have thus changed the hedging policy of the funds. We have taken the funds off of the more static currency program and intend to manage it actively going forward. We will have further updates in coming quarters regarding our positioning and thoughts on currency.

Outlook

We think that the prospects for both the Signature High Income and Signature Diversified Yield II funds in the coming three to five years are bright. It appears that much of the damage to the funds' target asset classes has been done – so our recommendation is to sit tight. We have been through yield sell-offs many times in the past and they have always produced a nice set-up for future returns.

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