Signature Castlerock commentary

Equity markets initially rose on renewed optimism that economic expansion would continue and that Europe's sovereign debt crisis would be contained in the fourth quarter of 2011. This optimism later waned with the realization that European leaders still did not have concrete solutions to the region's debt crisis. Nonetheless, most global indexes finished the fourth quarter with gains.

Global bond markets, meanwhile, also remained fixated on the unfolding European situation. Several European sovereign bond auctions went poorly or were cancelled, and risky assets deteriorated in price until "technocratic" governments were installed in Italy and Greece in mid-November. The relative attractiveness of Canada's fiscal position made the domestic bond market an attractive destination for foreign capital seeking "risk-free" returns. As many European nations saw borrowing costs crest to new highs, Government of Canada nominal bond yields receded to all time lows.

The 'risk-on/risk-off' trade will likely be the prime driver of high-yield bond returns again in 2012. We expect defaults in 2012 to climb slightly but to remain relatively subdued. In the low growth, low interest rate environment that should continue into 2012, we are inclined to think high-yield bonds can generate a "coupon-like" or high single-digit-type return.

Castlerock Canadian Bond Fund

Canadian economic momentum slowed noticeably during the quarter. The pace of job creation ground to a halt, markedly so in central provinces and consumer spending growth was anemic. In response, bond yields plummeted and the yield curve flattened, anticipating prolonged monetary accommodation by the Bank of Canada. Indeed, the Bank has downgraded growth expectations for 2011-13, believing that the austerity policies being implemented in much of the western world will impact global growth further early in 2012. It is unlikely that Canadian interest rates will be raised any time soon. This policy shift and the relative attractiveness of Canada's fiscal position made the domestic bond market an attractive destination for foreign capital seeking "risk-free" returns.

Castlerock Enhanced Yield Fund

High-yield securities then benefited from more stable global markets in the fourth quarter. Reasons for this improvement included coordinated action by central banks to ease the crisis and support European banks, and the perception that European policymakers may be able to "muddle through" without the crisis worsening. In addition, the U.S. economy has proven to be resilient, with economic data showing improvements in areas such as unemployment claims, manufacturing and retail sales.

In general, Canadian yield securities have performed well since the federal government changed the tax rules governing income trusts, even during the heightened market volatility of the past year. This reflects the scarcity value attached to higher-quality, dividend-paying companies following the end of income trusts.

While the fund has benefited from this, it also means that such securities have become expensive. In addition, share prices are vulnerable to a rapid correction at the first indication of a reduction in a firm's dividend. Therefore, the security and sustainability of the dividend is one our primary considerations in stock selection today.

As we enter 2012, we remain cautious, carrying an elevated cash position of about 15% given the continuing risks in global markets. We expect to invest the cash gradually as conditions improve and have already reduce the cash since the third quarter, when it was over 20%.

Castlerock Global High Income Fund

In the second half of the year, concerns about high levels of sovereign debt in the U.S. and especially Europe mushroomed into a much larger crisis. Driven by fears that the European situation could have a significant impact on the global banking system and economy, there were broad-based declines in global equity markets, high-yield corporate bonds and other high-yield securities. In a “flight to safety,” investors switched to securities deemed to be lower risk – such as government bonds of the certain countries, investment-grade corporate bonds and selected high-quality equities. Government bond yields in North America remained depressed for most of the second half of the year. The high yield bond market, meanwhile, finished the year up about 4.4% in U.S. dollars.

We took steps to reduce the fund’s exposure to emerging markets government bonds, and to focus on fewer holdings. We also boosted the fund’s running yield by investing in high-yield bonds on price weakness. The high-yield bonds in the fund are of higher quality, which helped relative performance. As the U.S. dollar gained strength relative to the Canadian dollar and the euro, we have benefited from exposure to the U.S. in the high-yield and government bond portions of the fund.

The fund is now invested approximately 50% in high-yield corporate bonds, with the remainder divided between government bonds, investment-grade bonds and cash.

Castlerock Total Return Fund

We started the quarter with a relatively high cash weighting. As we began to see significant improvement in European credit indexes and other market indicators early in the period, we made a major investment across several cyclical sectors to capture some of October’s rise in equity markets. Most of these trades were reversed again by early November and we finished the final quarter of 2011 as we started – in a very defensive position, with about 17% of the fund in cash, 50% in Canadian and global equities and 33% in fixed-income investments.

In the equity portion of the portfolio, the fund benefited from its financial holdings, a large underweight allocation to the lagging materials sector and strong stock selection in the information technology sector. Our underweight allocation to the surprisingly resilient energy sector was one of the major sources of underperformance for the period, although holdings including Canadian Natural Resources, National Oilwell Varco and Occidental Petroleum performed well on an absolute basis. In information technology, fund performance benefited from positions in several U.S. companies, including Seagate, Cisco and Intel, and from avoiding Research In Motion, which declined sharply during the period.

The fixed-income portion of the portfolio added value for the period. Our high-yield bond positions easily outperformed their benchmark, based the higher credit quality orientation of the portfolios and good credit and sector selection. The fund's currency hedge ratio was maintained at about an 80-85% level, allowing the portfolio to benefit from the appreciation of the U.S. dollar. Our government bond holdings also added to performance, and we added a modest amount of government debt in the fourth quarter based on the continuing elevated risks to the global economy.