Market Commentary
July 2014

Signature High Income Fund and Signature Diversified Yield II Fund
Mid-year update

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It's a grind out there

"Norway's $890 billion sovereign wealth fund, the world's biggest, is building up its organization and preparing for a move into infrastructure and private equity, its chief executive officer said….the fund, which owns 1.3% of the world's stocks, is struggling to meet a real return target of 4%."

– *Bloomberg*, June 25, 2014.

Norway's dilemma reminds retail savers they stand in good company when struggling to achieve their portfolio objectives in a low-yielding world. The current investment landscape is the result of central bank policies that include money printing, currency debauchment, and negative deposit rates, all of which have depressed bond yields to levels at or below inflation. Negative real interest rates make it easier for indebted entities such as governments and households to service their debt obligations. As nominal incomes grow alongside inflation and debt stays the same, it allows the indebted party to "grow their way out of the problem." This comes at the expense of savers, who struggle to maintain their purchasing power. This depressing state of affairs was thought to be taking a turn for the better as recently as January, when we outlined in our 2014 outlook what we believed was the consensus forecast:

"U.S. economic growth continues, unemployment comes down, and rates rise moderately, although still anchored at historically low levels by Fed policy. Europe plods along without incident and emerging market troubles remain contained to their respective geographies."

We pointed out Signature's base case was largely in line with this consensus. Halfway through 2014, four of the five predictions are playing out according to script, the major exception being "rates rise moderately." On December 31, 2013 Canada and U.S.10-year bond yields stood at 2.76% and 3.03%, respectively, and have since plummeted to 2.24% and 2.53%.

Dazed and confused

The abrupt drop in yields has been especially perplexing since the conditions for higher rates appear to be in place. The U.S. economy contracted in the first quarter, mainly as a result of poor weather, but now seems to be back on track. European and emerging market risks have subsided, and the U.S. Federal Reserve continues to taper its quantitative easing program. The confusing signals persist even today, one week into July, as U.S.10-year bond yields are several basis points ***below*** last week's level, which was ***before*** a surprisingly robust jobs report.

With the consensus view so obviously wrong for the year-to-date, market observers are scrambling for explanations. Our colleague Kamyar Hazaveh, head of Signature's interest rates team, conveyed recent bond market chatter declaring that declining bond yields were due to traders being on vacation. Signature Chief Investment Officer Eric Bushell relayed another explanation that traces its path to a summer student left unattended at the controls of a large fixed-income asset manager. No doubt, the attention commanded by the FIFA World Cup can share some of the blame for the low volatility environment we are also experiencing.

Other, more serious explanations include the expectation of European Central Bank stimulus, the continuation of massive Japanese stimulus, sluggish first half U.S. GDP numbers, and a slowing U.S. housing market. Perhaps the answer is simply that 2013's rise in bond yields was overly enthusiastic, considering 24 straight months of U.S. inflation under 2% and market expectations of structurally lower GDP growth.

Primed for a good move

While Signature shared the market's view that rates would rise, we believed the market had more than priced this scenario into security valuations, with the exception of high-yield bonds, which held up well through 2013. Through the fall of 2013, we therefore positioned our funds

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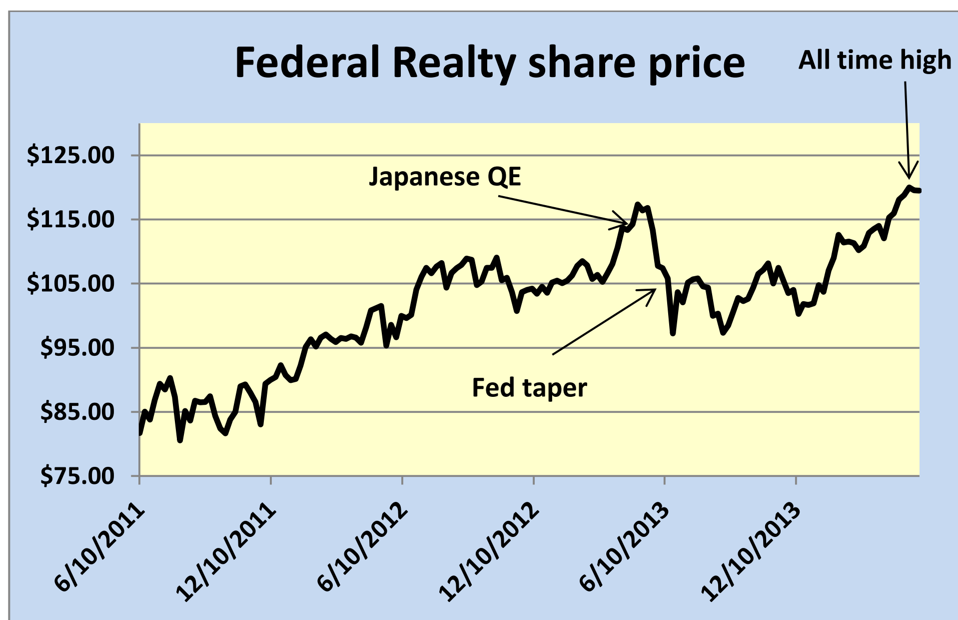
with a strong tilt toward our core equity yield sectors such as real estate, trusts and infrastructure. We maintained a relatively light weight in high-yield bonds. This posture benefited the funds, as high-yielding equity did exceptionally well as bond yields fell. For example, after underperforming the U.S. stock market by 30% in 2013, U.S. REITs were up over 15% in the first half of 2014, more than double that of the broader index. Canadian infrastructure stocks took flight, appreciating over 20% in many cases (not including dividends). Asian interest rate-sensitive sectors and S&P 500 "dividend aristocrats" were also beneficiaries.

Market participants' conviction that higher rates were imminent has now softened. A common view holds that interest rates might go up, but not by very much. Previous expectations of a 4% 10-year bond have been pushed into the future indefinitely.

As was the case at the start of the year, we find ourselves in line with consensus thinking. We also expect that business fundamentals will remain robust, dividends will grow, and high-yield defaults will remain subdued. However, also similar to the start of the year, we believe valuations currently reflect this (updated) consensus view.

The chart below highlights this point. Federal Realty Investment Trust is a U.S. REIT that owns premier shopping centres across the country. Signature does not hold this company but we chose it as an example because there have been no material changes at the company in the last couple of years.



Following a multi-year appreciation, Federal's share price popped an additional 10% in spring 2013 when Japan announced its massive quantitative easing program and U.S. 10-year bond yields bottomed at 1.6%. At this time, the stock traded at $116, for a 3.9% cash flow yield. Shortly thereafter, the shares declined nearly 20% when the Fed announced its intent to taper quantitative easing. As of June 30, 2014, the shares sold for $120 to yield approximately 4.0% again. While bond yields have gone down for the year-to-date, they are still almost 1.0% higher than the spring of 2013, meaning that, on a spread basis, Federal Realty shares have become even more expensive than their 2013 peak valuation.

This is happening in the credit markets as well. While corporate earnings are growing, less cash flow is being directed to debt reduction, and more is now being directed to shareholder-friendly activities like share repurchases, dividends and acquisitions. At June 30, the high-yield bond market was presenting us with an opportunity set yielding 5.01% (Bank of America Merrill Lynch U.S. High Yield Index, yield-to-worst) on average, just marginally higher than the all-time low of 4.99% reached in May 2013 before the Fed announced its plans to taper quantitative easing. As with the Federal Realty example above, the market is more expensive on a spread basis, as spreads-to-Treasuries have tightened 46 basis points to +372 basis points.

Not all yield securities have made up the losses incurred during the 2013 sell-off, but many have. In some cases, like high-yield bonds, valuations are through 2013 levels and we have begun to let our holdings in these sectors gradually decline with early calls and redemptions. The new issue calendar in most cases is not as compelling as the positions we are exiting. All told, once again it has become difficult to find new ideas in our core sectors.

Product needed, product provided

The return to rock-bottom yields has restarted income product innovation, this time under the name "Yieldco." The concept should be familiar to Canadian investors, who have known for years that higher-yielding stocks command higher valuations, even without a tax break. That is why so many Canadian companies continued paying abnormally high dividends after their income trust status was disallowed. This seemingly obvious point has taken a while to catch on globally, until now.

Since the second quarter of 2013 there have been four U.S. infrastructure spin-offs or IPOs structured to pay higher than normal dividends. Two came in June 2014 alone, and we expect a flurry of deals in the near future. In each case, a large parent company (or sponsoring entity) has taken mature cash-generating power assets from their portfolio and spun them into a new high-yielding company – a "Yieldco." The end result is two companies: one entity focused on high-return development and a sister company that buys the finished product, collects the cash, and pays a big dividend. The Yieldco's high valuation allows it to pay top dollar for assets, making the spin-off a very lucrative exercise for the parent.

In our experience, related-party income deals are fraught with conflict and risk as incentives are often misaligned. However, there are usually opportunities to invest at the beginning of an innovation cycle when underwriting standards are disciplined and valuations still reasonable. We have thus invested in two of the four IPOs: Pattern Energy and Abengoa Yield. Both companies hold excellent, long-life, contracted assets and have favourable structures that align the interests of both the parent and subsidiary. Both stocks did very well following their issue, with Pattern up 19% and Abengoa up 30% as of June 30. Not surprisingly, the latest Yieldco to come to market showed signs of underwriting and valuation liberties: Nextera LP came with a high valuation, a limited partner/general partner structure and is managed externally by the general partner, making it much less appealing to us. We therefore passed on the deal.

Product innovation is also occurring in fixed income. We have written extensively about the relative value proposition we see in subordinated debt of financials, as banks and insurance companies globally continue to de-leverage. New callable perpetual preferred issuance is allowing banks to shore up their balance sheets. Issued in the form of preferred “Additional Tier 1” shares paying a fixed rate for the first 10 years that then switches to floating, these instruments are treated as equity capital by the regulators and ratings agencies. These securities are callable at the issuer’s option after the 10th anniversary. So long as the “back end” floating rate is high enough to incent the issuer to call the security and refinance at cheaper rates, we believe most of these securities will trade to the 10-year call date and will not demonstrate the volatility associated with perpetual preferred shares and long-duration bonds. We have established positions in such securities issued by Citigroup, JPMorgan and Credit Suisse. We also continue to add to similarly structured legacy securities that stand to lose their preferential equity capital treatment and are thus subject to early redemptions – actions that would boost returns over existing yields to maturity and be accretive to fund performance. Positions we hold in this category include numerous issues from Lloyds, RBS, Bank of America, PNC and US Bancorp.

Both these new instruments and the legacy securities tend to fall in the BBB and BB rating categories. It is worthwhile to remember that credit risk is comprised of default risk and recovery risk. We believe that in this environment of stronger bank balance sheets, deliberately depressed capital markets activity and more regulatory oversight, the default risk in these securities is actually quite low. For the sake of ratings, let’s assign an A rating to the default risk. However, should any of these banks actually run into trouble, these deeply subordinated securities are designed as “bail-in capital” and “loss absorbing.” These are polite ways of saying they, along with the equity, could be wiped out to ensure the bank continues as a going concern without the need for a taxpayer-funded bailout. In this case, let’s assign the bottom rating in high yield, which is a CCC, to these securities. Averaging the A and CCC ratings together gives us a BB rating, the top end of high-yield bond ratings. Yet these preferreds are providing yields 100 to 200 basis points higher than comparably rated high-yield bonds. We continue to add to our holdings.

Strategy

As detailed above, we now think the lower-for-longer interest rate story is reflected in valuations meaning we have come full circle over the last 12 months. While our base case calls for structurally low yields, an abrupt move from the current 2.5% to 3.0% could seriously rattle our core sectors. We have therefore taken profits in several top performers such as Brookfield Energy Renewables, Gibson Energy, Brookfield Asset Management and Starwood Property Trust. We also trimmed our exposure to AIMCO, the U.S. apartment company detailed in our last note. The stock posted a total return of 27% through the first half of the year as the market became more relaxed about U.S. apartment supply and also began to better appreciate AIMCO's turnaround efforts. The stock was the largest holding in Signature Diversified Yield II Fund until the beginning of June, when we reduced it to a more standard weighting.

The most dramatic move on the equity side of the funds was a reengagement of the financials sector, a sector we sold out of entirely in the fall of 2013 as we rotated into core high-yielding stocks such as AIMCO. We deployed over $850 million (approximately 5.75% of both Signature Diversified Yield II and Signature High Income) to purchase a basket of six financial stocks, the largest of which was UBS.

We feel that the collective financials position has several investment merits: (1) the stocks are one of the last bastions of deep value in the entire market. Years of financial crisis litigation and low rates have kept stocks at or below tangible book value and near single-digit earnings multiples. The financial hangover from the crisis has been severe. Over time, we expect litigation expenses and investment banking costs to decline, and interest rates to rise. These factors should result in very good earnings growth. These institutions are also as safe today as they have ever been from a capital standpoint. As earnings normalize with far less bad news than what investors have become accustomed to, we expect to see significant share price appreciation. (2) The yield of the current basket is low at 2.6%, but dividend growth should be stellar in coming years. For example, Signature's financial services specialist, Portfolio Manager John Hadwen, has UBS's dividend growing to 7% (on today's price) by 2017. (3) The positions should also provide a hedge to rising interest rates.

As is always the case when we establish a position outside our core yield sectors, investors should not expect the financials position to be a permanent fixture of the funds. If the stocks appreciated significantly and fulfilled their secondary purpose as a rate hedge we would bring the weight back down to zero. Such a scenario (that includes rising rates) would probably bring opportunities to invest back into our core sectors. We are also mindful of the added volatility that the position will bring to the fund, but feel confident that this can be contained with other tools, most notably a very low hedge ratio on our U.S. dollar exposure.

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Outlook

Signature Diversified Yield II Fund and Signature High Income Fund performed well in the first half of the year as core sectors benefited both from falling bond yields and improving valuations. The funds' more equity-oriented peers (including our own Signature Income & Growth Fund) also posted good returns as global stock markets continued to grind higher. Signature High Income performed a bit better than Signature Diversified Yield II in the first half, owing mostly to higher energy exposure. Signature High Income Fund almost always has a higher weight in energy due to its Canadian bias.

The challenge now is to add to, or at the very least retain the gains. In a scenario where rates stay very low, and stock markets and economies are stable, we should be able to add further gains throughout the year leading us to high single-digit or low double-digit full-year returns. If and when rates do go up, the outcome will depend on how fast they rise. A mild drift higher should be fine but, in this scenario, the funds will probably lag their equity-oriented peers. An abrupt rise in rates could prove bumpy for the funds but we suspect it would prove bumpy for the broad stock market as well. As detailed in this note we are positioned for a rise in rates going forward. In most scenarios, we now think that we can improve on our initial guidance of a 5% total return for 2014.

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