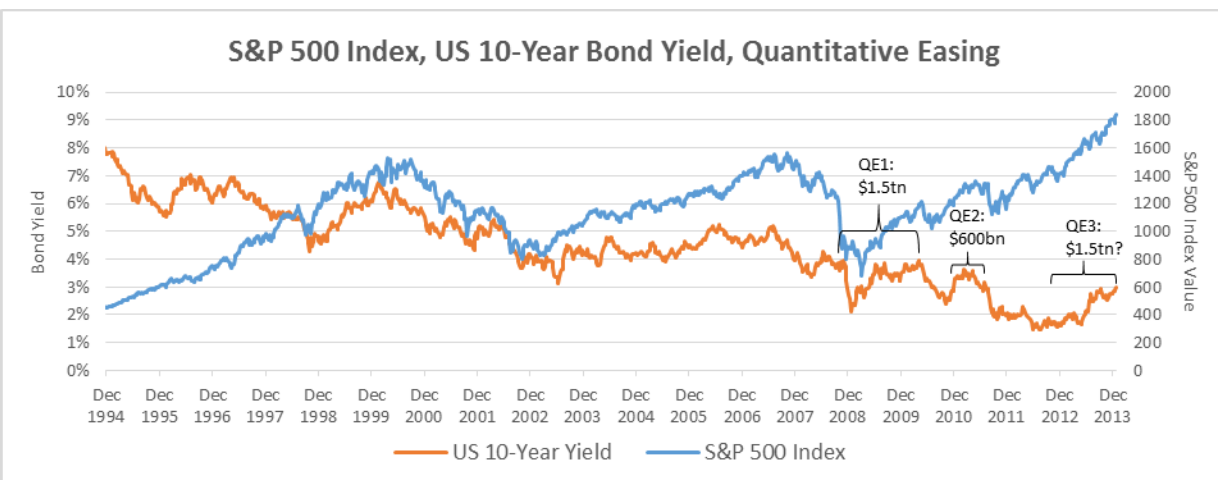
Q4 2013 Commentary

“Yesterday’s weeds are today being priced as flowers.”

-- Warren Buffett, 2003 Letter to Shareholders of Berkshire Hathaway

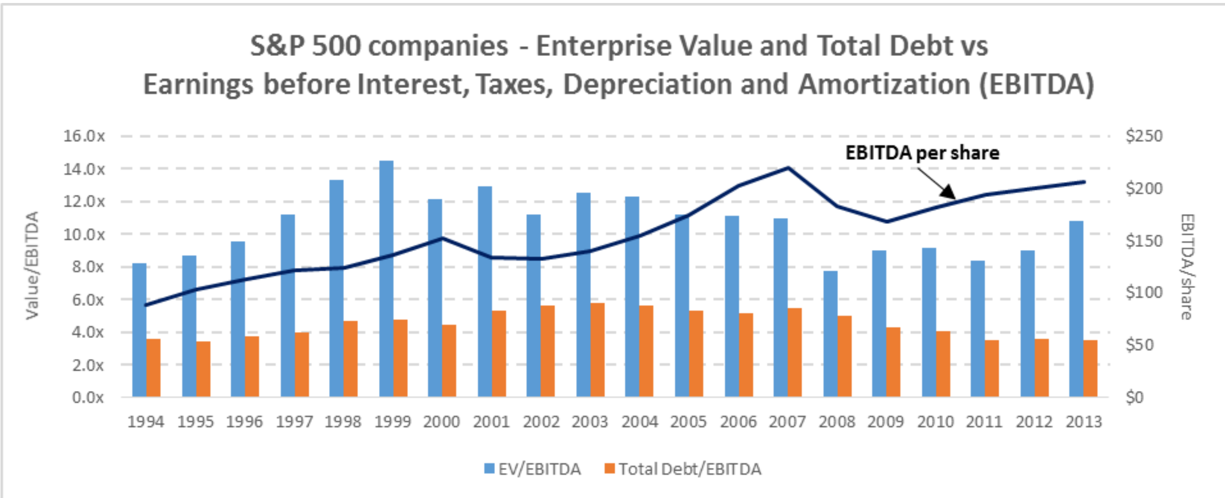
In 2003, Warren Buffett was cautioning about the high prices of high yield bonds. Credit spreads had narrowed significantly during that year and were near record lows. The bond market was thriving, and the $137 billion in new issuance of high yield was also near record levels.

Today, high yield bonds are once again in full bloom. This time around, high prices can be attributed to the low interest rate levels sustained over the past five years. Since the 2007-2008 financial crisis, the US Federal Reserve has purchased over $3 trillion of Treasury bonds and mortgage securities to drive down interest rates and keep them low. As can be seen below, the 10-year Treasury yield has essentially stayed below 3% for the past two and a half years, reaching as low as 1.45% in June 2012.



Source: Bloomberg

Low interest rates have helped the economy rebound from the financial crisis. As can be seen below, S&P 500 corporate earnings have grown and company valuations have reflated to pre-crisis levels. These large companies have healthier balance sheets today, accumulating cash and refinancing existing debt at lower interest rates to farther maturities. As such, corporate credit risk seems benign, particularly if economic prospects continue to improve.



Source: Bloomberg

Rather than credit risk, it is interest rate risk that threatens the bond market today. Even “high yield” bonds have not been very high yield. In May, the Bloomberg High Yield Corporate Bond Index reached an all-time low yield of 4.66%. Despite the low yields, investors have soaked up record volumes of new issues. $1,022.3 billion of investment grade and $325.7 billion of high yield debt were placed in 2013, close to the record levels of $1,035.5 billion and $329.5 billion in 2012.

With low yields and full maturities, new issue prices are susceptible to interest rate rises. In April, Apple issued $5.5 billion of 2.4% 10-year and $3 billion of 3.85% 30-year bonds to pay a special dividend. When interest rates rose from their lows, these bonds traded down in the secondary market to prices of 92 and 88 respectively at the end of June.

We’re not keen to pay full price and take on the interest rate risk of new issues. Instead, we view them as future opportunities, when they are available for purchase at a lower price. The Focused Yield Fund was positioned with a low duration of below two years throughout 2013.

New issues that we have purchased on occasion are leveraged loans. Leveraged loans pay floating rate coupons and secure a first or second lien on the assets of a company. If we are comfortable with the collateral coverage and/or prospects of the issuing company, the floating rate coupon protects the fund from any potential interest rate rise.

But we are cautious even with leveraged loan new issues. Although they sit at the top of a company’s capital structure, seemingly indiscriminate investor appetite for leveraged loans has allowed an increasing number of new issues to be “covenant-lite,” void of many prudent creditor protections that restrict risky company decisions such as paying large shareholder dividends or issuing additional debt. Loan funds and collateralized loan obligation (CLO) funds continue to create greater demand for these floating-rate securities, encouraging greater supply.

For 2014, we remain focused on finding under-appreciated investment situations in the secondary market of corporate debt securities. Our short portfolio duration protects against interest rate risk and, as always, our investment approach relies on fundamental credit analysis. Despite our defensive stance, we continue to find good investment opportunities to generate absolute returns.

Best regards,

Matt Shandro
President, Fulcra Asset Management Inc.