2014 Year-end Review

All about the rates

The defining story for the global bond market in 2014 was interest rates, but not in the way many predicted at the start of the year. 2014 was meant to be about the end of Quantitative Easing in the US, and the shift from an accommodative to a tightening bias by the Federal Reserve, with most analysts forecasting steeper yield curves and 10 year rates to rise from 3% towards 4%. The Fed acted as expected but in the face of deteriorating global growth, lower inflation, and growing anticipation of a quantitative easing program in Europe, rate curves actually flattened and 10 year government yields in Canada and the US ended the year at 18 month lows near 2%.

Credit markets generally had a subdued year; a constructive rally in the first half six months followed by a disappointing pullback that left spreads wider on a year-over-year basis. Investment grade credit indices generally returned between 0 and 1% for the year (Credit indices measure “excess return” over a similarly constructed government bond portfolio, or the “hedged return” from a pure credit portfolio). Clearly the drop in oil prices in the second half of the year was a major contributor to the weakness, though virtually all sectors were broadly wider. Falling rates was another factor, as institutional investors were less inclined to add to corporate holdings at historically low yields.

Most High Yield funds posted negative excess returns and only modestly positive total returns. High Yield fund flows turned negative in August and remained that way for much of the balance of the year. Loan funds similarly saw outflows throughout the second half. Supply on the other hand was strong, with a record amount of new bonds priced during the year.

From a fundamental point of view credit quality generally remained stable, with High Yield default rates under 2%, typical for the low point of the credit cycle. Canadian based rating agency DBRS notes in a recent report that the ratio of downgrades to upgrades in 2014 stood at 1.6:1, well below the 2009 peak of 5:1 and below the long term average of 2.5:1.

According to a recent Morgan Stanley research report, US Investment grade credit spreads on average widened 19 basis points in 2014, from 112 to 131, representing a 17% move. While total new issue supply was slightly behind 2013’s record levels it was ahead of 2013 on a net basis after factoring in maturities. The best performing sectors in 2014 were Financials (+7 basis points of credit spread widening) and Telecom/Media (+9 basis points) while the worst were Energy (+71bp), Basics (+27bp) and Healthcare (+22bp).

The Barclays Global Credit Index ("BGCI") produced hedged returns of 0.5% in 2014, compared with 3.2% in 2013 and 7.9% in 2012. The first half of the year had modestly positive returns of 1.5%, while the July-December period saw negative returns of 1%.

We got a number of things right…

Looking back at the performance of the Lawrence Park Credit Strategies Fund, we note a number of decisions we made this year which helped us to beat the BGCI benchmark index. Our sector exposures within the investment grade universe were appropriate for the environment. We remained overweight banks and underweight energy throughout the year. Mid-year we adopted a more cautious approach by increasing our exposure to carry oriented strategies and reducing our reliance on credit beta.

Our decision to invest overweight in US and European banks and underweight Canadian banks generated incremental return in 2014. Foreign banks outperformed their domestic counterparts significantly in the first half, while only moderately underperforming in the second half. By contrast, our increase in Canadian corporate (i.e. non-bank) exposure during the second half of the year proved prudent, as Canadian spreads remained more stable than US spreads.

Finally and perhaps most importantly we continued to turn over the portfolio despite increasingly challenging market conditions. We believe credit portfolios benefit tremendously from active management, taking advantage of pockets of liquidity such as new issue markets and identifying market dislocations. Our nimble approach to trading allows us to benefit from these inefficiencies.

The combined effect of the above factors allowed the fund to outperform the benchmark global credit index by approximately 390 basis points after deducting fees. In testament to our ability to preserve capital and generate alpha, we returned 2.9x the benchmark index in an up-market during the first six months, and produced flat returns in a down-market during the second half of the year. While the overall performance was below our target 6-8% return profile, we are reasonably satisfied given the subdued tone of the credit universe.

... and a couple wrong

What better time than the end of the calendar year for some introspection. Despite our outperformance of the benchmark index, there are clearly things we could have done better. First and foremost was our outlook on interest rates. We re-iterate that the Fund is designed to be an alternative fixed income vehicle which is generally agnostic to rates. We believe there is demand for this type of strategy given the low rate environment which currently prevails around the world: traditional bond portfolios produce almost no yield, and rely on the constant downward pressure on interest rates to produce viable returns. It is reasonable that in periods of falling rates such as 2014 our strategy will underperform traditional bond indices, and in periods of flat or rising rates such as 2013 our strategy should outperform. In the near three years since its inception, our fund has significantly outperformed the Canadian corporate bond index, and we feel confident we will continue to do so in the long run assuming interest rates find a lower bound.

Notwithstanding the above, rate hedging a global bond portfolio is an art as much as a science, and some latitude regarding the nature and degree of hedging is unavoidable. In 2014, it is fair to say we did not anticipate the extent of the interest rate rally, and found ourselves “over-hedged” at various times throughout the year. As the rate rally was undoubtedly a contributing factor in the spread widening that occurred during the July-December period, the fall in rates became a drag on our performance as it caused us to underperform traditional fixed-income.

The other call we underestimated in 2014 was the positive effect that rising Quantitative Easing expectations in Europe would have on Euro-denominated credit. As global credit markets reacted negatively to slowing growth and low interest rates in the second half of the year, the European market remained surprisingly resilient causing Euro-denominated credit to outpace North American during the period. We benefitted somewhat by owning Irish banks in Euros and a number of European bank names in US dollars, but owning more Euro-denominated credit would have led to improved performance in the fund.

Outlook for 2015

Looking ahead, we see a number of encouraging opportunities in global credit markets over the next 12 months.

Interest rates that much closer to the bottom; US credit has room to run

The contrast in prevailing sentiment from 12 months ago is striking. Most economists’ forecasts call for only a modest rise in rates in 2015, and in fact many traders are talking about rates remaining low and even heading lower as Euro QE and deflation take hold. While we recognize the fundamental rationale for lower rates, the fact that real rates ended the year negative in Canada (December Core CPI @ 1.9% vs 10y yield at 1.5%), that rates have fallen dramatically in January, and that nominal rates in many parts of Europe are already negative suggests to us that we may be near a lower bound. The ongoing European QE programme will keep rates low, but if we stay in a range for the balance of 2015 then traditional Fixed Income investors will be disappointed with their returns. Furthermore there is a lot of bad news priced into government bond yields, and any pickup in the economic or inflation picture could cause a rapid reversal. We are not saying rates will head higher, but the risk of a large move (similar to the second half of 2013) feels greater now than it has in the past year.

With respect to global credit markets, we feel the US looks the most opportunistically cheap, with spreads well off the 2014 tights. By contrast Europe credit remains near the tights and US equity markets start the year within 2-3% of the highs. Economic sentiment remains robust in the US despite lower oil and a strong dollar, and we believe there is room for US credit markets to improve from current levels.

Remain Overweight Global Banks

Bank credit spreads have recovered a long way from the financial crisis and are currently near flat to the non-financial sector. Banks are clearly facing more headwinds in 2015 with the prospect of further regulatory pressure, increased fines for past misdeeds, and rating agency action following the ongoing removal of implicit government support, particularly in Europe. However we continue to view “national champion” banks as safer institutions than they were in recent years; capital ratios continue to improve, and the more volatile trading businesses are being pared back. US and European bank spreads remain cheap to their Canadian counterparts. Consider major US banks such as Bank America and Wells Fargo raising preferred share capital at between 5.8% and 6.5% yields recently, compared to Canadian bank preferreds launched at 3.6%.

Opportunities to trade credit curves

Over the past 6-8 months credit curves have steepened (i.e. the difference between short-term and long-term credit spreads has increased) as the rate curve has flattened. As a result many curve differentials are now near historic highs. We anticipate that any stability in yield curves will likely lead to credit curves retracing some of this increase. This will create trading opportunities, especially in 5-7y and 5-10y curves. We can take advantage of this by extending exposure to longer dated maturities, or by short-selling 5 year bonds to buy longer dated bonds of the same issuer.

Cautious on Energy

The energy sector was the poorest performing sector in 2014 as oil prices fell. There will be some who consider the move an investment opportunity and will be looking to pick a bottom. While we do believe there are certain names which have been punished too harshly from a credit point of view, we remain cautious overall on the sector. We do not believe that credit markets have fully priced in a sustained multi-year period of low oil prices, and there will be companies that will inevitably fail under such a scenario. We do anticipate consolidation in the exploration and production sector which would be positive for weaker names, however some defaults are inevitable. As a result we will remain underweight until we see evidence of sustained improvement.

Don’t chase Europe

As noted earlier, European credit benefitted tremendously from expectations of Quantitative Easing during the second half of last year. Now that QE has been unveiled by the ECB in January, we question whether there is much room left to run. In many cases the valuations on US denominated debt of European banks and corporates is significantly cheaper than their Euro denominated counterparts. We anticipate that Global issuers will inevitably head to Europe to take advantage of lower yields and tighter spreads, while investors find better value in bonds denominated in the strong US dollar. As a result we can see the US-Europe credit spread differential collapsing in 2015 and are positioning our funds to take advantage of this move.

Canadian credit will be mixed

The Canadian economy is clearly feeling the effects of lower oil, with Bank of Canada governor Poloz describing lower oil as “unambiguously bad”. In addition to the significant selloff in energy sector credit, we are seeing secondary effects in the banking, retail, and real-estate sectors. We do expect certain names will benefit from lower interest rates and a weaker dollar, but overall we intend to reduce our Canadian credit exposure in the coming months.

In Conclusion: A relatively safe market with multiple opportunities

2014 proved to be a challenging year for the credit sector, but one in which we honed our mix of strategies to produce a definitive outperformance of our benchmark. 2015 begins with question marks around inflation and eye-watering low interest rates. At some point (we think relatively soon) rates will stop falling and investors will be inevitably disappointed with the returns from their fixed income portfolios. We continue to believe our fund is poised to outperform traditional bond strategies over the next few years, while continuing to exhibit significantly less downside risk than equities and high-yield. In other words if things go well we have a good shot at making you money in a zero-interest rate world, and if things go badly you’ll be glad you have the Lawrence Park Credit Strategies Fund in your portfolio.

As ever, we welcome your questions and comments.

The Lawrence Park Team

Please Read The Following:

Lawrence Park Capital Partners Ltd. is registered with the Ontario Securities commission as a Portfolio Manager, Investment Fund Manager and Exempt Market Dealer. The Lawrence Park Credit Strategies Fund is available in Canada to Accredited or Qualified Investors only. Please consult your advisor.

1. *All return figures for the Lawrence Park Credit Strategies Fund (the "Fund" or "LPCSF") are based on the A Series units and are net of management fees, performance fees, trailing commissions (if any) and Fund expenses. Other series may have different fees and redemption terms. Monthly returns are based on monthly NAV calculations by RBC Investor Services.*

2. *The XCB is an index-based ETF that replicates the FTSE TMX Canada All Corporate Index, a benchmark index of Canadian Dollar corporate bonds published daily by PC Bond Analytics. The Fund has a high % of its assets in C$ corporate bonds, and thus the FTSE TMX Canada All Corporate is a relevant index for comparing risk and return in the Fund. The FTSE TMX Canada All Corporate Index has a high component of interest rate risk, whereas the Fund has a low component of interest rate risk.*

3. *BGCI refers to the Barclays Global Corporate Index. Returns for this benchmark are calculated as excess daily returns, or the difference between total returns of the security and an implied Treasury portfolio matching the term-structure profile of that security. Returns are calculated in Canadian dollars, assuming currency exposures on non-Canadian holdings are fully hedged. In the opinion of the portfolio managers, this index represents a valid benchmark for the Credit Strategies Fund on the basis it is a) based on a global portfolio of publically traded corporate bonds, b) expressed in Canadian Dollars, and c) assumes currency and interest rate risk have been hedged from the portfolio.*

4. *Annualized volatility and Sharpe calculations are based on daily returns since inception, calculated by the Manager. The risk-free rate used for the Sharpe ratio calculation is 1.00%, approximately equal to the average Canadian 3 month T-bill rate over the past 12 months. All comparisons to the benchmark are since inception of the Fund, March 1, 2012, unless noted otherwise.*

5. *Ratings and Regional Breakdowns reflect the end of the month portfolio composition on a Total Exposure basis. Total Exposure is equal to the total directional long positions, plus total directional short positions, excluding hedges & cash. Investors should note that because the portfolio is turned over frequently, current composition may differ materially from the numbers stated herein.*

6. *The Fund's returns are not guaranteed, its value changes frequently, and past performance may not be repeated. No representations or warranties of any kind are intended or should be inferred with respect to the economic return or the tax consequences from an investment in the Fund. Potential qualified investors should read the Fund's offering memorandum carefully prior to investing.*

7. *Current and prospective investors should note that the Fund utilizes long and short positions in both domestic and international fixed-income products, and may incorporate leverage and derivative overlays. Fund performance may deviate significantly from benchmark indices shown.*

LAWRENCE PARK
CAPITAL PARTNERS

Contact Us

2 Berkeley Street, Suite 304
Toronto, ON M5A 4J5
Office: (416) 646-2180
Fax: (416) 304-9985
www.lpcapitalpartners.com

Kathleen Biggs
Director, Business Development
Office: (416) 646-2180 ext. 1029
kathleen.biggs@lpcapitalpartners.com