

Fixed-income commentary

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Sentry Tactical Bond Fund

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We would like to dedicate part of this fixed-income commentary to an open letter to the US Federal Reserve – the issues that have buffeted the credit market over the last couple months need to be both recognized and addressed.

To the US Federal Reserve:

Please stop manipulating the market without a full understanding of the ‘unintentional’ consequences that your actions create. In light of the recent weakness in the US economy, I know there is a temptation to launch into a third round of quantitative easing (QE3) after your exhilarating experience with QE2, but sometimes the cost of such actions far outweighs the benefits. Please take a moment to reflect on what has developed over the past several months.

Your stated goals with QE2 were to elevate equity markets, create a wealth effect that would spur consumer spending and stimulate the overall US economy. Is that what happened? From our perspective as credit asset managers, something else happened. You bought US Treasury bonds from the private sector – banks, insurance companies and pension funds – which left these institutions with non-interest-bearing cash. Basically, these institutions took this free cash and lent it out to more aggressive investors – read hedge funds and speculative investors – who in turn bought, among other things, high-yield bonds and emerging market debt. What you did was take away an AAA (almost) risk-free asset from their balance sheets, forcing them into the next best thing – overnight repos which are considered almost risk-free given their one-day time horizon and collateralization. I know that this is not a revelation, but money tends to flow to the best return opportunities, particularly when the investor is able to leverage this investment at a repo rate of 1/4 to 1/2 of a percent.

Let’s use Brazil as an example. The tsunami of funds into the emerging markets has resulted in Brazil’s 10-year government debt to trade below 3.5% – a mere 120 basis points over the equivalent Treasury bonds. Despite aggressive moves by the emerging markets central banks, currencies appreciated in value. In the case of Brazil, the real appreciated over 11% between November 2010 and July 2011. We need not talk about the inflationary implications on local economies; what is not talked about will hopefully be forgotten.

A little closer to home for us, the impact on high-yield bonds was no less dramatic. As fund managers, we found ourselves trying to buy bonds at origination on \$1 billion debt deals that were 10 times oversubscribed, and asking: where was all this ‘new’ money coming

from? The yield on BB bonds was driven down to 5% and sometimes below. Although we viewed these as solid corporate investments, we asked ourselves almost on a daily basis: did they truly merit a 5% yield, and were we being compensated for the underlying risk that we were taking?

All of this pales in comparison to the negative effect on markets when the liquidity taps were turned off in July. Just as a drug dealer has to take some responsibility for the plight of the junkie, you need to consider the effect of going cold turkey and how painful the withdrawal syndrome could be. High-yield credit spreads have gapped wider – almost double over the course of two months – and to the point that the credit market is clearly discounting a recession. Maybe the pain was worth it, but what did you really achieve? Real wages – those adjusted for inflation – are lower than when you launched QE2; unemployment is still over 9% and rising; and equity markets have given up a good deal of the gains that you so clearly desired.

So when your hand reaches for the QE3 lever, please take the time and consider the lessons from the recent past. As an investor, I would like to say that I have the will power to not try to kick the football knowing that it is going to be pulled away at the last second, in the classic Charlie Brown style. But deep down, I suspect that the repo cycle with the dramatically improving yields will draw me in again, since the liquidity that you provide is a powerful drug. The short-term high pushed by quantitative easing will not offset the longer-term deterioration in the health of markets, and I suspect that the longer the dependency, the harder the path to recovery.

Without QE3, I am confident the credit market can work through the turmoil that you have caused, and I suspect the economy can work through the debt deflation challenges on its own. Although the process will be painful and long, the net result may be a much stronger economy and a market that is not shackled by policy dependencies.

Market outlook

As always, we want to use this bi-monthly commentary as an opportunity to provide some investment insights. The past two months have been one of the most challenging periods in history for high-yield bonds. From a return perspective, August was the 8th worst month in high-yield bond history. Global high-yield bonds decreased more than 4% in value, according to data compiled by Barclays Capital.

Portfolio review

While we have been trying to be defensive, we also tried to take advantage of the volatile market. We invested in a company called Reynolds Group in August, when its newly issued US\$1.5 billion senior secured bond price plunged to US\$93.5 after two weeks of issuance.

Reynolds is one of the world's largest manufacturers and suppliers of consumer food, beverage and food service packaging products. The company has a very diversified and high-quality customer base numbered at 3,000 globally, and has built long-standing relationships with major customers whose businesses have historically been stable

and non-cyclical. It holds very strong and competitive market positions, with most of its revenue being derived from No. 1 or No. 2 market positions. The company has also been able to sign long-term contracts with its customers, further strengthening its cash flow stability. In addition, it manages raw material costs through a variety of mechanisms, including pass-through pricing in contracts, hedging and the ability to implement price increases. Finally, the senior secured debt is well protected through a cushion (debt ranked below) of 2.4x EBITDA and has a reasonable net leverage of less than 4.0x. And here comes the real good news: the bond subsequently recovered back to par in one week and is holding very well through the continuous market turmoil that we are still experiencing.

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