Fixed-income commentary

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Sentry Tactical Bond Fund

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Market outlook

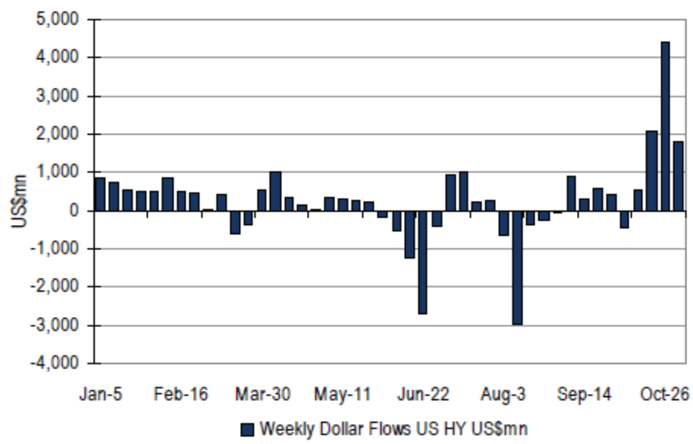
Ivan Getting's pioneering work on global positioning systems (GPS) at Raytheon Corporation in the 1950s dramatically changed travel a half a century later. The concepts of knowing your end goal and determining how you are going to get there are just as important in portfolio management as they are in driving.

While some asset managers adopt the goal of betting on a prescribed index – an objective that I have never really understood the real value of – our goal has been to offer investors an attractive running yield in an environment that is sorely lacking in investment alternatives. Just as it is important to question the directions offered by the GPS, I think it is equally worthwhile taking a step back and questioning the direction of an investment strategy. We have maintained a consistent commitment to the global high-yield market, including emerging market credits. We have been successful in constructing a pool of assets that meet a high monthly target payout on an earned basis – which means a target yield of over 8%. In an environment of near-zero, risk-free interest rates, the focus had to be in higher-yielding corporate credits. To this end, we have maintained a BB average credit rating for Sentry Tactical Bond Fund.

So where do we stand? Are we going in the right direction? In light of the market, and by extension, the NAV volatility over the past few months, this is an appropriate question to ask. At the heart of the issue, the underlying credit risk in global high-yield remains very tame by historic standards, with default rates expected to range between 1.5% and 2.0% for this year and next. There is good reason for this: companies are sitting on a good chunk of cash and healthy liquidity is usually the best tonic to ward off financial distress. I have lived my career by the rule that you never "fight the Federal Reserve" and the flip side of this is that most successful investment managers pay attention to what the Central Bank is trying to achieve. Monetary authorities around the world have made it a very easy environment to lend money to companies with the hope of stimulating economic growth. This takes the form of ample liquidity and near-zero, risk-free government interest rates – the risk/reward trade-off is highly skewed in favour of corporate lending. Why would anyone lend money to the Government of Canada at 2% for 10 years if inflation is above 3%? The answer is risk and reward. Finally, the economic environment of slow growth is actually favourable to credit lending. Companies tend to play defence in this situation and not look for innovative ways to destroy capital. Conservative borrowers are always a good thing when lending money.

Show me the money. Against the backdrop of some pretty volatile credit markets with Europe continuing to offer sequential surprises, the flows into high-yield bond funds have been steady, positive, and quite often large. The following chart, provided by BofA Merrill Lynch, shows the extent of the fund inflow in the US since mid-September.

US HY still seeing large inflows with $1.8 bn inflow this week



Source: BofA Merrill Lynch Global Research, EPFR. As at October 2011

The positive inflow into high-yield bonds should really be no surprise, given the alternatives like US Treasury (1/4% due 2013) or Walmart (3/4% due 2013). We do view it as some vindication of our investment strategy, particularly when the underlying assets in the Fund are yielding around 10%.

As for the macroeconomic environment, I don't think a lot has changed – namely what was broken is still broken. In the US, any short-term gains in consumer spending have come at the cost of diminished savings and in an overleveraged economy, this is simply not a sustainable trade-off. The housing market continues to soften and employment growth remains anemic, while the prospect of any concrete policies out of Washington remains in the distant future. Financial markets tend to be able to juggle only one ball at a time, and the main focus is squarely on Europe. The game of procrastination and buying time is quickly coming to an end, and while the outcome remains very much in doubt, capital market risk levels will remain very elevated. The one thing that I can say is that the policies of austerity have all but locked in a near-term recession in Europe – well done. It is important to listen to what the central banks are telling you. Both the Bank of Canada and the Federal Reserve have lowered their economic growth forecasts for 2012, and the European Central Bank (ECB) has recently lowered administered rates in Europe. It doesn't take a ruler to connect the dots – we are going to be faced with subpar growth for the foreseeable future. Slow growth and low interest rates will remain the "Goldilocks" scenario for high-yield investing.

Portfolio review

We increased our holdings of Grupo Virgolino de Oliveira's (GVO) 10.5% 2018 bond at $91.5. GVO is a Brazilian sugar and ethanol producer. Industry fundamentals for Brazilian sugar producers remain positive vis-à-vis other markets. Brazil is the world's largest producer of sugar and the second-largest producer of ethanol. In spite of sugar prices coming off record highs of $0.30/lb, they have remained above $0.24/lb in the second half of this year, still well above the levels of around $0.16/lb seen in 2009 and through mid-2010. This is mainly on the back of strong demand from Asia. GVO exported about 75% of its sugar production in the last quarter.

Brazilian domestic demand for ethanol is strong due to a mandated gasoline blend of no less than 25% ethanol, and a continuously growing fleet of "flex fuel" vehicles which can run on either gasoline or ethanol, or a mixture of both. Consequently, GVO sold about 90% of its ethanol production in the domestic market during the last quarter.

The Brazilian sugar and ethanol industry is highly fragmented. However, GVO sells its production (both domestic and exports) via Copersucar, a cooperative that provides sales, financial and logistical support to its member companies, and of which GVO is the largest member. Copersucar is the largest player in the Brazilian market at about double the capacity of the largest independent sugar producer, and its scale allows for cost-efficient operations, logistics and distribution.

Sugar ethanol is more cost-efficient to produce than corn ethanol, giving Brazilian producers an advantage over US producers. As such, GVO has a competitive cost structure and the flexibility to shift production between sugar and ethanol, depending on the demand-supply outlook for each product. GVO has a broad and diversified supplier base and the price of inputs (sugar cane) purchased from growers (50% of total sugar cane crushed) is indexed to the market price of sugar and ethanol, which provides a partial natural hedge to sugar price exposure. To provide further revenue stability, GVO – through Copersucar – directly hedges some of its sugar price exposure.

In addition to positive fundamentals, the GVO notes offer attractive carry and relative value. Debt/Adj. EBITDA stands at 4.4x. However, GVO generates positive free cash flow and has access to liquidity through Copersucar.