

Fixed-income commentary

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Sentry Tactical Bond Fund

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Market environment

Last year was a challenging environment for fixed-income investors, with government bonds being the top-performing fixed-income class for 2011. The past couple of months have challenged us in different ways, with interest rates remaining incredibly low and bad news continuing to come out of Europe.

In short, yield has been difficult to find. Ten-year Government of Canada bonds are around 1.9% and yields on three-year corporate bonds are in the 1.5% to 2.0% range. As Europe's woes escalated over the last two months, it put increasing pressure on credit and currency – and virtually everything we do as fixed-income managers. It's probably going to be just as challenging as we head into 2012.

Market outlook

We think that yield is going to continue to be difficult to generate – but not impossible, as rates are going to remain low and perhaps go even lower. Ten-year bond yields may test 1.5% to 1.0% in 2012. We expect the US economy to continue with its sputtering growth in the first part of the year. We don't think we'll see a real resurgence in US growth until the beginning of 2013, maybe even mid-2013. The US Federal Reserve is going to remain on hold this year, next year and probably even the year after that. For a fixed-income investor, that's a difficult environment in which to generate alpha.

Europe is most likely going to provide further pressure on capital markets in 2012. Disaggregation of the euro would cause a significant shock to capital markets and to the economy, and that's something we're going to have to manage to and monitor very closely. If that happens, it could set off a deep downturn in global economic growth. This is not our base case, but clearly represents the biggest downside risk.

Another factor is oil, as we think oil prices will remain elevated. The geopolitical developments in the Middle East, coupled with the developments in Europe, may lock us into that area of \$100+ oil for the first part of the year, providing little relief to the fragile US consumer.

In all of this seeming negative news, we think there is one positive grace for 2012: being rewarded for taking credit risk. And that's really where our main focus is.

How can you be rewarded for taking credit risk? In this "Goldilocks" type of environment, the global default rate in high yield is running at about 1.7%. That's a lower rate than we estimated going into the year and we think the downward trend will continue. Do the math: with the average on high yield running around 8% and with a 2% default rate

– or even less – we're seeing 6.5% yield, compared to government bonds yielding anywhere from 1.25% to 1.50%. That's the reward for taking credit risk.

We think the focus will continue to be on high yield and, according to US data, we're seeing continued daily inflows into the high-yield market. Economic growth should remain slow, but corporate balance sheets are still sound.

Portfolio review

So what direction is the portfolio compass pointing? I suspect strongly north, but before we go there, I think that it is worth highlighting some of the key developments in the Fund. If anything, the approach to the portfolio has been very consistent in that we have, for the most part, stuck with the credits that are in the Fund. We remain fully committed to the approach of doing solid credit work up front and desperately try to avoid a trade driven by panic. The average portfolio credit rating remains anchored at BB with the average duration of the Fund coming in close to four years – pretty consistent to where it has been throughout the year. Likewise, the Fund has followed consistently the investment philosophy of diversification across the global credit market with about a third of the investments in the emerging market space. The one significant change in the Fund has been a marked increase in government bonds – which now account for over 15% of assets. Just as putting ballast in the hold of a ship makes it more stable, the addition of Governments in a credit portfolio achieves the same goal. We tend to think of Canada bonds as a low-yield/risk-free asset but in a portfolio context, they provide another layer of diversification. While the Fund lost some altitude in the autumn credit market downdraft, the NAV has been characterized by relatively low volatility. This speaks to the benefits of assets that provide high cash flow, diversification and a relatively low duration.

In investment parlance, north means higher, a direction that I think is supported by the underlying credit quality of the assets in the portfolio. To be sure, the last six months have thrown up some challenges but during the last two months, a more positive tone has crept in. To no surprise, Europe has been the biggest challenge to the credit market. About a third of what we do is in the emerging markets space, and it's been one of the worst-performing sectors for the Fund. The reason for the underperformance wasn't a deterioration of fundamentals for the companies or countries in which we invested. These companies had good credit profiles, domiciled in economies growing at 4% to 9%. How could these securities underperform so

significantly? European institutions, being very large players in emerging markets, repatriated a lot of their funds back home. It made sense – if the European ship is tipping to one side, they’re going to do everything they can to right that ship before they invest in peripheral markets. The result was a real down draft in emerging market credits, particularly for Asia and Latin America. When the market has more sellers than buyers, market prices tend to get pushed down. We’ve started to see that come back towards the end of the last year and it appears to be coming back still.

We think running yield is going to be an important factor and we’re fundamental investors in that aspect. We look at companies and their ability to pay us back and what they pay us to lend them money. We have about 52 corporate holdings currently and have no negative credit events – all of our holdings continue to be money good. The average yield to maturity is close to 10% in the securities that we hold. That’s a positive factor in an environment where government yields are fairly close to zero.

Portfolio outlook

We think the reward for investing in high-yield securities far outweighs the risk and that these types of securities will offer the best opportunities this year. As a high-yield investor, one of the toughest risks to manage is what we call the “fear trade.” If you’re in an environment where corporate defaults are at 12% or 14%, there’s probably good reason to be afraid. When your house is on fire, you want to get out. But when corporate defaults are at 1.7% as they currently are, there’s probably nothing scary under the bed.

We don’t think that investment-grade securities are going to offer the same type of return as high-yield, but good-quality, investment-grade securities should still offer something in positive territory – a fact very relevant to the fixed-income component of Sentry Conservative Balanced Income Fund. We remain focused on a multi-dimensional

strategy – looking for opportunities in high yield, the Canadian preferred share market and the US credit market. Now, more than ever, diversification represents the largest risk-control factor in a portfolio.

When choosing a security, we look at three things: credit, quality and opportunity. Quality requires diligence, because “quality” doesn’t necessarily equate with “credit rating.” If credit rating and quality were the same thing, then in theory, Italy and Greece would have been considered top-quality a few years ago. Credit comes back to managing risk, and being rewarded for going into high yield. And opportunities come when a market has been in dislocation.

An example of the type of company that encompasses our selection criteria is Reynolds Packaging, one of the largest packaging firms in the US. Reynolds ties into a trend we’ve identified in the US market that we call “on-shoring.” Instead of having goods manufactured in China, the US is again developing as a player in the global manufacturing arena. It’s a growing trend and we’re looking to the US for additional opportunities there. Another credit that we are taking a serious look at is JBS – domiciled in Brazil and one of the largest beef/pork providers in the world. As the developing world continues to move along the path towards becoming developed economies, the demand for proteins keeps pace. The point is that while the Fund has held fairly steady, we continue to look and, more importantly, find investment opportunities with a positive risk/reward profile.

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