DWIC Diversified Bond Strategy

Fourth Quarter Commentary – December 31, 2012

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At year end, the major themes that have influenced capital markets since the 2008 financial crisis remained in place. Specifically, high and rising public debt, large public and private sector unfunded liabilities, high unemployment levels, moderate household income growth and a prolonged deleveraging cycle by the public, financial and household sectors.

In response to weak and some cases negative economic growth, central banks maintained aggressive policies – low rates and quantitative easing – that sustained a supportive backdrop for investors into year-end. In addition, willingness by the European Central Bank (ECB) to provide liquidity to the financial sector significantly reduced the risk of financial stress in Europe. The effort by the ECB to reduce systemic risk contributed to a reduction in capital market risk premiums in the latter part of the year. Bond yields edged higher, ending the year close to where they started, corporate bond spreads narrowed and equity prices rose.

Canadian bond yields held relatively steady throughout the quarter, partially contained by a continuation of foreign purchases of Canadian debt. This left Canadian bond yields fundamentally expensive given the positive, albeit low, inflationary pressures in Canada. Short-to-mid term government bonds offered negative real yields to investors. The Bank of Canada remained constrained to raise the overnight rate due to the persistence of weak global economic and financial conditions and the prospect of slower domestic growth into 2013.

Low government bond yields sustained the demand for income by investors. This has been a growing theme that contributed to the narrowing of corporate bond yield spreads throughout the quarter. Investors continue to assume more risk in order to achieve a modest positive yield on debt securities. Higher quality high yield bonds, those with a BB rating, now yield the same as a higher quality investment grade corporate bond would have yielded five or six years ago.

Current valuations have created challenges for fixed income investors. In this environment we view high quality corporate bonds to offer better relative value than government bonds. Nowhere in the bond market do we see attractive absolute valuations other than the context of long-term government bonds providing cheap portfolio insurance. Accordingly, we maintained reduced exposure to interest rate risk in the portfolios by maintaining duration of about four years. Secondly, we maintained a relatively high weighting in corporate bonds. We managed the credit risk by maintaining our security selection based on stable to improving credit profiles.

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