

# National Post

## Set for higher rates

Fri Feb 26 2010

Page: FP7

Section: Financial Post Investing

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Column: Buy & Sell: Big Picture Views, Current Issues, Outlook And Picks

Source: Financial Post

Illustrations: Color Photo: Aaron Vincent Elkaim For National Post / Christine Horoyski, head of the fixed-income team at Aurion Capital Management, says the managers are holding more cash and waiting to buy bonds when their yields are higher.

The fixed income market has seen a dramatic tightening of credit spreads that has them approaching pre-crisis levels. Liquidity has improved and new issues -- both investment grade and high yield--are coming to the market.

"All indicators point to normalized credit markets," says Christine Horoyski, who heads up fixed income at Aurion Capital Management.

She also cites a recovery in the Maple market, where foreign institutions issue bonds denominated in Canadian dollars, which was virtually shut down last year. Australian banks are currently leading the way.

"It's a reflection of the fact that those markets, much like Canada, have avoided the crisis more easily than some of the U.S. financials," says Horoyski.

She does expect the market will accept the re-entry of some U.S. names in the near future.

Aurion's fixed-income team, which also includes Derek Johnson and Nicole White, has shifted its focus to the rising interest rate environment.

"The only yields that haven't changed materially are short-term interest rates and that's because central bankers remain committed to a very easy monetary policy," says Horoyski, noting the fund is overweight in the mid part of the yield curve.

"We anticipate a removal of the emergency levels of policy rates this year, which should result in higher shorter term yields. That is the biggest risk in fixed income -- when monetary policies change, short-term interest rates can rise dramatically."

As a result, the managers are avoiding short-dated bonds in favour of higher-than-normal cash holdings, which they expect to invest at higher yields later. They also remain overweight the corporate and provincial sectors relative to government bonds, which increases the yield in the portfolio.

Last year, investment grade corporate credit represented the most attractive component of the fixed-income market. While corporate bonds still offer attractive income, they don't appear to have as much opportunity for capital gain.

"High yield is attractive because these bonds tend to be shorter term to maturity, so we don't have the interest rate exposure that a longer-dated corporate bond would have," says Horoyski. "Yet the yield on these securities is still attractive. The improving

economy, liquidity and balance sheets are all very supportive for the high yield market right now."

The sovereign risk posed by problems in Greece, Spain and Ireland provides another reason to position defensively for higher rates.

"It has basically raised the risk premiums required in the marketplace," says Johnson. "We were already biased toward higher rates given the amount of debt governments have taken on to provide stimulus for the recovery. The sovereign fear has just exacerbated this."

He adds that as more nations get into trouble, the risk premiums will rise further, and at some point, bank debt may look safer than sovereign debt.

White, who is responsible for currency strategy, notes that the fund's foreign content is 100% hedged. Foreign names account for between 20% and 30% of the portfolio. Since the managers believe the Canadian dollar will retain its strength, they don't want exposure to a weaker U.S. dollar.

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### BUYS

GREAT -WEST LIFECO INC. (7.127% note of 2018).

This recent addition to the portfolio represents the managers' top pick in the insurance space.

"Great-West Life has been able to manage through the turmoil of the last couple of quarters better than its peers," says Horoyski, noting that the company's recent quarter results were in line with expectations.

She also notes that these Tier 1 capital notes offer incremental yield over the banks and provide diversification away from these holdings

"In our view it's the most reward for the least risk. It's met expectations where others have failed." (Johnson)

Yielding 200 basis points over Government of Canada 10-year bonds and offering limited interest rate risk as a result of the term, Great-West's characteristics are representative of many current holdings in the portfolio.

J.P. MORGAN CHASE & CO. (5.058% of 2016).

Another recent addition to the fund, J.P. Morgan serves of an example of how the managers buy on weakness. Horoyski notes that spreads on U.S. financials weakened in January as equity markets pulled back on news of President Obama's proposed regulations for financial institutions.

The changes appear to impose stricter capital requirements on financial institutions and curtail risk-taking activities, both of which are very friendly to bondholders as opposed to shareholders, she says.

The manager also believes the potential short-term ramifications from a rating agency standpoint are already priced into spreads.

"While J.P. Morgan remains highly sensitive to the economic recovery, we think it has the balance sheet strength to manage through a weak cycle," says Horoyski.

#### GREATER TORONTO AIRPORTS AUTHORITY (4.85% of 2017).

Greater Toronto Airports Authority is more of a core holding in the portfolio and represents a play on the infrastructure space.

Horoyski notes that GTAA is attractively priced at an average of 100 basis points over 10-year Government of Canada bonds.

The security is also slightly shorter than 10 years, so it follows the managers' theme of "yield without significant interest rate risk."

"If we believe we're past the worst of the economic cycle, we should start to see an improvement in airline traffic and traffic through the airport," says Horoyski.

"We believe the company's debt metrics will remain under pressure as passenger traffic is challenged, but at the current level of yield, GTAA offers an attractive risk reward opportunity."

#### SELL

#### TWO-YEAR BANK OF CANADA BONDS.

While many feel that they can get defensive against rising interest rates by holding bonds that are only two or three years from their maturity dates, Horoyski notes that even two-or three-year Bank of Canada bonds will suffer price declines if yields rise in anticipation of higher administered rates.

"There is not a lot of yield right now that would offset the impact of a significant dramatic increase in interest rates on those bonds," she says.

"So you may actually lose money on a two-year Government of Canada bond in the next year."

The manager recommends going a little bit further out on the term structure and adding a high-quality corporate bond yielding an average of 4% to 5%.

She says this will provide a lot more protection against higher interest rates.

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#### THE MANAGER

Managers: Christine Horoyski, Nicole White & Derek Johnson, Aurion Capital Management

Fund: Aurion Income Opportunities Fund

Description: Diversified portfolio of fixed income securities

Style & Process: Top-down fundamental approach, multiple strategies with active trading, long only, no leverage

Firm's assets under management: More than \$4-billion (primarily institutional)