



Signature Report

2009 – A Good Time to be a Lender

While the precipitous drop in equities in the fourth quarter of 2008 grabbed headlines, the retrenchment in corporate debt markets was even bigger – and much more newsworthy. Ultimately, the final four months of the year will be remembered as a time when governments, investors, and companies all realized that credit is the grease that keeps the global economic engine running.

Credit can take many forms – for consumers, it can be mortgages, student loans, margin accounts, or credit card balances. Companies and employees are touched by company lines of credit, commercial paper, and corporate loans and bonds. Without credit, new homes and automobiles aren't sold or leased, manufacturing plants aren't built, international trade slows, and economic activity deteriorates. So, when the banks stopped lending – even to each other after the Lehman Brothers and Washington Mutual debacles – governments worldwide stepped in with bailout money to prevent a spillover into the economy. As politicians planned their attack, the global margin call on credit and leverage had begun.

The financial and economic quagmire began with problems in credit. Remember CDOs and sub-prime mortgages? And credit must flow again before there is a recovery. An old axiom states “when credit is hard to come by, it's a good time to be a lender.” At Signature, we intend to take advantage of the opportunity. We believe that credit, especially high-yield and investment-grade bonds, is the most attractive asset class in 2009. Valuations are much more compelling than historical averages and present an opportunity for very attractive risk-adjusted returns. Compared to stocks and government bonds, credit represents very good value.

Credit Attractive Compared To Government Bonds

As shown in Table 1, the principal measure of corporate bond valuations, yield spreads, are at all-time wide levels. (The yield spread is the difference in yield between a corporate bond and a government bond of the same maturity.)

A Comparison of Yield Spreads

	Canadian Investment Grade	U.S. Investment Grade	U.S. High Yield
Current yield	5.9%	7.7%	18.0%
Historical average [†]	11.2%	7.0%	11.2%
Current spread	287 bps*	574 bps	1642 bps
Historical average	55 bps	117 bps	505 bps
Current price	114.4	91.0	64.9
Historical average	95.7	102.3	92.2

[†]Last 20 years

*One basis point or bps equals 1/100th of 1%.

Source: DEX and Merrill Lynch bond indexes. Current data as of January 8, 2009; historical data from August 1988 to December 2008.

Table 1: The current spread on U.S. high-yield bonds over governments is at a record high of 1642 bps or 16.42%. The spread on U.S. investment-grade is considerably higher than the historical average, and comparable to the Great Depression.

The size of the spread is a function of a bubble in government bond markets and a “black hole” in the credit markets caused by the massive deleveraging during the credit crisis. The bubble formed because investors were looking for principal protection when stocks and corporate bonds were plummeting, banks were failing, and there was a sharp reversal in inflationary expectations. As the consumer price index fell from 5.5% to 1% in three months, the yield on one and three-month U.S. Treasury bills turned negative for several days in November and December. In early January, a Government of Canada 10-year bond was yielding 2.88%. Given the U.S. dollar's status as the world's reserve currency, yields are even lower in the U.S., with a 10-year Treasury bond yielding 2.45% – one of the lowest levels in the postwar era. Adjusting for inflation, the real yield on a 10-year U.S. Treasury bond is 1.45%, and 0.88% on a 10-year Government

of Canada bond. These levels cannot be sustained, unless deflation becomes an issue. With global central banks implementing super-accommodative monetary policies and governments providing fiscal relief, it is unlikely that deflationary pressures will persist for five to 10 years.

With such skinny yields to buffer price erosion, can government bonds generate positive returns in 2009? The Canadian government is likely to run a budget deficit this year and be a modest participant in the bond market. The U.S. needs to raise a lot more money, perhaps as much as US\$2 trillion, to fund budget deficits and bailout packages. Given the additional supply of government bonds, it is unlikely they will have positive returns in 2009.

“Get out of Treasuries”

In a recent issue of *Barron's* magazine, Mohamed El-Erian, Chief Investment Officer of Pimco, a leading global investment management firm which runs the largest bond fund in the U.S., said: “Get out of Treasuries. They are very, very expensive.”

If the yields on government bonds are set to rise, do investors want to own them? High-yield bonds are levered to economic activity. Historically, they have a negative correlation to

Treasuries and a positive correlation to stocks. According to JPMorgan, “in 13 of the last 29 years, five-year Treasury yields have increased, and in each of those 13 years, high yield has outperformed its higher-quality counterparts.” Investment-grade bonds typically have a stronger correlation to Treasuries, but they are now just 70 basis points cheaper than the historical average spread of high-yield bonds. This year, it appears that investment-grade bonds will trade with less correlation to Treasuries and more like their high-yield counterparts.

If government bonds are expensive, are corporates cheap? As shown in Chart 1, investors are demanding higher spreads to compensate for an increase in future defaults. Table 2 shows some of the causes of high-yield bond defaults over the past 20 years. In the current recessionary environment, higher defaults are a fair assumption. The massive deleveraging in the second half of 2008 – hedge fund redemptions and the unwinding of structured credit that forced selling into illiquid markets – drove spreads to a level that implied a default rate surpassing that of the Great Depression.

Investment-grade bonds rarely default, but it is a concern for high-yield bonds. According to JPMorgan, “Historically, spreads peak about six to nine months ahead of a peak in

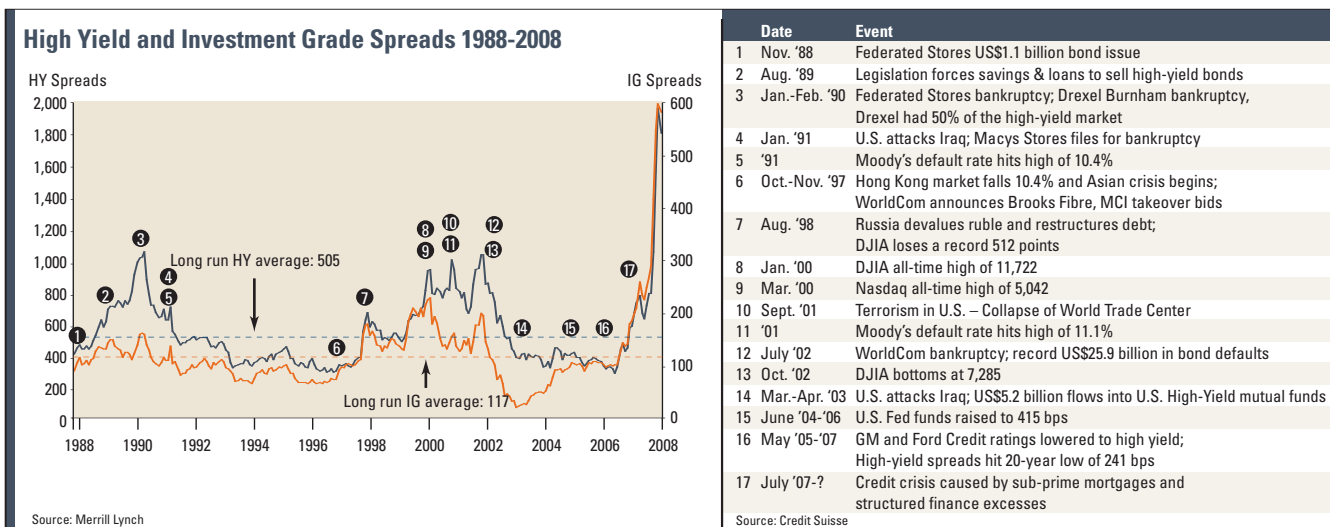


Chart 1 and Table 2: Over the past 20 years, there have been many events that lead to the widening and tightening of high-yield bond spreads. The current record-high spreads in investment-grade and high-yield bonds are a result of the black hole in credit markets created in the second half of 2008. For Signature, it's presented an opportunity to be a lender and purchase credit.



defaults. This time, spreads ascended so quickly that a peak in defaults, in all likelihood, remains several years off.” The high-yield bond default rate for 2008 will likely be around 4%, about the same as the annual average. A model that estimates defaults from variables such as current spreads, defaults, default losses and excess spreads implies that high-yield bond defaults this year are likely to be 23%. At Signature, we’re forecasting 10% in 2009 and 2010. Bonds need to be managed carefully to avoid default. When yields are low and prices high, defaults are a serious issue – especially when the average recovery on a high-yield bond is estimated to be 40%. But with an 18% average yield at 65¢ on the dollar, investors are more than adequately compensated for an increase in defaults.

Obviously, we would rather buy bonds at a lower price than a higher price, particularly when the likelihood of default increases. As insurance, we would rather buy a bond at, or below, recovery value, than above it. So, it is necessary to look at prices when valuing credit. Chart 2 shows the annual average high-yield bond price and recovery value. High-yield bonds are 27¢ cheaper than their historical average, which is significant. A bond purchased at par, which subsequently defaults and recovers to 40¢, has lost 60¢. It is still unfortunate when a bond purchased at 65¢ defaults, but when it recovers to 40¢, the loss is lessened to 25¢. In a diversified portfolio of 100 bonds yielding 18%, if 10% of the portfolio defaulted, the one-year return would still be a respectable 15.5%, without a valuation increase. An assumption of a 40¢ recovery may be too high in this environment, but today’s high yields provide a buffer. Investment-grade and high-yield bonds have never been cheaper. As interest rates declined from 1988 to 2008, the average investment-grade bond was above par. Now, the average price is 91% or 91¢ on the dollar.

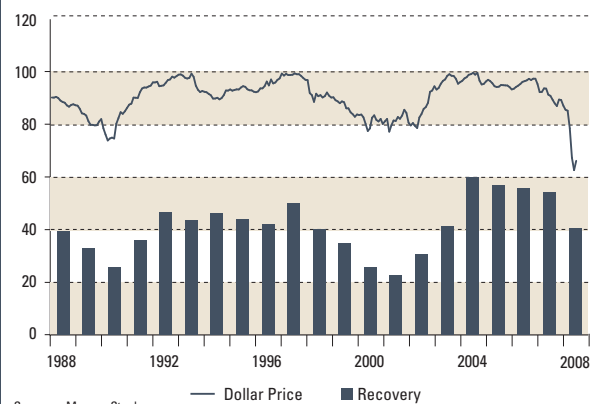
Credit Attractive Compared To Equities

Investors own corporate bonds because they want attractive yields with less risk than owning stocks. So, a valuation of credit versus equities is necessary.

Bondholders earn yields and enjoy a claim on assets, while equities are all about dividends and earnings growth. The equity market just suffered one of its worst years on record and

High-Yield Bonds

Price vs Recovery Values 1988 - 2007



Source: Morgan Stanley

Chart 2: It's a good time to buy high-yield bonds when the current valuations are close to the recovery value. High-yield bonds are averaging 65¢ on the dollar, while the average recovery value for 2008 is likely to come in at 40¢.

further deterioration cannot be ruled out. It's possible the S&P 500 may reach a P/E multiple in the single digits this year. In previous downturns P/E's troughed in the single digits, including the 1977-1983 period when the S&P 500 had an average P/E of just 8X. Credit is hard to come by and secondary equity issuance is expensive, so the high cost of capital may persist for some time, which could change valuations and mute the economic recovery. If 2009 earnings for the S&P 500 hit the current consensus – between \$53 and \$65 – a substantial downside risk will exist for equities. A P/E of 8X suggests the index could trough between the high 400s and low 600s, compared to 903 at year-end 2008.

With a 2009 earnings estimate of \$65, a significant discount in credit spreads implies record default levels and a P/E for the S&P 500 of 13.8X. Either the stock market is right and high-yield bonds are cheap, or the credit markets are expecting a more severe recession – in which case, equity markets are overvalued.

We believe the massive deleveraging in the fourth quarter of 2008 swung the pendulum too far and that equity markets may actually be sending the smarter signal. This signal does not necessarily indicate a buy for equities, but a sign that credit is cheap relative to stocks. In 2009 and 2010, that

cheapness provides investors with the opportunity to own corporate bonds with equity-like returns and credit-like downside protection.

Coming out of 2008, investors are unlikely to tolerate equity market volatility in an era of scarce earnings growth and no P/E expansion. In this environment, company management will be focused on paying down debt in lieu of increasing dividends or repurchasing shares or reinvesting in the business. This deleveraging may result in more secondary equity offerings, which dilute existing shareholders.

Recovery Depends On Credit Markets

A sustained recovery in equities is dependent upon the resumption of functioning credit markets – starting first with banks and then other lenders. Simply put, banks need to be able to borrow cheaper than their customers can borrow from them. Globally, governments have established innovative programs to ensure that banks remain solvent and can lend as cheaply as possible. Inroads are being made, and we believe success of these programs will become evident as the year progresses. A recession in 2009 will reduce earnings and cash flows, and increase the risk to lending, but valuations – yields, spreads and prices – will more than compensate.

The credit bust of 2008 is the defining event shaping corporate activity in 2009. We expect corporations to pursue lender-friendly actions. Dividend cuts, asset sales, operating cost reductions, capital spending cuts, income trust conversions and equity injections all feature in the exercise of preparing balance sheets for harder times. Lenders will insist upon it, and benefit from it. Surviving lenders, be they bankers or bond market participants, will have teeth in 2009.

At Signature, we have aligned ourselves with the lenders. Corporate credit risk has been repriced to attractive absolute levels – ones that we find competitive with equity return prospects. Given the economic uncertainty, we plan to shift our exposure up the corporate capital structure into the relative safety of the creditor's position. The impetus for this grows as cash yields fall with successive interest rate cuts by the Bank of Canada and the U.S. Federal Reserve. At the end of 2008, our income-oriented funds with distribution

commitments had cash positions of around 25%. The need to maintain our distributions is an added pressure to capture the unprecedented yields available in credit.

We aim to increase corporate credit exposure in our income and balanced funds by 10% above existing levels. Currently, Signature High Income Fund has 40% in credit, which is primarily high yield. Signature Income & Growth Fund is starting from 30%, with two-thirds in high yield and one-third in investment-grade bonds. Half of the fixed-income exposure or 20% of Signature Canadian Balanced Fund is now in investment-grade corporate bonds. Signature Corporate Bond Fund is already 65% investment grade and 30% high yield. The additional credit exposure in all funds will be in primarily North American investment-grade bonds.

The demise of the shadow banking system, structured finance and Wall Street investment banks has resulted in capital becoming scarce. Additional strains to capital availability will come from a home bias in lending. Worldwide, banks have failed and been nationalized. As a result, the new government shareholders will prioritize domestic lending at the expense of international operations. The globalization of capital will reverse, leaving only local lenders when the foreigners exit. In local markets, lenders with excess loans in relation to their equity will curtail lending and reduce risk wherever possible. As such, we expect there will be opportunities all year for credit market participants to bridge the gap left by bankers.



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