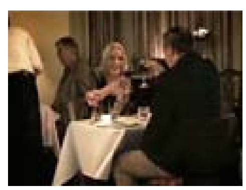
Return of equities

Michael McHugh, left, and Oscar Belaiche are lead managers at the Dynamic fund. National Post

Jonathan ratner, Financial Post · Thursday, Nov. 11, 2010

The world was looking pretty bleak when the Dynamic Strategic Yield Fund was launched on March 1, 2009. Just days later,



major market indexes bottomed, yet investors weren't sure if they had seen the worst.

At the time, debt securities were providing equity-like returns, so portfolio managers Oscar Belaiche and Michael McHugh went heavily overweight fixed income at the expense of equity exposure. Gradually, that become a 50/50 split and now the fund is more tilted toward equities.

"In the last couple of months we've been weighted more constructively toward a recovering economy, so we've shifted the portfolio in favour of the higher return attributes offered by equity income versus fixed income," Belaiche says. One key factor affecting the fundamental backdrop is the strong and diligent effort for a policy-induced recovery in risk assets, McHugh says.

Portfolio manager Jason Gibbs also works on the equity side, while Domenic Bellissimo helps manage the fixed income portion of the fund. Together, the two teams include 10 people, not including Barry Allen of Marret Asset Management, who provides the high-yield component as sub-advisor to the Dynamic High Yield Bond Fund.

As of the end of October 2010, roughly 51% of the portfolio was in equities, 39% in bonds and 10% in cash. Of the bond exposure, 14.6% was in corporates and 12.7% was in high yield.

One of the biggest selling points for this fund has been its relatively low volatility. From launch to the end of October, the S&P/TSX composite has seen 179 negative days, while the fund has experienced just 117. It has been down more than 1% in only 1.7% of its negative days, versus 45.3% for the TSX.

"As people have been seeking yield, they've also been looking to reduce volatility," Belaiche says. "They are more fearful than greedy."

The manager notes that there has been some yield compression in income trusts, driven by their high yields and conversions to dividend-paying corporations. He says there is also an index trade occurring, where institutional, ETF and mutual fund demand is rising as these stocks move into indexes.

Pengrowth Energy Trust is one name the managers expect to benefit, while its new CEO, Derek Evans, represents another potential catalyst.

Belaiche also explains that the fund is overweight financials because the sector represents a very stable source of income, while the high exposure to energy reflects the anticipated benefits from an improving economy.

"We're now in an environment where we're putting more

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emphasis on higher

credit quality balance sheets," McHugh says, noting his reduction of both high yield and corporate bond weightings. He explains that this reflects the better return and income-producing attributes of the equity income space.

Meanwhile, the fund has also started to increase hedging of interest rate risk as part of an effort to protect capital.

McHugh does this by shorting bond futures -- both 10-year U.S. treasuries and Canadian government bonds. He explains that while the short end for yields is anchored by governments, the United States and to a lesser extent Canada, at some point the long end of rates will start to rise.

"By adding the monetary easing in the United States, it reaffirms longevity to the zero interest rate policy at the front end, but it does put some pressure on the longer end, as investors demand greater risk premiums," McHugh says.

This has been evident in successive new highs in the U.S. 30-year bond since the end of August. While this has not yet occurred for the 10-year, the fixed income team has noticed that the decline in bond yields has stopped and a consolidative pattern appears to have begun as yields are beginning to migrate a bit higher.

McHugh explains that the dynamics in Canada are a bit different due in part to large foreign buying of the Canadian dollar and bonds. Another reason is the increasing aggressiveness of asset liability-driven mandates from insurance companies, who have been relatively consistent strong buyers at the long end recently.

However, the manager believes that too will expire at some point and these developments will add to volatility heading into 2011 across the yield curve.

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BUYS

Emera Inc. 4.83%, 2019 (EMA/TSX)

In keeping with the defensive-minded theme, Bellissimo highlighted the fund's position in this BBB-rated bond.

Emera owns Nova Scotia Power, a regulated entity that represents the lion's share of its revenues, cash flows and asset base.

"Emera has growth initiatives through the better part of this decade, and we're comfortable with how management is expanding its regulated rate base," Bellissimo says. "It is also taken a measured approach to adding assets."

He also likes Emera's relative value and says its spreads are attractive on a relative basis.

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TELUS CORP. 5.05%, 2020 (T/TSX)

The managers are very positive on both the debt and equity of Telus and view the telecom sector as defensive.

"It's a good cash flow generating business," Bellissimo says. "Their wireless and internet businesses combined have grown bigger than their wireline segment. It's a good place to be."

While Telus has lower penetration in such areas as smartphones relative to Rogers Communications Inc., the managers believe this is an area where it can capture more market share and additional growth. Meanwhile, Bellissimo notes that Telus' IPTV business is starting to get some traction.

WHISTLER BLACKCOMB HOLDINGS INC. (WB/TSX)

Despite difficulty with getting some IPOs to market in 2010, the owner of the largest mountain resort in North America did debut on the TSX on Tuesday. However, the deal was repriced twice.

"We were the lead order on Whistler Blackcomb and at the price the deal was done at, we were very happy to participate," Belaiche says. "It's not without risk because it's hard to predict weather. However, we feel we're being compensated because you can also have good weather."

With an attractive initial yield of roughly 8.1%, the manager believes the company has a conservative payout ratio.

SELL

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The managers were already selling these bonds by virtue of their valuations earlier in 2010, but then identified the risk of material losses in advance of the market dislocation in August and sold two small residual positions.

Several securities were issued in 2008 and 2009 with a provision allowing them to be called in the event of a Capital Disqualification Event. The recently announced regulatory changes by the Basel Committee may constitute such an event and may lead these securities to be called as early as 2013.

PROFILE

Lead managers Oscar Belaiche & Michael McHugh

Fund Dynamic Strategic Yield Fund

Description Go-anywhere blend of fixed-income and equity-income securities

Assets under management $1.9-billion

Style & Process Quality at a Reasonable Price (QUARP)

Performance 1-year + 18.3 % (as of Oct. 31, 2010)

MER 2.26%