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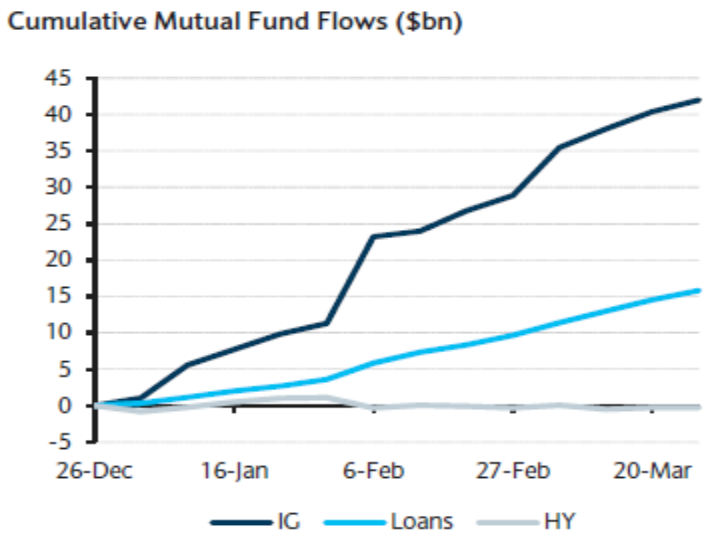
**Fulcra Focused Yield Fund – Q1 2013 commentary**

We've written previously about corporate bond markets setting issuance and low yield records. Well, the first quarter of 2013 was no different. According to Barclays, there was a record $128 billion of high yield corporate bonds issued in the first quarter. Despite this, retail high yield mutual fund flows (see graph below) were essentially flat through the quarter. While the high yield corporate bond market generates over $100 billion in cash annually from coupons …. stagnant demand in an increasingly supplied market, with yields at all-time lows, certainly doesn't scream of value.

While investment grade corporate bond issuance had one of its best quarters ever, yields have remained at record lows since November of last year. Relative to high yield, investment grade corporate bonds have become increasingly popular amongst retail investors. The low interest rate environment has apparently not discouraged investors from picking up some incremental yield from investment grade corporates despite the added duration risk. Benchmark investment grade bond indexes in Canada (DEX Universe) and the US (Bank of America US Corporate index) both have durations that are just shy of 7 years.



Source: Lipper/Thomson Reuters, Barclays Research

Nevertheless, the risk of interest rates going up isn't completely lost on investors; who have begun to increase allocations to loan funds. While loans and their floating rate coupons are virtually impermeable to interest rate increases it doesn't make them immune to overvaluation.

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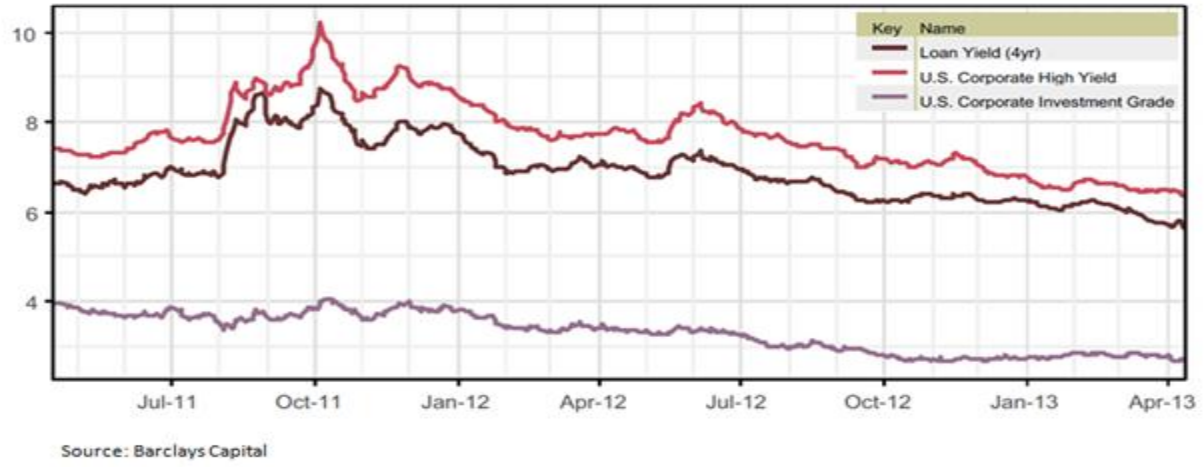
We have been speaking about the positive characteristics of loans for some time. While the fund has successfully employed the use of loans in the fund, we are becoming a little more cautious overall. Loans are increasingly being refinanced by new loans with smaller coupons and almost no call protection; virtually eliminating the prospect of capital gains.

A recent loan issue by Pinnacle Foods, with total net leverage of 4.6 times, was issued at a price of $99.75 with a Libor floor of 0.75%, spread of 225 basis points and call protection at 101 for one year. In an absolute best case scenario an investor in this loan would expect to make a little over 4 percent if the loan was called within the next year. A more likely scenario, assuming Libor does not rise above 75 basis points, is that the investor receives just over 3 percent per year over the seven year term of the loan.

Yield To Maturity: US Investment Grade, High Yield and Loan Indices




The previous graph highlights what we believe to be clear evidence of the importance of security selection for corporate fixed income investors that want to protect capital and generate absolute returns in a rising interest rate and/or default rate environment.

Some global broker dealers like to point out that high yield spreads today are just as low as those in the spring of 2011 when treasury yields were higher. The idea suggests that the high yield market still represents value today because it provides a premium to treasuries of 2.8 (4.75% HY spread divided by 1.7% US 10 yr Treasury yield ) versus 1.4 (4.6% HY spread divided by 3.25% US 10 yr Treasury yield) in 2011.

This type of relative value comparison screams of confirmation bias, the human tendency to seek opinions that agree with your own. No doubt there are many fully invested high yield corporate bond managers that are seeking out this clinical support in hope of sleep full nights.

Best Regards,

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