Signature High Income Fund/Signature Diversified Yield Fund Update
Fall 2019
Geof Marshall, Senior Vice-President and Portfolio Manager

We view 2019 as a year of validation for our strategy. Focus shifted multiple times in 2018, from investors chasing growth with technology stocks to becoming more risk-averse in the fourth quarter on concerns the U.S. Federal Reserve (the Fed) would be too aggressive hiking interest rates in 2019. Technology is part of the market that just does not work for our strategy and therefore increases the risk of the strategies underperforming other balanced funds. This year, numerous central banks have shifted policy and with interest rates falling, bond proxies (income-generating assets) have rallied alongside government bonds. As we look to the fourth quarter of 2019, a year where just about everything has worked for investors – rates and credit have rallied, and stocks are near all-time highs. This is despite decelerating global growth, tweets, and 180-degree pivots in U.S. monetary, foreign and trade policy. We are now faced with inverted yield curves, US$17 trillion in negative-yielding government bonds, US$1 trillion of negative-yielding corporate bonds, and the very real prospect of Canadian and U.S. bond yields being dragged lower by the rest of the world.[1]

Our base case is built on the assumptions that the U.S.-China trade war (read technology and currency wars) is not resolved and the Fed cuts another 50 basis points from the Federal Funds Rate by year-end. But this makes the policy mistake of sticking with its "mid-cycle adjustment" stance because the economic data is not yet bad enough to commit to a full easing cycle. In this environment, credit spreads appear range bound and at fair value, and we are in the process of gradually upgrading the credit quality of the funds as spreads tighten. Near term, economic growth looks like it will remain positive but subdued, victim to the protectionism that is eroding investor confidence. In the longer term we expect 0% front-end government bond yields and quantitative easing to be the norm, and a required hand-off from monetary policy fixing the world's ills to fiscal policy picking up the slack. Given this set-up, the prospect of muted business cycles, volatile financial markets and low interest rates, we wanted to update you on the three main levers of the Signature diversified income funds – high-yield bonds, real estate, and infrastructure – in the context of where we go from here and how we add value.

1 - Bloomberg Barclays Global Aggregate Index and Signature Global Asset Management, as at August 30, 2019

High-yield bond valuations are between fair value and rich (most asset classes are presenting as expensive in the current rate environment) with an average spread of 430 basis points at the end of August and 70-80 basis points tighter year-to-date. However, the volatility in early August is only back to early December 2018 levels (giving you a sense of the severity of the sell-off/widening in the back half of December). That translates into about a 6% yield. We are seeing pressure in the energy sector due to a lack of investor interest, as well as in retail, wireline telecom and generic pharmaceuticals companies – industries that are undergoing secular change. We believe we will see a slight uptick in defaults, especially with those health care companies facing opioid litigation risk, but this is priced in and we have very little exposure to those sectors. Otherwise, credit quality is generally good with most issuers respectful or even fearful of the credit re-pricing that happened last year and, as a result, focused on strengthening their balance sheets. We were sacrificing outliers, especially in the loan market and new companies coming to the bond market, but we are still finding good opportunities.

As with credit, this is not a "pound the table" moment for real estate investment trusts (REITs). Valuations are generally fair but in the context of global bond yields, the profile looks pretty good. Net asset values are backward looking, and capitalization rates are moving targets based on growth (which we're seeing in industrial REITs) or decline (e.g. retail) so we prefer to focus on free cash flow. We are finding companies with free cash yields of 4.5%-5% with free cash flow growth of 5%-7%. With no change in multiples, that's a double-digit return profile. We prefer real estate companies that are developing moats around their businesses and providing returns that are more attractive than just collecting rents. Fund holding Prologis, for example, is the largest industrial real estate owner in the world with 2% of global gross domestic product (GDP) associated with their buildings. Management is leveraging the insight from this data and we believe this will allow them to build a more fortified rental stream, as well as additional revenues that should flow back to unitholders in the form of higher risk-adjusted returns.

Infrastructure equities like pipelines, utilities, telecom companies and transportation stocks are priced at about 21 times price-to-earnings, just slightly above that of the S&P500 Index and appropriate given the stability of their cash flows.[2] However, the spread between their dividend

2 - MSCI World Core Infrastructure Index and Signature Global Asset Management, as at August 30, 2019 yields and the yield on government bonds has seldom been wider. In Europe and Australia, transportation companies such as Aena, Ferrovial, Sydney Airport and Transurban have seen growing traffic helped by the fall in government bond yields and posted double-digit returns year-to-date. In North America, power producers like Brookfield Renewable and Pattern Energy have grown cash flows and investor demand has pushed share prices higher. A lot of these stocks have done well, yet we are still finding interesting companies that have reasonable value. These are sectors that hold up well in a market pullback while still participating in the by-products of economic growth like air and road travel and energy consumption.

Returns year-to-date for our options writing strategy (a 5% allocation in Signature Diversified Yield Fund and 16% in Sentry Alternative Asset Income Fund) have been modestly positive and have followed a roundabout path this year as macro factors affecting the equities underlying the out-of-the-money puts and covered calls also affect option outcomes. That said, equity volatility has not increased as much as other asset classes (e.g. foreign exchange, government bonds) so we remain conservatively positioned and look to earn a higher risk premium if prominent conditions worsen. Strategies like this, and other parts of the fixed-income market like emerging markets will likely become increasingly important to income generation in the low-yield future.

In the funds, we have added a small position in the 30-year U.S. Treasury as a hedge if our base case forecast does not materialize. Also falling into the category of a near-term trade to provide some tail-risk hedging, we lowered the U.S. dollar hedge in the funds from 60% to 50%. While we are leaning towards long-term weakness in the U.S. dollar versus other major currencies, we think there is a trading opportunity as the Bank of Canada is pressured to pivot from their neutral stance to dovish like the rest of the world. We are also evaluating a small asset allocation shift that could provide decent yields and a defensive approach. This asset class is core to Signature's capabilities and has been previously held in the funds and we will provide further details once the trades are completed. These trades have been funded by trimming our allocation to the financials sector (Wells Fargo, Santander) as flattening yield curves should pressure banks' net interest margins. We have taken profit on some of our higher beta energy infrastructure and energy names like Enbridge, Total and Royal Dutch Shell in Signature High Income Fund and Kinder Morgan in Signature Diversified Yield Fund.

There are two things I want to leave you with. First, we are still finding good opportunities, although I do not expect returns for the next 12 months to be a strong as the past 12 months. These opportunities are sufficient for the time being to largely fund the distribution. The funding gap is in line with historical tolerances. For 23 years in Signature High Income Fund we have usually run with a funding gap, we feel these numbers are reasonable and we review distribution sustainability annually.

Second, realize we have built private pension portfolios in these funds. Funds like Signature High Income Fund and Signature Diversified Yield Fund are representative of how big pension plans and sovereign wealth funds are increasingly allocating their assets in a low interest-rate world. They have come to realize what you have, which asset classes don't need a lot of economic growth to work for investors? Real estate and infrastructure with dominant-style businesses and contracted cash flows. What parts of the market have been much less volatile than standard equities? Real estate, infrastructure and high yield bonds. For more than 23 years our belief has been: Do what is intuitive but somehow different – own income assets for income – plus pick up a diversification benefit to your existing growth equity/government bond balanced funds.

investment strategies. These investments may not be suitable to the circumstances of an investor. Some conditions apply.

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Bloomberg Barclays Global Aggregate Index, MSCI World Core Infrastructure Index and Signature Global Asset Management, as at August 30, 2019

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