FORTRESS Global Bond Fund (Laketon)

Fund Highlights

Investment Review

Fourth Quarter 2009

Market review

- The bond market in 2009 was all about the quarters – one's impression of the market depended very much upon which quarter one was looking at.
- In contrast to the corporate market, the government market was not all that rewarding .For perspective, the Merrill Lynch quarterly Global Government Index returned 0.86% in 2009, while the Merrill Lynch Broad Corporate Bond Index returned 16.27% for the same time period.
- Ten-year government yields rose globally, with the U.S. leading the charge (53 basis points), followed by the U.K. (42 basis points) and Canada (30 basis points). Noticeably, Japanese yields did not rise.
- At the shorter end of the yield curve, stability is still the name of the game, with the exception in the developed world of the commodity plays – Australia, Norway and to a lesser extent, New Zealand and Canada.
- We have only seen two central banks raise rates: Australia (in October and November) and Norway (in October and December). Although there was considerable speculation in the fourth quarter that the Bank of Canada (BoC) would at least adopt a more aggressive bias which remains to be seen, for now, the official holding pattern of the BoC remains in place.
- Perhaps, most dramatic was the quarterly dispersion of corporate bond returns. For 2009, by quarter, corporate bonds delivered the following returns: 3.48%, 6.49% 4.47% and 0.99% respectively. (second and third quarters presented huge returns by any historical standard.)
- Despite the reduced enthusiasm for corporate bonds in the fourth quarter, there was still significant appetite. Globally, new corporate issuance was substantial – U.S., Canadian and European markets saw 265, 16 and 423 $USD billion of new issuance respectively.
- In addition, the corporate bond market has undoubtedly seen some credit deterioration – downgrades to upgrades have been running at 4.7X in the U.S. and 2.7X in Canada. However, this ratio has greatly improved from this time last year.
- 2009 taught us two things: 1. the value of a well diversified bond portfolio and 2. don't get too caught up in the here and now, as fundamentals ultimately prevail over time.
- We are constantly reminded that fundamentals play out over time and that investors tend to underestimate the time it takes for them to unfold fully.
- Over the last year, investors have been preoccupied with the following:
- Deteriorating government finances. (this too will likely take time.)
- A virtuous economic recovery. (this will take more time.)
- Higher rates of inflation. (this will take even more time.)
- However, in our view, none of the above has materialized in a substantial way.
- We believe the economy has yet to prove itself – government intervention is too entwined, and there is this nagging feeling of the economy still being on life support.
- The Euro-zone economy displayed potential for solid GDP growth over the quarter as both France and Germany posted strong manufacturing and service purchasing managers index (PMI) numbers. The December composite PMI number for both Germany (54.9) and France (59.4) were both above their respective long-term averages (52.7 and 55.3 respectively).
- Australia displayed strong growth as GDP rose 0.2% in Q3 and unemployment fell to 5.5% in the latter half of the fourth quarter. Similar to the Canadian economy, Australia has been propped up by demand for commodities and a functioning banking sector. Geographic location has also aided Australia as they have strong exports to Asia.
- We concede that in the most recent quarter, we have seen improvement in business and consumer confidence surveys. However, there has not been convincing improvement in housing and employment.
- Consumer finances have improved marginally in the U.S. largely due to market appreciation. In Canada however, consumer balance sheets have deteriorated as mortgagors have responded to low rates by taking on more credit.
- We see government finances as the economy's and the bond market's "Achilles Heel". We are not yet at a point of no return or in market terms, significantly rising real yields but we may very well get there in the next year. U.S. debt to GDP has risen from 37% two years ago to 54% today and is projected to be 61% for this year, according to most recent Congressional Budget Office figures. The Canadian situation is clearly not as bad.
- We remain unconvinced for the prospects of higher inflation. Yes, M1 (money supply) is at record levels in the U.S. (45.6% year-over-year) but bank reserves have absorbed most of the excess liquidity. Lending to the consumer has improved, but only sparingly and lending to small business is a non-event.

Portfolio review

Performance contributors

- Australian and Canadian dollars continued to rally in the fourth quarter – 1.7% versus the U.S. dollar (USD) albeit somewhat abated from their appreciations of the third quarter. The portfolio's performance benefited from significant overweights in both Australian (AUD) and Canadian dollars (CAD).
- The value of the euro fell against most major currencies, with the exception of the yen, during the fourth quarter (- 3.7% vs. CAD; - 2.2% vs. USD; and - 3.2% vs. the Great Britain pound (GBP). The portfolio maintained a 5% underweight in the euro which added to performance.

Performance detractors

- The continual supply of global government bonds and an increased appetite for riskier assets caused government bond yields to rise globally, with the exception of Japanese Government Bond yields. The rising yields detracted from performance due to the portfolio's duration overweights in Canada, the Euro-zone and the U.S.

Outlook and strategy

- Forecasting is always easy in hindsight. Nevertheless, one can always learn from one's past errors and try not to repeat them. We were clearly heard saying:
- *"We continue to be more bearish than most, and are doubtful that any significant rebound in the economy and the stock market will occur in 2009."*
- While we continue to be more bearish than most (you might ask what exactly we've learned), we have a better appreciation that our bearishness will likely take more time to play out, and that our bearishness is relative. We expect a protracted recovery. However, we have learned not to underestimate the resolution, or short term impact of governments.
- With respect to government, we don't expect their intervention to disappear soon, and that should continue to benefit equities and corporate bonds as yield spreads become more stable and narrow.
- Government bonds may be another story – particularly in the U.S. If government balance sheets continue to deteriorate, we expect real yields to respond at some point by moving higher. However, we tend to lean toward that playing out much later in the year, albeit with some shorter term volatility.
- Global bond and currency markets will likely be brought into play in 2010, as central banks walk a thin line between attempting to cool inflation with higher interest rates and choking off the economy by forcing long-term funding costs too high.
- Any rise in yields will likely be capped by the negative impact that higher rates will have on the economy.
- The Canadian economy appears more resilient than that of its southern neighbour, although that may be a bit misleading. Growth to the north has been better, but most of that has been on the back of a more indebted consumer – responding to lower interest rates. We expect this behaviour is likely to wane as the year progresses.
- In regions where there is substantial excess capacity in plant, equipment and most importantly labour, we don't expect to see a rise in inflation. Effectively, this includes most developed and developing countries. The implication is that bond yields will not rise over the medium-term, due to rising inflation expectations.
- Aggregating our outlook for real bond yields and inflation expectations, leads us to expect coupon-like returns for government bonds in 2010. Investors have been anticipating the worst from government bond markets for several years. We expect this year to again surprise them with positive returns of 2% to 3%.
- Most central bank will remain on hold throughout most of the year, although we expect investor sentiment to shift around on this topic. Royal Bank of Australia has at least one more 25 basis point rate increase to bring the target rate to 4%.
- The bias for the yield curve is for flattening in Canada. The curve is already steep and any rise in short rates will likely imply flattening.
- We will also be looking to take advantage of a steep corporate yield spread curve through repositioning of our corporate exposure.

Any amount that is allocated to a segregated fund is invested at the risk of the contract holder and may increase or decrease in value.

This report is published to provide additional information on economic conditions and investment performance. It was prepared by Laketon Investment Management.

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