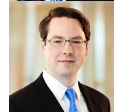
Sprott Diversified Bond Fund

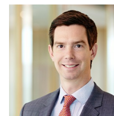
January 2018 Commentary

Investment Team

Mark Wisniewski,
Partner, Senior Portfolio Manager



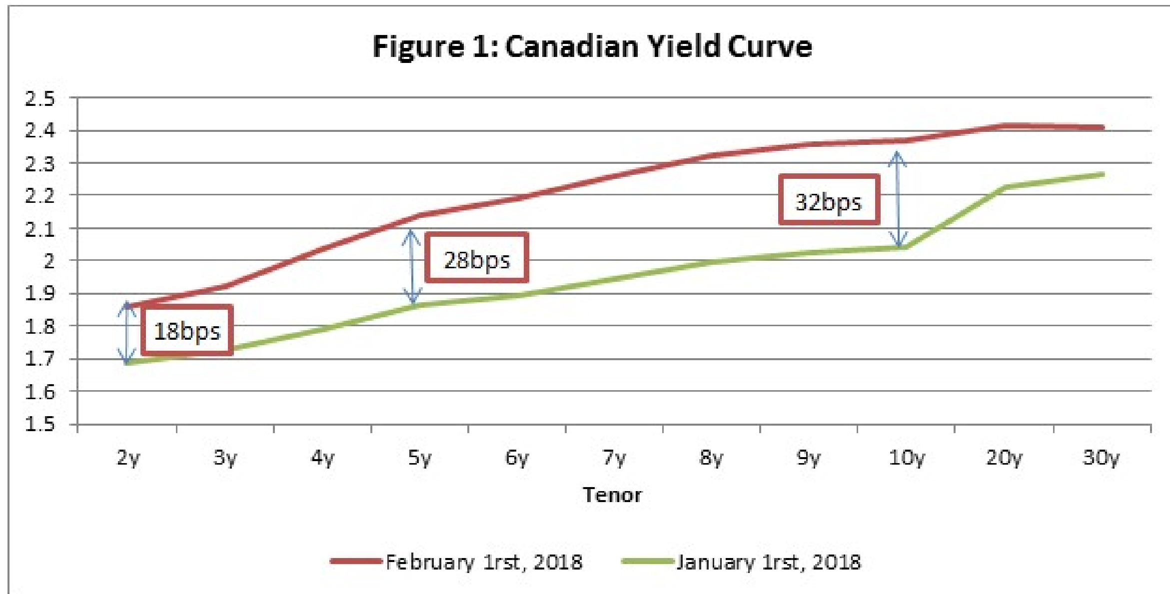
Etienne Bordeleau-Labrecque, MBA, CFA
Vice President, Portfolio Manager



Chris Cockeram, MBA, CFA
Vice President, Associate Portfolio Manager

January was a solid month for the Diversified Bond Fund, returning 32bps after-fees (Series F), outperforming our benchmark, the Bloomberg Barclays Canada Aggregate Index (-86bps), by 118bps.

Gains were driven by our low duration and credit positioning. In credit, spreads in investment grade (IG) and high yield (HY) continued their descent, and now stand at their lowest level since the Financial Crisis. As discussed in previous months, we continue to reduce risk in HY, redeploying proceeds in low duration IG as we await better prices. In this rising rate environment, our small portfolio of low-rate reset and floating rate preferred shares continued to perform well. Finally, our option hedges, government shorts and the overall low duration of the portfolio allowed us to weather, unscathed, the staggering increase in yields across the curve (Figure 1).



Source: Bloomberg

Absent these hedges (options and shorts), the portfolio would have been worse off by 20bps for the month. By contrast, major bond indices suffered heavy losses; the Bloomberg Barclays US and Canada Aggregate Bond Indices were down 1.15% and 0.86%, respectively. In our view, this past month is a perfect example of how our active and alternative strategies add value to our clients' portfolios.

In the current context of Central bankers itching to remove monetary accommodation, the strong start to the year in equity markets, upside surprises to economic data and relatively benign financial conditions means they have the green light to continue tightening. We expect four rate hikes in the U.S. this year, potentially more if inflation really surprises to the upside in the second half. In Canada, Poloz already has one under his belt, and we would not be surprised to see another two before year-end, particularly if the NAFTA renegotiations vanish from the headlines as the parties wait for the Mexican Presidential and U.S. mid-term elections.

Since we do not believe that yields are done going up, we remain positioned accordingly. Over the past few weeks, we have been deploying cash in IG floating rate notes (FRN). As of the end of January, approximately 8% of the fund is invested in FRNs. This serves two purposes. First, as central banks in Canada and the U.S. continue to raise short-term interest rates, those FRNs generate more income. Second, as interest rates move up and down, those securities' prices remain stable, reducing the volatility of the portfolio.

As of February 1st, the portfolio has a yield-to-maturity of 3.3% and a 4.4% current yield, with an effective duration of only 2.4 years (1.1 years after accounting for the impact of our option hedges). As shown in the table below, we still maintain a sizeable cash position (21%, including Bankers' Acceptances). Additionally, about 1/3 of our High Yield position (31%) is either callable or matures within the next 12 months, giving us additional firepower should bond prices become more interesting.

In summary, we remain conservatively positioned (cash, options hedges), but not at the expense of yield and current income (preferred shares, short duration HY, IG FRNs).

Until next month,

The Bond Team: Mark, Etienne and Chris

	Limits	Mar 2017	Jun 2017	Sept 2017	Dec 2017	Jan 2018	Outlook
Government Bonds	100%	17%	0%	3%	-2%	-2%	↔
Investment Grade	80%	3%	5%	15%	37%	44%	↑
High Yield	50%	60%	47%	48%	32%	31%	↓
Emerging Market Governments	10%	9%	4%	0%	0%	0%	↔
Preferred Equities	10%	4%	4%	4%	6%	6%	↑
Common Equities &ETFs	10%	2%	3%	0%	0%	0%	↔
Derivatives	+/- 2.5%	-0.5%	0.0%	0.0%	-0.1%	+0.1%	N/A
Cash and Equivalents		6%	37%	29%	28%	21%	↔
Total		100%	100%	100%	100%	100%	
Duration	1 to 8 years	4.4	1.7	2.4	2.1	1.1	↔
Geographic (% North America)	>75%	79%	78%	89%	90%	90%	↑

Current Net USD Exposure: 2%