



Sprott Diversified Bond Fund

September 2017 Commentary

The fund continues to perform well, returning 11bps in the month of September. By comparison, Canadian and U.S. 10 year yields increased 25bps and 20bps in September, leading to monthly losses of 2% for the respective benchmark risk-free securities. This important increase in long term yields reflected the return of the “reflation trade”, driven by renewed hopes of tax reform in the US, coupled with hawkish central bank communications (the Bank of Canada (BoC) unexpectedly raised rates again and, as expected the Fed initiated the reduction of its balance sheet). At this juncture, we believe that the hawkish BoC rhetoric has probably run its course; later in the month we saw Deputy Governor Lane and later Poloz himself attempt to talk down the Canadian dollar. In addition, with the NAFTA negotiations seemingly in trouble, the BoC will likely be incorporating this significant downside risk to the Canadian economy as they formulate their outlook. In the U.S., the Fed is now asserting itself in a resolutely hawkish stance, continuing to indicate its willingness to hike in December and to follow through with 3-4 further rate hikes in 2018. Meanwhile, credit conditions continue to be benign, leading spreads to perform well (maybe a bit too well).

Although we still favor credit, we maintain a cautious stance and look for a better entry points. Valuations (particularly in High Yield (HY)) are stretched, but they could remain so for an extended period of time. Consistent with this view, we continue to reduce our exposure to Emerging Markets (now less than 3% of the fund) and monetize gains in HY bonds, looking to recycle capital. It is important to note that about a third of our HY exposure matures or is callable within the next year, which greatly reduces HY risk in the portfolio.

In lieu of HY, we are finding attractive securities in the Canadian preferred shares market; particularly low coupon rate resets that trade at a discount to par. Because of their low coupon and upcoming reset dates, these preferred shares exhibit negative duration (they become more valuable with higher rates), presenting a compelling complement to the portfolio.

In Canada, the primary market has been very active, allowing us to buy good quality investment grade (IG) bonds at relatively decent yields, thanks to the recent rate hikes. Additionally, we continue to sift through the secondary market, looking for attractive IG additions to the portfolio.

Reflecting our view on interest rates, we have been keeping portfolio duration at a conservative 2.5 years, while preserving a yield above 3% (by contrast, the Broad Market Canadian bond ETF has an effective duration of 7 years and a yield of 2.5%). Furthermore, we have initiated a low cost duration hedge using options on the iShares 20+ Year US Treasury Bond ETF. This hedge would pay-off in the event long term US yields were to increase past previous highs, providing an additional layer of protection to the portfolio.

We feel the portfolio is currently well positioned and are committed to our objectives of reasonable

Investment Team



Mark Wisniewski,
Partner, Senior Portfolio
Manager

return, low volatility and preservation of capital.

Until next month,

The Bond Team: Mark, Etienne and Chris