VALUE CONTRARIAN
ASSET MANAGEMENT

October 25th, 2013

Hunting for "Yield" May be Dangerous to Your Financial Health

"With interest rates hovering at record lows, highly indebted companies have been able to sell their debt at ultra-cheap prices and on terms that borrowers (not lenders) dictate to investors who are starved for yield."

Financial Times of London
October 23rd 2013

"There's a gigantic ocean of liquidity, and the people getting that liquidity (borrowers) are having a wonderful time. But it's totally artificial, and it's going to end badly when it ends… I don't know how long this will go on…"

Jim Rogers
Co-founder, Quantum Fund

Today, companies (borrowers) are once again using esoteric structures along with a host of riskier borrowing practices associated with the leveraged buyout boom that helped inflate the 2005-2007 credit bubble. Last time (prior to the credit crisis) Wall Street came up with CDOs… packages of pooled subprime mortgages rated as triple A… This toxic "junk" was found in all sorts of investment products as we now know (remember ABC paper?).

Recently, there has been the issuance of junk bond PIK-toggle notes. These instruments give the junk bond borrower the option to pay lenders with more bonds instead of cash if they run into financial trouble. Good news for the borrowers, but perhaps a foolish move on the part of the junk bond lenders!

The question experienced and savvy fixed-income investors (lenders) are starting to ask is whether these are warning signs of the return of "toxic" practices and overheating in the credit markets (last seen prior to the start of the 2007 credit crisis).

As credit yields appear likely to remain extremely low for an extended period (maybe 5+ years)… the question remains what type of "riskier" fixed-income investments will Wall/ Bay Street come up with to satisfy the appetite of retail investors/hedge/pension funds for higher returns.

A perfect example is the recent TSX public offering of a fixed-income fund with the comforting title: "Senior Secured Floating Rate Loan Fund". This Fund is courtesy of CIBC – National Bank, RBC Capital, TD Securities and all the rest. The public offering prospectus is over 70 pages long. However, an investor only discovers at page 20 that "the average rating by S&P of the Indicative Portfolio is B+".

What's the significance of a B+ rating you ask? I quote from page 20 of the prospectus: "Loans that are rated 'BB+' and below by S&P or Bal and below by Moody's are **considered to be non-investment grade loans**…. And are

considered by rating agencies to be speculative and subject to high credit risk". Funny how the title of this new investment Fund being flogged to Canadian retail investors never mentions the word "junk" or "high-yield". At a sizeable discount, this could become an interesting investment.

Bottom line: Be wary of Wall/Bay Street bearing high-yielding gifts… or, get in early before the crowd. But make sure to time your exit well.

Market Comments

In the second quarter Value Contrarian Fund letter I wrote: "In 2013, the TSX Index has been one of the industrialized world's worst performing markets. The recent two year underperformance of the Toronto stock market leads us to believe we are due for a year of catch-up."

On a more pleasant note, the TSX has gone from flat performance in 2013 to up over nine percent since June. We often see last year's laggard Index's become next year's outperformers. My view is that the TSX is more likely to surprise on the upside in 2014.

Respectfully yours,

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V/C Fund year-to-date results
September 31st 2013: + 12.6%
(Next purchase: October 30th, 2013)

Please note: The timing of Ben's Market Comments has no specific dates. E-mails will only be sent when something of value should be shared.