

Educators Mortgage and Income Fund

Fund Review

The Fund's overweight positions in corporate and provincial bonds added value during the quarter, and have been positive over the last year. Duration, which was shorter than the benchmark, detracted value on the quarter as did the portfolio's overweight position in residential mortgages.

Investment Strategy

Heightened concerns surrounding European sovereign debt and slowing economic growth conspired against riskier assets in the second quarter. The beneficiaries of this elevated risk aversion were global fixed income markets, with bond yields moving materially lower during the quarter. Despite the exogenous risks however, credit markets remained relatively stable. Market expectations surrounding the Bank of Canada's course of action over the remainder of the 2011 and 2012 moved significantly lower in tandem with broader bond yield – the market now expecting the central bank to remain on hold this year. Since the end of March, the overall yield for the DEX Short Term Bond Index fell from 2.40% to 2.15%, after starting the year at 2.26%. The Short index generated total returns of 1.5% in the second quarter. Short term Federal government debt rose 1.4% in the second quarter. Corporate debt returned 1.7%, while Provincial government debt gained 1.8% on the quarter. Over the past year, the Canadian Short term bond market returned 3.2%, with sector returns again dramatically varied. Federal government, Provincial government and corporate bonds returned 2.6%, 3.6% and 4.1% respectively.

Market Outlook

Global economic activity continues to be characterized as modestly positive; however the pace of growth appears to have lost some of its momentum during the second quarter. While exogenous risks: political unrest in the Middle East and North Africa (MENA), the recovery process in Japan, continued concerns surrounding European sovereign debt and inflationary concerns in some of the largest emerging markets, pose some downside risk to the economic outlook, we believe that growth will pick up pace in the second half of the year. Overall, developing economies are expected to continue to outpace the developed world in 2011. While the domestic economy in Canada continues to perform reasonably well, the external sector has been a significant drag on growth over the past few quarters. With growth in the US expected to improve in coming quarters, the headwinds from trade may begin to subside somewhat over the next year. We believe that the next phase of the economic recovery in Canada will be driven by trade and business investment, after having been consumer led in the initial recovery. For 2012, we anticipate a similar pattern of a positive, but modest economic expansion. In this environment we expect the Bank of Canada to continue gradually moving away from emergency type interest rates. We expect the Bank of Canada to resume interest rate hikes by the end of the year. At this point, with longer term yields expected to rise modestly over the next year, the objective will be to maintain the Fund's interest rate exposure below the benchmark in the near term. While valuations in credit markets would be considered "fair value" after being historically very cheap early in 2009, we continue to prefer residential mortgages and corporate bonds over Government of Canada bonds. The Fund remains overweight these sectors of the bond market.

Takeaways

With the expectation of rising yields, we will maintain a shorter duration for the Fund and will favour residential mortgages and corporate bonds.



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