Fairway Capital Management
Conference Call
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Mark: Here and one of the things that weighed on the preferred market last year was new issuance. Last year, you had 23.6 billion was issued in the preferred market. It's slightly ahead of its average and anticipated in 2006, a $40 billion issuance which I remain skeptical on that estimate. Corporate deals are much lower and preferred than those that tend to probably attract some of the corporate issuance. As well as the fact that some of the companies we own, the utility companies, are free cash flow positive now and won't need to issue preferred to refinance some, some existing preferred that have been outstanding for more than five years. Overall the deferred was weaker than the corporate and government markets. During 2005, the Merrill Lynch preferred hybrid index returned 46 basis points. We're a long corporate index of 15 year long maturity is up 350 basis points. In 2006, we believe the utility prefers that the funds owned will be one of the stronger groups given the free taxable positive and a lot of upgrades we feel in the second will be warranted on the credit rating.

I'm going to turn it over to Greg Phelps to talk a little bit about some of the issues that happened in the fourth quarter and Greg if you like to.

Greg Phelps: Yeah. This is Greg Phelps. I'm going to talk a little about what happened during the fourth quarter which was a difficult quarter for fixed income in general but prefers in particular.

The month of October started out with the US 30 year treasury right around a 457. In mid October, October 14th, the September consumer price index and retail sales numbers were released which exceeded analysts estimates and there began probably a two month inflation scare which drove the long bond up from a 457 to a 471% in very short order in just a week and a half in early to mid October.

On top of that as treasury sold off preferreds, which tend to trade on a spread to treasury, sold off as well and what you had happened was two things that exacerbated that downward price movement. You had retail orientated tax loss selling in preferreds before the year end. And most of the preferreds in this fund are listed on the New York Stock Exchange and tend to have a fairly good retail base. So they are susceptible to retail selling. And of course we did see, I believe a fair amount of tax loss selling as the bonds declined. We had supply coming in as Mark said especially during the fourth quarter on top of that tax loss showing especially from real estate investments trust and insurance companies.

On top of all that we had bid list supplies of preferreds being sold on the market mostly by insurance companies probably raising money to help pay for hurricane claims. So you had kind of a perfect storm occurring there during September, excuse me, October of treasury selling off and inflation scare, retail tax loss selling, new issuance supply and supply from existing institutional holders raising capital.

By the end of October, October 27, the long bond had backed up all the way to a 480. November 1st, we saw the Federal Reserve open market committee meeting raise the said funds rate to 4%, treasury's backed up even further by October 4, the long bond was a 484. But then the tide slowly started to turn. October payroll numbers that came out on November 4th were weaker than expected and treasury started to slowly recover in price. Very slowly. And so November was kind of a dead month, the damage had been done in October.

And then the real turn started to occur in mid December when December 13th weaker than expected November retail sales numbers came out that helped treasury's rally. The bid lists were over. New issuance was largely over with. So there wasn't as much waiting on the preferred markets. Plus treasury's were rebounding. Despite the fact that the federal reserve open market committee meeting raised the fed's funds rate to 4.25 on December 13th. They said that they're going, the policies that they had were not accommodative anymore. So people read that to believe that you know, there weren't many, if any, further rate hikes to follow. Treasury's continue to recover and indeed by the mid December, December 15th, November consumer price index and producer price index numbers were lower than expected so the inflation fears really started to abate. The treasury markets really started to recover and with them the preferreds.

What works during this period, this difficult period during this sell off were defensive higher coupon preferreds with higher yields and higher credit ratings that also had short yields to call. Some of the names in the portfolio that fit that description would be Citigroup, Verizon, Georgia Power, which is subsidiary southern company and Wells Fargo all had 70 and coupon preferreds that performed well because they shared all those characteristics, they held their ground very well.

The other thing that worked were higher coupon utility preferreds. Energy East, Entergy, Florida Progress and Excel Energy were some of the names of issues in the portfolio that held their ground well because people felt more comfortable with the utility names plus again these were high couponed, short yield to call.

And then the other area that worked well were preferreds that had tax advantages for US individual investors. A couple of names there that stood out, that held their ground better than most were ABN Amro and Abbey National.

The issues that underperformed, we kind of touched on already. Real estate investment trusts such as Public Storage and Duke Realty didn't do well. That whole group sold off plus they were some of the larger issues during this period so new issues were pressuring existing issues in the marketplace.

Insurance names didn't do well, such as Met Life, RenaissanceRe and ING Group. That whole group kind of weakened in the fixed income markets and again was responsible for a fair amount of the new issuance as well which weighed on existing issues. And then generally speaking any preferreds that had a 6% coupon or less tended to get hit fairly hard when the treasurys really rolled over in October and in November.

We took a few steps to try to strengthen the NAV performance of the Fairway Investment Grade fund. In that we bought lower couponed, very high quality, highly rated by Moody's and S&P Preferreds that were trading at a attractive discounts to par that were some of the most beaten up issues in the October, November time period which have indeed rebounded very nicely. And the other thing that we did was we focused on buying more higher couponed or cushioned preferreds that have lower price volatility in a variety of interest rate environments.

And so those, those steps did help to stabilize the NAV somewhat after a fairly drastic sell off in the treasury market during the time period. And with that I'll turn it over to our colleagues at MSC, Mark.

Mark: Yep. Bob, are you there.

Bob: Yep, I'm here. Thanks a lot Greg, thanks Mark. First up, I just wanted to introduce Terry Carr, he's also here in the room. He took over the, took over the fund from Gary Stewart, previous, earlier this year. And has impressed, is right on his money. He's the managing director of North America Fixed Income up here in Canada.

So I'll speak briefly just on the, on the Canadian investor grade portion of this fund.

Over the course of the year, the Canadian government curve flattened dramatically. Two year bonds, 63 basis points higher in yield, 30 year bonds fell about 79 basis points in yield and the 10 year part of the curve which is fund, or which is portion of the fund that it's most exposed to with approximately 50 basis points in yield.

Overall the Scotia McLeod universe returned about 6.5% last year. And since this fund was implemented it actually returned close to 10%. And that mostly due to the following interest rate environment in Canada.

Credit expense overall in Canada, we're slightly weaker. Just very small, just by about three basis points which is much less than required to make negatively impact this portion of the fund, the investment grade portion of the fund. The funds, Canadian investment grade portion benefited, like I said before, from the fallen interest rates and also the additional yield offered by being fully invested in Canadian corporate bonds.

The fund will remain invested and a diversified base of high quality corporates. It's overall credit quality is of an a low, an average spread to Canada government in the neighborhood of 65 basis points.

Going forward, we're reasonably positive on investment grade spreads in the near term. Overall, we're cognitive of the pressures on credit quality. In the future, namely shareholder friendly activities, share buybacks, increased dividend of the sort and also the fear and probability of LBO like transactions.

So all these risks will be closely monitored. That's what we have from here in Canada.

Mark: OK. Jamie do you want to open it up to questions, I think.

Jamie: Thanks guys, that's, that's great. If we do have questions now, I'll just open things up. If you didn't mute your phone, I'll again, pound, six will unmute your phone and just go ahead and ask some questions.

Doug Visecar: Doug Visecar from Vancouver, can you hear me?

Mark: Yes I can hear you, Doug.

Doug Visecar: So question, question would be going forward in 2006, are you, is the fund taking in enough to pay the distribution as, as, as listed out in the prospectus. That's question a. And question b, what do you see going forward in 2006 in terms of NAV, in terms of stability, upward momentum or downward momentum.

Greg Phelps: Jamie, do you have the information on the dividends?

Andrew: I don't, it's Andrew here, I don't have that currently but I can get it for you.

Doug Visecar: I know what it is, are you making enough to, I mean, we know it's being paid out are you making enough to pay that? Is the coupon enough to make, to pay that.

Andrew: Doug, Andrew again. I'm not sure the, because of the combined John Hancock, MFC participation in the management here. I'm not sure they know that but I'll get that for you.

Doug Visecar: OK. And the key is someone needs to be looking at this from an overall point of view in terms of stability of distribution in NAV. So I understand the two pieces.

Andrew: Absolutely, yep.

Doug Visecar: The integration of that together.

Andrew: Yep, yep and I'll get that for you later on this afternoon.

Doug Visecar: OK.

Andrew: I'll send you, I mean we can look at, sort of the last year, in terms of distributions, what's been paid, what's actually been earned from the portfolio.

Doug Visecar: Right but so, so running yield right now, US side, what's what's the distribution of the fund between Canada and US, what's the split?

Mark: Right now, we have 75% US preferreds and 25% Canadian bonds. Pretty much what we said when we marketed those products.

Doug Visecar: OK, OK.

Mark: We assess that on a monthly basis to find out where the values are and the values clearly are in the US deferred market given that the overall yields in the States is much higher than it is in Canada and our belief that rates are going to continue to fall, we feel comfortable that a we can earn the coupon in the portfolio, and b we're going to remain 75% in the US, and c the NAV ability, NAV appreciation, we know we marketed the product saying that the most part from the beginning of last year, we were about to earn the coupon. This year going out we're still comfortable with that the yield curve will remain somewhat flat or inverted and the overall preferreds that we select on our value basis will outperform.

Doug Visecar: So, so from the US side, thank you, from the US side, from the US side, you believe that you can earn and just the US side of it, is that currency hedge for Canada?

Mark: Yes that ‘s correct.

Doug Visecar: OK. So you believe that the US side will do enough on the 75%, you’ll, you’ll earn enough coupon to pay your, your percentage waiting of the distribution that needs to get paid out, is that correct?

Mark: Correct.

Doug Visecar: And then, how about, how about, NAV stability? You know, NAV, do you see upward pressure flat or downward pressure? Where do the risks lie in terms of your portion of it and NAV stability?

Mark: Well, our, our portion of it and NAV stability, we have the ability to do short treasury futures. So if we feel that interest rates are going to shoot up dramatically we can insure for treasury futures trading which we have had on the fund. And you know, our process here is to access the duration of each security, assign a hedge ratio to it to determine the appropriate number, number of short treasury contracts to put on the portfolio. So we feel comfortable that, you know, our goal is to minimize the downward deterioration of the NAV, as well as maintaining a high quality, high coupon portfolio. So I think, you know personally that the preferred market had taken a significant sell off in the last quarter and has just rebounded back within the last 45 days which is in particular, unusual for this group. It’s somewhat of an annual event, it’s just determining what month that, that its going to happen.

Doug Visecar: Right. What about, what about the, what about the possibility over time of having NAV appreciation in this fund, in addition to paying the coupon.

Mark: Well you know, our, our theory is to try to buy preferreds at a discount. We try to avoid premiums when possible and that was you know, longer term lead towards NAV appreciation. Also credit quality as far as identifying securities that we feel, you know, may not, may be mispriced in the marketplace giving their current ratings.

Doug Visecar: Yeah.

Mark: So, so part of it's value to part position now, we sold the fund, you know, back the conditions last year, as you know, the interest rates were falling pretty dramatically in the Spring of last year.

Doug Visecar: Right.

Mark: So, so, you know, it's definitely, leverage worth the direction of the yield curve.

Doug Visecar: Right. So, so in terms of like, so a client, you know, a client who paid, you know, par for this thing, right 10 bucks, I think from what you're saying is they'll get their coupon but in terms of you know, anytime, any type of client expectation that NAV may climb, you know, back towards $10, I think, I think from what you're saying that's not an expectation that should be set.

Mark: Well, I think, I wouldn't use $10 because I look more as a NAV because the sales load is taken out of the NAV.

Doug Visecar: Yeah.

Mark: I look at 9, you know, 9.36 is the, as the level plateau if you will.

Doug Visecar: Yep.

Mark: You know, make that the, the 4.5% commission or I think it's 5% commission on this, is somewhat, you know, it hasn't even been a year yet. So one I, I look at a longer term and two I look at, you know, the function of that commission may take, you know two to three years to make back.

Doug Visecar: So, so it's, OK, but that's important. I, it's not about one year, it's about over time, you think you can make that commission back?

Mark: Well that's our goal. If we, if we.

Doug Visecar: OK. Good. I hadn't heard that before, that's important.

Mark: Well, you know, it's, it's something that we try to do here with all our funds, we try to, you know, have the return of the portfolio be around 90% of the total.

Doug Visecar: Yeah.

Mark: So if your funds up 6%, I'm saying that you know, 5.5% is income, 50% 50 basis points being capital depreciation.

Doug Visecar: Yeah.

Mark: So, we do, you know, we buy some convertible preferreds that are equity based, that you know, we look at some of the utilities the way they've traded all year along and some of them have worked out OK.

Doug Visecar: Yep.

Mark: But it is a longer term process. I mean, it's, I wouldn't not sell this to anyone, anybody with a heavy emphasis on capital appreciation.

Doug Visecar: Right. And from a client's point view, its, its, from a client's point of view, its, its, you know, I got this thing at 10, yeah I got some distribution but its, you know, I'm taking the heat this thing's down 12% so I'm still in the hole 4 or 5 and you know, I mean, as soon as something goes down, right, investor's duration goes to zero. That's the issue. Out in retail land we're dealing with.

Mark: Right, I have to look at a longer term than that.

Doug Visecar: No. I understand. I understand. A final question, will you guys, you guys, you guys at Hancock, what do you see for the, you know, US fuel curve is, you know, a touched inversion that kind of thing, what do you see, what do you, and you know gold has flown up here and some people say well gold is, gold is showing that there's, you know, inflation that the fed doesn't see and you know all this kind of debate. Where do you … where do you guys come out in all that?

Mark: Well you know, to be honest with you, the feds have been raising rates, and you know, when they started raising rates back in June of '04, the 10 year was at a 458, they were at a 455. So we've had 350 basis points on the short end and, and the long end has gone down three basis points. So, if they want, you know, pretty much, take the, take the housing market down, doing it through fed's funds may not be the proper step but you know, they continued on that pace. That said, you know, they may have gone a little bit too far on the hikes. So we think that the yield curve is, will probably remain inverted even though it's pretty much just flat right now and you know, technically it may be two or three basis points but you know it could be, it could be 50 basis points inverted. We think that the long end is going to continue to go down. If you look at interest rates across the globe, the US is still probably one of the higher quality and higher yields trades out there.

Doug Visecar: Right. So is the 10 year where it is today because there isn't inflation? Because of some complex hedge fund trading going on. I mean, why is it.

Mark: I wouldn't given them that much credit. I think it's more of the fact of the double deficit we're in, you know, the, we have much more foreign dollars coming in between the petro dollars and the Asian buyers of the US currency, given the yield advantage. You know, there is a lot of foreign buying in the US treasury currently.

Doug Visecar: But, that's. OK. So that's at the, and that's at the, that's at the short end?

Mark: When you're, we should probably talking about by Thursday to see what the bid to recover on this 30 year. There hasn't been a 30 year issuance since 2001.

Doug Visecar: Yeah.

Mark: Everyone's been moved from the 30 year tack down to a 10 year, if they want to take anything with a triple A rating.

Doug Visecar: Yes.

Mark: Quality has been on a general decline.

Doug Visecar: Yeah.

Mark: So, you know, people want to take a risk pretty bet. Where else would you go.

Terry: This is Terry up in Toronto. Just to help out a little bit on the question. With foreign buying, whether it's in Canada's or in the US market, just to correct perhaps a misconception. It used to be mainly front end buying of the yield curve. It's very much across the board, it's 10s, it's 30s, it's 2s. It's across the board.

Doug Visecar: So people buy a balanced portfolio now if they want to buy in the yield curve.

Terry: Well, I don't know that balance that is as controlled as that, it's tactical, it's very sophisticated but there' significant recycling of money that is going overseas and products and services through a trade deficit and coming back into bonds.

Doug Visecar: Yeah. So I just, I just the thing, the thing that I'm, I'm been wrestling with in reading, there's people buying the 10 year right now, that's why the yield is where it is, why it isn't, why the yield isn't a lot higher. So there's people, there's people buying it, there's demand for it. Who's buying the 10 year and what's their thought in buying it.

Terry: Well just, I'll continue Mark, if you don't mind, for a moment, try to answer the question. Whether it's 10 year or even think longer, a 30 year. Even in the domestic side, pension funds are facing very long duration liabilities and are kind of forced to play between 10s and 30s and where possible even beyond.

Doug Visecar: Yeah.

Terry: On the yield curve.

Doug Visecar: Yeah.

Terry: And, you know, demographics and in the longer run, poor equity returns and different things are kind of driving those forces and there's actuarially reassessments, revaluations occurring that compel them to boost their long duration fixed income assets and it's also that as well as kind of foreign buying that's kind of, you know, pressuring the mid to long end that stay at fairly low rates.

Doug Visecar: And if rates went to five, they're willing to accept the capital difference?

Terry: They, thus far appear to. Yes.

Mark: I think, I've seen an estimate of 150 billion in 30 year paper needs just a pension which is pretty significant. I mean they're only going to issue about 14 billion on Thursday.

Doug Visecar: You know, that's huge. So I guess, I guess, you know watch that, watch the demand for that one and then watch how that shifts the 10 year. That's going to be an important indicator.

Mark: Well I think that's going to be one of the, you know, driving directions, directional trades, I mean their options won't be for another six months. So there is a lot of paper being issued right now that when issued, yields are lower than the current markets so there's, you know, to me that's said there's demand out there.

Doug Visecar: Yeah. So would you, would you take the state, would you go with the take that inflation in the United States is reasonably tame? Like, like overall inflation?

Mark: That's food and energy, I think it's same.

Doug Visecar: OK. So gold, so what's happening in gold isn't telling us something about inflation that the fed doesn't see.

Mark: Greg follows gold a little closer than I do.

Greg Phelps: What I would, this is Greg Phelps, what I would suggest about gold is several things. One, you know, as the US dollar has slipped in value, gold has gone up because it takes more dollars to buy more gold and similar to oil. Oil's dominated in dollars too and as US, US dollar weakens, the price goes up. So I think part of it is the gradual weakening of the, of the US currency from the year end 2005 and I think another part of it is tremendous demand from Asia particularly China and India where gold is used as sort of their own bank account and a store of value and given the emerging middle there, you're seeing a lot more demand from Asian buyers.

Doug Visecar: So you're buying into the, you're advocating the remonetization / more demand theory of, for gold.

Greg Phelps: Well, and then you add on top of that, a lot of speculative hedge fund buying that just goes with momentum.

Doug Visecar: So you'll give them some credit.

Greg Phelps: I'll give them, I'll give them some credit, yes.

Doug Visecar: OK, OK. Well listen guys, I, I maybe I'm the only guy asking questions but I appreciate your time and you know, the key is, the key is, I mean, we are where we are, you know, continuing to pay the distribution and NAV, you know, stability plus upward momentum, you know, upward momentum is, would be very good for me to talk to my retail investors about.

Greg Phelps: Very good.

Doug Visecar: OK. So thank you very much for your time. It's appreciated. And you guys all have a good day.

Andrew: Thank you Doug, you too.

Mark: Thanks Doug.

Doug Visecar: Thanks guys, good bye.

Jamie: Anymore questions from callers? Maybe, maybe Doug had them all. Mark, Todd, Greg, Terry, thanks again for your time

Mark: Your welcome.

Terry: Your welcome.

Jamie: This was recorded. It will be posted to the website. So along with the monthly commentaries that you guys do to provide, we'll have this call for the next 30 days at least and you know, over time this will become more and more appreciated by the retail IAs out there.

Mark: Thank you.

Terry: Thanks again.

Jamie: Thanks, bye bye.