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Take profits in bonds

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Illustrations: Color Photo: Brett Gundlock, National Post Files / Ben Cheng, manager of the IA Clarington Tactical Income Fund, has been selling some high-yield bonds, moving the proceeds into bank loans and first lien debt.

Ben Cheng's cash position has moved from 5% to 10% in the past quarter as the president and chief investment officer at Aston Hill Financial is taking some profits in fixed income. This part of the portfolio is predominantly U.S. high-yield bonds, but also includes some Canadian names.

"The high-yield and subordinated junk bond market has rallied incredibly this year," says the portfolio manager. "So we've taken some money off the table there and now I'd like to protect some of those gains."

Mr. Cheng has moved about a third of the fixed-income portfolio into bank loans and first lien debt. For example, he owns the first lien bank loans of Australia's Fortescue Metals Group Ltd.

"There is no bank that can get in front of us on that debt. We are the first priority on all their assets."

The idea there is to maintain a very high level of yield, the manager says, noting Fortescue's roughly 10% yield. Another example of his bank debt holdings is Canadian Crude Separators Corp., which offers about a 16% yield to maturity.

"What we're doing here is trying to get more protection for our unitholders' capital," says Mr. Cheng.

With yields between 8% and 12%, the manager sees an opportunity emerging in the preferred shares of U.S. real estate investment trusts (REITs) such as Vornado Realty Trust and Prologis.

For many of these REITs, "their balance sheets look a lot better because throughout the spring, they spent a lot of time shoring up their balance sheets by issuing equity," says Mr. Cheng, adding that a lot of them did so near the bottom of the market. "If they had not issued equity and had not strengthened their balance sheets, then that probably wouldn't have been the bottom of the market."

He is also looking to capitalize on the Canadian market and expects the income trust index will do even better than it already has at some point.

"I think a lot of these trusts are essentially being abandoned by investors, particularly because they are not sure what income trusts will look like in 2011," the manager says. "It's beholden to the management teams to show investors what they look like in a fully taxable environment."

Financial analysts may be able to analyze these companies, but until investors are convinced that these income trusts will still pay big dividends and that the businesses are sound post Jan. 1, 2011, investors will be uncertain, he adds. It doesn't help that many banks have trimmed the number of analysts they have covering income trusts.

Business trusts (not including REITs or oil and gas names) currently make up about 5% of the portfolio. However, Mr. Cheng wouldn't be surprised if somewhere down the road he decides to "back up the truck" and own 20% to 30% in business trusts again. "Some of them are cheap."

THE MANAGER

Manager: Ben Cheng, Aston Hill Financial Ltd.

Fund: IA Clarington Tactical Income Fund

Description: Tactical balanced fund (bonds and equities), focus on generating high level of cash income

Fund size: $675-million

Aston Hill's mandates: $1.5-billion

Style & Process: Growth at a reasonable price (GARP) with an emphasis on value

Current asset mix: 60% bond, 30% equities, 10% cash

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BUYS

DOLLAR GENERAL CORP. BONDS (10.265%, 2015).

Mr. Cheng bought these U.S. first lien bonds in July. They have rallied roughly 10% since and now trade at nearly US$110.

Private equity firm Kohlberg Kravis & Roberts (KKR) took the large U.S. discount retail store chain private almost three years ago, but recently brought Dollar General public on the equity side.

"With the equity issue, KKR has since paid down debt on the balance sheet," the manager says. "So the balance sheet is in much better shape and we've got about a 20% annualized rate of return."

Mr. Cheng notes that while the company's stores previously did not offer products above $2, items are now priced up to $9.99.

"We're trying to capture that buyer who is trading down from Wal-Mart. It is only a recession if you lose your job. And if you lose your job, at times Wal-Mart itself is too expensive."

DOLLARAMA INC. (DOL/TSX).

The manager bought Dollarama as a new issue when the company went public in early October and has since added to this position.

His logic is similar as to that of Dollar General--many consumers have lost their jobs and a lot of them are in Canada.

"I think it is a business that continues to grow here," says Mr. Cheng, predicting that the company will add more than its planned 35 to 40 stores in the next 12 months. It already has 585 locations in Canada.

"In a tough retail and economic environment, Dollar General and Dollarama are the guys you want to stick with," the manager says, adding that existing store sales continue to grow at 8% to 10%.

"Once we're more convinced that our economy is well on track, then there are probably other retailers we'd try to buy to catch some of the cyclical upswing."

PENGROWTH ENERGY TRUST (PGF. un/TSX).

This name was added to the fund near $9 per unit earlier this year and Mr. Cheng boosts this position on weakness.

Pengrowth offers a relatively even mix between oil and natural gas, with slightly more exposure on the gas side.

"They've got a bunch of great opportunities in front of them, including some very, very good properties at Carson Creek, as well as a coal bed methane play, which I think will add a tremendous amount of value to the trust," the manager says.

Recent changes put Derek Evans in charge. Mr. Cheng considers the former CEO of Focus Energy Trust "one of the smartest guys in the patch" and says he has done a lot of the right things, including raising equity to pay down debt.

"Now, with a cut in the distribution and the pay down of debt, the prospects for the company -- especially given the portfolio of properties it has --is much, much better."

SELL

REAL ESTATE INVESTMENT TRUSTS.

Mr. Cheng has been selling both Canadian and U.S. REITs recently, bringing down his exposure from 15% to 5% in the past quarter.

He notes that Canadian REITs have rallied by almost 70% since March 6 and even moreso in the United States.

"I think valuations are pretty full," the manager says, adding that financing costs are up at least 100 to 200 basis points. "So that's going to negatively affect their cash flows for sure."

While the economic environment is recovering, Cheng notes that good REITs like H&R, RioCan and Calloway will still have to deal with tenant bankruptcies. In order to attract new tenants, they will have to lower rents.

"I don't think we've seen that yet, but I certainly think it's coming," he says.

"At the end of the day, in a tough economic environment, vacancies are going higher."