

TOP FUNDS REPORT

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MONTHLY COMMENTARY

With last week's highly anticipated launch of Vanguard's Canadian ETF line-up, the age old discussion on the costs that Canadian investors pay for their mutual funds has once again been reignited. With a quick look at the MER's on the Vanguard ETFs and it's not hard to see why. The **Vanguard MSCI Canada ETF (TSX: VCE)** has a rock bottom MER of 0.09%, compared to 0.27% for the **iShares S&P/TSX Capped Composite Index ETF (TSX: XIC)** while the median Canadian equity mutual fund carries an MER of 2.37%..

The view from the media is that Canadians pay too much for their mutual funds and the arrival of Vanguard will help push the costs down. While I agree that Canadians pay too much for mutual funds, I'm not sure that the arrival Vanguard will have a meaningful impact on fees, at least not in the short to medium term. I expect that there may be a reduction in the MERs of competing ETFs, but what impact Vanguard will have on the mutual fund world remains to be seen. iShares have been operating in Canada for several years and to date, we have not seen a meaningful reduction in mutual fund MER's.

While I agree that mutual fund costs are too high Canada, I **DO NOT** believe that costs should be the only factor considered when making an investment decision. There are a number of other factors that need to be considered when selecting an investment for your portfolio including the role you want the fund to play in your portfolio, the track record of the manager, depth of investment management team, investment style, security selection process, the historic performance, the level of value added performance, volatility, and of course cost.

I believe that if I am going to use an actively managed fund in a portfolio rather than an ETF, then the actively managed fund has to offer me a reason to use it. Reasons usually include higher expected returns than the ETF, lower volatility, or ideally a combination of the two. In a number of cases, it has been my experience that a higher priced, actively managed fund can make a better addition to the portfolio than would an ETF in the same asset class.

In general, it is my opinion that the relative importance of cost is dependent on two things; the level of expected return for the type of fund being considered, and the likelihood of the manager to be able to outperform the ETF. For example, in the fixed income world the level of expected return is relatively low with modest potential for outperformance. Therefore the importance of cost is extremely high and low cost products are the preferred choice in almost every case. However when we look at a highly specialized sector fund, for example precious metals, the expected return is higher with a higher potential for outperformance. In those cases, the importance of cost is lower when compared to the other selection criteria such as investment style, security selection process and the manager. With core equity products such as Canadian, US and Global equities, the importance of cost is somewhere between the two examples mentioned in that it is an important factor, but not the only factor.

As a rule of thumb, I tend to use cost as a tie breaker. When considering two investment products of similar quality and similar risk reward profiles, I always lean towards the fund with the lowest cost, be that an ETF, a no load mutual fund or a load mutual fund.

Please send your comments to feedback@paterson-associates.ca

FUNDS YOU ASKED FOR

A reader emailed me a couple of weeks ago and was interested in an update on the mutual funds offered by Calgary based Mawer Investment Management. For those unfamiliar with the firm, Mawer began in 1974 as an investment counsellor providing discretionary money management services to high net worth individuals and not for profit institutions. In 1987 the firm expanded its offerings to the investing public with the launch of a small family of no load mutual funds, which has since expanded to 10 funds. Today the employee controlled firm manages more than \$9.2 Billion for private clients, institutions and mutual funds.

The funds are no load funds which many investors purchase directly from the company. Additionally, the funds can also be purchased through a wide range of financial advisors. The minimum investment will vary based on province, however in most cases the minimum account size will be \$50,000 if dealing directly with the firm. Because the funds pay no commission or embedded trailer fees to advisors, the management fees are very low relative to many of the advisor sold mutual funds in Canada.

Perhaps best known for their equity management, the company employs an investment approach that can best be described as a “Growth at a Reasonable Price” or GARP. The management focuses on companies that have the ability to “deliver a return on capital greater than their cost of capital over time” - in other words, companies that can create value for its shareholders. By focusing on companies that create value, the managers are more likely to be able to avoid “value traps” or companies that are just cheap, rather than trading at a discounted valuation.

The security selection process looks to identify high quality companies that are trading below what the managers feel it is worth – it’s intrinsic value. In determining the intrinsic value, the managers will conduct detailed fundamental analysis including the use of a discounted cash flow model which will give them an estimate of what the company is worth relative to its growth prospects. They will only purchase those companies that offer strong growth prospects with attractive valuations. Because the portfolio is constructed on a stock by stock basis, the portfolios will often look dramatically different than the broader market indices. Quite frankly, this is what you want from a manager in an actively managed mutual fund.

Mawer Canadian Equity Fund (MAW 106) – This Canadian equity fund is managed by Jim Hall and Vijay Viswanathan. They scour the Canadian equity universe in search of companies that will meet the company’s main requirements of creating shareholder wealth and trading below their estimate of intrinsic value. The portfolio focuses on large cap stocks and tends to be fairly concentrated, holding between 40 to 50 names, with the top 10 making up more than half of the fund. The fund’s MER is 1.22%, well below the category average. Performance for the fund has been strong, outpacing the S&P/TSX Composite Index and most of its peer group, and doing so with less volatility. This fund would make a good core equity holding for most investors.

Mawer World Investment (MAW 102) – Despite its name, the Mawer World Investment Fund is not truly a world fund but more of a non North American Fund. David Ragan took over the lead management duties of this fund in April 2010 after long serving manager Gerald Cooper-Key stepped down from the day to day management of the fund. The firm's head of research, Jim Hall, stepped in to join the management team of this fund. There has been nary a blip in the performance of the fund with it posting returns which continue to outpace the MSCI EAFE Index and most of its peer group. The fund is consistently in the first and occasionally second quartile. The volatility of the fund has been in line with the broader market. With a low MER of 1.49%, it is well below the peer group median of 2.54%. For investors looking for a high quality, low cost international fund, this is one that should be at or near the top of their list.

Mawer Canadian Balanced RRSP Fund (MAW 104) – This is a global balanced fund which invests in other mutual funds that are offered by Mawer including the Mawer Canadian Bond, Mawer World Investment, Mawer Canadian Equity, and Mawer U.S. Equity. The target asset mix of this fund is 60% equity and 40% fixed income and the manager, Greg Peterson will make some shifts around that target mix when conditions warrant. Performance has been solid and volatility has been in line with its benchmark. The MER for the fund is 0.98%, which is very inexpensive for this type of fund. This fund is a fund that can be used either as a core holding or as a full portfolio solution.

Mawer Canadian Diversified Investment Fund (MAW 105) – Similar to the Mawer Canadian Balanced RRSP Fund, this is a global balanced fund that will invest in other Mawer managed funds, but also has the ability to invest in individual securities where the manager feels opportunities exist. The fund has a go anywhere mandate that allows the manager to invest wherever they are able to find the best risk adjusted opportunities. The MER is extremely cheap at 0.96%. The fund is slightly more actively managed than the Mawer Canadian Balanced RRSP Fund, which in our opinion, makes it a more attractive option in volatile markets. This fund could serve as either a core holding or a full portfolio solution.

Mawer New Canada Fund (MAW 107) – This is a small cap fund that has been managed by Martin Ferguson since December 1996. Performance has been strong, handily outpacing the BMO Canadian Small Cap Index, and posting first or second quartile performance in all time frames. With an MER of 1.46%, this fund is one of the cheapest in the category. Unfortunately for those wishing to invest in the fund, it has been capped to new investors. However, for investors who are willing to pay a bit more to get a near identical fund, they may want to consider the **BMO Guardian Enterprise Fund (GGF 464)** or the **HSBC Small Cap Growth Fund (HKB 505)**, both of which are managed by the same manager and are currently accepting new money.

Mawer U.S. Equity Fund (MAW 108) – Manager Grayson Witcher has been at the helm of this fund since September 2007 and quite frankly has struggled to differentiate the fund from the pack. The fund struggled in 2010 and 2009 but appears to be enjoying a solid 2011. Despite the fund's rock bottom MER of 1.25% and recent strong performance, it is our opinion that there better choices in the U.S. equity category available to investors.

Mawer Global Small Cap Fund (MAW 150) – Launched in October 2007, portfolio manager Paul Moroz scours the globe looking for undervalued global small cap opportunities. Performance of the fund has been strong, however recently some cracks have begun to appear with short term performance landing in the fourth quartile. Given the disciplined process employed by the manager, we would expect that this is more a temporary blip and performance will improve on a relative basis over time. Volatility is in line with the broader global small cap category and costs are lower than the category average for a small cap fund with an MER of 1.85%. While this MER is lower than the category, it is our opinion that it is high. Given that there is no embedded compensation in the fund, 1.85% seems a bit expensive. If you were to look at the global equity category median MER of 2.65%, subtract the 1% embedded trailer fee, we get an MER without compensation of 1.65%, which is 20 basis points less than this fund. While this fund is not our favourite in the Global Small Cap category, this is still a solid fund for do it yourself investors.

Mawer Global Equity Fund (MAW 120) – This is a relatively new Mawer offering that was launched in October of 2009. The fund is managed by Jim Hall and Paul Moroz with the investment objective to provide attractive, long term risk adjusted returns by investing in equities anywhere in the world. The managers use this go anywhere mandate to invest in companies of any size that meet the Mawer investment criteria. To date performance has been strong, finishing first or second quartile in all time periods. Given the fund's relatively short operating history, we would be inclined to favour the Mawer World Investment Fund or a more established global equity fund from our Recommended List over this offering. It is our preference for at least 36 months of proven track record before we consider a fund on our Recommended List.

Mawer Canadian Bond (MAW 100) – In managing its fixed income funds Mawer looks to exploit inefficiently priced areas of the bond market in an effort to provide investors with attractive long term returns from both capital gains and interest income. To do this, the manager Michael Crofts will create a portfolio which is constructed using Government of Canada bonds as its core. He will then add provincials, corporate and other types of bonds to the portfolio in an effort to generate higher yield and potential capital gain opportunities. The MER for this fund is a touch high at 0.94% and performance has been decent, but not extraordinary. The current portfolio is approximately 35% corporate bonds with the balance being in either Government of Canada or Provincial bonds. This positioning will likely lag its competitors in a flat or rising rate environment. This fund is an acceptable bond fund for those who are using only Mawer products. But for those who are using a wide range of companies and products, it is our opinion that there are a number of better options for investors.

Mawer Canadian Money Market (MAW 103) – Like the name suggests, this fund invests in Canadian money market instruments. The MER of the fund is 0.59%, which is actually more than the one year return of 0.35%. Unless there is a need to keep funds within Mawer to maintain the minimum account size, investors are better served in using one of the high interest savings accounts that are available to them, rather than using this, or any other money market fund for that matter.

DECEMBER'S TOP FUNDS

PH&N Bond Fund

Fund Company	Phillips, Hager & North Investment Management
Fund Type	Canadian Bond
Rating	\$\$\$\$
Style	Multiple
Risk Level	Low
Load Status	No Load (Series D)
RRSP/RRIF Suitability	Excellent
TFSA Suitability	Excellent
Manager	PH&N Fixed Income Management Team (Since Dec 1970)
MER	0.61% Series D
Code	PHN 110
Minimum Investment	\$1,000 with minimum \$25,000 account size

Analysis: In the fixed income world, it really doesn't get a whole lot better than this. You get a well diversified portfolio that is managed by an experienced team that has a demonstrated track record dating back decades, and all for one of the lowest MERs in the category.

When interest rates move higher, as they are expected to do, fixed income investments will fall in value, which makes the present a potentially perilous time for fixed income investing. But not all fixed income funds are created equally. Those funds which have a higher exposure to corporate bonds are expected to hold their value better since in most cases, corporate bonds are not impacted as much as Government of Canada bonds in rising interest rate environments. Also, those funds which have a shorter term to maturity are also expected to hold their value better when rates move higher.

The PH&N Bond Fund has both of these advantages, holding more than 43% of the fund in corporate bonds and only 5.5% of the fund in Government of Canada bonds. The fund also has a healthy 31% exposure to provincial bonds, which offer high yields than Canada's and should outperform in a rising rate environment. From an average term perspective the fund has nearly 50% invested in fixed income instruments with a maturity of less than 5 years. The portfolio is also very high quality, holding 89% in bonds rated "A" or better.

If there is a downside to this fund it is that it is somewhat limited with respect to the investment strategies that are available to the fund. For example, it can only invest in bonds that are rated "BBB" or higher, which limits the manager's ability to add high yield which can add incremental returns to the portfolio. Further, the manager cannot utilize derivatives to help preserve value and add return.

Given our expectation of a flat to rising rate environment in the near to medium term, combined with the limitations on the strategies the fund may employ, we would favour the **PH&N Total Return Bond Fund (PHN 340)**. The Total Return Bond Fund may invest in some high yield opportunities and may use some derivative strategies. We would expect that the Total Return Bond would outperform the PH&N Bond Fund in that type of fixed income environment. (November 30, 2011)

Dynamic Small Business Fund

Fund Company	Dynamic Mutual Funds
Fund Type	Canadian Small / Mid Cap Equity
Rating	\$\$\$\$
Style	Bottom Up, Value
Risk Level	High
Load Status	Optional front, back end or low load
RRSP/RRIF Suitability	Good
TFSA Suitability	Good
Manager	Oscar Belaiche since August 2002 Jason Gibbs since March 2007
MER	2.77%
Code	DYN 087 – Front End
Minimum Investment	\$500

Analysis: The management team of Oscar Belaiche and Jason Gibbs look to provide long term capital growth by investing in small cap stocks. The Fund used to focus on income trusts however, since the demise of the income trust sector, they tend to focus on high yielding small and mid cap stocks, business trusts, royalty trusts and REIT's. In addition to the capital gain opportunity, the fund also pays investors a monthly distribution of \$0.014 per month, which translates into an income yield of approximately 1.7% at current prices. The yield on the underlying portfolio is estimated at 6.6%, which indicates that the level of distribution is very likely sustainable going forward.

The managers employ a fundamentally driven, bottom up security selection process that seeks out "best in class" businesses for the portfolio. They are looking for "quality at a reasonable price" which typically involves companies that have strong balance sheets, dominant positions in their industry and a strong alignment of interests between management and shareholders.

As of October 31, the fund is invested 66% in common stocks, 20% cash and 11% in REIT's. The focus of the fund is in Canada, with nearly all of the fund's holdings invested domestically. The portfolio is fairly diversified, holding approximately 60 names, with the top 10 holdings making up 35% of the fund.

Despite struggling in 2009, recent performance has remained strong, posting a one year return of 2.86%, handily outpacing both the BMO Nesbitt Burns Small Cap Index and the broader Canadian Small Cap category, posting returns in the first or second quartile in all time periods. Volatility has been lower than the broader market indices and the small cap category average.

Given the current volatile environment, we believe that this is a good pick for investors looking for small cap exposure for a number of reasons. The managers seek quality small and medium sized businesses with higher than market yields. Further, the managers employ an active style which will help them to better navigate the turbulent markets, helping preserve value and take advantage of capital gain opportunities. The biggest drawbacks to this fund are the costs, with a 2.77% MER and the key person risk associated with the manager. (December 14, 2011)

Manulife Global Opportunities Class Fund

Fund Company	Manulife Mutual Funds
Fund Type	Global Equity
Rating	\$\$\$
Style	Bottom Up Value – All Cap
Risk Level	High
Load Status	Optional front, back end or low load
RRSP/RRIF Suitability	Average
TFSA Suitability	Poor
Manager	Christopher Arbuthnot since Inception
MER	2.80%
Code	MMF 8522 – Front End
Minimum Investment	\$500

Analysis: This is an all cap global equity fund that has been managed by Christopher Arbuthnot since the fund's April 2007 launch date. The manager is not bound by any market cap, sector or geographic constraints, so he is able to truly to embrace a "go anywhere" philosophy. In selecting stocks for the fund, the manager uses a value focused approach, looking to pay a reasonable price for a stock, relative to its growth expectations. The manager looks for good businesses with strong management, efficient use of capital and a history of product innovation. The managers will also look for turnaround situations such as a new management team in place, new products being brought to the market or industry consolidation.

The portfolio is heavily concentrated in Energy, Consumer Discretionary and Industrials, which combined make up more than 61% of the total portfolio. Geographically, the portfolio holds a quarter of the fund in the U.S., 19% in Brazil and nearly 13% in Canada. The Fund is fairly concentrated with the top 10 holdings making up 46% of the fund.

Performance in the past year have been disappointing, with the fund losing nearly 25% while the MSCI World Index gained 1.3%. Looking at the most recent three years, the fund has delivered an annual compound return of 17% per year, compared to the index, which has returned 6%. This fund is highly volatile and has tended to gain more than the index in a rising market, but has also shown losses which are greater than the index in falling markets. This is attributable to the fund's concentrated positioning and its higher exposure to small and mid cap stocks. This is not a cheap fund with an MER of 2.80%.

While this may be a good fund to hold in a rising market, we do not feel that it is a good fund for all investors, and certainly do not envision it being used as a core holding for most investors. It is our opinion that given the higher levels of volatility, active management style, and all cap nature of the fund that it is best used as a complimentary fund in a well diversified portfolio. The Fund is also fairly highly correlated to the major equity indices, so it would play the role of a return enhancer, rather than bringing much in the way of risk diversification benefits. (December 14, 2011)

IA Clarington Real Return Bond Fund

Fund Company	IA Clarington Investments Inc.
Fund Type	Canadian Inflation Protected Fixed Income
Rating	\$\$\$
Style	Duration Management, Yield Curve Management
Risk Level	Medium
Load Status	Optional front, back end or low load
RRSP/RRIF Suitability	Good
TFSA Suitability	Good
Manager	Francois Lalonde since October 2008
MER	1.39%
Code	CCM 412 - Front End
Minimum Investment	\$500

Analysis: One of the biggest threats to the fixed income component of one's portfolio is the impact of inflation can have on its value. One product type which can help to address this erosion of value is a real return bond fund. Real return bond funds invest in real return bonds, which are bonds that adjust both the coupon payment and the principal value based on the level of inflation in the economy.

One of the better choices in the inflation protected fixed income category is the IA Clarington Real Return Bond Fund. The fund, managed by 25 year veteran Francois Lalonde, invests in Canadian federal and provincial real return bonds. The manager employs an active and opportunistic approach in managing the fund, which is possible given its relatively small asset base of \$71 million.

As of November 30, the fund is invested 73% in Government of Canada Real Return Bonds and 24% in provincial real return bonds. The quality of the portfolio is very high, with the average rating being "AAA". The costs for this fund are reasonable, with an MER of 1.39%, which is one of the lowest in the category.

While this may be one of the best funds in the category, one has to wonder if it makes sense at the moment to hold real return bonds in your portfolio. Real return bonds tend trade off of inflation expectations and will outperform when the actual level of inflation is higher than the expected level. Looking at the current inflation expectations, the bond market is pricing in a level of inflation of approximately 2.1%. While recent inflation numbers have been closer to 3%, the longer term trend is for lowered inflation and the Bank of Canada is targeting inflation of between 1% and 3%. Given that, we would be reluctant to have much real return bond exposure in our portfolios and would likely lean towards a fund where the manager has the ability to add some real return bond exposure to the fund when they feel the opportunities exist. That said, for those who absolutely want some direct exposure to real return bonds in their portfolios, this would be our top mutual fund pick, given its lower MER, smaller asset base and opportunistic management style.

(December 7, 2011)