

TOP FUNDS REPORT

OCTOBER 2011

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MONTHLY COMMENTARY

Perhaps the only constant in the mutual fund industry these days is change. The industry is in a constant state of flux with new companies setting up shop, new products being launched on a near daily basis, and the ever increasing competition from other investment products, most notably from Exchange Traded Funds (ETFs).

Another area that is in a constant state of change is with the individuals who manage mutual funds – the portfolio managers. There are always managers leaving firms and moving to other firms. At some places it's almost like the portfolio managers are working in a revolving door, with the high levels of turnover experienced at some firms.

When a fund manager leaves, there are many factors to consider when assessing the impact the change will have on the fund. The first thing considered is how integral was the individual manager to the fund's performance? For example, if the fund is managed by a team then the impact to the fund will most likely be very minimal.

On the other hand, if the fund is run by a "star manager" with a very distinct investment style, an in-depth review of the new manager is required to better understand how the fund will likely perform going forward. In this review, such things as any previous track record with a similar mandate, with the current fund company or another firm, are considered in detail. It is also important to review how such things as the new manager's investment philosophy, investment process, sell discipline and trading style compare to the old manager.

If all of this analysis indicates that fund performance will likely be similar to the performance under the previous manager, no changes to the fund's expected risk/reward profile or rating are needed in most cases. However, if things look dramatically different under the new management team, changes will definitely be needed.

I mention this because in the past couple of weeks, we have seen a number of fairly high level portfolio manager changes which have kept me fairly busy. Two of the highest profile announcements were the departure of John Arnold, who will be retiring from AGF effective October 31, and David Taylor who resigned from Dynamic Funds on October 5. These cases are very different. In the case of AGF there was a clear succession plan in place resulting in very little impact to the fund. With Dynamic, the impact to the fund is expected to be significant. We will discuss each one in more detail below.

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FUNDS YOU ASKED FOR

AGF European Equity Class Fund: Within the European equity category, one of the hardest hit funds has been the AGF European Equity Class Fund which has dropped more than 15.7% in each of the past three years. When you open the hood on this fund, it is not hard to see why. The fund is heavily invested in financial stocks, which have been severely punished by the markets since the onset of the global credit crisis in 2008. With continued volatility expected in the sector and continued loan write downs expected, more downside for this fund is likely.

On October 4, it was announced that long-time fund manager John Arnold would be retiring from AGF effective October 31, handing the reigns to co-manager Rory Flynn. While the timing of Mr. Arnold's retirement may be a bit of a surprise, his successor is not. It has been common knowledge that Mr. Flynn would take over from Mr. Arnold when he finally decided to hang it up.

Under Mr. Flynn's management, there will be no changes to the stock selection process. They will continue to follow their 30/30/30 approach which seeks out stocks which have a price to earnings ratio that is 30% lower than the market, dividend yields which are 30% higher than the market, and a stock price that is at least 30% below its 18 month high. There will, however, be some refinements to the portfolio construction process which include setting the maximum exposure of any one stock within the portfolio, setting the minimum and maximum number of stocks within the portfolio, and setting the minimum number of sectors which must be in the portfolio.

It is our opinion that these refinements are positive for the fund and over time will prevent significant sector concentration such as we've seen in the fund recently. Further, we expect that these changes will help to bring the overall level of volatility down within the fund, to levels which are more in line with the broader index.

That said, even with the changes, we would be reluctant to recommend the AGF European Equity Class Fund at the moment. In our opinion, with a final solution of the European debt crisis many months or even years away, there is far too much volatility risk within the region. While we believe that the region will inevitably come back and reward investors with gains, we feel that it may be many months before that occurs. Instead, it is our recommendation that investors take their European exposure and invest it in a more broadly focused, actively managed global mutual fund. This approach is favoured as the fund will still have some exposure to the European region, but the manager may invest as little or as much in the region as they feel the risk reward trade off warrants.

Dynamic Value Fund of Canada: On October 11, it was announced that David Taylor, manager of the Dynamic Canadian Value Class and Dynamic Value Fund of Canada has left the firm after nine years. He has been replaced by Cecilia Mo, who left Fidelity on October 5. At Fidelity Ms. Mo was lead manager on the Fidelity Dividend Plus Fund and was a manager on the Fidelity Dividend Fund and the Fidelity Northstar Fund.

Under Ms. Mo's leadership, we expect that there will be significant changes to the portfolio. Mr. Taylor followed a more contrarian, value focused approach which relied as much on his instincts as it did his process. He focused on statistically cheap stocks that were unloved by investors. The process was very much a bottom up approach and sector mix and geographic allocation was the by-product of stock selection.

The portfolios that Mr. Taylor ran tended to follow a go anywhere mandate, were benchmark agnostic and heavily concentrated. As of July 31, the Dynamic Value Fund of Canada held 30 names and was invested 73% large caps and 27% in mid cap stocks. The fund was also very heavily weighted to materials, making up nearly 40% of the fund. As a consequence, Mr. Taylor's funds tended to be more volatile than the index and peer group but until recently performance had rewarded this excess risk.

In comparison, Ms. Mo has cut her teeth managing more income focused products. Her investment philosophy is value focused and she follows a fundamentally driven, bottom up stock selection process. Her goal is to provide investors with consistency and provide a strong level of downside protection. She looks for well managed companies, with strong balance sheets that are trading below her estimate of intrinsic value.

It is her intention to bring the Dynamic Value Fund of Canada more into line with her philosophy and approach over the next several months. She does not plan to make any radical changes to the portfolio immediately, but plans to increase the number of holdings from the current 30 to 50 or more. She has a limit of 5% as the maximum exposure any one stock can have in the portfolio, but will increase that to 7% for exceptional investment opportunities. It is our expectation that under Ms. Mo's management the fund will be less volatile, but we also expect that performance will not be as strong in up markets as it was under Mr. Taylor.

While Ms. Mo's track record with Fidelity was strong, it is important to note that the fund on which she earned this track record is a vastly different mandate than the Dynamic Value Fund of Canada. Also, her style is considerably different than that of Mr. Taylor and will likely result in significant portfolio turnover. Therefore, we will be removing this fund from our Recommended List for the near term. Once the portfolio is fully transitioned, we will revisit the fund to see how the changes have impacted performance and the risk reward profile.

OCTOBER'S TOP FUNDS

CHOU RRSP Fund

Fund Company	Chou Associates Management Inc.
Fund Type	Canadian Small Cap
Rating	\$\$
Style	Value
Risk Level	High
Load Status	Front End Load
RRSP/RRIF Suitability	Fair
TFSA Suitability	Fair
Manager	Francis Chou, since inception (1986)
MER	1.84%
Code	CHO 102
Minimum Investment	\$5,000

Analysis: Portfolio manager Francis Chou follows a well articulated, value focused approach in the management of this Canadian small cap fund. He looks for profitable, well managed companies that have strong balance sheets and strong cash flow generation, that are well positioned in their respective industry. Being a value manager, Mr. Chou pays particular attention to the price paid for a stock and is basically looking to buy \$1 for \$0.50.

Mr. Chou's portfolios tend to be fairly concentrated holding between 25 and 35 stocks. However, as of August 31, the fund held only 18 positions with 4.3% invested in cash. While this approach will amplify gains, it will also amplify losses. No more was this prevalent than in the period between May 2007 and March 2009 where the fund dropped more than 55% in value, a decline from which the fund has yet to recover. Another by-product of this portfolio is volatility. Since early 2010, the volatility of the Chou RRSP Fund has become much higher than that of the broader equity market.

The fund is managed by Francis Chou. While we believe that Mr. Chou is a skilled manager over the long term, we do have some concerns surrounding his role with this fund. The largest is one of key person risk. Chou Associates is basically a one man show. If something was to happen to Mr. Chou and he was unable to continue managing this fund, investors would be negatively impacted.

Performance has been weak, dropping 11.6% for the year ending September 30 and is down more than 22% so far in 2011.

Based on the total risks and outlook for the fund, we are cutting its rating from \$\$\$ to \$\$\$. Further, we do not recommend this fund as a core holding within a portfolio, but rather as a small cap fund within a well diversified portfolio. (Dave Paterson, October 11, 2011)

Trimark U.S. Small Companies Class Fund

Fund Company	Invesco Canada Fund Inc.
Fund Type	U.S. Small / Mid Cap Equity
Rating	\$\$\$
Style	GARP with a Value Bias
Risk Level	High
Load Status	Optional front or back-end load
RRSP/RRIF Suitability	Good
TFSA Suitability	Good
Managers	Rob Mikalachki (August 2002) Virginia Au (April 2010) Jason Whiting (April 2011)
MER	2.83%
Code	AIM 5523 (Front End)
Minimum Investment:	\$500

Analysis: Despite the April 2011 defection of long standing co-lead portfolio manager Ted Chisholm to Edgepoint Wealth Management, this fund has held up relatively well. Stepping into Mr. Chisholm's shoes is Virginia Au, who has worked on the fund since 2006. Adding bench strength to the team was the appointment of Jason Whiting who has managed a number of other small cap focused products for Trimark including the Trimark North American Endeavour Fund.

It's important to note that since the departure of Mr. Chisholm, there has been no change to the investment management process or investment philosophy in the management of the fund. The Fund is still managed under the basic Trimark philosophy of "business people buying businesses". The process used is very much a value focused, bottom up approach where the managers are looking for high quality, well managed stocks that are largely ignored by the rest of the investment world. They look for good management teams that are typically the number one or number two ranked companies in their industry.

Given the investment philosophy, the portfolio tends to be fairly concentrated, holding anywhere from 20 to 30 companies. The managers are also very patient and tend to take a 5 year or longer view for the stocks in the fund. As a result, portfolio turnover tends to be consistently very low.

Performance has been strong, both on an absolute and a regular basis. As of September 30, the fund is up 14.4% while the Russell 2000 Index in Canadian dollar terms was actually down by nearly 2.8%. So far in 2011, the fund is up 0.9% while the index is down by 13.2%.

Given the process and approach that the manager takes, there will be periods of time where this fund will underperform over the short term. But given the well defined process and approach in place, we feel that this fund can be a good compliment in a well diversified portfolio for the long term. (Dave Paterson, October 12, 2011)

RBC O'Shaughnessy Canadian Equity Fund

Fund Company	RBC Global Asset Management Inc.
Fund Type	Canadian Focused Equity
Rating	\$
Style	Value / Growth Blend
Risk Level	Medium
Load Status	Optional front or back-end load
RRSP/RRIF Suitability	Poor
TFSA Suitability	Poor
Manager	James O'Shaughnessy – since inception (1997)
MER	1.52%
Code	RBF 550
Minimum Investment	\$500

Analysis: Like the other O'Shaughnessy Funds, the RBC O'Shaughnessy Canadian Equity Fund uses a quantitatively driven stock selection process that is highlighted in the manager's book "What works on Wall Street". Essentially the manager employs various screens looking for stocks that have a history of above average sales, above average trading value and above average cash flow. The manager will then pick the highest ranked 50 stocks for inclusion in the portfolio on an equally weighted basis. The screens are run several times a year, with the end portfolio being made up of between 150 and 200 stocks. The Fund will be fully invested at all times.

The focus of the fund is in Canada however the manager does have the ability to invest in U.S. and international equities. Any foreign exposure will be hedged back to Canadian dollar terms, which will help boost returns in periods of rising currency and hurt returns in a declining currency relative to funds which do not hedge their currency exposure.

The Fund was reopened to new investors in November 2009, after having been closed in January 2007.

While we like the transparency of the process and the fund's relatively low MER, the fund's performance simply does not justify recommending it to investors. As of September 30, the fund had a 1 year return of -7.6%, while during the same period, the S&P/TSX Composite Total Return Index (which includes reinvested dividends) returned -3.6%.

For investors who are seeking a fundamental index type of product such as this, they may want to consider the Claymore Canadian Fundamental Index ETF if they purchase ETF products, or if they wish to stay within a mutual fund product, the PowerShares FTSE RAFI Canadian Fundamental Index Class A. Both of these funds offer a similar product with relatively low costs, yet with better risk adjusted performance. (Dave Paterson, October 13, 2011)

IA Clarington Canadian Conservative Equity Fund A

Fund Company	IA Clarington Investments Inc.
Fund Type	Canadian Dividend & Income Equity
Rating	\$\$\$
Style	Value
Risk Level	Medium
Load Status	Optional front or back-end load
RRSP/RRIF Suitability	Excellent
TFSA Suitability	Excellent
Manager	George Frazer since 1950 Douglas Kee since 2006
MER	2.43%
Code	CCM 1300 (Front End)
Minimum Investment	\$500

Analysis: If you are looking for a fund flash and sex appeal, then you had best keep looking. But if you are looking for a conservatively managed, high quality blue chip equity fund, this fund is definitely worth considering.

The Fund has been managed by George Frazer and his team at Leon Frazer & Associates Investment Counsel since 1950 using a very value focused approach. The team looks for companies with a demonstrated history of growing dividends paid to investors over time based on their belief that “dividend increases drive growth in both income and capital and offer capital protection in volatile markets.” The team also looks for a history of strong earnings, cash flows, and quality management. Valuation is also a concern as the team focuses only on the stocks that they feel are reasonably priced based on their estimate of value and the growth prospects.

There is definite evidence that this process works. During the period between July 2008 and February 2009, the S&P/TSX Composite Index Total Return Index plunged by more than 57%, while the IA Clarington Canadian Conservative Equity Fund was down by 32%.

The portfolio is fairly concentrated, holding approximately 35 companies with the top 10 making up nearly 60% of the total fund. Given the fund's focus on dividends it is not surprising that the fund is heavily weighted towards financial services, utilities and communications. What may be surprising to some is the fund's exposure to energy. However, this is a result of many of the pipeline stocks being considered energy. Of the 35% of the fund that is invested in energy, nearly half of it is invested in the more conservative, income generating pipeline stocks.

If there is a drawback to a fund such as this it is that it will lag in up markets. According to IA Clarington, the upside capture ratio of this fund is 65%, which means that on average, if the S&P/TSX Composite is up 1%, this fund will only be up 0.65%. (Dave Paterson – October 14, 2011)