Top Funds Report

Monthly Commentary

Interest rates will soon be on the way up. Find out how to protect your portfolio from the rate rise.

Fixed income investments have long been known for their safe haven appeal. In periods of uncertainty, investors flock into government bonds, knowing that they are protected. That trend has held true in Canada. Market volatility has been on the upswing since July. Not surprisingly, from August 2011 until January 2012, bond funds received $9.3 billion in new money. During the same time frame, equity funds lost $9 billion in assets.

From an intuitive point of view, we understand why this has occurred. Markets became very volatile and investors in general tend to be risk averse. Another reason for this switch has been the unprecedented run that we have seen in fixed income investments over the past several years. After the credit crisis in 2008, governments around the world pushed interest rates lower to help spur economic growth, which resulted in fixed income prices being pushed higher, providing strong returns for investors.

This trend cannot continue forever. Interest rates will move higher. The questions now become when will they move, and what can you do to protect yourself?

The question of when rates will go up is a difficult one to answer. There is still a tremendous amount of uncertainty in the global economy. Canada, while in a relatively strong position, is not immune to this uncertainty. The BoC also has to ensure that any interest rate increase does not create further hardship for our manufacturing sector. We have seen some pressure on interest rates in the middle to long end of the yield curve (bonds with maturities of five years and longer). This part of the yield curve is likely to remain under pressure for the foreseeable future. As this happens, it will likely result in low to modest losses in most bond funds.

How to protect your portfolio is an easier question to answer. The first thing to do is not panic. Yes, rates will be going up, but they will not be skyrocketing higher overnight. It will take time for things to really be impacted. We are not suggesting that you run out and sell your current fixed income holdings. On the contrary - fixed income can play a critical role when used as part of a well diversified portfolio by helping to reduce the overall levels of portfolio volatility. All portfolios should have some exposure to fixed income at all times.

But there are a number of ways to protect your portfolio First, focus on active bond funds where the managers have a number of tools available to them which allow them to tactically manage the fund and best position it for the environment. Second, corporate and high yield bonds are expected to hold their value better in a rising rate environment. While government bonds trade solely off the interest rate environment, corporate and high yield bonds have the potential to trade off other fundamental factors and may behave like a hybrid between fixed income and equity investments. Third, investors may want to focus on shortening the duration of their government focused fixed income holdings by switching some of their assets into short term bond funds. In doing this, the potential losses from any rate rises will be effectively reduced.

By taking some preventative steps within your fixed income holdings, you can help preserve value when rates finally do move higher, while not significantly impacting its benefit as a safe haven in times of market turbulence.

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

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Funds You Asked For

More manager changes at Trimark, Dynamic Diversified Real Asset, Sentry funds and more!

Trimark Fund – On March 8, it was announced that Dana Love, manager of the Trimark Fund, had resigned from the company.

He will be replaced by Michael Hatcher, who has been co-manager on the fund for the past year or so. He will be supported by the current co-managers Darren McKiernan and Jeff Feng.

From an optics standpoint, this is yet another blow to the venerable Trimark franchise, which over the past few years has seen a near complete changing of the guard within the portfolio manager ranks. It is also very disappointing because the fund had begun to show a marked improvement in performance on both an absolute and risk adjusted basis.

But digging deeper, this may not be as big a blow as first thought. Dana Love is being replaced by a very capable team which has worked together for a number of years, the last two of which were at Trimark. Before that, they were at Burgundy Asset Management. This is important to note because Burgundy uses a fundamentally driven bottom up investment management approach that is very much like that which is employed within the Trimark discipline. Both firms have a reputation of seeking out strong, well managed, financially sound companies that are trading at a significant discount to their intrinsic value.

The other factor which causes us to not pull the panic switch at the moment is that the team has been working on this fund since April of last year. They are very familiar with the fund, the process, and, most importantly, the names in it. Thus far it is expected that there will not be a significant amount of portfolio turnover, nor is there expected to be any fundamental change in the way in which the fund is managed.

While our preference would have been for Dana Love to remain with the fund, we feel that there is a strong team replacing him. Under the new regime, we do not expect a significant change to the fund. Despite that, we will be placing the Trimark Fund UNDER REVIEW immediately. We will be meeting with the new management team in the coming weeks to discuss their approach and any further changes which are expected to the fund. We will continue to monitor the fund to ensure that there is not any significant erosion in the risk reward profile.

Dynamic Diversified Real Asset Fund - The Dynamic Diversified Real Asset Fund is an interesting concept for an equity focused balanced fund. It is designed to protect investors against the threat of inflation by investing predominantly in a mix of securities that are exposed to real assets such as real estate, real return bonds, precious metals, energy and infrastructure.

It is managed by Michael McHugh using a top down approach. Mr. McHugh, in tandem with Dynamic's chief economist, Dr. Martin Murenbeeld, evaluates the current economic and market conditions. Based on this analysis, Mr. McHugh determines the relative attractiveness of each of the five sectors mentioned above. The target weighting of each sector is 20%, however, based on the outlook, the target weights may range between 10% and 30%.

To gain the investment exposure, the manager will invest in other funds managed by Dynamic, specifically the **Dynamic Precious Metals Fund, Dynamic Global Infrastructure Fund, Dynamic Strategic Energy Class, Dynamic Focus+ Resource Fund** and **Dynamic Global**

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Real Estate. The fund will also hold fixed income investment directly.

Performance since the February 2009 market low has been strong, boasting a three year return in excess of 21%, outpacing the index and its peer group. In the past six months, however, the fund has taken a breather, largely due to the struggles of gold, which has dragged performance.

Volatility of the fund is high, particularly for a balanced fund. The monthly volatility is higher than the volatility for the S&P/TSX Composite Index. In fact, the fund is the most volatile balanced fund we follow.

Given this risk profile, we do not feel that this fund is suitable as a core holding for most investors. In our opinion, it may be a good specialty holding for those investors seeking some protection against the impact of inflation. Given that many economists don't envision a particularly robust inflationary environment in the near term, we expect that the short term performance may be particularly volatile. Longer term, investors worried over the potential impact of inflation may want to consider this fund for a small portion of their portfolio, given its diversified approach.

Dynamic Power Balanced Fund - Like other funds that carry Dynamic's Power label, this Canadian neutral balanced fund is not for the faint of heart. It carries a target asset mix of 50% equities and 50% bonds, although the managers have some flexibility around that. As of January 31, the fund was nearly 60% stocks, 38% bonds and 2% in cash.

Rohit Sehgal runs the equity portion of the fund using a growth focused, bottom up approach that looks for companies that have strong growth contributors including strong return on equity, high profit margins and better than average growth rates. The equity sleeve of this fund will look very similar to the **Dynamic Power Canadian Growth Fund**.

Michael McHugh looks after the fixed income side of the fund. He tends to focus on high quality government and corporate issues.

While the long term returns have been impressive, the volatility is very high. In fact, the volatility of this fund is on par with what one would experience in a pure dividend or conservatively managed Canadian equity fund.

Mr. Sehgal has made some changes to the portfolio in the recent months by reducing his exposure to Canada. As of January 31, Canadian equities stood at 36.2% of the fund while U.S. equities have been increased to 18.8% - the highest it has been in the fund's history. In the U.S., the fund is focusing on large cap, blue chip stocks. From an asset mix standpoint, the managers believe that stocks are more attractive than bonds at the moment, and as a result will continue to hold an overweight allocation to stocks.

With the focus on blue chips, the quality of the equity portfolio has increased, which should also help to lower overall volatility. Given the expectation of a volatile environment, it is our opinion that these changes will be positive for the fund in the near to medium term.

Despite this, this is not a fund that we would recommend for most investors. Even with the increase in quality, it is far too volatile. However, for those willing to accept the higher risks, this is a fund that has the potential to deliver higher than average returns.

Sentry Small Mid Cap Equity Fund - This small cap fund has the dual investment objectives of providing investors with consistent monthly income and capital growth. To meet these objectives, the fund invests in income producing securities of small and medium sized companies.

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The fund formerly invested predominantly in income trusts, but has since shifted its focus to invest in high yielding common shares, preferreds, and to a lesser extent bonds and other debt securities.

The management team use a value oriented process that seeks out companies that have high returns on invested capital, modest capital expenditure requirements, and have the demonstrated ability to generate free cash flow.

The portfolio tends to be fairly concentrated, holding between 40 and 60 names. The top 10 holdings as of December 31 made up 45% of the fund. Given the focus on income, the portfolio's make-up is much different than the benchmark. For example, the fund is significantly underweight in energy and materials, and significantly overweight in industrials and consumer discretionary names.

This would also help explain why the performance and volatility profile is much different than the benchmark. For the five years ending February 29, the fund posted an annual compound return of 12.1% compared with the BMO Small Cap Index which returned 3.9%. The volatility of the fund is much lower than the index and the category.

The fund pays investors a monthly distribution of $0.05 per unit. At recent prices, this equals an annualized yield of approximately 4.1%. The MER is 2.84%, which is in the upper half of the category.

Given the total risk profile, combined with its focus on income, this is a fund that we believe will perform very well over the long term. We would expect that it will outperform its small cap brethren in flat or volatile markets, but will likely lag in a rising market environment.

This fund is one of our top picks in the small and mid cap equity category.

Standard Life International Equity Fund - This international equity fund focuses on large and midsized companies that are not listed on any North American stock exchanges. It is run by Standard Life's internal portfolio management team and uses a number of proprietary research techniques including management interviews, industry conferences, site visits and a detailed fundamental analysis. The team researches and updates more than 2,000 companies which are then rated and ranked in terms of their opinion of quality as well performance outlook.

The end result is a fairly well diversified portfolio holding between 80 and 100 names. The top 10 holdings make up just under 30% of the fund. The manager is fairly active, with a level of portfolio turnover that has averaged 88% for the past five years.

As of December 31, the fund is nearly fully invested, holding 1.8% cash. The fund has 73% of its assets in Europe with the U.K. making up 31% of the fund. Asian holdings represent 25% of the fund, with the biggest exposure being Japan.

The sector weights are fairly close to the weightings in the MSCI EAFE Index. The fund is overweight in technology and energy and holds an underweight position in telecommunications.

Performance of the fund has been middle of the pack, posting a three year return of 4.4%. That lags the MSCI EAFE Index which returned 6.7% while the average international equity fund returned 6.0%. Volatility of the fund has been in line with both the index and the category average.

Given the fund's current positioning, combined with the historic track record and volatility, we would expect that it will continue to muddle along. We don't expect that this is a fund that will shoot the lights out on a consistent basis, nor do we expect it to dramatically underperform. It is our opinion that there are better choices available.

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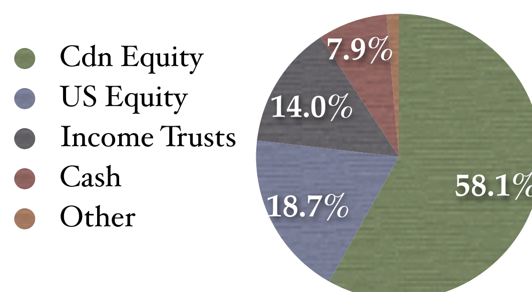
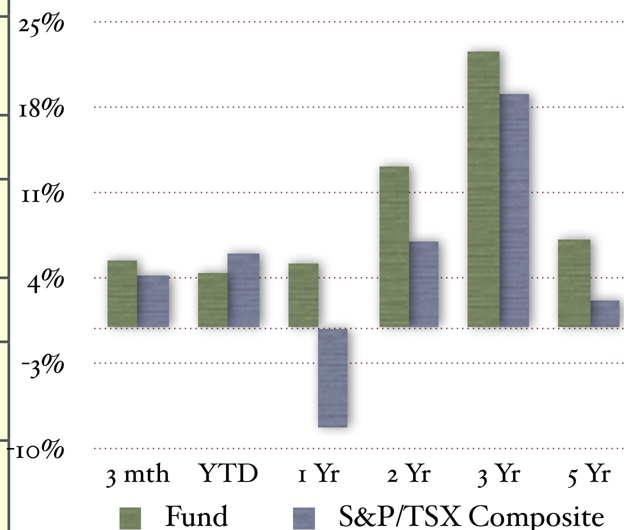
Sentry Canadian Income Fund

Fund Company	Sentry Investments
Fund Type	Cdn Dividend & Income Equity
Rating	$$$$
Style	Blend
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
TFSA Suitability	Good
Manager	Michael Simpson since Feb 02 Aubrey Hearn since 2010
MER	2.70%
Fund Code	NCE 717 - Front End Units NCE 317 - DSC Units
Minimum Investment	$500

Asset Mix





ANALYSIS:

Managed by Michael Simpson and Aubrey Hearn, the fund invests in a mix of large and mid cap income producing securities like common equity, fixed income and REITs.

It pays investors a monthly distribution of $0.0775 per unit, which works out to an annualized yield of 5.8%, using February 29 prices. In 2011, nearly two thirds of the total paid to investors was treated as return of capital, which increases the tax efficiency of the distributions.

The fund is conservatively managed and will typically hold between 50 and 60 names. As of December 31, it held 55 names with the top 10 making up 46% of the fund. Not surprisingly, the fund is heavily weighted towards energy, which makes up more than 20% of the portfolio, and REITs which are nearly 18%.

In recent months, the managers have taken profits in the utilities and infrastructure investments held in the fund. With the cash, they took some strategic positions in U.S. based names in the industrial sector, and added to their Canadian healthcare exposure. They have also said that they feel that some names in the oil sector don't reflect the true price of the commodity. As a result, they have added to their energy exposure.

Performance has been strong. For the five years ending February 29, the fund returned 7.4% while the S&P/TSX Composite returned 2.2%. The fund has finished in the first quartile in every calendar year since inception, except for 2006, when it lagged the broader market by 13%, ending in the fourth quartile.

Volatility is lower than both the category average and the broader market. The biggest drawback to this fund is its MER, which at 2.70% is significantly higher than the category average.

On balance, this is a good fund for investors seeking regular income, with the potential for capital gains over the long term. The experienced management team has done a tremendous job navigating the conversion from an income trust fund.

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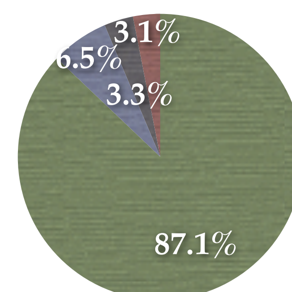
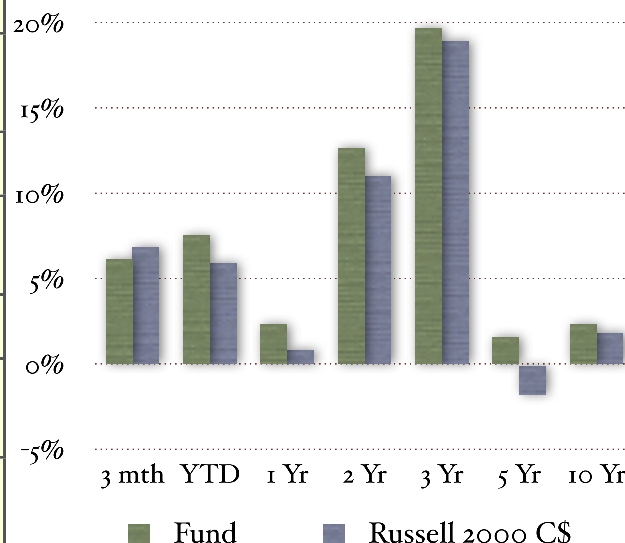
TD U.S. Mid Cap Growth Fund

Fund Company	TD Asset Management
Fund Type	U.S. Small / Mid Cap Equity
Rating	$$$
Style	Growth
Risk Level	Medium High
Load Status	No Load / Optional
RRSP/RRIF Suitability	Good
TFSA Suitability	Good
Manager	John Berghuis since December 93 John Wakeman since July 06
MER	2.54%
Fund Code	TDB 974 - No Load Units TDB 312 - Front End Units
Minimum Investment	$500

Asset Mix





ANALYSIS:

Managed by the team of Brian Berghuis and John Wakeman, the TD U.S. Mid Cap Growth Fund seeks out well managed, medium sized companies operating in traditional growth industries. The focus is on those companies that have market caps of between $1 billion and $12 billion which have annual earnings growth rates of more than 12%. Companies must also be underpriced, relative to their growth prospects, before they are added.

The fund is very well diversified, typically holding between 125 and 175 names, across a wide range of sectors. As of February 29, there were 133 names in the portfolio, with the top 10 making up 22.5% of the fund. The manager is fairly patient in implementing their investment process. Portfolio turnover has averaged 40% in the past five years, which has added an average of 0.06% to the cost of owning the fund.

Not surprisingly, with its emphasis on growth, the fund is heavily weighted towards technology and industrials. Combined, those two sectors make up just less than half of the total fund. Instrument maker Ametek, retailer Dollar General, defence contractor Textron, and software maker Nuance are some of the names held in the portfolio.

Performance has been strong on a relative basis, with a five year compound return of 1.7%, handily outpacing the Russell 2000, finishing in the first quartile. The fund has been one of the least volatile funds in the category, with a monthly standard deviation that is well below the category average. Cost is a touch on the high side, with an MER of 2.52%, roughly in line with the category average.

Overall, we believe that this is a good fund for investors who are looking to add exposure to U.S. mid cap stocks to their portfolio. Mid caps have the potential to add incremental return when incorporate in a well diversified portfolio. However, there may be periods of higher volatility. Therefore, we suggest that investor's use this fund cautiously, limiting exposure in their portfolios to a maximum of 10% for the more aggressive investors, and lowered for more conservative investors.

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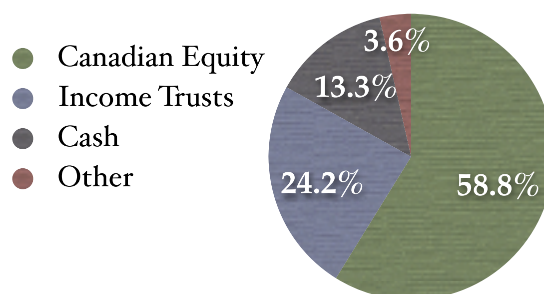
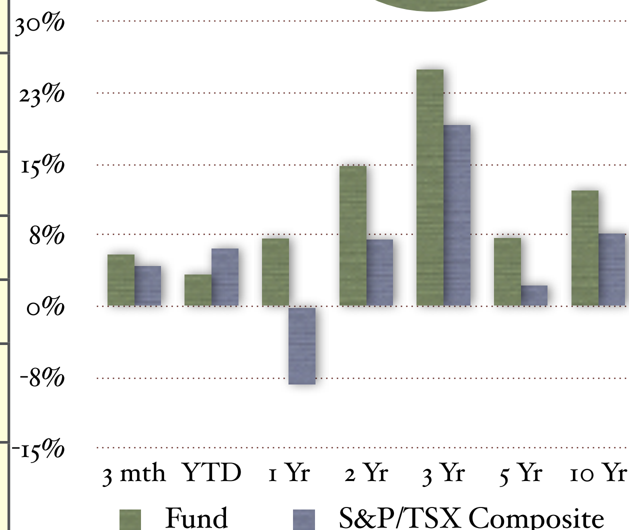
Dynamic Equity Income Fund

Fund Company	Dynamic Funds
Fund Type	Cdn Dividend & Income Equity
Rating	$$$$
Style	Blend
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
TFSA Suitability	Good
Manager	Oscar Belaiche since July 2001
MER	2.15%
Fund Code	DYN 029 - Front End Units DYN 729 - DSC Units
Minimum Investment	$500





ANALYSIS:

Managed by the much respected Oscar Belaiche since the fund's launch, the Dynamic Equity Income Fund aims to provide investors with tax advantaged monthly income from a diversified portfolio of cash flow generating businesses. The team focuses on companies that offer investors sustainable cash flow distributions, hold a dominant position in their industry, and are managed by a high quality management team that holds a significant equity stake in the business.

The fund plays very much to the expertise of the management team and tends to be heavily weighted in the oil and gas, and real estate sectors. As of January 31, real estate, energy and utilities made up nearly 64% of the fund. The cash weighting of the fund was just under 10% of total assets. The top 10 holdings were a third of the fund.

The manager is fairly patient in executing his management strategy. For the most recent five year period, portfolio turnover has averaged 20% per year. However, in the past two years, the manager has been very active, and has posted portfolio turnover levels which are closer to 40% per year. Part of this stems from the tactical use of cash, which has been used effectively to help keep overall portfolio volatility in check.

The fund pays investors a monthly distribution of $0.07 per unit. At current prices, this is an annualized yield of approximately 4.7%. In 2011, this distribution was a mix of return of capital and dividend income. The MER is 2.15%, which is slightly higher than the category median.

Performance has been strong, finishing in the first or second quartile in every year, with the exception of 2006. For the year ended February 29, the fund returned 7.2%, while the broader market lost 8.2%. The volatility profile is comparable with the category average and is lower than the broader equity market.

On balance, this is a good fund for investors seeking regular income, with the potential for capital gains over the long term. Oscar Belaiche and his team have done a good job in providing strong total returns, while volatility in check. This is a good fund for investors seeking some level of income with the potential for modest capital gains over the long term.

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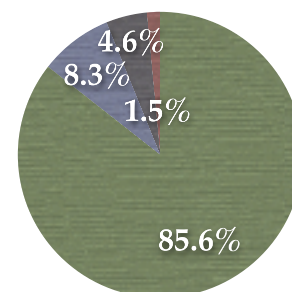
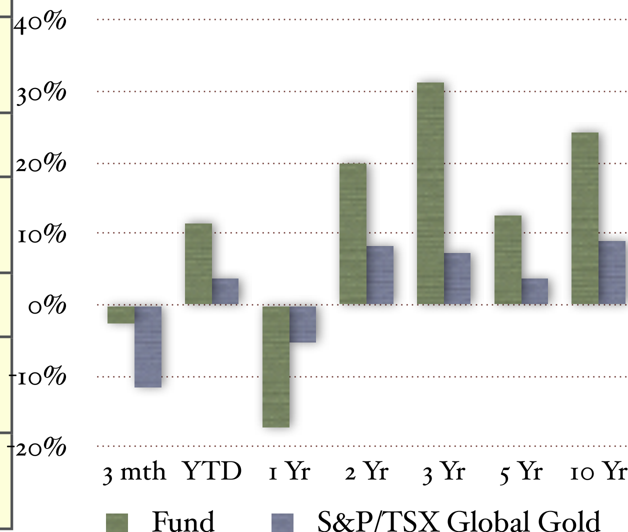
RBC Global Precious Metals Fund

Fund Company	RBC Global Asset Management
Fund Type	Precious Metals Equity
Rating	$$$$
Style	Growth
Risk Level	Very High
Load Status	No Load / Optional
RRSP/RRIF Suitability	Poor
TFSA Suitability	Poor
Manager	Chris Beer since March 2003 Brahm Spilfogel since April 2007
MER	2.13%
Fund Code	RBF 468 - No Load Units RBF 774 - Front End Units
Minimum Investment	$500

Asset Mix





ANALYSIS:

This is one of our favourite precious metals fund available to investors today. It is managed by the team of Chris Beer and Brahm Spilfogel. It invests in companies that are involved in the exploration, mining and production of gold, silver and platinum, and may also invest in gold bullion and gold certificates up to a maximum of 20%.

The team looks for companies that are run by experienced management, have strong balance sheets, and proven reserves or excellent geological potential. They look for companies involved in both exploration and production. Typically, the fund will hold approximately a third of the assets in a select group of high quality, liquid, large cap names which are selected using the resources of the RBC Global Asset Management Team. For the balance, the team looks for small and mid cap names, conducting intensive research, looking to uncover new and unknown investment candidates.

The end product is a portfolio that will typically hold more than 200 individual names. Despite the breadth of names, there is significant concentration with the top 10 making up roughly half of the fund.

Performance over the long term has been phenomenal. For the 10 years ending February 29, the fund has returned an annualized compound return of 24.3% to investors. Not surprisingly, most of that gain has occurred since mid 2008, when gold began its rapid ascent. Shorter term numbers are less impressive, with a one year loss of 17.2%.

Volatility is very high. On a historic basis, it is more than two times the volatility of the broader market. We do not expect that to change. But within the precious metals category, this has been one of the least volatile funds and has consistently delivered above average risk adjusted returns.

Despite the strong returns, this is a category that most investors will want to take a pass on. The volatility and probability of a loss is significant and far too high for most medium risk investors. However, for high risk investors looking for exposure to the precious metals sector, this is definitely a fund worthy of consideration.

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