Top Funds Report

Monthly Commentary

Anticipation of another round of quantitative easing boosts gold and commodities higher.

Those who adhered to the old adage of selling in May and going away for the summer may have been sorry that they did. Global equity markets were again higher in August, their third month in a row of gains. This time around, it was Canadian equities leading the way higher, as our three main sectors, financials, energy, and materials, all enjoyed decent gains. The S&P/TSX Composite rose more than 2.4% in the month. The energy and financial sectors matched the gains of the broader index.

The biggest winner by far was the precious metals, which saw the S&P/TSCX Global Gold Index rise by 9.1%. This jump was spurred by the price of gold which hit the $1,700 per ounce level again on speculation that the U.S. Federal Reserve would be announcing another round of quantitative easing. Traders believe that if such a plan is announced, it would result in a drop in the U.S. greenback.

In the U.S., the S&P 500 gained 2.3% in U.S. dollar terms, ending the month at 1,406.58, its highest close in nearly four years. The MSCI EAFE Index rose by 2.4%, while the MSCI World Index rose by 2.3%. Market sentiment was much improved on optimism that the European Central Bank would resume its buying of sovereign bonds and that the Euro-zone leaders would work out a solution to the debt crisis. This pushed European shares sharply higher, with the MSCI Europe Index gaining 4.1% in the month. For Canadian investors however, these gains were muted by the increase in the Canadian dollar which finished the month at $1.0139 from July's close of $0.9986.

Signs of an economic slowdown continued to emerge out of China, with manufacturing output dropping more than expected. Japan also struggled as a rise in the Yen hurt the outlook for manufacturers.

Despite the positive summer, we believe that there are many reasons to remain cautious as we enter into the fall. September and October have historically been nasty months for investors, and with the macro risks that are currently overhanging the markets, we expect that this year will be no different. While the ECB buying up bonds will help in the short term, it does very little to solve the actual crisis. Until a firm plan is in place, the region is ripe with uncertainty. Compounding the situation is a slowing Asian economy and concerns about the U.S. "Fiscal Cliff", a series of tax increases and spending cuts that are set to take effect in the New Year. Without a deal in place to postpone these, it is likely their implementation will halt the already fragile recovery. All of these factors are expected to continue to weigh on the market sentiment, causing increased levels of uncertainty well into the fall.

Considering this, our investment stance remains defensive. It is our expectation that interest rates will remain unchanged for the next several months. This will help to provide some support for fixed income investments. Within the fixed income space, we are focusing on actively managed, high quality bond funds that allow the managers the tools to help navigate the tricky waters. For equities, we continue to focus on actively managed, large cap focused funds that invest in well managed, high quality companies that generate strong cash flows. We are still avoiding Europe and China specific funds as we believe that there is too much risk in the short term. Instead, we continue to favour Canada and the U.S.

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

Funds You Asked For

This month, we take a look at Fidelity Far East, CI Global Health Sciences, Bill Kanko's Blackcreek Global Leaders and more.

Fidelity Far East Fund - Henry Chan recently took over the management duties of this fund from Joseph Tse, who had been at the helm since July 2003. Under Mr. Chan's management, there aren't expected to be wholesale changes as both managers follow a similar process.

The fund invests in companies that are located in Southeast Asia, excluding Japan. Mr. Chan will look for companies that are in the early stages of an earnings cycle. His rationale is that he believes that earnings growth and valuation expansion will result in greater stock price performance. The portfolio is built using a combination top down, bottom up approach. The top down analysis is used to identify trends that are used in focusing the portfolio in the most opportune areas. Individual securities are selected using a bottom up, "Growth at a Reasonable Price" process that looks for companies that are expected to experience earnings growth over the next few years.

Companies must also have quality management teams in place, strong balance sheets, ample funding, and there must be a near term catalyst that will help unlock the potential share price growth. A great deal of emphasis is placed on downside protection and the manager carefully assesses the downside potential and overall volatility of each position in the fund.

It can invest in companies that have at least $500 million in market capitalization, which allows a great deal of flexibility for the managers. It is expected that the portfolio will be biased towards large caps. It will be a diversified portfolio, holding between 100 and 150 names.

While performance of the fund has been decent, now that a new manager is in charge, it becomes less important. Mr. Chan does have an impressive resume, managing funds for Baring Asset Management and Invesco before joining Pyramis in 2011.

Looking ahead, we don't envision significant changes in the risk reward profile of the fund. We do expect that the fund will become slightly more concentrated, but will still hold well north of 100 names. We may also see a slight uptick in volatility as the new manager will be looking for companies that are earlier in the growth cycle than the previous manager. Ideally any increase in volatility will be offset by higher returns.

Given the recent change in manager, we would be reluctant to recommend this fund at the moment. We would like to see at least a few quarters with the new team to get a better sense of how the fund will be managed. Once we have seen this, we will be reexamining our rating on the fund.

CI Global Health Sciences Fund - As we pointed out in our last review in March 2012, volatility had been increasing in the fund which had been causing us some concern. While five months may not be a long enough period on which to judge, we have noticed that volatility appears to have stabilized, providing us with some level of comfort and reinforcing our view on the fund.

We haven't witnessed any major changes to the fund. The manager appears to be doing what he has done since taking over the fund, which has been quite successful, particularly on a long term risk adjusted basis.

Looking at healthcare as a component of a well diversified portfolio, there are a number of factors which support its inclusion. The first is that healthcare is a necessity. As a result, it tends to be a great defensive holding and tends to do better in periods of elevated volatility. It is our belief that there is a significant amount of headline risk in the global economy at the moment which could result in a sharp uptick in overall market volatility in the next three months or so. Should this play out, healthcare is likely to hold up well, helping to dampen overall volatility within the portfolio.

Second is the continuing development of the emerging economies which are bringing healthcare to a much wider market. As this continues, demand for healthcare worldwide will continue to grow, increasing revenues and earnings for companies operating in the sector. Third, in North America, people are are living longer and spending more more money on not only life saving, but life enhancing drugs and services. Combined, these factors paint a compelling picture for the outlook for healthcare over the medium to long term.

But, there are risks. Perhaps the biggest is that if the Republicans win the upcoming November election, they will look into reopening the "Obamacare" healthcare plan. If this happens, it is highly likely that we will see a great deal of uncertainty resulting in higher volatility in the sector. How this plays out is still to be determined. Regardless, it won't be resolved until at least the election, possibly much later.

Within the fund specifically, the manager conducts a top down analysis that helps form a macro view that is used to position the portfolio. This type of investment process can be a double edged sword. For example, if the manager is correct in his forecasts and assumptions about the market, it is likely that the fund will miss much of the volatility because it will be well positioned for such an outcome. A common issue to those who use such a strategy however, is that while the macro picture shows the broader trends, the markets can sometimes be slow to acknowledge them. That is what happened to this fund in 2007 and 2008, where it entered a few names too early and paid for it dearly with a 16% drop in 2007 and a 20% drop in 2008. However, in 2009, investors were rewarded with a 28% gain that outpaced the entire healthcare category. Since then, except for a bump in the road in the second half of 2011, the fund has done well on an absolute, risk adjusted and relative basis.

Longer term, we still believe in both the macro outlook for healthcare, and the longer term prospects for this fund. We believe in the manager, their style, process and approach. We also acknowledge that if we see a repeat of 2007-2008, this fund has the potential to be hit harder than some others in the category.

For those who are concerned about a repeat of 2008, but still want to include some healthcare in their portfolio, we would encourage you to take a look at **TD Health Sciences Fund**. However, if you have a longer term outlook and are not worried about short term volatility, CI Global Health Sciences remains our favourite in the category.

Blackcreek Global Leaders Fund - Managed by Bill Kanko and Richard Jenkins, this fund was known as the Castlerock Global Leaders Fund until July 2012.

The fund has a go anywhere mandate and can invest in companies of any size. The portfolio is very concentrated, typically holding between 20 and 25 names, with the top ten making up more than half of the fund.

They are looking for high quality and unique companies, and are often invested in companies that aren't exactly household names. For example, some of the current holdings include former tech darling Oracle Corporation, Carnival Corp. the cruise ship company, and healthcare firm BioMerieux Inc.

The process is bottom up which means that sector weightings and country allocations are the result of security selection. The focus on companies that have the potential to grow by taking market share, introducing new products or expanding into new markets. They pay particular attention to valuation and try to not overpay for this growth

As of July 31 the fund was fully invested, holding 40% in U.S. equities with the balance invested abroad. It is heavily weighted towards industrials and consumer stocks.

Performance has been strong since they took over the fund in 2006, outperforming its peer group and the index. The exception to that was 2011, when it underperformed, posting a 15% loss while the MSCI World Index was down only 2.9% in Canadian dollar terms.

For long term investors with medium to high risk tolerances, we believe that this is a good core holding. Both of the managers have their own money invested in the funds, which will help to align their interests with those of investors. We are also believers in the investment process that they use. The downside is that with the concentrated portfolio, it has the potential to be volatile, and only investors who can stomach the volatility should consider investing in it.

Fidelity Canadian Balanced Fund - The fund is headed up by Mariana Egan and Geoffrey Stein and is run much like a fund of funds. The two lead managers are responsible for the asset mix, while teams of specialists take care of the security selection for the underlying asset classes. The target asset mix for the fund is set at 50% equities, 40% investment grade bonds and 10% high yield bonds.

As of July 31, it held 40% Canadian equity, 6% global equities, 37% Canadian bonds, 11% in high yield and 6% in cash. The equity focus of the fund is on high quality, well managed companies that are trading below their intrinsic value. While they are primarily invested in Canadian equities, they may opportunistically add some U.S. and global exposure when appropriate. Stocks are selected using a mix of top down and bottom up analysis. Large caps make up the majority of the equity component, with the top holdings being represented by familiar names like TD Bank, Royal Bank and Suncor Energy.

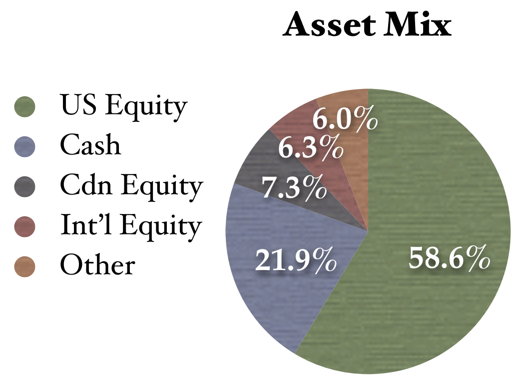
Within the fixed income portion, the managers use a duration neutral approach that looks to add value while controlling overall volatility. They use a number of yield enhancing strategies designed around security selection and sector allocation. Individual bonds are selected using a quantitative and fundamental bottom up process. Corporate bonds make up about 40% of the bond sleeve, while governments represent nearly 50%. This government weighting is up to protect the fund against potential economic "tail risks" such as the European debt crisis.

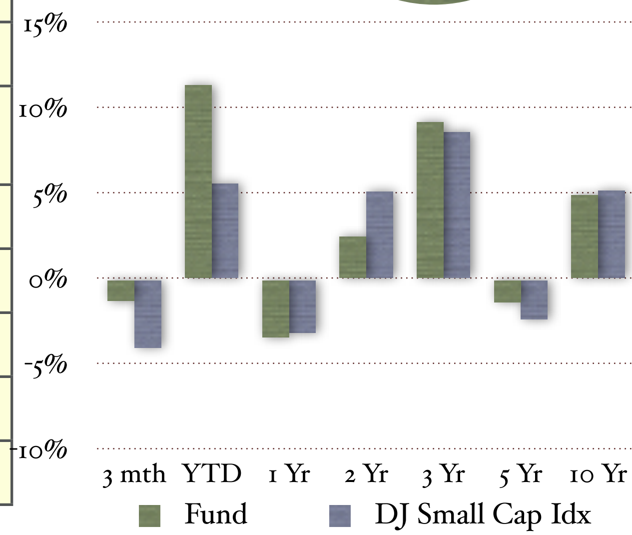
The fund may be at a bit of a disadvantage to a more actively managed balanced fund because of its static asset mix. This limits the managers' ability to protect against rising rates. For the time being, with rates expected to remain on hold, we expect that this fund will continue to do what it has done for the past ten years – deliver relatively stable returns for investors. However, as the threat of a rate hike begins to loom larger, some caution may be warranted.

Is there a fund you would like us to review?? Please send any requests for fund reviews to feedback@paterson-associates.ca.

Chou Associates Fund

Fund Company	Chou Associates Management
Fund Type	Global Equity
Rating	$$$
Style	Value
Risk Level	High
Load Status	Front End
RRSP/RRIF Suitability	Fair
TFSA Suitability	Fair
Manager	Francis Chou since October 1996
MER	1.84%
Fund Code	CHO 100 - Front End Units
Minimum Investment	$5,000





ANALYSIS:

The Chou Associates Fund one that is definitely hard to classify. If we look strictly at its holdings, it would be a global small cap fund. The reality is that manager Francis Chou runs it as a global equity fund with a go anywhere mandate and the ability to invest in companies of any size.

His management style is a high conviction, deep value approach that produces a portfolio with 25 to 35 names. He follows a fundamentally driven, bottom up approach that focuses on balance sheet strength, cash flows, management and future growth potential. Valuation is critical; Mr. Chou won't even consider adding a position unless it is trading at a discount of at least 40% to his estimate of its intrinsic value.

He sticks to his beliefs and is not afraid to hold significant cash balances if no suitable investment opportunities are available or he feels that volatility is too high. He is not afraid to take big bets on stocks he feels are cheap. For example, in March, he held 10.4% in Sears, 8.5% in Level 3 Communications and 8.4% in Berkshire Hathaway. The top 10 holdings made up more than 60% of the fund. When evaluating a stock, he takes a long term view, putting less emphasis on shorter term market factors. As a result, portfolio turnover tends to be low. For the most recent five year period, turnover has been less than 20%.

Given this approach, the fund has the potential to be very volatile. It can also tend to zig when other funds zag. Over the long term, we believe that it has the potential to deliver decent returns.

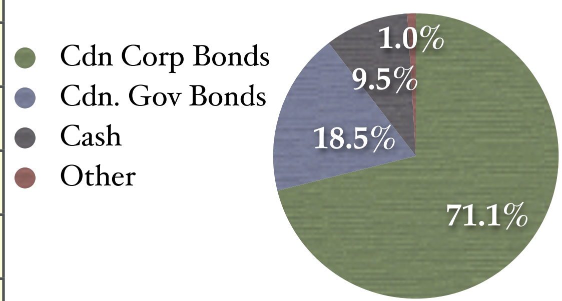
There are risks with this fund. Along with the volatility, nearly one quarter of the fund is held by Fairfax Financial. If they were to redeem their holdings, the manager would have to raise cash, which could have a negative impact on the fund. Further, this is largely a one man show. If anything were to happy to Francis Chou, the funds would be negatively affected until a suitable replacement were found.

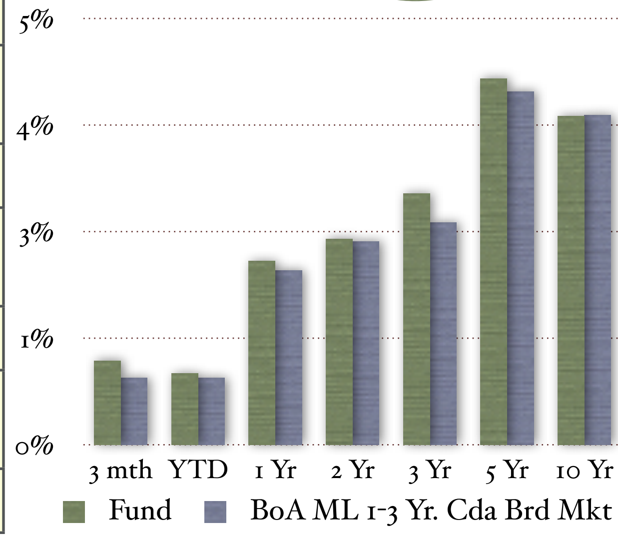
We like this fund but would be reluctant to recommend it as a core holding. In our opinion, it is best used as a component in a well diversified portfolio. Our rationale is based on two factors. First is the key person risk. Second is the deep value style that is employed. While we believe that investors will be rewarded over the long term, there is a good chance of high volatility in the short term. As long as investors are aware of these risks, we feel it can play a part in an investor's portfolio.

TD Short Term Bond Fund

Fund Company	TD Mutual Funds
Fund Type	Cdn Short Term Fixed Income
Rating	$$$$
Style	Short Term
Risk Level	Low
Load Status	No Load / Optional
RRSP/RRIF Suitability	Excellent
TFSA Suitability	Excellent
Manager	David McCulla since June 2003 Olga Bylaard since January 2009
MER	1.11%
Fund Code	TDB 967 - No Load Units TDB 814 - Front End Units
Minimum Investment	$500

Asset Mix





ANALYSIS:

With the current low interest rate environment, short term bond funds have become a great alternative to money market funds and GICs. Investing in diversified portfolio of bonds that mature in less than five years, these funds offer modest returns with very low risk. One of our favourites in the category is the TD Short Term Bond Fund.

Managed by David McCulla and Olga Bylaard, it is conservatively positioned with a duration of 2.6 years, which is lower than the benchmark. Duration is a measure of interest rate sensitivity, giving an estimate of how much the fund will move when there are changes in interest rates. In this case, if rates were to rise by 1%, it is expected that this fund would drop by 2.6%. In comparison, a traditional bond fund would be expected to fall by approximately 7%.

The portfolio is very high quality, with all the holdings being investment grade. To help boost the yield, the fund is heavily weighted toward corporate bonds. As of July 31, more than 64% of the fund was in corporates. Costs are reasonable, with an MER of 1.11%, which is in the lower half of the category.

Performance has been modest at best, with a five year return of 4.3% and a two year return of 2.4%. Despite the disappointing absolute numbers, it is still in the upper half of the category. Given the interest rate forecast, we don't expect much improvement in the medium term.

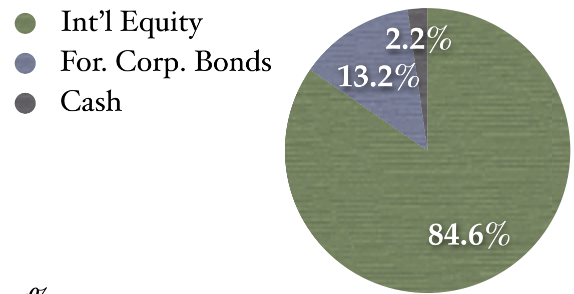
What the fund lacks in upside, it more than compensates with downside protection. In the past ten years, there have only been 2 times where it lost money in a 12 month period. The worst peak to trough drop was 1.42%.

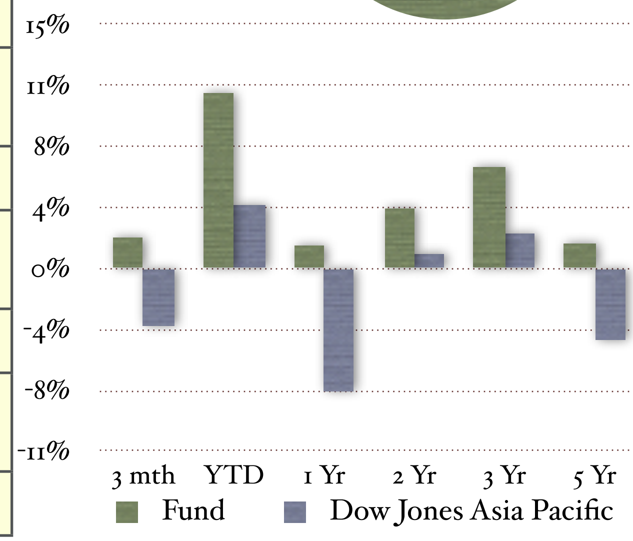
For investors, we see this fund having two potential roles in a portfolio. First it can be a great short term parking spot for cash. While there is a chance it may post a loss, the magnitude is not expected to be substantial and should recover quite quickly. The second would be as part of your fixed income portion of your portfolio as a way to shorten the overall duration. By shortening the duration, you lower the potential losses that you might experience when rates move higher.

BMO Guardian Asian Growth & Income

Fund Company	BMO Investments
Fund Type	Asia Pacific Equity
Rating	$$$$
Style	GARP
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
TFSA Suitability	Good
Manager	Robert Horricks since Aug. 2009 Jesper Madsen since March 2011
MER	2.87%
Fund Code	GGF 620 - Front End Units GGF 120 - DSC Units
Minimum Investment	$500

Asset Mix





ANALYSIS:

Until recently, China had been posting double-digit growth, resulting in increasing demand for commodities and helping boost productivity in the developed world. In recent months however, Asia has been experiencing a slowdown, which has hurt not only the region, but also dragged the broader markets, highlighting the risks of investing in the area.

Despite this slowdown, there are a number of compelling reasons to invest in Asia for the long term, namely the growth opportunities. As with any emerging growth story, there are risks and the potential for high volatility. This fund is a great way for investors to access this growth story without taking on excessive volatility risk. While technically classified as an Asia Pacific Equity Fund, it is more of a balanced fund. As of July 31, it held 85% stocks, 13% bonds and 2% in cash.

In building the portfolio, the managers use a fundamentally driven, bottom up GARP process that considers the current fundamentals as well as the long-term growth prospects for a company. They focus on dividend paying shares and U.S. dollar denominated convertible bonds. Dividends are a key element to managing overall portfolio volatility. They believe that if a company is growing dividends, it is highly likely that the company itself is growing. The fund has a dividend yield of 3.8%.

Performance has been strong, outpacing both the index and the peer group by a significant margin. Perhaps even more impressive is that this has been accomplished with a level of volatility that is significantly lower than the category average.

We were concerned last year, when long time manager Andrew Foster left the firm. However, since his departure, the fund has not missed a beat. Performance continues to tick along nicely and we have not noticed any meaningful increase in portfolio volatility.

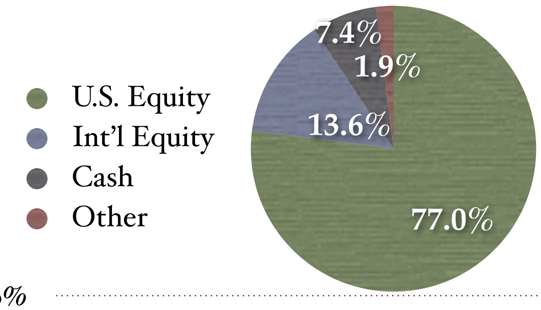
The cost of the fund is a touch on the high side, with an MER of 2.87%, which is in the upper half of the category. The fund also pays a quarterly distribution that varies from quarter to quarter.

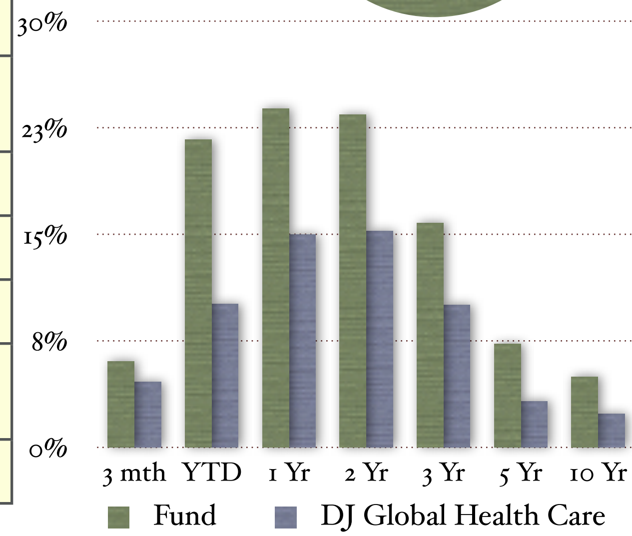
This is definitely not to be considered a core holding. Instead, it should be regarded as a fund that can add some incremental return to the portfolio over the long term, and help to reduce overall portfolio volatility.

TD Health Sciences Fund

Fund Company	TD Mutual Funds
Fund Type	Healthcare Equity
Rating	$$$
Style	Growth
Risk Level	Medium High
Load Status	No Load / Optional
RRSP/RRIF Suitability	Good
TFSA Suitability	Good
Manager	Kris Jenner since January 2000
MER	2.82%
Fund Code	TDB 976 - No Load Units TDB 320 - Front End Units
Minimum Investment	$500

Asset Mix





ANALYSIS:

Along with the growth opportunities created from the rapid development of the emerging markets and the research and development on life saving drugs, there has also been unprecedented dollars spent on life enhancing drugs, as the baby boomers spend countless dollars to try to reclaim their youth. Further, as more people gain access to health care coverage the demand for drugs and treatments will inevitably increase. The combination of these factors provides solid growth prospects, and good downside protection in volatile markets.

One of our favourite funds in the sector is the TD Health Sciences Fund. It invests in companies that are involved in the research, development, production, or distribution of products or services related to health care, medicine, or the life sciences. To qualify for selection, companies must derive at least 50% of their assets, revenues, or operating profits from those activities. The manager tends to focus in the U.S. where nearly 81% of the fund is invested.

Volatility is in line with the category average, which is impressive given its focus on mid cap names. Performance has been strong on an absolute and relative basis, posting first quartile performance in all time periods, and handily outpacing the Dow Jones Global Health Care Index.

Health care has historically been a good defensive sector in periods of market volatility. For example while the MSCI World Index plummeted by more than 35% between June 2008 and February 2009, the fund was down by 10.5%.

Another reason we like this fund is that is has exhibited a relatively low level of correlation to the traditional asset classes. As of July 31, the correlation between the fund and the S&P/TSX Composite was 0.22. This will allow it to provide some reasonably compelling diversification benefits when included in a well-diversified portfolio. The biggest drawback to this fund is its cost, with an MER of 2.82%. That said, to date, it has more than justified this cost when considering the risk reward profile and historic return.