
Top Funds Report

Fed Fears Continue to Spook Markets

Investors sell bonds, equities and commodities in anticipation of the end of QEIII

June proved to be a rough month on the markets as traders continued to digest comments from the U.S. Federal Reserve Chairman Ben Bernanke about the eventual end to the \$85 billion bond buying program. Many took these comments to mean that the Fed would be ending the program much sooner than many had anticipated, and sold off stocks, bonds and commodities with abandon.

Interest sensitive investments were hit the hardest. The DEX Bond Universe was down more than 2%, as the yield on the benchmark ten year Government of Canada Bond closed the month at 2.44%, up from 2.06% at the end of May. This is a jump of nearly 80 basis points from the May 2 close of 1.67%.

By far, the worst performing segment of the fixed income market in June were inflation protected bonds, which plummeted by nearly 7%, and are down nearly 11% so far this year. The reason for this tumultuous drop is twofold. First, real return bonds trading in Canada typically have a very long term to maturity. This is important because the longer the term to maturity, the more sensitive a bond will be to changes in interest rates. The second reason is if the Fed turns off the liquidity taps, it is likely that there will be less inflationary pressures in the economy, further reducing the demand for real return bonds.

These lowered inflation expectations were also one of the reasons that the gold sector continues its downward trajectory. Gold has long been considered a very strong hedge against inflation. This weighed heavily on the price of bullion, which sank another 15% in U.S. dollar terms in June. Gold equities didn't fare much better with the S&P/TSX Global Gold Index dropping by another 17%, bringing its year to date loss to nearly 44%.

Recent market events have not substantially altered my outlook. First, I believe that the markets overreacted to what was said and that we'll see yields pull back a bit. I don't expect them to get down to the ranges we saw in the spring, but do expect them to fall some. I also believe that volatility in the bond markets is likely here for the near to medium term.

To help protect against this, I would suggest that you shorten the duration of your fixed income holdings and move into corporate bonds. The higher yields offered by corporates should provide better downside protection. Those with higher risk appetites may want to consider adding some exposure to high yield, and floating rate notes. I would suggest that you approach these with caution since they can be considerably more volatile than traditional fixed income.

I continue to favour equities, with the U.S. being my preferred country. Economic activity is improving and valuations are still reasonable. The Eurozone is still mired in a massive recession, but there are still some interesting investment opportunities there, if you can stand the potential volatility. If you are looking to dip your toes in the region, I'd suggest you go with a high quality, actively managed global equity fund. Asia, particularly China is expected to remain very volatile, as evidence continues to mount that the slowdown may be a lot worse than initially thought. This will continue to put pressure on the emerging markets.

I expect that the markets will continue to be a challenging place for the next little while. It is the type of environment where I expect that high quality, actively managed funds will outperform the indices, at least on a risk adjusted basis.

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

Funds You Asked For

This month, we highlight a few of my favourites from PH&N, and reviews of Chou, Invesco and HSBC

PH&N Bond Fund (PHN 110)

This has long been one of my favourite bond funds, and looking at its track record, it's not hard to see why. It has consistently posted returns on both an absolute and risk adjusted basis that are near the top of the Canadian fixed income category.

These results are due to the disciplined process that the PH&N Fixed Income Team uses in managing the fund. When setting the fund's allocation, the use such strategies as duration and yield curve management, investing in corporate bonds, and taking advantage of trading opportunities as they arise.

Currently, it holds 46% in government bonds, with about two-thirds of that in provincial bonds. Provincials offer higher yields, which should provide a touch more downside protection in a volatile market. 42% is invested in corporate bonds with the balance in cash. Credit quality is very high, with all the holdings rated as investment grade. The duration and yield are in line with that of the DEX.

While I still like the fund, I believe that going forward the **PH&N Total Return Bond Fund** will be a better choice. Unlike this offering, it can invest in high yield, mortgages and some derivative strategies which should help as rates move higher.

If you can, invest in the Series D units because of its rock bottom 0.61% MER. If you have to buy one of the higher cost series, it becomes a less attractive option.

PH&N Total Return Bond Fund (PHN 340)

Despite the recent bump in yields, I still believe that fixed income should form a cornerstone in most investment portfolios, and the PH&N Total Return Bond Fund, particularly the Series D version remains one of my favourites.

What I like about this fund is that it is managed by one of the best fixed income teams on the street who have

continued to put up strong risk adjusted numbers year after year. It is managed in a very similar fashion to the **PH&N Bond Fund**, but can use a number of nontraditional strategies including high yield bonds, mortgages and derivatives to help protect downside and add incremental return. Because of this, it has outpaced the PH&N Bond Fund of late and I expect that trend to continue into the future. There are a couple of reasons for this. First, the managers have a number of different strategies in their toolbox that will give them more flexibility to add yield and protect capital. Second, it has a smaller asset base, which should allow them to be more nimble in managing the fund.

As of June 30, it holds more than half of the portfolio in corporate bonds, 30% in provincial bonds, 14% in government bonds, with the balance in cash and mortgages. It offers a yield to maturity of 3.1%, which is slightly above the DEX, and a duration of 6.6 years, which is neutral to it. Credit quality is very high, with only 3% invested in bonds that are rated BB or lower.

I believe that this can be a great core fixed income holding for most investors. The Series D units are considerably more attractive than the advisor sold units which carry an MER that is nearly double the 0.60% MER of the D-units. If you can't buy them, you may be better off looking at an alternative such as the **Dynamic Advantage Bond Fund**, which while more expensive, offers better downside protection than the more expensive advisor sold units.

PH&N Dividend Income Fund (PHN 150)

Since Warner Sulz took over the management duties of this fund in 2010, it has become a fairly competitive offering in the Canadian dividend category. As the name suggests, it invests primarily in big, dividend paying Canadian companies.

Mr. Sulz follows the PH&N philosophy of "quality growth" that looks for strong, well managed

companies that offer an attractive dividend yield. They must be highly profitable, financially sound, and have a history of strong earnings and dividend growth. It also must be trading at a valuation level that they believe is reasonable. Dividends must be sustainable and have the potential to grow.

With a focus on yield, it is not surprising to see it heavily concentrated in financials and energy, which combined, make up more than two-thirds of the fund. The top ten is littered with many of the usual suspects including the big banks, Enbridge, and Suncor. It holds between 60 and 70 names, and portfolio turnover is modest, in the 20% per year range.

Performance has been decent, with a one year gain of 11.8% at June 30, handily outpacing the S&P/TSX Composite's more modest 7.9% gain. Volatility has been higher than the category average for the past five years, but most of that can be attributed to the fund's nearly 33% drop in 2008. Since the manager change, volatility has been roughly in line with the peer group.

The cost, especially for the Series D units is quite favourable, boasting an MER of 1.18%. The advisor sold units are more costly, coming in at 2.05%, which is just below the category average.

While performance has improved of late, I would still be reluctant to recommend it. I believe that there are more compelling dividend fund options available including the **Beutel Goodman Canadian Dividend Fund**, or the **CI Signature Dividend Fund**, both of which have outperformed, and done so with less volatility.

PH&N Overseas Equity Fund (PHN 410)

PH&N is one of those shops where the vast majority of their funds tend to be high quality investments, offering decent returns and reasonable volatility at a fair price. Unfortunately this fund an exception to that.

It invests in a diversified portfolio of companies located outside of North America. They follow a value focused approach that looks to find companies that offer good value at their current prices. Typical companies are industry leaders with strong management teams that have delivered high levels of profitability and earnings growth.

It is built on a stock by stock basis and currently holds 66 names with the top ten making up slightly more than a third of the fund. Their investment process is quite active, with portfolio turnover averaging more than 80% per year over the past five years.

The current positioning is fairly defensive, with exposure to pharmaceuticals and telecom, which helps offset an overweight position in the energy sector. Despite this, performance has largely disappointed. For the three years ending June 30, it has gained an average of 3.4% per year, dramatically underperforming the MSCI EAFE Index and its peer group. At the same time, volatility has been higher than the index.

The costs are reasonable with an MER of 1.39%. But when you factor in the disappointing performance, the cost is largely irrelevant. There are much better international funds available, including offerings from Mawer, National Bank and Renaissance.

Chou Bond Fund (CHO 400)

The Chou Bond Fund, like the other funds offered by the firm, is rather hard to classify. This is nothing like a traditional bond fund, and is managed using Francis Chou's deep value philosophy. Despite being a bond fund, it is considered a Global Fixed Income Balanced Fund because nearly 20% is invested in one U.S. equity holding. That holding, Resolute Forest Products, was the result of a debt restructuring of AbitibiBowater, where shares were issued for its debt.

Notwithstanding that exposure, it invests in Canadian and U.S. bonds, including high yield and convertible bonds. As of March 31, it held 50% in foreign corporate bond, 15% in Canadian corporate bonds, and 15% in cash. Of the names in the portfolio, there aren't any what I would call "household" names. It includes MannKind Corporation, Atlanticus Holdings Corporation, and RH Donnelly Inc.

Like other Chou Funds, the portfolio is very concentrated, with just 15 positions, not including the cash. This level of concentration, combined with the small cap focus of the holdings has provided one heck of a bumpy ride for investors. The fund's standard deviation is more than five times that of a traditional bond investment.

Granted, returns have also been higher, gaining 5.65% in the past three months while the Canadian bond market was down 2.5%. In the past year, it has gained more than 30%, outpacing every other fixed income fund in Canada by a wide margin.

Costs are fair, with an MER of 1.45% which is lower than a many high yield and global bond funds.

This is not a typical bond fund, and should not in any way, shape or form be considered to be one. It is an extremely high yield bond fund, and in my opinion, has a risk profile that is higher than many equity funds. If you have a very high, nearly speculative appetite for risk and you are looking for a bond fund that is much different, then this might just be the ticket. If you are looking for anything close to a traditional bond fund, you will want to keep looking.

Trimark Fund (AIM 1513)

The Trimark Fund has been a staple on my Recommended List for a number of years. The management team of Michael Hatcher, Darren McKiernan and Jeff Feng run a concentrated portfolio of high quality, well managed businesses that have sustainable competitive advantages and the ability to generate strong levels of free cash flow.

It will generally hold around 40 names with the top ten making up about a third of the fund. Individual position sizes will typically be equally weighted, because they don't believe that they can consistently pick the best performing stocks over short periods of time.

Because the fund is built on a bottom up basis, it has a sector mix that is much different from its benchmark. Currently, they are overweight in consumer focused names and technology, while are underweight in real estate, communications and utilities. They tend to take at least a three to five year outlook when evaluating an investment, which is reflected in their relatively modest levels of portfolio turnover. They will sell a company for a few reasons including a change in their investment thesis, they believe the stock has become fully valued, or they find a better idea.

Like their sector exposure, the cash weighting is a byproduct of their stock selection process. If they cannot find any suitable investments, cash will rise.

Currently, it is sitting at around 8%. While this will help protect the value of the fund in periods of market volatility, it will drag performance in a market rally. They tend to be more active in volatile periods, stepping in and picking up quality companies at lower prices.

While this has been on my Recommended List for what seems like forever, it is mainly for the SC units. The reason is cost, with the "SC" units carrying a reasonable MER of 1.73% compared with 2.87% for the A units. If you can buy the "SC" units and have a long term time horizon, I believe that this can be a great core equity holding. If you must buy the higher cost Series A units, I believe that there are better global equity offerings available.

HSBC Equity Fund (HKB 497)

This large cap focused fund has a portfolio that looks very much like the S&P/TSX Composite, except for a slight underweight in materials and a modest overweight position in financials. The top ten is filled with many household names including the big banks, Suncor Energy and Canadian National Railway. The investment approach has been fairly patient, with portfolio turnover averaging 20% or so for the past five years.

Performance has been unimpressive. As of May 31, the fund generated an annualized loss of 1.2% for the past five years, while the benchmark was down 0.1% during the same period. Year to date, the fund has outperformed due to its modest underweight in commodity focused sectors, and slight overweight in financials and consumer focused sectors.

Looking at its current positioning, I don't expect performance to stray too far from the index. If you want truly active management, I don't believe that you will get that with this fund.

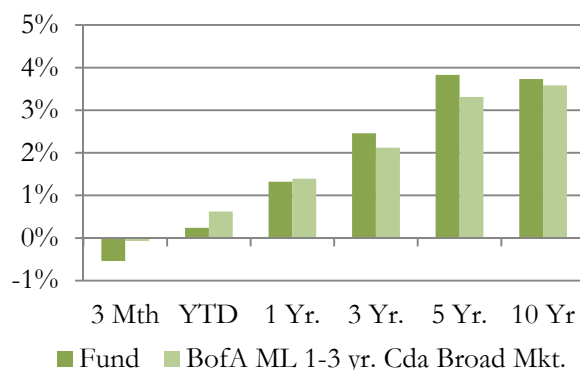
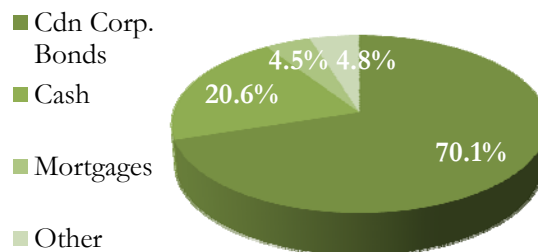
If you are only looking for market exposure, you can access it much cheaper through an ETF or a lower cost index fund. If you want an actively managed fund, there are much better options available.

If there is a fund that you would like reviewed, please email it to us at feedback@paterson-associates.ca.

PH&N Short Term Bond & Mortgage Fund

Fund Company	Phillips, Hager & North
Fund Type	Cdn Short Term Fixed Income
Rating	Not Rated
Style	Duration Management
Risk Level	Low
Load Status	No Load / Optional
RRSP/RRIF Suitability	Excellent
Manager	PH&N Fixed Income Team
MER	0.61% - No Load Units 1.15% - Low Load Units
Fund Code	PHN 250 – No Load Units PHN 6250 – Front End Units
Minimum Investment	\$5,000

Asset Mix



ANALYSIS: With the recent bump up in yields, many may now be looking for ways to shorten the duration of your fixed income holdings. For those looking to do that, this fund my top pick, particularly if you can buy the Series D units, which carry a 0.61% management fee. If you have to pay the full freight of the Advisor Series units, it's not as attractive an option as the 1.15% MER eats into the returns.

It is a well managed portfolio that invests in a mix of short term bonds and up to 40% in NHA insured mortgages. As of June 30, it holds 16% in mortgages, 53% in corporate bonds, with the balance in government bonds. The focus of the fund is on bonds with maturities of less than five years. The current average term to maturity is 2.7 years. The fund's credit quality is very high.

While the short term nature of the fund implies that it is a good parking place, it can still experience losses, as we have seen in the past couple of months. In June, it lost 0.6%, and was down 0.4% in May as bond

yields shot higher on worries spurred by comments by U.S. Federal Reserve Chairman that the massive bond buying program may come to an end sooner than later.

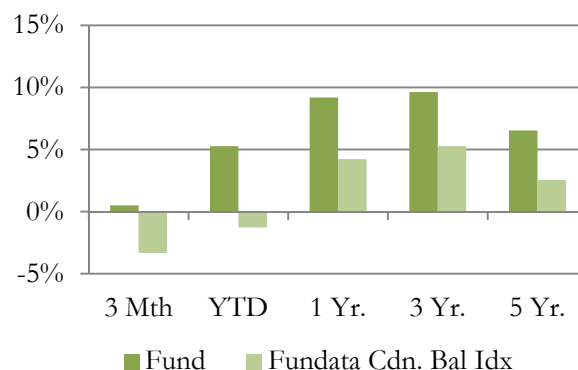
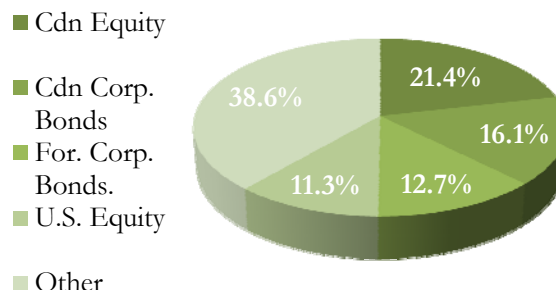
Despite the losses, it held up much better than longer dated fixed income investments. The DEX Bond Universe was down more than 2% in June and nearly 1.5% in May. While the losses with this fund are unfortunate, it did exactly what it was supposed to do in a rising rate environment, and that is provide better downside protection than traditional bonds.

Looking ahead, I expect that the recent volatility that we've witnessed in the bond markets will stick around for a while. Short term bonds, while not immune to losses can play a key role in helping protect your assets by providing better downside protection than more traditional fixed income investments. The Series D units of this fund remain my top pick for short term bond exposure. The Advisor Series units are still a good bet, but not nearly as compelling an option.

Fidelity Monthly Income Fund

Fund Company	Fidelity Investments Canada
Fund Type	Canadian Neutral Balanced
Rating	A
Style	Value
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Excellent
Manager	Geoff Stein since April 2011 Derek Young since Sept. 2011
MER	2.09%
Fund Code	FID 269 – Front End Units FID 569 – DSC Units
Minimum Investment	\$500

Asset Mix



ANALYSIS: This high quality balanced fund has not missed a beat since managers Geoff Stein and Derek Young took the reins in 2011. The team runs the fund much like a fund of funds, where it invests in a number of underlying funds run by various asset class teams at Fidelity based on their outlook.

It invests mainly in a mix of Canadian high yielding equity and fixed income securities, but will also have exposure to global equities with some high yield and emerging market debt.

Looking at the portfolio's makeup, it is defensively positioned. The fixed income exposure is overweight in corporate bonds, with 11% in high yield. In the equity sleeve, they like companies that have stable, defensive and less economically sensitive businesses. They are overweight in consumer defensive and technology sectors, and are underweight financials and resources. They are avoiding banks on worries over consumer debt loads, while resources are a concern based on continued

pressure on the price of commodities. This positioning should help keep volatility in check.

Performance has been very strong, finishing in the top quartile every year since its launch except for 2008 when it was in the third, and 2004 when it was in the second. Even with the manager change, performance has been strong, posting an impressive 9.2% one year gain to June 30, leaving the benchmark in the dust.

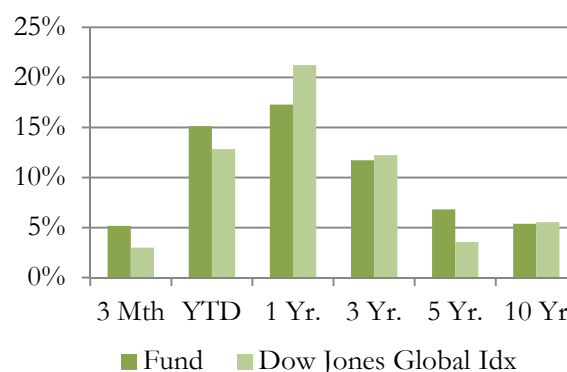
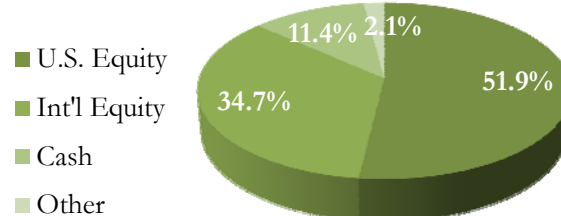
As the name suggests, it pays a regular distribution that in the past year has ranged between \$0.0097 and \$0.0244. At current prices, it is yielding approximately 1.4%. It is also available in a T-Series that will pay annualized 5% and 8% distributions if you are looking for that cash flow.

With its balanced asset mix, I wouldn't be counting on this to deliver double digit returns into the future. But if you are looking for a high quality balanced fund that should continue to outpace its rivals, this is definitely a fund to consider.

Mackenzie Ivy Foreign Equity Fund

Fund Company	Mackenzie Financial Corp.
Fund Type	Global Equity
Rating	B
Style	Blend
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Excellent
Manager	Paul Musson since January 2001 Matt Moody since January 2009
MER	2.60%
Fund Code	MFC 081 – Front End Units MFC 611 – DSC Units
Minimum Investment	\$500

Asset Mix



ANALYSIS: The main reason that we like this fund is that it holds up well in volatile markets. Management has definitely been earning their keep of late, with the fund gaining 15.1% in the first half of 2013. With volatility expected to remain high for the next little while, this fund will continue to be at the top of our list for global equity picks.

It is a concentrated portfolio of high quality companies from around the world with strong balance sheets and excellent management teams that are trading at a reasonable valuation. They are very patient in their approach as evidenced by their low levels of portfolio turnover. For the most recent five year period, it has averaged less than 20% per year.

With its emphasis on capital preservation, it is not surprising to see the fund very defensively positioned. As of April 30, it was very heavily overweight in consumer staples and consumer discretionary, which combined make up more than half of the fund. Currency is not hedged, which will

hurt the fund when the Canadian dollar is appreciating, but will boost performance when the Canadian dollar is declining.

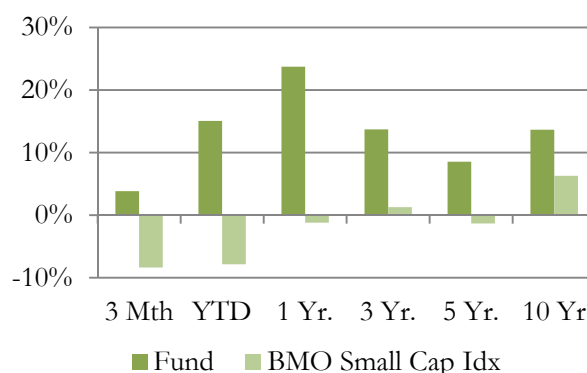
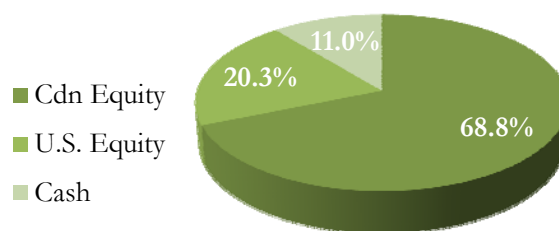
Performance, particularly on a risk adjusted basis has been strong. For the five years ending June 30, the fund gain an average 6.8% per year while the index gained only 4.0%. Perhaps more impressive is that this return was generated with a level of volatility that was significantly lower than both the index and its peer group.

The biggest knock on this fund is that it will very likely underperform during a significant market run up. Given our expectation for continued volatility, this is a fund that will serve most investors well until things settle down. Within the context of a portfolio, it is our opinion that this fund is a great core global equity holding for most investors. Those with a higher risk tolerance may want to look at a more aggressive global fund for the better upside participation when markets do rally higher.

CI Can-Am Small Cap Corporate Class

Fund Company	CI Investments
Fund Type	Cdn Focused Small / Mid Cap
Rating	A
Style	Value
Risk Level	Medium High
Load Status	Optional
RRSP/RRIF Suitability	Excellent
Manager	Joe Jugovic since Dec. 2005 Leigh Pullen since Dec. 2005
MER	2.42%
Fund Code	CIG 6104 – Front End Units CIG 6154 – DSC Units
Minimum Investment	\$500

Asset Mix



ANALYSIS: The team follows a relatively simple philosophy – find quality businesses trading at attractive valuations. To do this, they look for companies with a demonstrated history of generating high returns on equity and have lower debt to equity and debt to cash flow ratios than the broader market. They also like companies that pay a dividend. The result is a concentrated portfolio holding 31 names, with the top 10 making up 45% of the fund.

The portfolio is underweight resources because they are highly volatile and many companies do not generate consistent strong returns on capital.

The portfolio looks much different from its benchmark which results in returns that are also quite different. In June, the BMO Small Cap Index was off by more than 4.6%, yet this fund was higher by 1.8%. For the past

twelve months, a similar pattern emerges with the fund gaining nearly 25% while the index fell by 1.2%.

As impressive as the returns have been, the level of volatility it has experienced is even more impressive. Over the past five years, it has shown a level of volatility that is significantly lower than its index, peer group, and even the S&P/TSX Composite Index.

Given the fairly conservative nature of the fund, I would expect that it will generate very strong risk adjusted returns going forward. However, it is very likely that in a rising market environment it will lag its peer group. Still, for those looking for conservative small and mid cap exposure, this is one of our favourites, especially since the capping of the Mawer managed BMO Enterprise Fund.