
Top Funds Report

Syria and tapering worry investors

Concern over possible military action and outlook for higher yields push equities lower.

Investor worries over when the U.S. Federal Reserve would begin tapering its bond buying program re-emerged in August, pushing yields higher. The yield on the benchmark ten year U.S. Treasury bond rose from 2.60% to 2.78%. In Canada, it was similar, with the yield jumping from 2.45% to 2.61% on the Government of Canada ten year bond.

This continued rise in yields caused losses in the bond market, with the DEX Universe Bond losing 0.60%. Not surprisingly, with their higher yields, corporate bonds outperformed government bonds, and short term bonds fared better than longer dated bonds. The DEX Short Term Bond Index was off by 0.07% and the DEX Long Term Bond Index fell by nearly 1.4%.

Political tensions rose as the global community discussed how to best punish Syria for the August 21 chemical weapon attack on its own citizens. Commodities, particularly oil and gold were higher. Oil gained more than 4% as worries over a new conflict in the Mideast worried investors. This also sparked a rally in gold, which gained more than 6% on safe haven buying.

With commodities on the rise, the S&P/TSX Composite Index gained 1.55% while global equities were mostly lower. The S&P 500 lost 2.9% in U.S. dollar terms and the MSCI EAFE Index was down by 1.3%. For Canadian investors, the returns were better, thanks to a drop in the value of the Canadian dollar. When we factor in the weakening currency, the S&P was only down 0.4% and the MSCI EAFE was actually higher by 1.2%.

As we enter into October, there are many reasons to be cautious. While the situation in Syria appears to be under control at the moment, it could fall off the rails at any time, creating even more uncertainty in the Mideast. Investors remain worried about the Fed

tapering and its impact on yields. Expectations are that an announcement will be made at the Fed's September policy meeting. Other sources of uncertainty include the upcoming debt ceiling negotiations, and the announcement of a new Fed Chairman.

Despite the potential for high volatility this autumn, I am keeping my investment outlook largely unchanged. Mid to long term, I favour equities over bonds because with a longer term bias towards higher interest rates, the return expectations for fixed income remain under pressure. Still, there is the potential for a short term rally in bonds, as some believe that yields may have jumped ahead of the fundamentals. Some level of pullback may be necessary, given the economic growth environment. Within fixed income, I continue to favour shorter durations over long, corporate bonds over governments, and where possible, high quality global bond exposure. These strategies should help to minimize the impact of rising rates.

Within equities, I favour the U.S., but am starting to warm up to global, large cap names in Europe. Canadian equities should remain volatile, and may be prone to a drop if we see a sustained pullback in gold or oil. There are also some concerns about the earnings outlook for banks, particularly if we see any sort of correction in the Canadian housing market.

In this environment, I favour actively managed funds over those that look like the index. This is true of both equity and fixed income funds. I firmly believe that if you stick with high quality funds, managed by strong managers with disciplined processes in place, you should be able to withstand the volatility better than with a more passive strategy.

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

Funds You Asked For

This month, I highlight a new offering from Sprott, Dynamic Strategic Gold and a fund from PIMCO.

Special Notice

Starting in September, I will be releasing my Top Funds Report on the 20th of each month. This change will take the guesswork out of when you will be receiving my detailed and timely analysis on mutual funds and ETFs.

PIMCO Monthly Income Fund (PIM 005)

When it comes to fixed income investing, PIMCO is easily the most recognizable company in the space, and is arguably one of the best. Still, they are relatively new in the Canadian mutual fund industry, launching a small fund family in early 2011.

This is one of their global bond offerings, and is probably their best. It is a very actively managed and invests in non-Canadian dollar denominated fixed income investments. It is managed using PIMCO's proven investment philosophy and process that uses a mix of top down and bottom up analysis to build the portfolio. The top down macro view is used to set the fund's duration, yield curve positioning and sector exposure, while the bottom up research looks to identify the most attractive non-Canadian securities that meet the its broader asset mix objectives.

They are extremely active in their approach with portfolio turnover of 580% in 2011 and 310% in 2012. To put that in perspective, they turned the portfolio over three times in 2012. Typically, portfolio levels of more than 100% are considered high.

Despite this, or perhaps because of this high level of portfolio turnover, the fund has come out of the gate quite strong, gaining 18% in 2011 and 24% in 2012. As impressive as these numbers are, there is no way that these returns are sustainable, particularly in an environment where the bias for interest rates is to the upside.

With interest rates on the rise, it is no surprise that the shorter term return numbers are considerably more modest. On a year to date basis, it has gained

3.4%, outperforming both its benchmark and peer group. For the three months ending July 31, it lost 1.9%. In absolute terms this performance is disappointing, but on a relative basis it is pretty strong, outpacing the Barclays U.S. Aggregate Index (CAD Hedged) by more than 1.1%.

Realizing that there was likely to be upward pressure on interest rates, they took some risk off the table earlier in the year. In the current environment, they are not focusing on interest rate strategies, but are instead looking to identify high quality, income generating assets that are likely to outperform in a rising rate environments.

To that end, the portfolio is fairly conservatively positioned holding 39% in government bonds, 35% in mortgages, 13% in high yield, and 8% in emerging market debt. The duration, which is a measure of its sensitivity to interest rates was 4.4 years, which was well below the duration of the benchmark of 5.5 years.

They have recently been focusing outside of the U.S., primarily Australia, where the pressure on yields is lower. They will continue to invest in countries that have what they believe to be strong balance sheets, specifically the U.S., Canada and Australia.

As you would expect with Monthly Income in the name of the fund, it provides regular cash flow to investors. It pays a monthly distribution that has ranged between \$0.04 and \$0.05 per unit. At current prices, that works out an annualized yield of approximately 2.5%.

I like this fund for a number of reasons. First, it has a very strong management team in place. PIMCO is one of the global leaders in the fixed income realm, and I see no reason that should not continue. Second, the managers are following a disciplined, repeatable process. Finally, the cost is very reasonable, with an MER of 1.39%.

While the fund has held up relatively well, the current macro environment is more risky than we

have seen for some time. Because of this, I expect that this fund, and other fixed income focused funds have the potential to experience higher levels of volatility in the near to medium term.

Still, this fund should continue to deliver better than average returns, but nowhere near the level of absolute returns it has posted since its launch. Realistically, returns in the low to mid-single digits are more reasonable. I also expect that we will see the level of volatility move higher.

On balance, this is a very strong global bond offering. When used in a portfolio, I believe it is best used as a compliment to a core of high quality Canadian bonds, rather than your entire fixed income exposure.

Dynamic Strategic Gold Class (DYN 2300)

To say that gold has been under a bit of pressure lately might be a bit of an understatement. With the global economic growth continuing to sputter and news that the U.S. Federal Reserve would be slowing the pace of its massive bond buying program sooner than many had expected, bullion plummeted nearly 35% from its recent high. In July and August however, bullion has rebounded, clawing back some of those losses.

The debate continues to rage on whether it is a good time to buy gold or if there is still room to fall. The gold bulls will point to its ability to act as a hedge against inflation. Considering the massive amount of liquidity that has been injected into the financial system in the past several years, they believe that it will inevitably push inflation higher. Bears on the other hand, will point out that the near term outlook is not overly encouraging with a strengthening U.S. dollar, and fears that some European central banks will sell gold holdings to raise money. Furthermore, some central banks have openly discussed ending their massive quantitative easing programs much earlier than originally thought. Any of these can help keep prices in check.

For those considering adding some gold to their portfolios, this is an interesting option to consider. Unlike a traditional precious metals fund, it can invest not only in gold companies, but also gold bullion directly. Historically, the correlation between the equities and bullion has been high, but in recent

years, we have seen somewhat of a decoupling. This fund allows you to access both.

The mix of equities over bullion is set by the manager based on their view of the economy and the markets. Ideally, their goal is to hold bullion in periods of high market volatility and overweight gold equities when they are undervalued relative to bullion. The asset mix can range between 30% and 70%. The current mix suggests they expect higher volatility, holding 58% in bullion, and 38% in gold companies. The theory is that this mix should provide better risk adjusted returns when compared to holding either pure bullion or a gold focused fund.

Absolute performance has been abysmal, losing 31% in the 12 months ending August 31. Still, that managed to outperform many of the precious metals funds, but lagged the pure bullion funds. Volatility has been much higher than the broader equity markets, but has been considerably less volatile than precious metals funds.

Cost is middle of the road, with an MER of 2.43%. CI has a similar fund offering, but it currently has more exposure to gold bullion, which will drag its performance should we see a bounce in gold companies.

This fund, and any other gold focused fund are best avoided by anybody who does not have a very high tolerance for risk. Those who do not should avoid this fund.

Fidelity True North Fund (FID 225)

Using a "growth at a reasonable price" approach, manager Max Lemieux is not afraid to make "big sector bets" when he believes that the opportunities for outsized returns exist. When he sees such opportunities, he can invest up to 20% in any given sector. Currently, both financials and energy are near this limit.

He is also very comfortable avoiding sectors that he feels are particularly unattractive. Currently, he has minimal exposure to the materials sector. The rationale for this is he believes that the outlook for many commodities is muted at best, given the overall level of global economic growth. He also believes that the situation in China is much worse than we are led to believe, which will put further pressure on

companies operating in the commodity focused sectors. Should this play out, it will likely result in an even more pronounced slowdown here at home. As a result, he is avoiding many consumer focused companies, and is instead looking at industrial focused exporters, which can benefit from the rebound in the U.S.

Like with other sectors, he can invest up to 20% in cash, and he is not afraid to do so. When he is unable to find attractive opportunities, cash will creep towards the limit. It is currently sitting around 10%.

While the portfolio may be concentrated on a sector basis, it is quite diversified, holding more than 80 names, with the top ten making up approximately 36% of the fund. Portfolio turnover has been modest, averaging 40% for the past five years.

Since 2009 when Mr. Lemieux took the reins of the fund, performance has been steadily improving. For the three years ending April 30, it posted an average annual return of 4.7%, handily outpacing both the index and most of the peer group. Volatility has been in line with the index.

Despite the recent improvement, I would be reluctant to recommend this fund. It is a decent offering, but I believe that there are better options available. Within the Fidelity family, I would suggest the **Fidelity Canadian Large Cap Fund**, which I believe offers a more favourable risk reward profile.

Sprott Enhanced Equity Class (SPR 430)

This relatively new offering from Sprott is interesting because unlike the firm's other offerings, it is not positioned for the imminent collapse of the global banking system. Instead, manager John Wilson works from the basic premise that investors can win over the long term simply by not losing.

Because of this, it takes on an absolute return focus where he uses option overlay strategies, tactical cash allocation and a well-defined investment process that involves both loss limits and a strict sell discipline. The portfolio is concentrated, holding 25 to 30 high quality companies. To be considered for inclusion, a company must have a history of generating free cash flow, provide a high degree of earnings

predictability, and be trading at a discount to its long term value.

To help preserve capital, an option strategy that involves protective put options to help protect against downside, call options to provide increased upside participation and covered call options to increase the income the fund generates. Typically, no more than 5% of the fund will be invested in these strategies.

He is not afraid to make big bets on cash, which will typically range between 0% and 40% of the fund. The more bearish his view, the more cash he holds. As of August 31, he held 45% in cash. He uses a strict sell discipline and will sell a stock if it makes a 30% to 40% profit. He is benchmark agnostic, meaning the portfolio will not look anything like its benchmark.

He is very defensively positioned. Along with his high cash weighting, he has no exposure to Canadian banks and minimal exposure to the highly volatile commodity sectors. It is Canadian focused, with about half the equity holdings being invested at home. The U.S. makes up the lion's share of the balance of the equities.

Since inception, performance has been decent, gaining 14% in the past year, outpacing the 9.3% rise of the S&P/TSX Composite. More impressive has been that the volatility has been significantly lower than the index.

The fund is too new to make a definitive call on, but early results are definitely promising. I expect that this is the type of fund that will provide long term returns that are in the middle to upper half of the category, but with much less volatility than its peers. It should hold up well in periods of extreme market volatility, but will likely lag when markets take off. Given the makeup of the portfolio, it will not behave like the market over the long term. This could be a nice compliment to a more index focused fund

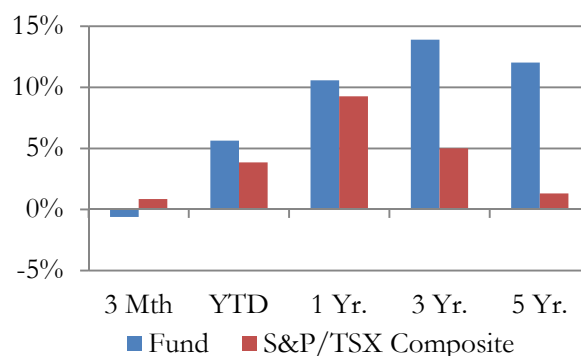
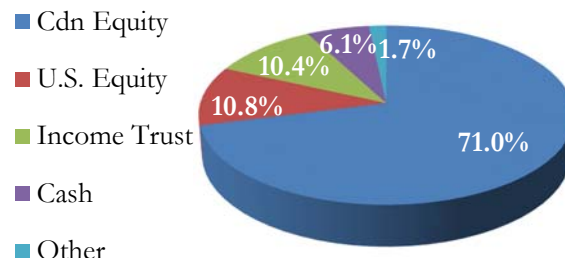
If there is a fund that you would like reviewed, please email it to me at

feedback@paterson-associates.ca.

RBC Canadian Equity Income Fund

Fund Company	RBC Global Asset Management
Fund Type	Cdn Dividend & Income Equity
Rating	A
Style	Blend
Risk Level	Medium High
Load Status	No Load / Optional
RRSP/RRIF Suitability	Excellent
Manager	Jennifer McClelland (Aug. 06) Brahm Spilfogel (January 2012)
MER	2.10%
Fund Code	RBF 591 – No Load Units RBF 762 – Front
Minimum Investment	\$500

Asset Mix



ANALYSIS: It's not hard to see why people like this fund. It has consistently delivered above average returns with below average risk. However, in recent months it has failed to keep pace, and has found itself in somewhat unfamiliar territory with below average returns. When this happens to any fund, the question becomes is this a permanent or temporary issue.

When I look at this recent underperformance I see a couple of reasons why it happened. First, the fund is very underweight in materials, which have been a big driver of the benchmark returns over the past couple months. With its income focused mandate, I would be more concerned if there was a big weight in the sector.

Another reason it has lagged has been its overweight exposure to REITs. REITs have been hit very hard in the past few months, as bond yields have moved higher. An underweight to the outperforming insurance sector has also been a drag on relative performance.

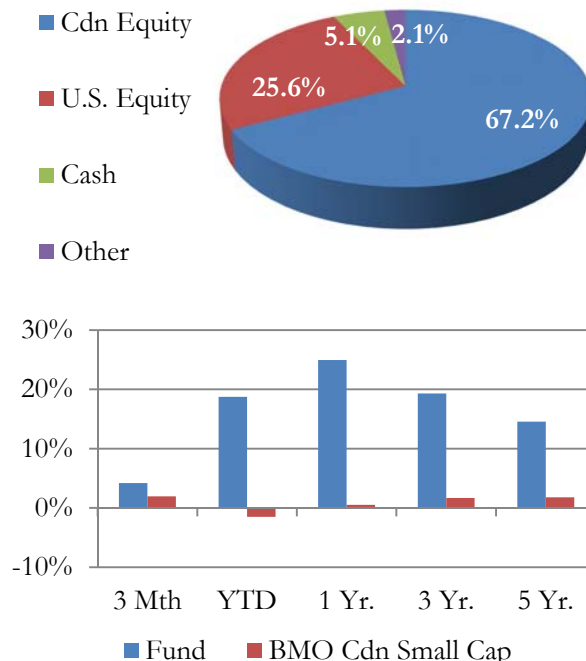
While the shorter term performance has been disappointing, I don't see any reason for concern. I reiterate my comments of my last review, when I said that I like the fund, but don't believe that the past levels of outperformance are likely to be repeated. Still, I expect that it will do better than the average Dividend & Income Equity Fund for the near to medium term and can be considered a good core holding for most investors.

If you hold this fund, I certainly would not be rushing to the exits. If you are considering this fund as a new addition, you must be willing to accept a level of volatility that is higher than the average dividend fund, and is more in line with the broader equity markets. Those not willing to accept that higher level of volatility may want to consider the **Sentry Canadian Income Fund**. It has a similar mandate, and has delivered comparable risk adjusted returns, but with much less volatility.

Sentry Small / Mid Cap Income Fund

Fund Company	Sentry Investments
Fund Type	Cdn Focused Small / Mid Cap
Rating	A
Style	Blend
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Excellent
Manager	Aubrey Hearn since July 2005 Michael Simpson since July 05
MER	2.77%
Fund Code	NCE 721 – Front End Units NCE 321 – DSC Units
Minimum Investment	\$500

Asset Mix



ANALYSIS: This has long been one of my favourite small and mid-cap offerings. Managed by Aubrey Hearn and Michael Simpson, it has the dual objectives of providing consistent monthly income and capital growth.

It invests in the same type of companies as the **Sentry Canadian Income Fund**, namely those with high returns on invested capital, modest cash flow expenditures, and the ability to generate free cash flow, that are trading at a discount to its true value. The big difference is the companies in this fund are too small to be included in the large-cap focused Canadian Income.

It is fairly diversified, holding approximately 60 names, with the top ten making up approximately 36%. With its emphasis on income, it is significantly underweight in energy, materials, and financials. In a recent commentary, they said that they believe “banking and base metals are likely to experience further challenges to their earnings.” It has a heavy emphasis on industrials, so it should perform well as the economy recovers.

They have recently increased their exposure to U.S. based companies. It can invest up to 35% outside of

Canada. At the end of August, 28% was in the U.S. They believe that the U.S. is better positioned for economic growth than Canada. Further, the U.S. provides opportunities for diversification at attractive valuations.

It has consistently generated returns that have beat both the index and its peer group. An exception would be 2009 when it finished in the third quartile, despite posting a 43.5% gain. It has been significantly less volatile than small and mid-cap stocks, and also its large cap brethren. Still, with a focus on mid-caps, it does have the potential to be more volatile than it has been.

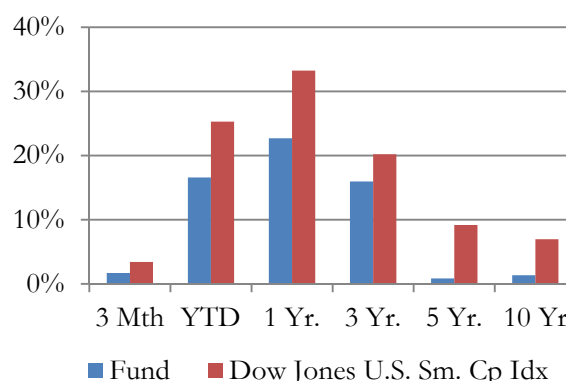
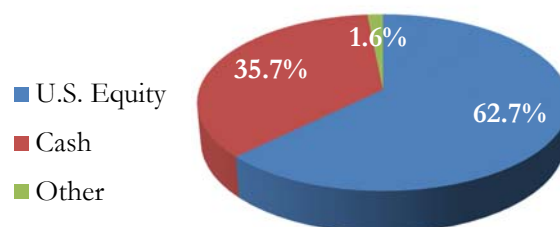
It pays a monthly distribution of \$0.05 per unit. At current prices, this is a yield of approximately 3.5%.

The biggest drawback to the fund is that it is fairly expensive, with a 2.77% MER. Thus far, this has been a case where the risk adjusted performance has been well worth the higher cost. Considering the management team and investment approach, I expect that at least for the medium term, that trend will continue. I expect that it will continue to deliver above average returns with below average risk.

IA Clarington Sarbit U.S. Equity Fund

Fund Company	IA Clarington Investments Inc.
Fund Type	U.S. Equity
Rating	B
Style	Blend
Risk Level	Medium High
Load Status	Optional
RRSP/RRIF Suitability	Fair
Manager	Larry Sarbit since June 2009
MER	2.70%
Fund Code	CCM 150 – Front End Units CCM 151 – DSC Units
Minimum Investment	\$500

Asset Mix



ANALYSIS: Since June 2009, this fund has been managed by Larry Sarbit using a high conviction, bottom up, investment process. His process is a tough one to classify as it really is a mix of both a growth and value style.

He looks for businesses that have a strong franchise, very high barriers to entry, operate in an expanding market, and are generating high levels of free cash flow. He prefers businesses which have a simple, easy to understand business model.

Valuation is an important part of the process but only after all other factors have been considered. There are many companies that are cheap, but not necessarily great businesses that offer a high margin of safety.

It can invest in companies of any size, but currently most of the opportunities are being found in the mid cap space. The fund is overweight in consumer cyclical, consumer defensive and communication while very underweight in technology, industrials and healthcare.

Mr. Sarbit is not afraid to hold large cash balances when there are no suitable investments available. At June 30, he held 11 stocks, with the top ten making up approximately 64% of the fund. Cash was relatively high, at nearly 36%.

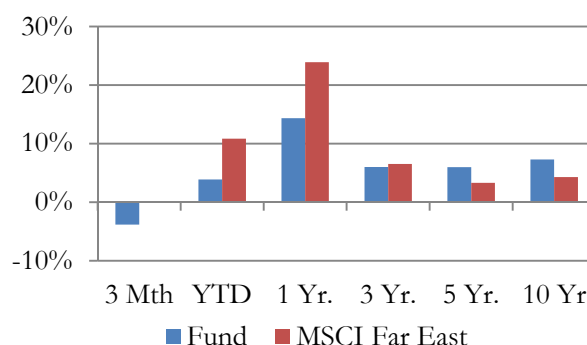
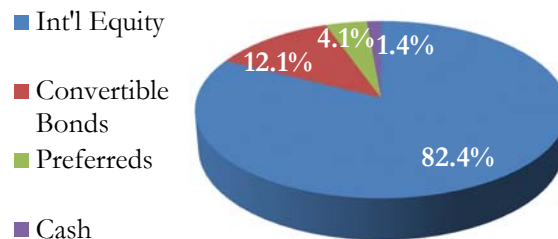
As much as I like Larry Sarbit as a manager, this is not a fund for everybody. Because of his high conviction portfolios and willingness to hold significant cash balances, investors need to understand what they are getting into. If you believe that a fund is supposed to be close to fully invested at all times, you will definitely want to look elsewhere.

However, if you are looking for a manager who has the stomach to make defensive cash calls, and are willing to accept the risks associated with a concentrated portfolio, this is definitely worthy of consideration. I believe that this is a good fund for investors who have the patience to remain invested over the long term as it may be prone to periods of high volatility and underperformance.

BMO Asian Growth & Income Fund

Fund Company	BMO Investments Inc.
Fund Type	Asia Pacific Equity
Rating	B
Style	Blend
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Robert Horrocks since Aug 09 Jesper Madsen since March 11
MER	2.84%
Fund Code	GGF 620 – Front End Units GGF 120 – DSC Units
Minimum Investment	\$500

Asset Mix



ANALYSIS: With growth rates in Asia expected to normalize at levels well below what they had experienced a few years ago, there is much concern about potential volatility. Even with this normalization in growth, it is expected to be a significantly higher pace than what we can expect in the developed world.

Given its more balanced mandate, this fund may be a great way to gain exposure to Asia with much less risk. For the most recent five years, its volatility was about 70% of the category average.

It invests predominantly in high yielding equities, but will also invest in convertible bonds and preferred shares. As of June 30, it had about 80% exposure in equities, and 20% in convertibles and preferreds.

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 3.5%, which is higher than both its peer group and benchmark.

Performance, particularly over the long term, has been strong, outpacing both the index and the peer group by a significant margin. The cost is a touch on the high side, with an MER of 2.85%, which is in the upper half category.

While the growth story is strong and the volatility appears to be well contained, I do not believe that this should be used as a core holding. Instead, it should be viewed as a great way to gain some exposure to Asia. In the context of a well-diversified portfolio, I believe that it has the potential to add some incremental return, without adding significant volatility risk.