



Volume 19, Number 9

September, 2013

Single Issue: \$15

WHAT'S NEW

♦ **Change in publication dates** – Starting this month, we will be publishing the Mutual Funds / ETFs Update on the 10th of each month. This change will take the guesswork out of when you will be receiving our detailed and timely analysis of the Canadian mutual fund and ETF landscape.

♦ **ETFs see outflows in August** – Canada's red hot ETF market took a breather in August as investors sold \$318 million more ETFs than they bought, according to Pat Chiefalo, ETF Strategist at National Bank Financial. With yields spiking higher, it is not surprising that fixed income took the biggest hit, with estimated outflows of \$400 million. Canadian equities, with their commodity focus were also shunned by investors, seeing outflows of more than \$337 million. U.S. and global ETFs were positive in the month. This pause in no way suggests that the popularity of ETFs in Canada is waning. I believe that it is more reflective of today's complicated investing environment. I expect we will see inflows return to positive in the coming months.

♦ **Som Seif returns** – Mr. Seif, the former president and CEO of Claymore Investments has launched a new asset management firm, Purpose Investments Inc. The company offers five fund mandates; **Purpose Core Dividend Fund**,

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MIXED RESULTS FOR ETF
RECOMMENDED LIST

By Dave Paterson, CFA

Equities were mostly higher, while bonds sold off after jump in yields

Bond yields have moved sharply higher since our last update, with fixed income and interest sensitive equities paying the price. Gold also took a hit, as talk of the U.S. Federal Reserve slowing their bond buying program put inflation worries on hold. It was not all bad news with equities, particularly non-Canadian equities moving sharply higher.

This has been a challenging year for investors, and as we hit the home stretch, it is likely to remain so. Along with continued speculation about when the U.S. Federal Reserve will begin to taper its latest quantitative easing program, we now have much uncertainty in the Middle East, as the global community debates what action is most appropriate in reaction to Syria's alleged use of chemical weapons. Should we see any form of coordinated military attack, I expect to see a rally in the traditional safe haven investments, specifically government bonds, and gold.

Even without any military action, I reckon there will be a short term rally in bonds. Yields have definitely moved ahead of what the fundamentals suggest is appropriate for the economic fundamentals. As I write this (Thursday, September 5), the yield on the ten year U.S. Treasury Bond has continued to march higher, flirting with the 3% mark, the highest since 2011. With yields at these levels, there is the potential that economic growth will be negatively affected, given the fragility of the economy. I expect that we will see a pullback in yields, giving back some of the recent losses in bonds. However, I don't expect that yields will return to the lows we saw earlier in the year.

With uncertainty over Syria looming, I believe the potential for a modest rally in gold exists. I don't expect that any such rally will be sustainable, as the inflation outlook remains muted. This is particularly true with bond yields significantly higher than they were just a few months ago.

My investment outlook remains largely unchanged. I continue to favour equities, with the U.S. and international equities holding favour over Canadian equities. I don't expect that we will see a sharp selloff in Canadian equities, but there is far too much

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exposure to materials, energy and financials, all of which I expect to remain under pressure for the balance of the year. I am hesitant about Asia, but see some opportunities in Europe, if you can stand the potential volatility.

Within fixed income, apart from a potential safe haven rally, I expect that corporate bonds will continue to outpace government bonds, and short term bonds will outpace longer term bonds. From a portfolio perspective, I favour a slight overweight to equities, but still believe that fixed income should remain a cornerstone of most investor portfolios.

ETFs Added to Recommended List

iShares Diversified Monthly Income Fund (TSX: XTR) – Many ETF investors are looking for income and cash flow, which is the main objective of this ETF. It pays a monthly distribution of \$0.06, which works out to a yield of just over 6% at current prices. It invests in a basket of income generating iShares including the **iShares DEX All Corporate Bond Index (TSX: XCB)**, **iShares S&P/TSX Equity Income Index (TSX: XEI)**, and the **iShares Dow Jones Canada Select Dividend ETF (TSX: XDV)**. The asset mix is approximately 60% fixed income and 40% equities. One drawback is that it has historically been more volatile than you would expect for the more conservative asset mix. However, if you back out 2008, where everything except government bonds sold off sharply, volatility is more in line with a traditional balanced fund. This is a great way to generate income in your ETF portfolio. It can also be a great core holding in a well-diversified portfolio.

iShares MSCI EAFE Minimum Volatility Index ETF (TSX: XMI) – With international stocks expected to outperform, many investors may want to increase their global exposure. With much uncertainty on the horizon, higher than normal levels of volatility will likely remain a concern. This ETF helps to address that by investing in the least volatile companies in the MSCI EAFE Index. As I have discussed in previous editions of this newsletter, low volatility investments tend to outperform in all market environments except for a sharp market rally. This should be no different, and I expect that over the long term it will provide stronger risk adjusted returns than the **iShares MSCI EAFE Index (TSX: XIN)**.

ETFs of Note

iShares 1-5 Year Laddered Corporate Bond ETF (TSX: CBO) – Despite losing 0.50% in the most recent three month period, I am not disappointed with the performance of this ETF. It did exactly what it is supposed to do. It lost significantly less than the longer dated fixed income ETFs, and outperformed, albeit slightly, the **iShares DEX Short**

Term Bond Index ETF (TSX: XSB). Going forward, with volatility expected to remain high, this will continue to be a great short term holding.

BMO Low Volatility Canadian Equity ETF (TSX: ZLB) – I am a big fan of the low volatility investing approach and this is my top pick in the Canadian market. Performance was modest in the three months ending July 31, gaining 2.1%. Longer term, it has done very well, gaining nearly 24%, handily outpacing the 13.5% jump in the S&P/TSX Composite. With more volatility on the way, this is a great way to gain exposure to Canadian equities, while leaving some risk on the table.

iShares S&P/TSX Completion Index (TSX: XMD) – With more than 40% exposure to energy and materials, this mid-cap focused ETF may be in for a short term bump should the current geopolitical tension in Syria escalate. If it does, we should see a jump in both the price of oil and gold, which will bode well for XMD. Even without that, I believe there is a decent medium term outlook for small and mid-caps in Canada. If you have a higher than average risk tolerance, you may want to consider adding to your position.

iShares S&P/TSX Canadian Dividend Aristocrats (TSX: CDZ) – One of the things I like about this dividend focused ETF is that it invests only in companies that have a proven history of growing their dividends. Because of this focus on dividend growth instead of just pure yield, it should hold up better than other dividend focused ETFs.

iShares US Fundamental Index (TSX: CLU) – Fundamental indexes select stocks and set position weights based on fundamental factors have been shown to drive share prices higher, while traditional indexing uses nothing more than market capitalization. The theory is that fundamental indexing should result in a higher quality portfolio that will be able to withstand periods of volatility better. Combine that with my favourable outlook for U.S. equities, see why this is my top U.S. equity pick. It should hold up better than the **iShares S&P 500 Index (TSX: XSP)** during periods of high volatility.

BMO Equal Weight REITs ETF (ZRE) – For the most part, REITs are considered to be more of an income investment rather than a growth investment. The value of income investments tends to move in the opposite direction to interest rates, which helps to explain why REITs were hit as hard as they were in the past few months. While the selloff may have scared some people away, others are beginning to see some significant opportunity in the sector, not only from an income standpoint, but also from a growth perspective. There is very strong institutional demand for high quality properties, which

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will provide some level of support for REITs over the long term. Even with this underpinning of support, it is highly likely that the sector will remain volatile. Those with an above average risk tolerance may want to consider buying on any dips. Others may be better off waiting this volatility out, and focus on less risky investments such as short term bonds.

BMO Global Infrastructure (TSX: ZGI) – After a pretty decent run up, infrastructure has struggled in the past few months as yields rose. While I like the infrastructure story for the long term as both a reliable stream of income and modest capital growth, I do expect near to mid-term we may see a period of consolidation. I would suggest that any investors who have held this ETF for a while look to take some profits. I would also be cautious of taking any new positions in the sector at the moment.

B U I L D I N G W E A L T H**Mutual Funds / ETFs Update**

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ETF	FIRST MENTION	3 mths ending Jul 31	RESULTS (to Jul 31)	COMMENTS	ACTION
Fixed Income					
iShares 1-5 Year Laddered Corporate Bond (CBO)	Jul-12	-0.5%	2.4% (1 Yr)	Short term corporates should outperform	Hold
iShares Advantaged U.S High Yield Bond (CHB)	Jan-12	-1.7%	7.5% (1 Yr)	Uncertainty may cause higher volatility	Hold
iShares DEX Universe Bond Index (XBB)	Dec-07	-3.5%	4.98% (5 yr)	Mid-East tensions may cause near term rally.	Hold
iShares DEX Short Term Bond Index (XSB)	Aug-04	-0.5%	3.65% (5 yr)	Shorter duration helps to preserve value	Hold
Canadian Equity					
BMO Low Volatility Canadian Equity ETF (ZLB)	Jan-13	2.1%	11.1% (6 mth)	Low vol should outperform in most markets	Buy
PowerShares FTSE RAFI Canadian Fundamental (PXC)	Jan-13	4.5%	2.8% (6 mth)	I prefer fundamental ETFs to Cap Weighted	Hold
iShares S&P/TSX Completion Index (XMD)	Jan-12	0.3%	9.1% (1 yr)	Mid-East tensions could give short term boost	Buy
iShares S&P/TSX CDN Preferred Share (CPD)	Jun-09	-3.6%	4.2% (3 yr)	May see gains as rate uncertainty settles	Hold
iShares S&P/TSX Canadian Dividend Aristocrats (CDZ)	Sep-08	2.3%	7.1% (5 Yr)	I still like the dividend growth story.	Buy
iShares S&P/TSX Capped Composite Index (XIC)	Dec-07	1.2%	1.1% (5 yr)	Low cost keeps this an attractive option	Hold
Foreign Equity					
iShares MSCI EAFE Minimum Volatility Index (XMI)	Aug-13	NEW	NEW	Great low vol way to play Europe and Asia	Buy
iShares MSCI EAFE Index (C\$ Hedged) (XIN)	Jan-13	0.5%	8.8% (6 mth)	Prefer international large caps to Canadian	Buy
Vanguard MSCI U.S. Broad Mkt (C\$ Hedged) (VUS)	Jan-13	7.0%	14.5% (6 mth)	Very low cost exposure to U.S. large caps.	Hold
iShares Global Monthly Advantaged Dividend (CYH)	Jan-12	0.9%	13.7% (1 Yr)	Mid cap focus means higher volatility	Hold
iShares US Fundamental Index (CLU)	Mar-11	7.0%	16.9% (3 Yr)	A great way to gain U.S. equity exposure	Buy
iShares S&P 500 Index (XSP)	Dec-07	6.1%	6.0% (5 Yr)	Solid U.S. equity pick	Hold
Specialty / Sector					
iShares Gold Bullion Fund ETF (CGL)	Oct-12	-10.4%	-18.3% (1 Yr)	Syria troubles should provide temporary boost	Hold
BMO Equal Weight REITs Index ETF (ZRE)	Jul-12	-13.3%	-6.7% (1 Yr)	Higher yields hit REITs. More volatility expected	Hold
BMO Global Infrastructure (ZGI)	Jan-12	-1.6%	15.8% (1 Yr)	Expect a pause. Long term story remains solid	Hold
iShares S&P/TSX Capped Financials Index (XFN)	Sep-09	5.7%	8.7% (3 Yr)	Bank earnings beat expectations. Take profits	Hold

Note: Funds Highlighted in Green are Funds rated a Buy, while funds highlighted in Red are rated a Sell

BOND SELLOFF DRAGS COUCH POTATO PORTFOLIO

By Dave Paterson, CFA

Tapering fears spook markets, push yields higher

After three successive quarters of gains, the Couch Potato Portfolio stumbled, posting a modest 0.23% drop for the three month period ending July 31. Bond yields around the world shot higher on comments from Ben Bernanke, the Chairman of the U.S. Federal Reserve stating they were considering slowing the pace of their bond buying program.

In May, when I did the last review on this portfolio, I stated: *"We are also somewhat concerned about the fixed income environment. While rate increases are not imminent, they are much closer to reality than they were even a few months ago. There are real rumblings coming out of the U.S. Federal Reserve that their massive quantitative easing program will be coming to an end sooner than most had expected. When this does happen, it will push interest rates higher. Government bonds, which make up nearly 70% of the DEX Universe Bond Index will be hit the hardest once rates begin to rise."*

It turns out that my fears were well founded, albeit much sooner than anticipated. After Mr. Bernanke made his comments, the yield on the benchmark Government of Canada ten year bond shot from 1.68% in early May, reaching 2.45% by the end of July. U.S. Treasuries were hit even harder, ending July with a yield of 2.60%, which was 94 basis points higher than where it was in early May. Traders continue to punish the bond, driving the yield higher. In the days since, both have continued to move higher, touching recent highs.

While the Couch Potato Portfolio has a very simplistic appeal, I continue to have some concerns about it. The first is the fixed income environment we are now experiencing. With short term volatility and continued pressure on yields it will be very difficult for a passive bond investment to keep up with high quality actively managed bond funds. For example, if I look at the performance of a couple of my favourites, specifically the **PH&N Total Return Bond Fund**, **TD Canadian Bond Fund**, and the **Dynamic Advantage Bond Fund**, all managed to outpace the XBB over the same period. Perhaps surprisingly, it was the Dynamic Advantage Bond Fund, with an MER that is nearly triple that of the XBB that was the best performer, posting a loss of 2.47%. This trend is likely to continue as long as the upward pressure on yields remains.

Another concern I have is with the heavy sector concentration found in the **iShares S&P/TSX Capped Composite Index ETF (TSX: XIC)**. Three sectors, financials, energy and materials make up more than 60% of the index. In comparison, the top three sectors of the **iShares S&P 500 C\$ Hedged ETF (TSX: XSP)** make up only 45%. The concentration of the Canadian market is not new, but with the potential for a continued slowdown in China and a correction, however modest in the housing market at home, there is tremendous risk embedded in our market.

There are a few options to help protect yourself. Within the fixed income portion of your portfolio, you could switch into one of our recommended actively managed bond funds. If you prefer to stick with ETFs, you will want to shorten duration and increase yield. Please see our ETF Recommended List elsewhere in this edition for some ETF suggestions. Either of these should help provide better protection against rising yields.

Within the equity portion, I would suggest that you increase the exposure to XSP and the **iShares MSCI EAFE C\$ Hedged ETF (TSX: XIN)**. Doing this would provide better diversification and should help to provide better growth potential for the current environment.

For demonstration purposes, I will be keeping the asset mix of the Couch Potato Portfolio as it is.

Here is the latest report on the Couch Potato Portfolio performance. Results are based on the closing prices as of July 31, 2013.

ETF	Shares Owned	Target Weight	Book Value	Market Value	Dividends Paid	Total Return since Inception
XBB	140	40%	\$4,019.40	\$4,237.80	\$932.23	28.63%
XIC	140	30%	\$3,015.30	\$2,765.00	\$381.58	4.35%
XSP	82	15%	\$1,489.94	\$1,583.42	\$103.79	13.24%
XIN	55	15%	\$1,500.40	\$1,106.60	\$135.01	-17.25%

Totals **100%** **\$10,025.04** **\$9,692.82** **\$1,552.61** **12.17%**

TO HEDGE OR NOT TO HEDGE

By Dave Paterson, CFA

Currency exposure can add more risk to your portfolio

A couple of weeks ago, I was talking to a client and the topic of currencies came up. The question was as an investor, are you better off buying a U.S. equity fund in U.S. dollars or Canadian dollars? They seemed surprised when I told them that unless you are going to need U.S. dollars at some point in the future, there is very little difference in the returns between the Canadian dollar version and the U.S. dollar versions of a fund.

I can understand why they seemed surprised. I know I was before it was explained to me, but once I worked through the math it made perfect sense. As an example, let's look at the **RBC U.S. Equity Fund** for the ten years ending June 30. In Canadian dollar terms, the fund earned an annualized return of 2.22%. In U.S. dollars, the return was 4.83%. On the surface, the U.S. dollar version appears to have the edge.

Digging deeper, we can see how the returns end up being virtually identical. Let's assume an initial investment of \$10,000. After ten years in the Canadian dollar version of the fund, we would have approximately \$12,455. In the U.S. dollar version, there is a bit more work involved. The first step would be to convert our Canadian dollars into U.S. dollars. Using the exchange rate from ten years ago, we start with \$7,378 U.S. At the end of ten years, we end up with \$11,813 U.S. When we convert that back to Canadian dollars at current rates, we end up with \$12,420, a difference of \$35.

This example shows that buying the U.S. dollar version of a fund does not hedge against currency risk. To do that, you would need to buy a currency hedged version of the fund. These types of funds eliminate the impact that changes in the value of the currency would have on returns. In the example above, the net return in Canadian dollars would have been in the ballpark of 4.8% in a hedged version, rather than 2.2%.

The question then becomes is better to use a hedged or an unhedged version of a fund. Unfortunately that's not an easy answer. The experts will tell you that in the long run it shouldn't make a difference. In the real world however, it often does.

Taking a look at our dollar, I expect that we will see it drop in value over the short to medium term. With interest rates expected to start moving higher in the U.S. before they do here, combined with a slowing economy and a softer outlook for

commodities, the demand for our dollar should drop. I certainly don't expect to see it in the \$0.65 range like we saw back in the early 2000's, but to see it in the low \$0.90's wouldn't be completely out of the question.

Considering that outlook, I would suggest that investors use an unhedged version of U.S. and global equity funds. A falling dollar can add some additional return for investors. However, if you want to completely take currency risk out of the picture, then a hedged version is the way to go.

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Purpose Total Return Bond Fund, Purpose Tactical Hedged Equity Fund, Purpose Diversified Real Asset Fund and Purpose Monthly Income Fund. Each is managed using a disciplined, rules based fundamental security selection approach, and is offered as either a traditional mutual fund or as an ETF. Costs, at least for the mutual funds are expected to be in the lower half of their category averages. While I'd be reluctant to jump into these funds at the moment because of their lack of track record, they are definitely on my radar.

Blackrock to launch mutual funds – ETF giant Blackrock Asset Management has filed a preliminary prospectus launching a series of seven new mutual funds. The funds are balanced mandates that cover a wide range of investor types, from ultra conservative to aggressive. There is also an income option, **Blackrock Diversified Monthly Income Portfolio** which will pay a monthly distribution and look to effectively manage volatility. Asset mixes are expected to be fairly static, and will be rebalanced on a regular basis. Unfortunately at the time of this writing, the prospectus has yet to be finalized so we don't know what the management fees and dealer compensation will be. Given the passive nature of the underlying funds, cost will be a critical factor in determining if these are worthy of consideration or not.

READER'S QUESTIONS

Q. – *With interest rates moving higher, I am becoming quite concerned about the fixed income part of my portfolio. Right now, I have Canadian bonds, corporate bonds, and short term bond funds. I am thinking about selling everything except the short term bond fund, and adding in some global bonds and American high yield bonds instead. What are your thoughts on this?*

A. – I can certainly understand why you would be concerned about the bond market. In the past couple of months, we have seen yields shoot up higher than anybody had expected. This has scared many bond investors, and rightly so.

As far as your plan to sell all your Canadian holdings and replace them with global bonds and American high yield, I would suggest you proceed with caution. There is nothing wrong with selling some of your Canadian bond holdings and bringing these types of investments into your portfolio, but I would be very reluctant to suggest you sell it all.

Yes, there is a potential that Canadian bonds will experience further losses as rates move higher, but I certainly don't expect that we will see continuing losses over many years. If we look at the periods between 1955 and 1982, we saw the yield on the ten year Government of Canada bond move from around 3% to 15% of so. Even during this sustained rise in rates, the return on the ten year was approximately 3.2%.

Government bonds also tend to be thought of as safe haven investments in periods of extreme uncertainty. Look at how government bonds behaved in 2008. Both Canadian and U.S. government bonds held up well, while all others sold off significantly. While I don't expect a repeat of 2008, having some exposure to government bonds is a pretty good idea.

Global bonds tend to be good in a portfolio because they are less correlated to Canadian bonds and the major equity indices. However, they can be quite volatile at times. You will also want to make sure that you invest in a currency hedged version of the bond fund otherwise the movements in currency can increase your risk substantially. I tend to limit the exposure to global bonds in a portfolio because of the additional risks.

What I would suggest that you consider would be to look at your portfolio's fixed income component in two distinct buckets. The first would be "traditional" fixed income, which would include most of what you currently hold. I put government bonds, investment grade corporate bonds, and short

term bonds in this bucket. I call the second bucket "specialty" fixed income, and it includes things like global bonds, high yield bonds, emerging market debt, and floating rate notes.

For a balanced investor, I typically suggest that the two buckets be equally weighted within a portfolio. For example, if your fixed income allocation is 50%, I would put 25% in the traditional fixed income investments, and 25% in the specialty fixed income. I like this allocation because you still have some exposure to the more conservative fixed income investments, yet still have a meaningful exposure to investments that aren't as sensitive to movements in the Canadian rate picture. Funds that I like to include in this bucket include the RBC Global Corporate Bond Fund, Manulife Strategic Income Fund, RBC Global High Yield Bond Fund, and the Trimark Floating Rate Income Fund.

Q. *I have held the Mutual Beacon Fund for a few years now and notice that it is not on your recommended list. What is your opinion of this fund?*

A. Many years ago, this was one of my favourite U.S. equity funds. Before September 2008, it had delivered strong risk adjusted returns, with very low levels of volatility. Volatility had been about half to two-thirds that of the market. That all changed when the financial crisis hit, decimating this fund. Between October 2008 and February 2009 it dropped nearly 44%. While that was disappointing, it was in line with the losses experienced by other deep value type funds. While I had expected it to hold up better than it did, it was really the jump in volatility that really hurt the fund in my eyes. Its volatility more than doubled, and has remained high ever since.

Like other funds managed by the Mutual Series, it is managed using a disciplined, three pronged approach. The core of the portfolio is invested in undervalued stocks that the managers believe have a viable, near term catalyst in place that will help to unlock shareholder value. In selecting names for the portfolio, they must be trading at a level that is a significant discount to their estimate of its true value. These types of opportunities will typically make up around 90% of the fund.

With the balance of the portfolio they will invest in distressed securities and merger arbitrage opportunities. Distressed securities are those that are undergoing some sort of turmoil, such as emerging from bankruptcy protection, spinoffs, or

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management changes. Merger arbitrage involves trying to generate profits by trading the different securities of companies that are involved in a merger or other acquisition. Because these strategies carry higher risks, their exposure within the portfolio is fairly limited. At the end of May, 8% was invested in distressed opportunities and just under 2% was invested in a merger arbitrage play.

The portfolio is very well diversified, holding more than 100 names with the top ten making up about a quarter of the fund. While the focus is on the U.S., it can invest up to 30% abroad.

As mentioned above, the biggest issue I have with this fund is its volatility, particularly compared to its counterpart the

Mutual Global Discovery Fund. Managed in a near identical manner, Mutual Beacon has shown a level of volatility that is significantly higher. Much of that has to do with the fund's performance in 2008, when it sank by more than 45%. That management team has since been replaced, and shorter term performance has been fairly strong, outpacing the majority of the U.S. equity category for the past three years.

I am generally a fan of the Mutual Series investment approach, but the volatility of this fund has been much higher than I am comfortable with. I would suggest that investors consider the more globally focused Mutual Global Discovery Fund. It is managed in a near identical fashion, but is more globally diversified with much less volatility.

ETF TRADING TIPS

By Dave Paterson, CFA

Some helpful advice in getting the best order execution

One of the great features of ETFs is that unlike mutual funds which are priced once per day, you can buy or sell an ETF anytime during the trading day. An unfortunate drawback to this is sometimes the market price may be higher or lower than the net asset value (NAV) of the underlying basket of securities. When the market price is higher than the NAV, it is trading at a premium, and when it is below NAV, it is trading at a discount.

There are a number of reasons that premiums and discounts happen. One reason is the ETF has low trading volume. When this happens you may see fairly large spreads between the bid price, which is the price at which somebody is willing to buy the ETF, and the ask price, which is the price at which somebody is willing to sell the ETF.

Another reason this could occur is that the underlying securities in the ETF are not very liquid and do not trade very often. In most cases, when pricing an ETF, each of the underlying securities are priced at their last traded price. Where the underlying securities don't trade very often, the prices used to calculate the NAV can be out of date, and not reflective of the current value. This is more likely to happen in very specialized ETFs, or in fixed income ETFs, where bonds trade over the counter. When this happens, it is the market value that is often a more accurate reflection of the true value.

A third reason that a premium or discount can occur is with ETFs that have significant holdings in European or Asian equities. Like with the case of an ETF that holds illiquid securities, the prices used to calculate the NAV of international ETFs may be out of date. This is because these markets are often closed when the North American markets are open. In

these situations, assuming you are looking at a large cap focused ETF, it is very likely that the market price is more reflective of the out of date NAV.

There are ways you can protect against these potential pricing issues. Three of the main ones include:

1. **Use limit orders** – A limit order is one where you specify the price at which you want to buy or sell a security on an exchange. With an ETF trade, pick a price that you feel is indicative of the true value of the ETF, and use that as your limit. This price will typically be between the bid and ask prices.
2. **Avoid trading in the opening or closing minutes of the day** – Because these periods tend to be the most active trading times of the day, it may be more difficult for the NAV to be reflective of the price. By trading in periods where things are calmer, it is much more likely that the market price will be much closer to the NAV.
3. **Trade International ETFs early in the day** – Given that price discrepancies are generally larger when markets are closed, you will want to buy or sell international ETFs while the international markets are still open for trading. Unfortunately Asian markets are closed well before North American markets open, but European markets are open until 11:30 EST. If you can, try to place orders for international ETFs between 10 am and 11 am EST.

Bottom Line: The ability to buy and sell ETFs at any point during the day is one of their more attractive features. It can also be a source of short term price distortions. By taking some basic precautions, the likelihood of being hurt by any of these price distortions can be minimized.

THINGS COULD GET UGLY

By Dave Paterson, CFA

September and October have historically been the rockiest months of the year

I believe that it was famed writer T.S. Eliot in his signature poem "The Waste Land" who said that April is the cruelest month. Looking at historical market behaviour, he obviously wasn't talking about the equity markets. No matter how you slice it, April has historically been a fairly decent month for investors. Unfortunately the same cannot be said for August, September and October.

The table below breaks down the historic monthly returns for the S&P 500 between January 1950 and July 2013.

Performance of the S&P 500 from January 1950 to July 2013

	Average Monthly Return	Worst Monthly Return	Best Monthly Return	% losing months	% of months with losses > -5%
January	1.11%	-8.57%	13.18%	38.10%	12.70%
February	-0.10%	-10.99%	7.15%	46.03%	4.76%
March	1.16%	-10.18%	9.67%	36.51%	3.17%
April	1.44%	-9.05%	9.39%	33.33%	4.76%
May	0.16%	-8.60%	9.20%	44.44%	12.70%
June	-0.08%	-8.60%	8.23%	49.21%	9.52%
July	0.99%	-7.90%	8.84%	46.03%	7.94%
August	0.00%	-14.58%	11.60%	44.44%	15.87%
September	-0.51%	-11.93%	8.76%	53.97%	17.46%
October	0.78%	-21.76%	16.30%	39.68%	6.35%
November	1.48%	-11.39%	10.24%	36.51%	7.94%
December	1.72%	-6.03%	11.16%	23.81%	1.59%

Source: Yahoo Finance, Fundata

From a perception standpoint, most believe that October is the worst month for the equity markets. With two of the biggest drops in history happening in October, namely the stock market crash of 1929 and Black Monday in 1987, it's not hard to see why many share this belief. Perhaps surprisingly, on average, investors will realize a positive return in October, and there is about a 40% chance of realizing a loss during the month. I'm sure most would be comfortable with those odds. But, where things get really scary is that if there is going to be a big drop, there is a higher probability that it will occur in October.

October has also been the month that has shown the largest monthly decline, by a fairly significant margin.

Surprisingly, it is actually September that has been the cruelest for investors. More than half the time since 1950, investors have suffered losses in September, and nearly 20% of the time, that loss is more than 5%. Once we get into November and December, things tend to settle down.

Many are predicting this autumn to be one of the most volatile in recent memory. Last week, JPMorgan said that they see a "tsunami of volatile data" coming in September that will set the stage for the rest of the year. Concerns continue to mount over the U.S. Federal Reserve slowing the pace of their bond buying program, the upcoming debt ceiling negotiations, a lackluster economy, and resurging tensions in the Middle East. On their own, each has the potential to create big volatility in the markets, combined, it could be the perfect storm.

While some may be tempted to move their entire portfolio into cash and wait out the potential volatility, I would strongly suggest against that. The problem with moving fully into cash is twofold. First, if we are wrong and the markets instead continue to rally higher, investors on the sidelines will have missed out on those gains. Second, even if the volatility does materialize, the challenge becomes timing your entry back into the markets. Most people are often late in making their reentry, thus posting lower gains than they could have realized had they stayed invested.

Instead, I believe a better strategy is to remain invested in a portfolio that was constructed so that it is in line with your investment objectives and risk tolerances. If the thought of a big market drop is keeping you awake at night, then you could consider moving **some** of your portfolio into cash or short term bonds so that you will have some dry powder available to buy in after or during any sell off.

Bottom Line: Market selloffs can be scary, but they can also be a great opportunity to improve the quality of your portfolio at a discounted price. Whether you prefer mutual funds, ETFs, or individual securities, taking advantage of market volatility can be a great way to improve your long term returns, picking up high quality investments when they are on sale.