

Top Funds Report

Last minute deal averts U.S. default

Deal does little more than push problems back into the New Year.

On Thursday, U.S. president Barack Obama signed a deal passed by Congress to reopen the government and raise the debt ceiling. Without this deal, it was a very real possibility that the U.S. would default on its debt, which could have caused a financial catastrophe.

While some short term celebrations may be in order, this is nothing more than a short term fix. It funds the government through January 15, and raises the debt ceiling until February 7. The reality is this deal did not to fix any of the underlying issues. No progress was made on the budget, tax reform and the Tea Party's view on Obamacare. It was 16 days of posturing and bickering and accomplished nothing. The upside is that some are now speculating that the Republicans have seen the reaction of the American public on this issue, and may be more accommodating when negotiations begin again in January.

This now allows us to again focus on the economy and trying to guess when the U.S. Federal Reserve will begin tapering its bond buying program. Many market participants were expecting this to begin in September and were taken by surprise when it didn't.

Global markets rejoiced with the S&P 500 gaining more than 3% in U.S. dollar terms, while the MSCI EAFE Index shot up by more than 7%. Europe and Asia were also strong with the MSCI Europe Index gaining 7.2% and the MSCI Pacific Index up nearly 8% in U.S. dollar terms. Unfortunately for Canadian investors, the loonie gained against the U.S. greenback, muting returns in Canadian dollar terms.

My investment outlook remains consistent from last month. 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 remains the potential for a continued short term rally in bonds.

Within fixed income, I favour shorter durations over long, corporate bonds over governments, and where possible, high quality global bond exposure.

Within equities, I favour the U.S., but am warming up to Europe, although valuations may be getting ahead of fundamentals at the moment. Canadian equities should remain volatile, and may be prone to a drop if we see a pullback in gold or oil. There are also some concerns about the earnings outlook for banks, particularly if we see a slowdown in housing.

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.

Join Me, Dave Paterson
in TORONTO
OCTOBER 24-26, 2013
for My Presentation
THE TALE OF THE
TAPE—MUTUAL
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Funds You Asked For

This month, I highlight a couple HSBC funds, PH&N High Yield Bond, and TD Short Term Bond.

HSBC Canadian Bond Fund (HKB 506)

The HSBC Canadian Bond Fund is a fairly run of the mill bond fund that invests in a mix of Canadian corporate and government bonds, as well as some exposure to mortgages. Looking at the current asset mix, it is overweight in both corporate bond and mortgages, which is prudent given the interest rate environment. Combined, this will result in a lower sensitivity to interest rates than the broader bond market. Given the rate outlook, the managers expect to keep this positioning over the near term.

Performance has been more than respectable, consistently finishing in the upper half of the Canadian bond category. While it has outpaced many of its peers, it has failed to keep up with the DEX Universe Bond Index on an absolute basis. However, if we take its lower volatility into account, it has matched it on a risk adjusted basis.

Costs are decent, boasting an MER of 1.17%, which is below the category average.

All things considered, this is a decent Canadian bond offering. Still, I would likely go with the **Dynamic Advantage Bond** or **PH&N Bond Fund** over this one given their duration management approach, which I expect to add value over the near to medium term. That said, with the lower than average MER, you likely won't go too far wrong with this fund.

HSBC Monthly Income Fund (HKB 518)

As the name suggests, this fund looks to deliver a consistent monthly income, while preserving capital over the long term. It pays a monthly distribution of \$0.02 per unit, which works out to an annualized yield of 2.5%, which is pretty low by income fund standards.

The neutral asset mix is 10% in preferred equities, 30% in Canadian equity, and 60% in short and medium term bonds. As of September 30, the fund was more or less in line with the target mix. The manager believes that equity valuations are reasonably

attractive based on history, and feels the earnings environment will continue to be supportive. The focus will remain on high dividend paying equities.

The bond portion of the fund is overweight in corporate bonds and mortgages. They believe that valuations are more attractive in the corporate bond space. Given the outlook for interest rates, they will not be taking on any more interest rate risk in the fund at the moment.

Performance, particularly of later has been strong, outpacing the majority of its peer group. But, it has experienced higher than average volatility. For example, in 2008 the benchmark lost 4.8% while the fund lost 9.7%. It did manage to outpace it on the rebound, gaining nearly 15%, outpacing the benchmark by nearly 300 basis points.

Looking at the risk reward characteristics of the fund, I believe that there are better options available in the category. Even with the recent uptick in performance, I don't believe that investors are adequately rewarded for the risk that they take on with this fund and could do better elsewhere.

Dynamic American Value Fund (DYN 041)

One of my core beliefs about investing is that if you can minimize the risk, the return will take care of itself. This David Fingold managed fund is one of the best U.S. equity funds for managing the downside risk of the markets. When I look at its downside capture ratio, which measures how the fund has performed compared with its benchmark in falling markets, it has consistently been one of the best funds in down markets. The unfortunate drawback is that of late, this defensive positioning has also dragged the upside performance, resulting in chronic underperformance.

In the past twelve months, the fund has underperformed the S&P 500 nine times. In the past three years, it has underperformed two-thirds of the time. For the three years ending September 30, the

fund has gained an annualized 6.35%, while the S&P 500 has gained more than 16%.

While I haven't spoken with the manager recently, everything I have seen from him seems to indicate that they are doing the right things, at least on paper. He continues to use a fundamentally driven, bottom up value focused approach to securities selection, buying stocks trading at a significant discount to their intrinsic value and selling when they become fully priced. The portfolio is quite concentrated, typically holding about 30 names and he places large bets on stocks he likes. As of September 30, the top 10 holdings made up nearly 45% of the fund.

Coming out of the financial crisis, this was one of my favourite U.S. equity funds. It held up remarkably well during periods of volatility, and had shown decent overall performance. Unfortunately things seem to have come off the rails.

David Fingold has done a good job with the other funds he manages however this one has continued to lag. While I believe that the performance will eventually improve, I can't say when.

In my opinion, there are definitely better options in the U.S. equity category that will provide a more favourable risk return profile than this offering. Unless you are looking for U.S. equity exposure with very little downside risk, you are most likely better off looking elsewhere for the near term.

RBC Global Precious Metals Fund (RBF 468)

If you are an investor with a strong appetite for risk looking for a precious metals fund to add to your portfolio, then this is definitely one to consider. It is managed by the team of Chris Beer and Brahm Spilfogel who for companies that are run by experienced management and have strong balance sheets, and proven reserves or excellent geological potential. They look for companies involved in both exploration and production.

Typically, the fund will hold approximately a third of the assets in a select group of high quality, liquid, large cap names which are selected using the resources of the RBC Global Asset Management Team. For the balance, the team looks for small and mid cap names, conducting intensive research,

looking to uncover new and unknown investment candidates.

The result is a portfolio that will typically hold more than 100 individual names. Despite the breadth of names, there is significant concentration with the top 10 making up roughly half of the fund. The managers are active in their approach with portfolio turnover levels averaging 90% per year.

Performance, while disappointing on an absolute basis, has been strong compared to other precious metals funds, particularly over the long term. Volatility is very high. On a historic basis, the volatility is more than two times the volatility of the broader market. I do not expect that to change. Within the precious metals category, this has been one of the least volatile funds and has consistently delivered above average risk adjusted returns.

While some exposure to gold may be beneficial to a portfolio over the long term, this is a category that most conservative or balanced investors will want to take a pass on. The outlook for gold is far too uncertain at the moment. With economic growth expected to be modest at best, inflation fears are well contained. In the U.S., the Fed has stated that it will begin to remove the stimulus in an ordered manner, which should help to keep future inflation in check. With that as the backdrop, I believe that the risks to gold are to the downside and more volatility is expected.

Under that backdrop, I believe that the volatility and probability of a loss is significant and far too high for most investors with an average risk tolerance. However, for high risk investors looking for exposure to the precious metals sector, this is definitely a fund worthy of consideration.

TD Short Term Bond Fund (TDB 967)

When yields jumped higher in the summer, this fund did exactly what it was supposed to do which is hold its value better than bond funds that have a higher exposure to interest rates. While some were surprised when it dropped by slightly more than 1% in May and June, it more than held its own compared to the nearly 3.5% drop in the broader DEX Bond Universe Index.

Short term bonds are not immune to increases in rates, but rather they are less affected by them. With more volatility in yields expected as speculation returns over when the U.S. Federal Reserve will begin to withdraw some of the stimulus it is providing the economy, it is possible that more months like May and June could happen. Still, short term bonds will likely hold up much better than any other type of bond when rates do move higher.

Within the short term bond space, this has long been one of my favourites. It is managed by David McCulla and Olga Bylaard and is conservatively positioned with a duration of 2.6 years, which is lower than the benchmark.

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 August 31, more than 62% 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. Despite the disappointing absolute numbers, they are still in the upper half of the category. Given the interest rate forecast, I 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 has only been 2 times where it lost money in a 12 month period. The worst peak to trough drop was 1.42%.

I 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.

Mutual Beacon Fund (TML 213)

Like other funds managed by the Mutual Series, this U.S. focused offering 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 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.

One surprising aspect of this fund is just how volatile it has been, particularly compared to its counterpart the **Mutual Global Discovery Fund**. Managed in a nearly identical manner, the 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%. The management team at the helm has since been replaced and shorter term performance has been impressive, 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 provides a similar, but more globally diversified asset mix with much less volatility.

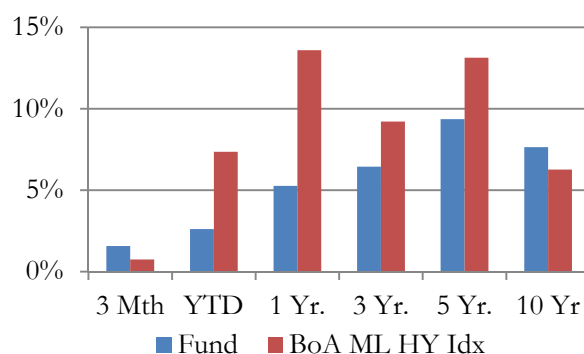
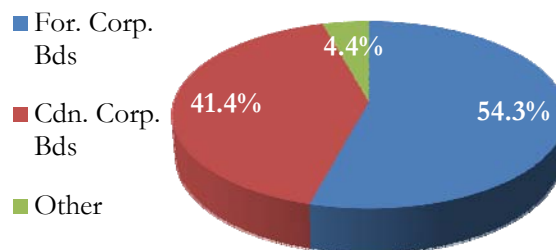
If there is a fund that you would like reviewed, please email it to me at

feedback@paterson-associates.ca.

PH&N High Yield Bond Fund

Fund Company	PH&N Investment Mgmt.
Fund Type	High Yield Fixed Income
Rating	Not Rated
Style	Credit Analysis
Risk Level	Low to Medium
Load Status	No Load / Optional
RRSP/RRIF Suitability	Excellent
Manager	Hanif Mamdani since July 2000
MER	0.88%
Fund Code	RBF 1280 – No Load Units RBC 6280 – Front End Units
Minimum Investment	\$500

Asset Mix



ANALYSIS: If you don't already own units of this great fund, then you are out of luck, with it being capped since November 2010.

It focuses on medium quality corporate bonds, convertibles, and preferreds. At the end of August, 77% of its holdings were rated BB or lower.

It can invest anywhere in the world, but currently about 40% is in Canada, 55% in the U.S and the balance in other developed markets. The sector mix is based on the relative attractiveness based on their top down macro analysis. Once the sector mix is set, the managers conduct a fundamental analysis on a number of companies, looking at their free cash flow, and interest coverage ratios to determine quality.

It is conservatively positioned with a yield to maturity of 5.5%, which is well above the yield of the DEX Universe Bond Index. Its duration is 3.8 years, which is considerably less than the benchmark duration of 7 years. Because of this positioning, it will hold up

better than the broader bond market when rates move higher. That was the case between May and September, when yields shot higher. In that period, the DEX Universe was lower by 3.35%, while this fund only lost 0.14%.

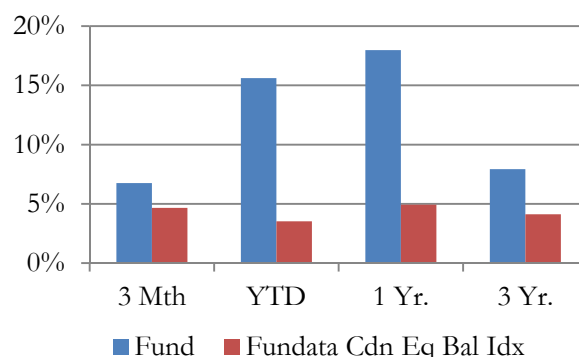
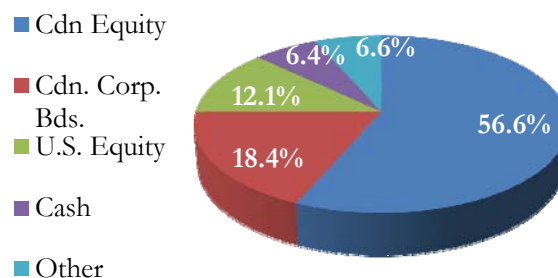
Given the more conservative nature of the fund, its performance can be a bit of a mixed bag compared to other high yield fund. It will likely lag in a market where high yield issues rally sharply higher, yet will hold up much better in periods of extreme uncertainty. Longer term, results have been very strong, outpacing the DEX and Global High Yield universe over the past 10 years. Volatility is also the lowest in the category. Another bonus is that it carries a rock bottom MER of 0.88%.

This has long been one of my favourites in the fixed income space and I expect it to be for the foreseeable future. It is a great way to add high yield exposure in your portfolio without taking on huge risk. The only drawback is that it is closed to new investors.

EdgePoint Canadian Growth & Income

Fund Company	EdgePoint Wealth Management
Fund Type	Canadian Equity Balanced
Rating	A
Style	Bottom Up Value
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Excellent
Manager	Tye Bousada since Nov. 2008 Geoff MacDonald since Nov. 08
MER	2.14%
Fund Code	EDG 188 – Front End Units EDG 388 – Low Load Units
Minimum Investment	\$15,000

Asset Mix



ANALYSIS: EdgePoint Wealth Management was launched in 2008 by former Trimark managers Tye Bousada and Geoff MacDonald. They were joined in 2011 by another Trimark veteran, Ted Chisholm.

Their investment philosophy is conceptually very simple – they are long term investors looking to buy an ownership stake in a small number of high quality businesses at prices that are below their estimate of its true value. For the equity sleeve of the fund, they employ a fundamentally driven, bottom up investment process that is based on the old Trimark approach.

For the fixed income component of the fund, they are looking for securities that will provide an attractive total return through coupon payments and capital appreciation while focusing on the issuer's ability to pay. They can invest in any type of fixed income security, but it is heavily weighted towards corporate bonds. They can invest in either investment grade or high yield bonds, depending on their relative attractiveness. Any non Canadian fixed income exposure is hedged back to Canadian dollars.

The asset mix can vary widely, depending on the relative attractiveness of the various asset classes. The fixed income exposure can range between 25% and 60% of the fund. In setting the asset mix, the managers want to ensure that they are properly concentrated for the risk they accept. As of September 30, the fund was 33% in bonds, and 67% in equities.

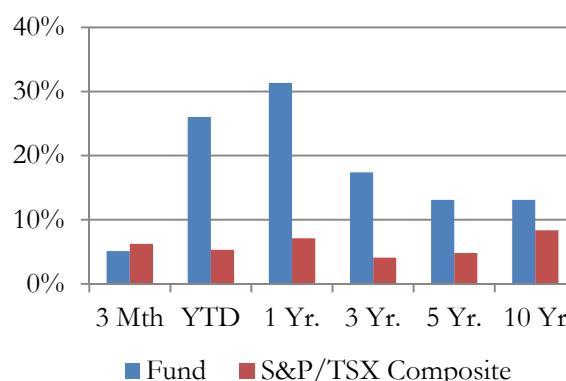
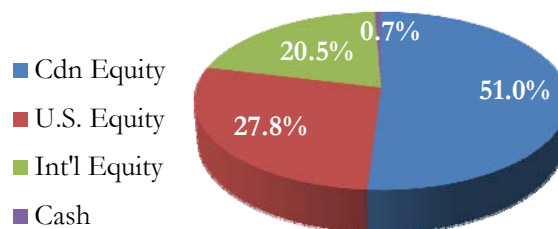
Performance has been strong on both an absolute and relative basis, finishing first or second quartile in each year since its launch. The volatility of the fund has been in line with the category average. The MER is 2.14% for the front end version of this fund, which below the category average.

This is a great core balanced fund for investors who have a medium to high risk tolerance and a long term time horizon. Given their investment style and discipline, it may experience short term periods of underperformance, but over the long term, I expect that it will deliver above average returns with average risk.

Fidelity Canadian Large Cap Fund

Fund Company	Fidelity Investments Canada
Fund Type	Canadian Focused Equity
Rating	A
Style	Value
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Excellent
Manager	Daniel Dupont since March 11
MER	2.29%
Fund Code	FID 231 – Front End Units FID 531 – DSC Units
Minimum Investment	\$500

Asset Mix



ANALYSIS: This has long been one of my favourite Canadian equity funds, and manager Daniel Dupont has done a stellar job since taking the reins. Between March 2011 and September 2013, the fund has gained nearly 40%, while the S&P/TSX Composite Index has lost nearly 2.3%.

This past quarter the outperformance took a pause, which was not unexpected given the sharp run-up the fund had in the second quarter of the year. In July, I said, “While I have a lot of confidence in Daniel Dupont’s style, process and approach, I would strongly suggest that you take advantage of the recent gains and rebalance your portfolio, taking some profits off the table. For the long term, I still believe that this is a great core holding for most investors.”

I stand by those comments. Protecting capital is the cornerstone of his investment process. To date, he has been very successful, posting below average volatility and strong outperformance in down markets.

He uses a bottom up, fundamentally driven, value focused stock selection process that looks to buy strong, well managed companies that have unrealized growth potential that are trading at a significant discount. An ideal investment candidate has a sustainable business model and is expected to deliver high return on capital. The upside potential is carefully considered with the downside risk.

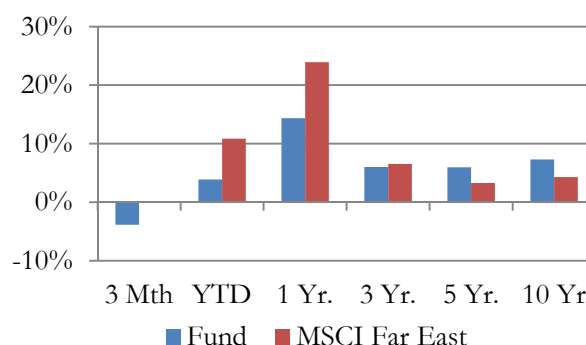
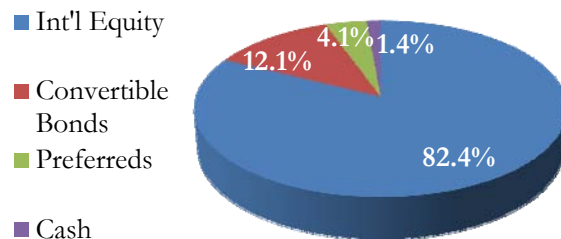
The concentrated portfolio is focused on Canada, but can invest up to 49% of the fund abroad. It looks dramatically different from the index, with no exposure to materials and a significant underweight in financials and energy.

While I don’t expect that the absolute level of outperformance can be sustained, it remains one of my top picks in the Canadian equity category. Its costs are reasonable, the expected risk reward profile is favourable, and it looks much different from the index. This is exactly the type of fund you want when considering an actively managed fund.

TD Entertainment & Communications Fund

Fund Company	TD Mutual Funds
Fund Type	Global Equity
Rating	A
Style	Growth
Risk Level	High
Load Status	No Load / Optional
RRSP/RRIF Suitability	Fair
Manager	Daniel Martino since Oct, 2009
MER	2.82%
Fund Code	TDB 652 – No Load Units TDB 324 – Front End Units
Minimum Investment	\$500

Asset Mix



ANALYSIS: Finally, a fund after my own heart – entertainment and communications! This fund invests in companies such as Amazon, Google, and Facebook. Given the pace at which our communication technologies continue to evolve, there is significant growth opportunity, if you have the stomach to withstand the potential of another tech bubble.

It is a concentrated portfolio where the top 10 names make up slightly more than half of the fund. Not surprisingly, it is heavily weighted towards technology, which makes up nearly 60%. Consumer services is the next largest sector, making up 35% of the fund. It has a go anywhere mandate, but its historic focus has been in the U.S.

As part of the investment process, the manager looks for multi year, secular trends that they expect to evolve over the broader technology landscape. Because of this longer term focus, portfolio turnover been fairly modest, averaging in the 40% range. They

will use periods of higher volatility to improve the portfolio, as they did in 2008 and 2009.

It has been a very strong performer, finishing in the first quartile every year except for 2008 and 2002 when it finished near the bottom. It is slightly more volatile than the category average, which is not surprising given the narrowness of its mandate. If you are considering investing in this fund, you'd better be ready for a potentially bumpy ride.

It is classified as a global equity fund because the Science & Technology category is no more. Despite the strong performance and modest historic volatility, this is not a fund that I would consider to be a core holding. Given that it invests only in a few sectors, the potential for extreme volatility is fairly high. Instead, I believe that this fund should be treated much like a sector fund, and is only suitable for those who can accept its higher risk profile. Exposure within a portfolio should also be limited.