Top Funds Report

Markets Higher in August

Except Asia, all equity markets higher. Bonds rally on accommodative central banks.

August was another strong month for investors, as most markets ended in positive territory. The exception was the MSCI EAFE Index, which was lower by 0.4% in Canadian dollar terms as Asian Pacific markets, specifically Japan were lower.

Bonds were higher as the combination of accommodative central banks and increasing geopolitical uncertainty pushed yields lower.

Canadian equities continued to roll along, gaining 2.09% in August, bringing the year-to-date gain to more than 16%. Positive economic news has helped to provide a tailwind to stocks, as the Canadian economy roared back to life, with GDP growing at an impressive 3.1% in the second quarter. This was above expectations, with many economists looking for a more muted 2.5% rise.

As we enter what has historically been the most volatile period of the year for the markets, I remain cautious. Equities remain fully valued, and if there is any stutter with revenue or earnings, a downturn is likely. There is increasing geopolitical pressures bubbling in a number of areas including Ukraine, Syria and Gaza. If we see a meaningful escalation in any of these conflicts, many investors may head for the exits, embracing the traditional safe havens of gold and government bonds.

Finally, many investors have become complacent. Market volatility is now at levels that are below what we saw in 2007 and 2008. Any increase could leave investors concerned, causing them to sell their equity holdings and run for the exits.

Still, I continue to favour equities over fixed income, particularly for the medium to long term. As rates begin moving higher, it will act as a major headwind for fixed income investments. Equities, even at current levels offer a more compelling risk-reward trade-off than bonds.

While the conditions may be ripe for a market correction, I believe that that it would be ill-advised to try to time any such correction. The damage of being wrong can more than outweigh the short-term pain of remaining fully invested. However, if you have a time horizon of three years or less, it may be wise to protect your capital by taking a more defensive position.

My current investment outlook is:

	Under-weight	Neutral	Over-weight
Cash		**X**	
Bonds	**X**		
Government	X		
Corporate		X	
High Yield	X		
Global Bonds			X
Real Ret. Bonds	X		
Equities			**X**
Canada		X	
U.S.		X	
International		X	
Emerging Markets	X		

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

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Funds You Asked For

This month, I take a look at a few RBC offerings, as well as Trimark and Dynamic funds

RBC O'Shaughnessy Global Equity (RBF 1036) – This is managed using a quantitative strategy designed by Jim O'Shaughnessy. He screens the global equity universe looking for characteristics such as strong sales growth, cash flow, and dividend yield. He also considers trading liquidity. This could serve as a core global equity fund, with its diversified portfolio and go anywhere mandate. The portfolio is made up of the top 200 rated stocks and is rebalanced on a yearly basis. Like other O'Shaughnessy managed funds, it tends to be a bit more volatile than other global equity funds, but over the long term, it has shown it can deliver decent risk adjusted returns.

RBC Global Dividend Growth (RBC 1035) – Investing industry leading companies located anywhere around the world, the managers like companies with consistent and predictable profit growth, and the ability to pay and grow dividends. Performance, particularly recently, has been strong. It has been one of the better global equity funds around since 2011. For the three years ending July 31, it's gained an annualized 16.4%, handily outpacing its peers. Be warned, despite its emphasis on high quality dividend paying companies, it tends to be more volatile than the index. Still, over the long term, I expect it can deliver above average returns, on both an absolute and risk adjusted basis.

RBC Emerging Markets Equity (RBC 1099) – Launched in December 2009, this emerging markets fund shows a lot of promise. Managed by veteran Phillippe Langham and his team using a "Growth at a Reasonable Price" approach, performance has been very strong. To the end of July, it has gained an annualized 8.10% for the past three years, handily outpacing both the index and many of its peers. Perhaps more impressive, the fund's overall volatility and downside capture are very favourable. In fact, on a risk adjusted basis, this fund is starting to give my current favourite, Brandes Emerging Markets, a run for its money. The downside is that while it appears that the emerging markets have turned the corner, there are still significant risks in the region, and more volatility is expected. Unless you can stomach the higher risk, you will probably want to avoid this fund for now.

RBC European Equity Fund (RBF 1033) – European equities remain attractively valued when compared to their North American brethren. Given the struggles in many European economies, these valuations may be justified. Aggressive stimulus action from the European Central Bank has the potential to spur a liquidity driven rally that may push prices up. Unfortunately we can't say when or even if that will happen. But if you have a long-term time horizon and want to gain exposure to the troubled region, this is not a bad way to do it. Managers Dominic Wallington and David Lambert take a hands on approach with this diversified, large-cap offering. Looking at the portfolio, I don't expect this to shoot the lights out, but I don't expect it to hurt you too badly either. However, given the economic situation in Europe, only those who can stomach the potential risks should even consider this fund.

RBC Canadian Dividend Fund (RBF 266) – In my conversations with Canadian equity managers, one of the topics that comes up rather often is how challenging it becomes to find suitable investment opportunities as the size of the fund increases. That makes the performance the team of Stu Kedwell and Doug Raymond have been able to squeeze out of this behemoth even more impressive. At more than $19 million, this is the largest mutual fund in Canada.

Despite this hulking size, it has generated an annualized three year return to the end of August

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of 14.1%, finishing in the top 25% of the Canadian dividend funds. Volatility has been in line with other dividend funds, but is lower than the broader Canadian equity markets.

The portfolio looks exactly how you would expect a large cap dividend fund to look, with nearly half in financials, and each of the big five banks in the top ten holdings. Higher yielding energy names also play a big part of this fund, making up more than a quarter of the portfolio.

Not surprisingly, the underlying yield is higher than the broader TSX, yet it lags its peer group. This is largely because its size prevents it from taking any meaningful positions in some of the smaller index names that offer better yields.

Understandably, the biggest concern I have with this fund is its size. The managers are somewhat limited, as they may not be able to be as nimble as they could be with a lower asset base. Because of that, I would expect that this will continue to do what it has done for the past several years – deliver slightly above average returns with average risk. If you are looking for a fund that showcases the manager's skill set, you may want to take a look at the **PH&N Canadian Equity Value** or the **RBC North American Value Fund**. Either of these could quite easily work as a core holding in a well-diversified portfolio.

Trimark Income Growth Fund (AIM 1543) – This is a fund that is currently in transition, and on paper, the prognosis looks good. The equity portion of the fund is managed by the team of Clayton Zacharias, Mark Uptigrove, and Alan Mannik. This trio took the reins in the middle of 2012, and run their portion in an identical fashion to all other Trimark branded funds. They are looking to build a concentrated portfolio of high-quality Canadian stocks with strong management teams that are attractively priced relative to their historical earnings, cash flow and valuation record. Ideally, they are looking for names that are trading at least 30% below their estimate of its true value. Another solid aspect of their process is they take a relatively long term outlook, which affords them the time to be patient and allow their investment thesis to develop.

Like other Trimark funds, they are benchmark agnostic, meaning they can invest in companies of any size, operating in any sector of the market. At the end of August, they were overweight energy, technology and healthcare, with significant underweights in materials and consumer focused names. There was also a meaningful exposure to mid-cap stocks.

There is also a new team in charge of the fixed income sleeve of the fund, after industry veteran Jennifer Hartviksen was tapped to run the bond team. With Ms. Hartviksen's arrival last year, the focus shifted heavily towards corporate bonds, which now make up more than two-thirds of the fixed income sleeve. I believe this to be a very prudent move in light of the current rate outlook, as I expect that corporates should outperform government bonds.

The fund has a neutral asset mix of the traditional 60% equities and 40% fixed income, but the managers have flexibility around those targets. The asset mix is set by Mr. Zacharias with input from both the equity and fixed income teams. Like other Trimark branded funds, it is currently holding a significant cash balance, currently around 17%. Rounding out the mix are equities, which make up 53% and bonds are roughly 30%.

I expect that the recent changes will be a positive. However, it's a bit too early to say for certain. Performance YTD has lagged, but much of that may be attributed to the high cash balance. The managers are ready to take advantage of market correction that will allow them to pick up some good companies at favourable valuations.

I am cautiously optimistic on the fund. I like the changes that have been made and believe that we should start to see a turnaround in performance over the next few quarters. Still, I am taking a

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wait and see approach, looking for evidence the changes have indeed been positive.

Dynamic Dividend Advantage Fund (AIM 1543) – Looking at the underlying holdings of the dividend fund reinforces what a unique offering it is. Unlike most traditional dividend funds that are heavily weighted towards banks and energy, this Cecilia Mo managed fund has only 12% invested in financials, 5% in REITs, and 18% in energy. These are well below not only the benchmark, but the category average.

While Ms. Mo has managed this fund since late 2011, its mandate is very similar to the **Fidelity Dividend Plus Fund**, which she ran with great success from 2005 until 2011. Her research driven, bottom up approach to find high yielding stocks that are trading at a discount remains the same. She targets a dividend yield of between 3% and 4%, but also focuses on a company's fundamentals to ensure that the dividends are sustainable, and likely to grow. She focuses on a company's payout ratios, balance sheets and earnings growth opportunities.

Valuation is also key to her process. She believes that by buying a company below its worth provides a strong margin of safety, helping to protect capital. She targets an annualized return of between 7% and 8%, of which half is expected to come from dividends.

Since taking over, she has more than met her return target, with an annualized three year gain of 16.7% at the end of August. Clearly this level of absolute return is not sustainable going forward, but I do believe that she will be able to continue to deliver above average returns.

One drawback to her process is that has historically been more volatile than other dividend funds. Her funds tend to be more in line with the volatility of a more traditional equity fund. Not a deal breaker by any stretch, as long as you are comfortable with the extra risk.

There are a number of reasons to like this fund including the manager, the process, and of course, her long term track record. Another positive is that it boasts an MER of 1.60%, which is one of the lowest in the category. It pays a monthly distribution of $0.055, which works out to an annualized yield of 4.4%. If you are comfortable taking on a higher level of risk, this is a fund that should be considered.

The World Money Show

I am very excited to be presenting at the World Money Show at the Metro Toronto Convention Center on Friday, October 17. This year, my presentation is titled "Understanding Smart Beta and Active ETF Strategies". This interesting and informative seminar discusses a number of the new and innovative "smart beta" and actively managed ETF strategies that being brought to the market. I will be highlighting what they are, how they work, and how they can benefit your portfolio. The show runs from October 16 – 18. If you are attending the show, please drop by and say hello!

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

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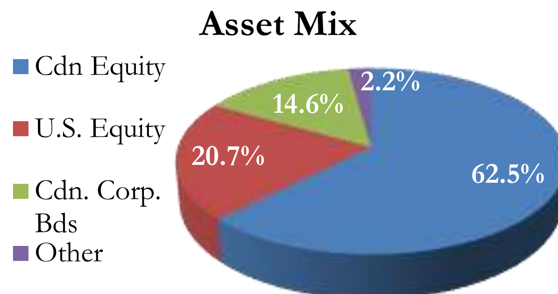
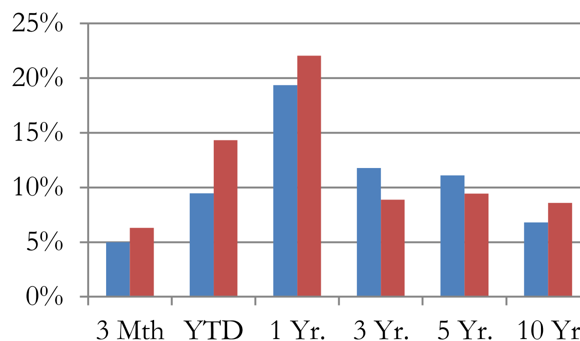
Franklin Bissett Dividend Income

Fund Company	Franklin Templeton Investments
Fund Type	Canadian Equity Balanced
Rating	A
Style	GARP
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Excellent
Manager	Ryan Crowther since June 2011 Les Stelmach since Dec. 2012
MER	2.39%
Fund Code	TML 203 – Front End Units TML 303 – DSC Units
Minimum Investment	$500





ANALYSIS: Managed using Bissett's fundamentally driven, bottom up security selection approach, this fund provides exposure to a mix of high yielding equities, and up to 25% invested in fixed income investments. The equity sleeve invests predominantly in Canada, but can also invest in the U.S.

Their approach looks to find companies that have strong, consistent earnings, growing cash flow and a history of financial strength. With the emphasis on income, it invests primarily in dividend paying companies. The investment process is very patient, as portfolio turnover has averaged less than 15%.

At the end of June, it held approximately 15% in bonds, with the balance in equities. The fixed income holdings are somewhat defensively positioned with a duration that is well below the benchmark.

The equity portion looks a lot like you would expect a dividend fund to look, with significant allocations to both energy and financials. Combined, these two sectors make up more than half the fund. It pays a monthly distribution of $0.055 per unit, which works out to an annualized yield of approximately 2.1%.

Performance since 2010 has been very strong, outpacing most of its peer group. So far this year, it has lagged, largely because of underperformance from some of its key financial names, and zero exposure to Encana, Suncor and Canadian Natural Resources. For the three years ending August 31, it has generated an annualized return of 12.07% per year. As with many of the funds I like, the volatility has been well below both the index and its peer group. Capital protection is also quite strong, with a stellar down capture ratio across all time periods.

Looking forward, I expect that this fund will continue to deliver. Many of the holdings continue to show nice gains based on the growing profitability of their underlying businesses. Further, the manager believes that in most cases, these companies are trading below what would be defined as their intrinsic value, providing strong upside potential.

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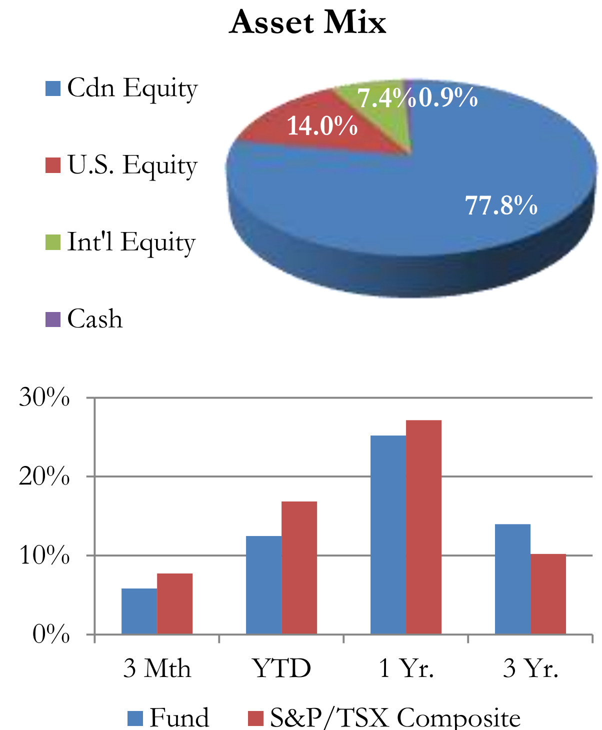
Jarislowsky Fraser Select Canadian Equity

Fund Company	Jarislowsky Fraser Ltd.
Fund Type	Canadian Focused Equity
Rating	B
Style	GARP
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Margot Ritchie since Oct. 2010 Helen Beck since Nov. 2012 Charles Nadim since Nov. 2012
MER	1.47%
Fund Code	NBC 3402 – Front End Units
Minimum Investment	$500



ANALYSIS: With roots dating back to 1955, Jarislowsky Fraser is one of the oldest and highly respected investment management firms in Canada. Until recently, they did not offer any mutual funds directly to investors under their own banner, until the launch of three funds in 2010.

This Canadian focused equity offering invests mainly in large, industry leading companies that have strong management teams and a track record of earnings and limited financial leverage. The managers rely heavily on the firm's in-house equity team, and use a top-down and bottom up economic analysis with a focus on long-term investment themes to help identify the most attractive areas of the market. They believe this allows them to find companies that have long-term, stable earnings prospects.

When evaluating a specific investment, the managers use a fundamentally driven, bottom up analytical process that relies heavily on meetings with company management. Philosophically, their approach is more "growth at a reasonable price." There are four key criteria that must be met before a company can be added to the portfolio. They are: strong management, sustainable growth in earnings and cash flow, sound balance sheets, and reasonable valuations. This approach is very patient, with low levels of portfolio turnover.

Since its launch, the performance of this fund has been quite strong, with a three year annualized return of 14%, outpacing both the S&P/TSX Composite and most of its peer group. It has also been significantly less volatile than both the index and its peers. It has also done a great job at protecting capital. For the three years ending August 31, it has experienced less than 40% of the downside movements of the TSX.

Another thing going for this fund is its cost. It has an MER of 2.16%, which is well below the average for a Canadian equity fund. This is certainly a fund to take a look at. It has a strong management team at the helm following a process that has been in place for decades, all at a reasonable cost. This has the potential to be a great core holding for most investors.

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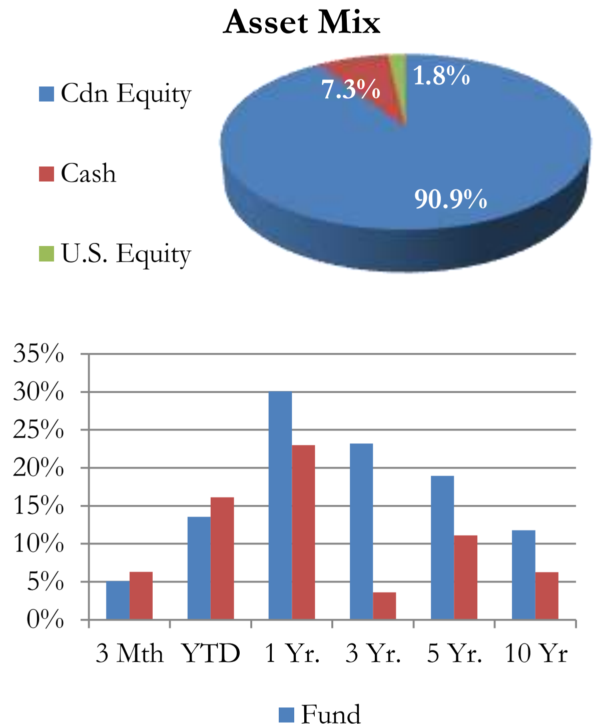
IA Clarington Canadian Small Cap Fund

Fund Company	IA Clarington Investments Inc.
Fund Type	Canadian Small/Mid Cap Equity
Rating	A
Style	Blend
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Excellent
Manager	Ian Cooke since November 2008 Joe Jugovic since March 2007
MER	2.94%
Fund Code	CCM 520 – Front End Units CCM 521 – DSC Units
Minimum Investment	$500



ANALYSIS: I have been a fan of the QV managed small/mid cap funds for as long as I've been in the business. The current management team of Ian Cooke and Joe Jugovic look for high quality businesses run by strong management teams that are trading at attractive valuations.

Once a potential investment is identified, the team assess whether the companies truly have a sustainable competitive advantage that will allow them to deliver consistent cash flows. Once they determine this, they do a scenario analysis based on discounted cash flows to get an estimate of the intrinsic value of the company. They like to see companies trading at a significant discount.

The portfolio will be fairly concentrated, typically holding between 30 and 40 names. At the end of June, the top ten names made up about 40% of the fund. Sector exposure is largely the result of the stock selection process, but more often than not have exposure to at least seven of the ten sectors. They are not afraid to make sector calls. At the end of June, it was underweight materials and real estate, while overweight in financials and consumer names.

Performance, particularly over the long term has been excellent. For the three years ending August 31, it has gained an annualized return of more than 23%, leaving most of its competitors in the dust. Even more impressive, the fund's volatility is about two-thirds that of the average small cap fund, and it has unbelievable downside protection.

If I had to pick a fault with the fund, it is that it is quite expensive with an MER of 2.94%. This is well in the upper half of its peer group. Another issue to consider is the fund is much bigger than it used to be, meaning that the managers may have more difficulty in implementing their process with the same level of effectiveness. This mandate has been capped to institutional investors, and it may be closed to retail investors at some point in the future. Until then, this remains one of the best small cap offerings available.

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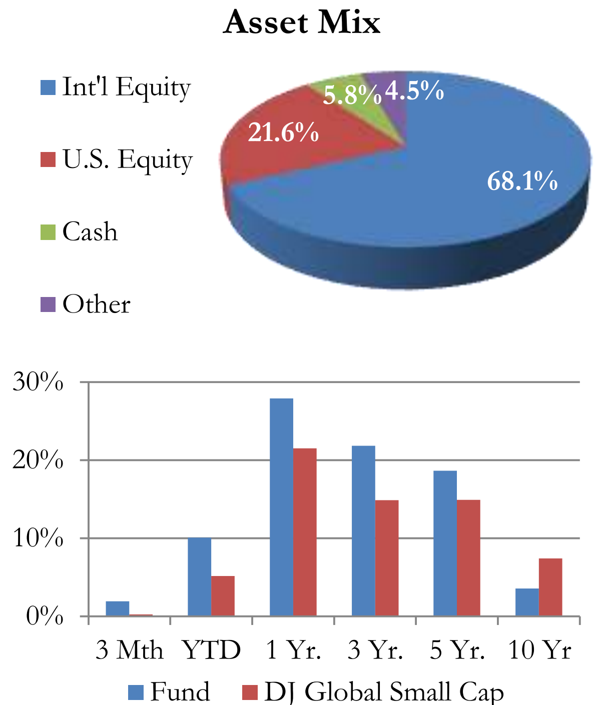
Steadyhand Small Cap Equity Fund

Fund Company	Steadyhand Investment Funds
Fund Type	Cdn Focused Small/Mid Cap
Rating	A
Style	Blend
Risk Level	High
Load Status	No Load
RRSP/RRIF Suitability	Good
Manager	Wil Wutherich since Feb 2007
MER	1.78%
Fund Code	SIF 150 – No Load Units
Minimum Investment	$10,000



ANALYSIS: This small cap offering from Steadyhand is definitely worth taking a look at. It is a concentrated portfolio of 15 to 20 names managed by Wil Wutherich.

Using a disciplined bottom up process, he looks for companies that have promising prospects and are expected to deliver high relative earnings growth, but are trading at a reasonable valuation. All companies in the portfolio must show some level of growth, be it revenues, earnings, or cash flows. A typical company will be a simple, repeatable business that is easy to understand. It will have a strong balance sheet and an experienced management team with significant ownership interests in the business.

Because the portfolio is built on a stock by stock basis, the sector mix and geographic allocation are driven by the available investment opportunities. At the end of June, he held 63% in Canadian equities, 18% in U.S. equities and held nearly 19% in cash. Mr. Wutherich is disciplined, and unafraid to hold significant cash balances if no suitable opportunities are available. Given the current valuations, suitable opportunities are scarce. This high cash balanced can be a positive, protecting capital if we see a market selloff. It can also act as “dry powder” allowing him to take advantage of opportunities as they arise. The downside is it is a drag on performance if there is a significant market rally.

Performance, particularly the longer term numbers are impressive. On an annualized basis, it has gained 19.1% for the past five years, handily outpacing the index and competition. Shorter term, things don’t look as good, with a more modest 5.67% in the first eight months of the year. With a concentrated portfolio, it is not uncommon to see periods where there is a significant disconnect with the index. Longer term, the fund has been able to outperform with a much lower level of volatility, and excellent capital protection.

Another risk with this fund is key person risk. It is largely Mr. Wutherich who runs this fund and if he were unable to continue, there would be a significant effect to investors.

On balance, for those who can stomach the potential risks, this is a great small cap offering and can be a part of an otherwise well diversified portfolio.

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