Top Funds Report

The Beginning of the End?

Volatility returns with a vengeance leaving many asking if this is a repeat of 2008.

Historically, September and October have been the cruelest months for investors, and this year is no exception. Between September 1 and October 15, the S&P/TSX Composite dropped by 12%, the MSCI EAFE plunged by nearly 15%, and the S&P 500 was off 7%.

Some are expecting this selloff to continue as we head towards the end of the year. Valuations, even after the selloff remain near the upper end of historic averages. The global economy continues to show subpar levels of growth, and geopolitical concerns continue to rise. Add to that the worries over a global outbreak of the Ebola virus, and the markets are ripe for a continued drawdown.

On the positive side, the U.S. economy is finally showing signs of meaningful job creation. The U.S. ISM Purchasing Managers Index continues to show signs that the economy is growing. While headwinds remain, things appear to be on track.

My view is that this current correction is just a normal selloff that is necessary to take some steam out of the markets. In North America, particularly the U.S., I see the positives outweighing the negatives. As jobs return, so too will consumer spending which will help increase top line revenues, keeping corporate profitability moving in the right direction. I remain positive on U.S. equities and expect they will continue to outperform for the near term.

The situation in Canada is more tenuous. Our economy continues to slow and with consumer debt loads rising, some slowdown could be on the horizon. Factor in lower commodity demand, and the outlook is not particularly positive. However, a rising U.S. dollar may bring some relief to our export sector, helping to mitigate some of the pressure. Under this scenario, I am neutral to slightly negative on Canadian equities.

In Europe, the much anticipated stimulus measures have failed to spur much in the way of a market rally. However, speculation remains that further easing measures are likely. Any additional stimulus is expected to spur a liquidity driven rally, unfortunately we cannot predict when such a rally will occur. I remain neutral to slightly negative on European equities.

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.

Funds You Asked For

This month, I take a look at a few defensive offerings, as well as picks from Renaissance and Mawer…

Dynamic Advantage Bond (DYN 258) – For those looking to play defense in the b markets, there really isn't a better choice than this fund. The management teams number one objective is to preserve invested capital. To do this, they actively manage the duration exposure and credit profile. To date, the results have been impressive, only experiencing a fraction of the downside movements of the Canadian bond market. One very big warning is that you are likely to be left behind in any bond rally because of the defensive positioning. But if you're only looking to preserve your capital, this is my top pick.

PH&N Total Return Bond (RBF 1340) – The fixed income team at PH&N is arguably one of the best on the street and this fund gives them a bit more flexibility than the highly regarded **PH&N Bond**. Basically, this fund is approximately 70% of the bond fund, with 30% invested in more non-traditional investments like mortgages, high yield and derivatives. In a rising rate environment, I expect this to outpace their traditional bond offering, but expect it to be hit harder than the Dynamic fund discussed earlier. Those looking for more balance between upside and downside will want to look at this fund.

RBC Global Corporate Bond (RBF 580) – With an emphasis on corporate bonds from around the globe, the managers use an active approach to managing both interest rate risk and credit exposure. They have done a great job in preserving investor capital. Looking at its performance in periods where the bond market in general is falling, it has managed to post positive returns. A drawback is it is likely to underperform in a sharp market rally. But if you're comfortable with the underperformance in exchange for a stronger downside protection, this is a fund worthy of consideration.

Templeton Global Bond (TML 704) – The manager uses a very active, somewhat non-traditional approach to building this portfolio. Instead of mirroring an index, they use a relative value approach looking for undervalued currencies, government bonds, and interest rates in countries that are healthy or on their way back. It has done a great job in protecting capital, but has been a touch more volatile than other global bond offerings. Another drawback is cost, with an MER of 2.19%, it's a little pricey. Still, given the process, protection and diversification benefits, this is a good fund to hold in period of volatility.

CI Cambridge Canadian Equity (CIG 14120) – Performance of this Canadian focused offering has been very strong. Perhaps more impressive is that its volatility level has been significantly lower than the S&P/TSX Composite Index and its downside protection has been stellar. Historically, it has captured the overwhelming majority of the gains when markets are rising, but has experienced less than half of the drawdowns in falling markets. That makes it a great holding for periods of above average volatility.

Franklin U.S. Rising Dividends Fund (TML 201) – Of the U.S. equity funds available, there are none better at protecting capital in down markets than this one. While most other U.S. equity funds tend to fall more than the S&P 500, this gem has only fallen between 60% and 70% of the broader market. Even in 2008 when the S&P was off by nearly 30%, this fund was only down 11%. A drawback is that it will lag when markets are rising. But if you are looking for a U.S. equity fund that is likely to hold up in volatile times, this is one you should take a look at.

Mackenzie Ivy Foreign Equity (MFC 081) – When the global equity markets get rocky, this is the fund you'll want to own. When markets are falling, this concentrated global offering has historically held up better than most. For example, in 2008 when the average fund was down 30%, it was down only 6.7%, and in 2011, the average fund was down 6.7%, yet this fund was higher by 3.2%. The tradeoff, of course, is that you will lag behind in a sharply rising market. But if you're comfortable with not making as much on the upside to protect capital when things get rough, this is the fund to do that.

Renaissance Optimal Growth & Income Portfolio (ATL 2939) – Like the highly regarded **Renaissance Optimal Income Portfolio**, this invests in a number of other funds offered by CIBC's Renaissance brand.

It is like a traditional 60/40 balanced portfolio. Within the fixed income sleeve, it provides exposure to not only traditional bonds, but also high yield, floating rate notes, and global bonds.

The equity component is income focused, with the **Renaissance Canadian Dividend Fund** making up the lion's share. It also has about 15% invested in global infrastructure, which is a great way to get not only growth potential, but also lower volatility, and a decent yield.

With just a year of track record under its belt, I am encouraged by what I have seen so far. For the year ending September 30, it gained 13%, finishing well in the upper half of the global neutral balanced category.

Costs appear to be reasonable, with an estimated MER of 2.10%.

If I had to pick a weakness, it would be their U.S. equity fund. I have been less than impressed with it over the years. That said, the managers have done a great job at squeezing the extra juice out of the portfolio with the Income Portfolio. I am cautiously optimistic they can do something similar with this offering.

I can't give it a full thumbs up, since it only has a year's worth of data. But as long as you don't bet the farm on it, I think you'll do okay.

Steadyhand Equity Fund (SIF 130) – Despite dropping nearly 2.5% in September, and another 5% in the first half of October, the Fund is still up 6.7% on a year to date basis (as at October 15). This is well ahead of the pack.

There are a number of reasons it has been able to hold up better than many of its peers. The first is the managers, CGOV, focus only on high quality companies that have sustainable business models, a growing and sustainable dividend yield, and excellent management teams with a history of generating strong levels of free cash flow. While quality is a key consideration, so too is valuation. They will only buy a name if it is well below their estimate of intrinsic value. This allows for a margin of safety that will help to preserve value when things get rough.

This concept is also evidenced by their excellent downside capture ratio of under 30% for the past three years. This means that the fund, on average, has only participated in 30% of the downside of the broader Canadian market. Since the beginning of September, it has experienced about two-thirds the volatility of the S&P/TSX Composite. An impressive feat for such a concentrated portfolio.

As I said in my June review of the fund, their emphasis on downside protection and margin of safety will go a long way to outperformance over the long term. If nothing else, it has certainly helped during the recent weeks.

Fidelity Global Disciplined Equity Fund (FID 200) – The most interesting aspect of this fund is that it is managed using a sector neutral approach, with the portfolio's sector mix matching the benchmark. It is a hybrid between indexing and active management, with the sector exposure preset and the manager able to use their stock selection process to build out the portfolio.

The theory is this approach will allow the manager's stock picking ability to shine through. Unfortunately, it has failed to do that, underperforming the MSCI World Index by a substantial margin, on both an absolute and risk adjusted basis. For the five years ending September 30, the fund gained 8.4%, while the index was up by 13.6%.

In my opinion, there are a couple of flaws with this type of fund. First, by forcing sector weights to match the benchmark, a very important tool is taken away from the manager. Without the ability to overweight or underweight sectors, it becomes increasingly difficult for them add value. Further, the end portfolio tends to perform somewhat similarly to its benchmark, as evidenced by its high correlation and R-squared to the MSCI World Index. Basically, the portfolio is substantially similar to the index.

If the portfolio is very benchmark like, it highlights the second flaw with this fund, being the relatively high cost. The MER for the front end version is 2.47%, which is slightly below the category average, but the DSC version is above the average, with an MER of 2.67%. If you have a portfolio that is much like the benchmark, the cost becomes a critical factor in its performance. Adding an additional 247 basis points of performance, while being saddled with the index weights is a near impossible task for most portfolio managers.

Fidelity offers this type of fund for both Canadian and U.S. equity. The results have been similar for the U.S. version, which has lagged the S&P 500 over time. The Canadian version has fared much better, producing shorter term results that have actually outperformed the S&P/TSX Composite.

Still, I would be reluctant to recommend this strategy for most investors. It is my opinion that most are better off going with a high quality actively managed fund, or a low cost passive index fund or ETF to gain a similar investment exposure. I believe that in both cases, investors will fare better than with this type of fund.

Mawer U.S. Equity Fund (MAW 108) – Mawer is one of those companies that seems to do most things right. They offer a decent family of funds run by quality managers, following a disciplined repeatable process, all at a reasonable cost.

Each of their funds is managed using a research driven, bottom up approach that looks for well managed companies that have a history of earning attractive return on capital, strong balance sheets, and a record of delivering strong operational and financial results. Valuation is a consideration, and he will try to buy names when they are trading below their estimate of its true worth. They stress test their models and assumptions through an intensive scenario analysis that gives them a stronger understanding of the company's fundamentals and valuation. The process is very patient, with portfolio turnover averaging well below 10% for the past five years.

The result is a well-diversified portfolio that holds just under 60 names with the top ten making up a third of the fund. Sector positions are capped at 20% of the fund based on book value, but recent market growth has brought the weighting of the financial to 23% of the fund. Industrials are the next largest sector, coming in at 16%.

Given Mawer's track record with most of their other mandates, I really want to like this one as much as I like the others. Unfortunately, it continues to struggle to differentiate itself from its peers. For the three years ending September 30, it has gained an annualized 23.8%, trailing the 25.7% earned by the S&P 500. It did however finish in the upper half of the category.

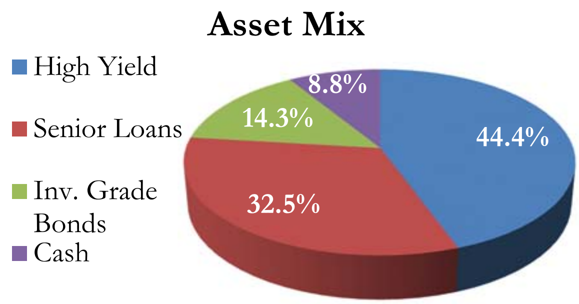
I remain lukewarm at best on this fund. I don't believe you will get hurt too badly, but I feel that there are better U.S. equity funds available.

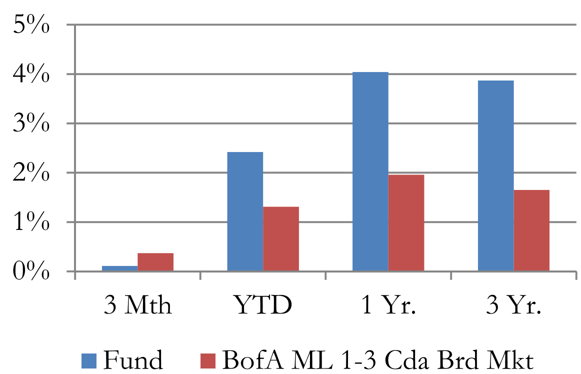
If there is a fund that you would like reviewed, please email it to me at

feedback@paterson-associates.ca.

Norrep Short Term Income Fund

Fund Company	Norrep Funds
Fund Type	Miscellaneous – Income & Real Property (Short Term Bond)
Rating	A
Style	High Yield
Risk Level	Low to Medium
Load Status	Front End
RRSP/RRIF Suitability	Good
Manager	Bill Holy
MER	1.71%
Fund Code	NRP 1101
Minimum Investment	$500





ANALYSIS: This is not your father's short term bond fund. While a more traditional short term offerings focus on high quality, investment grade short term bonds, this invests mainly in short term high yield bonds and senior loans. At the end of September it held 44% in high yield, and 33% in senior loans. The rest was 9% cash and 14% in investment grade bonds.

With the emphasis on high yield and loans, credit quality is lower. For example, the **TD Short Term Bond Fund** is invested fully in bonds that are rated BBB or above. In comparison, this has more than half invested in bonds rated below BB.

At the end of September, the yield to maturity was listed at 5.3%. This is nearly three times the yield offered by more traditional short term bond funds. Duration is comparable, coming in at 2.3 years.

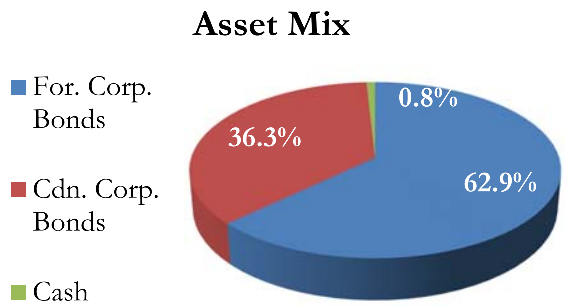
Performance, particularly over a three year period has been strong, gaining an annualized 3.87% to the end of September. This handily outpaced its peers. Over the same period, the TD Short Term Bond Fund gained 1.45%, while the **PH&N Short Term Bond & Mortgage Fund** was up by 2.09%.

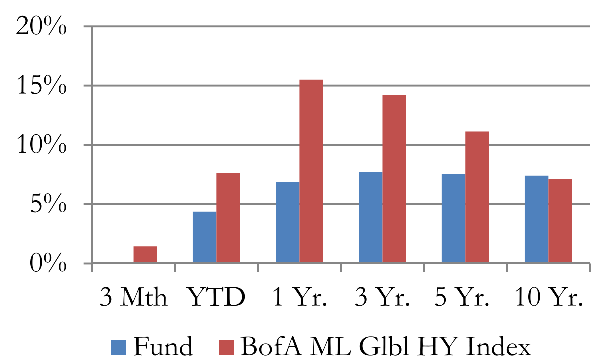
With the higher risk investments, it is not unexpected to see that volatility has been higher. Surprisingly, it has only shown a loss in 3 of the past 36 months. Going forward, I would expect this to increase, as the lower quality offerings may suffer at the expense of higher quality bonds as investors move into higher quality investments during the market volatility.

While I like this fund, it is not for everybody. It is riskier than most of the traditional short term offerings. If there any sort of a liquidity issue in the high yield or senior loan market, the fund could experience a larger drop. I also expect that it will lag during periods of market volatility, as the riskier bonds are sold off as investors flee to the safe haven of government debt. Still, over the long term, if you have an above average appetite for risk, this may be a decent spot for your short term money. If you're not comfortable with the prospect of a loss of capital, you will want to avoid this and focus on a fund that invests in higher quality issues.

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





ANALYSIS: It is almost like Christmas came early, with the announcement that the **PH&N High Yield Bond Fund was reopening**. This has long been my favourite high yield offering, but it has been closed to new investors since November 2010.

With current market conditions, they felt it was possible to reopen the fund. However, according to RBC, there is only a limited amount of capacity, and they will not hesitate to close it again as that level approaches.

Its focus is on medium quality corporate bonds, convertibles, and preferreds. At the end of August, 96% of its holdings were rated BB or lower.

It can invest anywhere in the world, but currently about 37% is in Canada, 63% in the U.S. The U.S. allocation is up significantly from a year ago. 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 duration of 2.5 years, well below the 3.8 years of a year ago. This positioning will allow it to hold up better than the broader bond market when rates move higher.

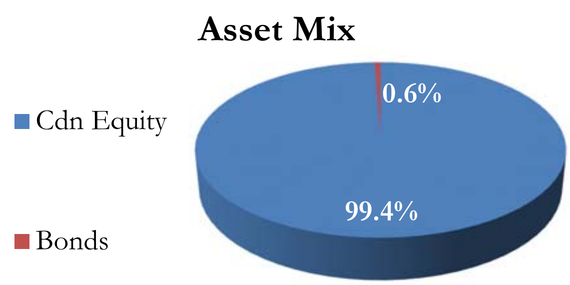
Given the more conservative nature of the fund, performance can be a bit of a mixed bag compared with other high yield funds. It tends to lag in markets where high yield issues are rallying higher, yet holds up much better in periods of extreme uncertainty.

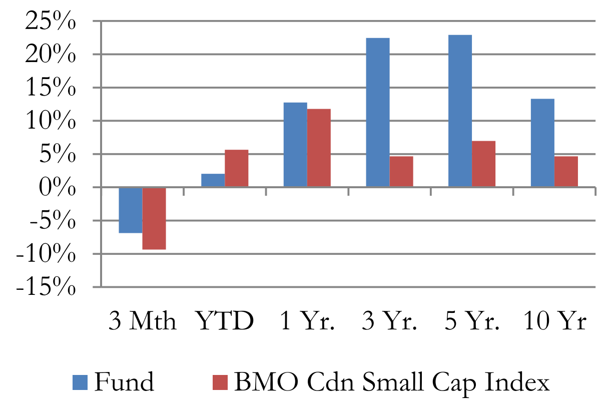
Volatility is the lowest in the category, resulting in consistently above average risk adjusted returns. Another bonus is that it carries one of the lowest MERs in the category, even for the advisor sold units.

This has 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 likely to be closed again as new assets flow into the fund.

Franklin Bissett Microcap Fund

Fund Company	Franklin Templeton Investments
Fund Type	Canadian Small/Mid Cap Equity
Rating	A
Style	Value
Risk Level	High
Load Status	Optional
RRSP/RRIF Suitability	Fair
Manager	Ralph Lindenblatt since Sep 10 Richard Fortin since Sep 2010
MER	3.78%
Fund Code	TML 207 - Front End Units TML 306 - DSC Units
Minimum Investment	$500





ANALYSIS: This has been one of the best performing small cap funds available in Canada since 2009, gaining an annualized 22.5% for the past five years. As impressive as that has been, it has really struggled so far this year, losing 7% on a year to date basis, after dropping 13.5% since September 1.

There are a couple of reasons for this big drop. First, the fund focuses solely on very small companies with market caps of less than $350 million. When markets get volatile, investors tend to flee small, more illiquid names in favour of higher quality companies.

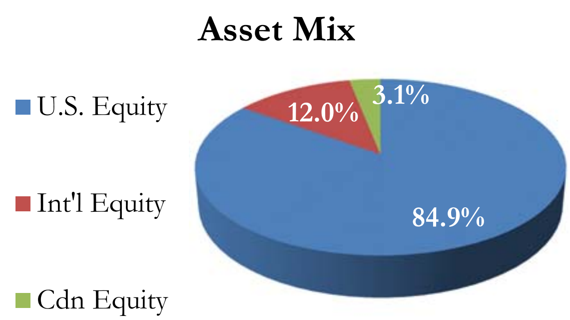
Second, it had more than 35% invested in energy at the end of June. With increasing supply from the Middle East and worries over global demand, the price of oil has been in a tailspin, bringing this fund with it for the ride.

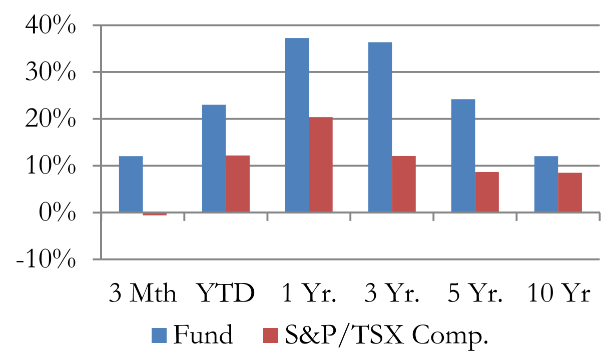
Despite the recent troubles, I believe that this can be a great small cap fund for those with an above average risk tolerance. Make no mistake about it, this is a very risky fund. It invests in microcap companies. To put this in perspective, the average Canadian small cap fund has an average market cap of around $2 billion. This fund is at roughly $250 million. The result is a fund that tends to be more volatile than both the benchmark and the category.

In addition to this being a risky fund, it is also quite pricey. The MER is listed at 3.78%, which is more than 120 basis points higher than the category average. While returns have made up for this above average cost, in a period of more modest returns, it can be quite the headwind for the managers. With its emphasis on microcap companies, this really is a rather unique offering. That said, I believe it is best suited for investors who have a very high risk tolerance that are looking for above average gains over the long term. Given the high levels of volatility, portfolio exposure should be limited for most investors. Those not comfortable with the high levels of risk may want to consider a more traditional small cap fund.

TD Health Sciences Fund

Fund Company	TD Asset Management
Fund Type	Healthcare Equity
Rating	A
Style	Growth
Risk Level	High
Load Status	No Load / Optional
RRSP/RRIF Suitability	Fair
Manager	Taylor Tamaddon since Jan 13
MER	2.82%
Fund Code	TDB 976 – No Load Units TDB 320 – Front End Units TDB 350 – DSC Units
Minimum Investment	$500





ANALYSIS: Since mid-2010 healthcare stocks have been on a tear, with the S&P Global 1200 Health Care Index gaining nearly 26% a year for the past three years. Part of the reason for this has been that the sector has a number of stable businesses that generate strong free cash flows, pay above average dividends, and have an earnings stream that is not tied to the global economy.

Healthcare is considered a defensive sector, and given many investors' preference to play defense in light of potential volatility, it has gained a lot of attention. And rightly so. Since September the broader equity markets have been hit hard, yet healthcare is down marginally.

While the sector is strong, all healthcare funds are not created equally. One of my favourites has been the **TD Health Sciences Fund**. It invests in companies that are involved in the research, development, production, or distribution of products or services related to health care, medicine, or the life sciences. To qualify for selection, companies must derive at least 50% of their assets, revenues, or operating profits from those activities. The manager tends to focus in the U.S. where nearly 85% of the fund is invested.

Performance has been strong on an absolute and relative basis, posting first quartile performance in all time periods. It has also done a great job in protecting investors' money. Historically, when the healthcare sector has lost money, this fund has lost much less, while managing to outperform when markets are rallying.

Another reason I like to have some healthcare exposure in a portfolio is that is has exhibited a relatively low level of correlation to the traditional asset classes. When included in a well-diversified portfolio, it can help to reduce the overall volatility, while helping to boost the expected return.

As of August 31, the correlation between the fund and the S&P/TSX Composite was 0.27. This will allow it to provide some reasonably compelling diversification benefits when included in a well-diversified portfolio. The biggest drawback to this fund is its cost, with an MER of 2.82%. That said, to date, it has more than justified this cost when considering the risk reward profile and historic return.