

Top Funds Report

Markets Bumpy Ride Continues in October

Despite volatility sanity returns in second half of the month. .

In September, the long awaited market correction began, continuing well into the first half of October. 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%.

Fortunately, as October unfolded, cooler heads prevailed. Many global equity markets starting the process of digging out of the hole caused by the selloff, returning value back to investors. Still, equity markets ended the month largely mixed, with the U.S., Asia, and the emerging markets finishing in positive territory, while Canada, Europe, and Japan ending in the red.

At home, markets were dragged lower on continued weakness from the commodity sector. Worries that the global economy was in a slowdown put pressure on energy and material names. Continued worry over the strength of the European economy was a headwind in the region.

The Canadian dollar continued to weaken, ending the month at \$0.8869, down from \$0.8922. This helped to improve returns for foreign investments that were unhedged. Another benefit is the lower dollar makes Canadian exports more attractive to U.S. and foreign consumers, which may help to light a fire under the economy.

Fixed income markets were higher across the board with long-term and government bonds leading the way on a flight to safety trade. High yield, which had been sold off sharply in

September rebounded in October, as investor confidence returned.

As we head into the final weeks of the year, I remain cautiously optimistic that markets will continue to rally. I continue to favour equities over fixed income. I don't expect to see any material change in interest rates, which should help to keep bonds relatively stable.

Within equities, I continue to favour the U.S. There is much uncertainty in Europe, and Canada is likely to be driven by commodities. With global economic growth a question mark, I am expecting continued volatility in Canada.

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 picks from my Recommended List of Funds...

PH&N High Yield Bond Fund (RBF 1280 – No Load Units, RBC 6280 – Front End Units)

– Last month, I highlighted that this excellent fund was re-opened to new investors. At the time, I knew it was only a matter of time before it was closed again. Not surprisingly, that time has come with the recent announcement that the fund would be capped again on November 26. If you currently don't have any exposure to this fund, but would like some, you had better act fast. This is arguably the best high yield bond fund in the country, providing access to the space with a much lower volatility profile than many of its peers.

IA Clarington Canadian Small Cap Fund (CCM 520 – Front End Units, CCM 521 – DSC Units) – Recently, I added this to my Recommended List of Funds. It was more difficult decision to make than you would imagine. Not because it doesn't belong on the list, but because it is a very similar fund to one that was already on the list – the **CI Can-Am Small Cap Fund**. Both are managed by QV Investors out of Calgary using a near identical process that looks for high quality businesses run by strong management teams that are trading at attractive valuations. Both funds are built on a bottom up basis, and tend to be fairly concentrated.

But they are also somewhat different, with the CI Can-Am Small Cap having more exposure to mid-cap names, and more than 22% invested in U.S. small cap stocks. It is this difference which ultimately tipped the scales towards the IA Clarington offering.

In a recent conversation with manager Joe Jugovic, he indicated that valuations in the U.S. small and mid-cap space were less attractive than

what is available with Canadian small caps. Looking at the valuation metrics of both portfolios confirmed this, with the P/E ratio, operating margins, expected earnings growth, and the debt ratios favouring the IA Clarington Canadian Small Cap. Looking forward, while short term momentum may still favour the U.S. small caps, the valuation story in Canada is more compelling mid to long term. Because of that, I opted to make the switch.

That said, I still believe that the CI Can-Am Small Cap is a great fund. If you hold it, and are comfortable with it, I would not suggest that you make an immediate change. Going forward, I believe the environment slightly favours the Canada focused Clarington Canadian Small Cap.

Renaissance Global Markets Fund (ATL 1029 – Front End Units, ATL 1873 – DSC Units) – I have been growing increasingly concerned about this fund for the past few quarters. Manager David Winters uses a fundamentally driven, deep value approach that looks for undervalued and distressed companies of any size, that are out of favour with the broader market that have strong prospects for a significant return.

The portfolio looks nothing like the benchmark, and neither does its performance. Unfortunately, recent performance has lagged by a significant margin, and the risk / reward metrics have continued to erode. The manager is taking steps to improve the outlook for the fund, taking advantage of the selloff in Asia to add to their holdings in the region, particularly Hong Kong. At the end of September, more than a quarter of the equity holdings were invested in Asia. Cash within the portfolio was sitting at nearly 13%.

While I believe that over the long term China is likely to return to solid growth, I'm not sure the

risks of this fund continue to justify keeping it on my recommended list in the near term.

Another factor in my decision is the fund is managed in a similar fashion to the **Franklin Mutual Global Discovery Fund**. Looking at the portfolio metrics of that fund leads me to favour it over this offering in the near term. Its holdings are more attractively valued on a number of criteria including Price to Earnings, Price to Book, and Price to Cash Flow. While its recent performance has been somewhat underwhelming, its risk reward characteristics have been improving. I continue to monitor that fund closely as well.

CI Global Health Sciences Corporate Class (CIG 201 – Front End Units, CIG 701 – DSC Units) – I have long been a believer in the health care story, and that hasn't changed. What has changed is how I want to access the sector. The CI Global Health Sciences Fund had quite a run, however, the tide turned on it back in February when the entire sector sold off. However, while the other funds in the sector have made up their losses, this fund has continued to languish and the risk reward characteristics have eroded significantly. I am currently reviewing the other healthcare options and will determine which I believe to be the best way to play the sector.

Dynamic Global Real Estate Fund (DYN 085 – Front End Units, DYN 785 – DSC Units) – I had become increasingly concerned about the risk reward metrics of this fund for a few quarters now. While I don't believe it to be a bad fund, I don't believe it is the best in the category. It has struggled for a couple of years, on both an absolute and risk adjusted basis, and when I look at the metrics of the underlying portfolio, I don't expect that there will be a rapid turnaround.

Fidelity Canadian Large Cap Fund (FID 231 – Front End Units, FID 531 – DSC Units) – One of the things I like about this fund is manager Dan Dupont is disciplined and sticks to his value focused style. He runs a portfolio that looks

nothing like its benchmark, and in a rarity for a Canadian focused fund, has no exposure to Canadian banks or golds. It is also significantly underweight in energy. The result is a return stream that is much different from the index, which helps explain why it has struggled to keep up with its peers so far this year, as energy and materials have been rallying sharply. However, when these sectors hit the skids in September, it was able to outperform both the index and the overwhelming majority of its peers.

Over the long term, I believe that the value focused style will result in above average returns with lower risk. However, I also expect there to be periods where it dramatically underperforms. As a result, if you are at all uncomfortable with the potential for significant underperformance for a quarter or two, you may want to consider another fund that is more closely aligned with the index. However, if you are looking for the potential for above average risk adjusted returns, this is a fund that is definitely worthy of consideration.

Trimark Canadian Small Companies Fund (AIM 1683 – Front End Units, AIM 1681 – DSC Units) – Invesco recently announced that this fund would be closed to new investors effective October 8. It is a "soft cap", meaning that those investors who already held the fund could add to their holdings. While it is unfortunate that one of the best small cap funds in the country is being capped, it really is in the best interest of the current investors for them to do so.

The managers run a very concentrated, high conviction portfolio that is made up of the managers' best 25 to 40 ideas. They are disciplined in their approach and will not make any investment that does not meet their strict quality and valuation criteria. This can result in significant cash balances, which at the end of September sat at more than 30%.

If you hold this fund and it is appropriate for your portfolio, I would continue to do so. However, if you are looking for an alternative high quality Canadian small cap offering, you will have to look elsewhere. The **IA Clarington Canadian Small Cap** (or the other QV man-aged funds **CI Can-Am Small Cap**, or **NEI Ethical Special Equity**), or the **Sentry Small Mid Cap Income Fund** would be my picks.

Mackenzie Ivy Foreign Equity Fund (MFC 081 – Front End Units, MFC 611) – I have long said that this is the global equity fund you want to own when markets get volatile, and that point was driven home by recent market activity.

Between September 1 and October 16, the MSCI World Index dropped by nearly 6% in Canadian dollar terms. During the same period, the Ivy Foreign Equity Fund dropped a little more than 3%, or roughly 56% of the downside movement of the market. This is in line with its historic average.

The managers run a concentrated portfolio of high quality companies from around the world with strong balance sheets and excellent management teams that are trading at a reasonable valuation. They are very patient in their approach as evidenced by their low levels of portfolio turnover.

For the most recent five year period, it has averaged less than 20% per year. With more volatility likely in the next few quarters, those investors looking for a way to gain global equity exposure with lower volatility will want to consider this offering. One warning, given the conservative nature, it is likely to lag in rising markets.

Dynamic Power Global Growth Class (DYN 014 – Front End Units, DYN 1714 – DSC Units) – The overwhelming majority of the time, I focus on funds that do a great job at managing volatility and protecting capital. This fund is definitely an exception to that, with a standard deviation that is nearly double the MSCI World

Index, a beta that is well north of 1, and upside and downside capture ratios that will leave you shaking your head.

Managed by Noah Blackstein, this is a concentrated portfolio of 20 to 30 companies from around the world that he believes to have the best growth prospects, strong earnings momentum and a history of upside earnings surprises.

At the end of September, it had exposure to only three sectors; technology, consumer discretionary and healthcare. Tech names made up more than half the fund, and consumer names were 30%. Mr. Blackstein's style is very active, with levels of portfolio turnover averaging more than 200% a year for the past five years. This approach is very successful when markets are rallying sharply higher, but it can be devastating when markets get hit.

For example, in 2008, the MSCI World Index was down by nearly 30%, while this fund was down by 47%. It recovered nicely, gaining 30% in 2009, more than doubling the 13% rise in the index. So far this year, it has matched the performance of the index, but still finished easily in the top quartile. In October, it gained 6.76%, more than four times the 1.6% gain in the index.

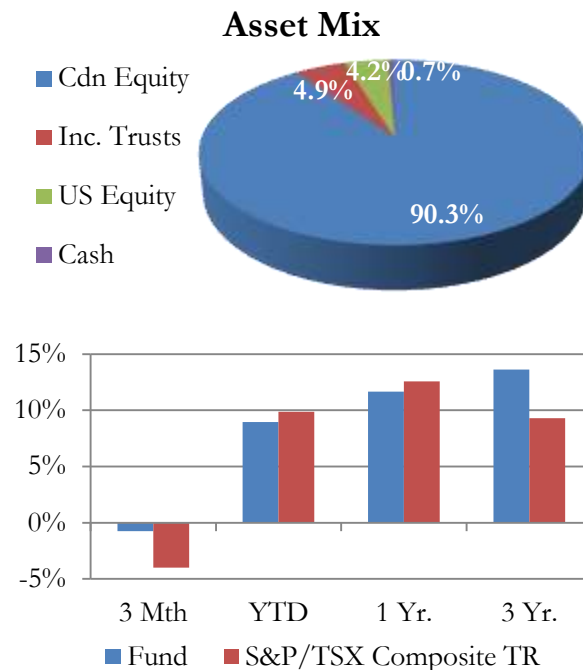
Obviously given the risk reward profile of this fund, it is definitely not for everybody. Nor should it be viewed as a core equity holding. Instead, I see this as a fund that should only be considered by those who have a risk tolerance that is well above average, and are comfortable with the potential of losing a big chunk of their money over a relatively short period of time. But if you can stomach the ride, the potential for outsized gains as we move into the last couple months of the year remains strong.

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

feedback@paterson-associates.ca

PowerShares Canadian Dividend Index

Fund Company	Invesco Canada
Fund Type	Cdn Dividend & Income Equity
Rating	A
Style	Value
Risk Level	Medium
Load Status	Front End
RRSP/RRIF Suitability	Good
Manager	PowerShares Management Team
MER	1.81%
Fund Code	AIM 44203 – Front End Units
Minimum Investment	\$2,000



ANALYSIS: This was one of the first funds that invested solely in ETFs. It invests in the **PowerShares Canadian Dividend Index ETF (TSX: PDC)**, which invests in the 45 largest Canadian listed companies that have had stable or increasing dividends for at least the past five years.

With its focus on large, dividend paying companies, it is heavily skewed towards financial services. At the end of October, financials made up more than half the fund. The next largest sectors are energy at 15% and communications at 12%. This is even more concentrated than the S&P/TSX Composite, where the three largest sectors make up less than two-thirds.

Performance has been strong, handily outpacing the S&P/TSX Composite Index. Volatility has been well below the broader market, and it has offered very strong downside protection, resulting in strong outperformance on a risk adjusted basis.

The underlying yield estimated at more than 4%, well above the broader market. This will help to preserve capital and increase returns in periods of higher than normal volatility. It pays a monthly distribution that has yielded approximately 3.6% over the past year.

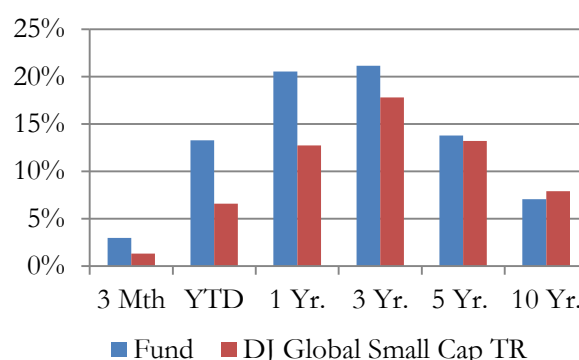
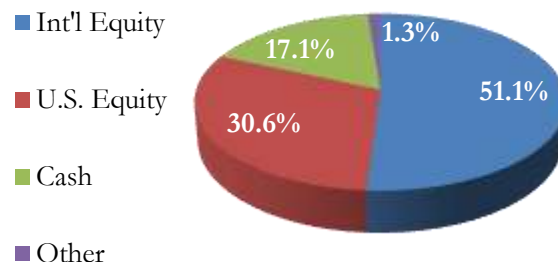
Because the underlying investment is an ETF, the costs are very competitive, with an MER of 1.81%. Yes, this is higher than the underlying ETF, but it's important to note that it includes the cost of the underlying ETF, a 1% trailer to the dealer, and a modest amount of operating expenses. So all in, the costs are still very reasonable. If you are a buy and hold, DIY investor, the ETF is a better choice, but if you are working with an advisor, would like to make ongoing transactions or prefer the structure of a fund, the fund is the way to go.

My biggest concern with this fund is its concentration. While the fund has been less volatile than the broader markets, the level of concentration increases the total risk of the fund. If there is any sort of a crisis that hits the banks or other financial services companies, this fund could be hit very hard. As a result, I am somewhat reluctant to recommend it as a core holding. Instead, I can see it as a portion of your Canadian equity exposure, providing a low cost way to access higher yielding equities and generate a modest cash flow.

Fidelity NorthStar Fund

Fund Company	Fidelity Investments
Fund Type	Global Small / Mid Cap Equity
Rating	B
Style	Mid Cap Value
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Excellent
Manager	Daniel Dupont since Oct 2011 Joel Tillinghast since Jan 2012
MER	2.40%
Fund Code	FID 253 – Front End Units FID 553 – DSC Units
Minimum Investment	\$500

Asset Mix



ANALYSIS: The management team of Daniel Dupont and Joel Tillinghast have been at the helm of this go anywhere, all cap global equity fund since early 2012. They struggled out of the gate, but have been on a tear ever since, outpacing both the index and its peer group. Equally impressive is that volatility has been lower than the index and peer group and the downside protection has been very strong, participating in less than half of the market declines over the past three years.

The managers have informal and formal meetings where they discuss the relative attractiveness of investment opportunities in various regions around the world. Apart from that, they work largely independent of each other, with each using their unique, bottom up, value focused approaches to security selection.

Daniel Dupont uses a more concentrated approach that focuses the portfolio in 20 to 50 companies with sustainable business models that can deliver high return on capital over the long term. To be considered, it must be trading at a significant discount to its true value. In comparison, Fidelity veteran Tillinghast uses a value

focused approach that focuses on companies that are growing faster than their peers, have little or no debt, excellent management teams, and have the ability to deliver consistent earnings and stable revenue. One interesting quirk to his approach is he will only buy stocks that are trading under \$35 a share and appear undervalued relative to its peers.

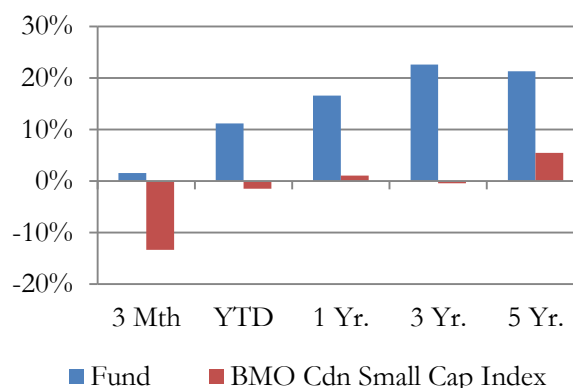
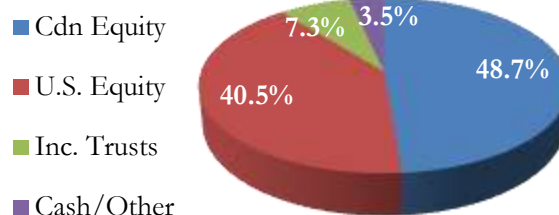
The end portfolio is well diversified, holding more than 400 names. The top ten make up around 20% of the fund. Neither manager is afraid to hold cash when no opportunities are available. At the end of October, 16% of the fund was in cash, 31% in U.S. equities with the rest in Europe and Asia.

This is not a fund that will shoot the lights out when markets are rallying. But it should hold its own when markets get rocky. The result is that over the long term, you can be expected to earn an above average rate of return, at a below average level of volatility. If you have an above average risk tolerance, you could use this as a core global equity holding, but if not, it can be a good complement to an otherwise well diversified portfolio.

Sentry Small / Mid Cap Income Fund

Fund Company	Sentry Investments
Fund Type	Canadian Small/Mid Cap Equity
Rating	A
Style	Mid Cap Blend
Risk Level	Medium High
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Aubrey Hearn since July 2005 Michael Simpson since July 05
MER	2.72%
Fund Code	NCE 721 – Front End Units NCE 321 – DSC Units
Minimum Investment	\$500

Asset Mix



ANALYSIS: This has been one of my favourite small and mid-cap offerings for nearly five years now. Managed by Aubrey Hearn and Michael Simpson, it has the dual objectives of providing consistent monthly income and capital growth, and has succeeded on both. Since I began recommending it, it has outperformed its competition by a wide margin on both an absolute and risk adjusted basis.

It invests in the same type of companies as the highly regarded **Sentry Canadian Income Fund**. The key difference is this fund looks for small and mid-cap names, while the Canadian Income Fund tends to skew towards large cap companies. They look for companies that have high return on capital, low leverage, rising free cash flow, low earnings volatility, strong management teams, high barriers to entry, sustainable competitive advantages, and the ability to consistently grow their dividends over time.

It is fairly diversified, holding approximately 60 names, with the top ten making up less than 30%. With its emphasis on income, it is significantly

underweight in energy, materials, and somewhat surprisingly, financials. The portfolio is positioned for an economic recovery, with a heavy emphasis on consumer and industrial names.

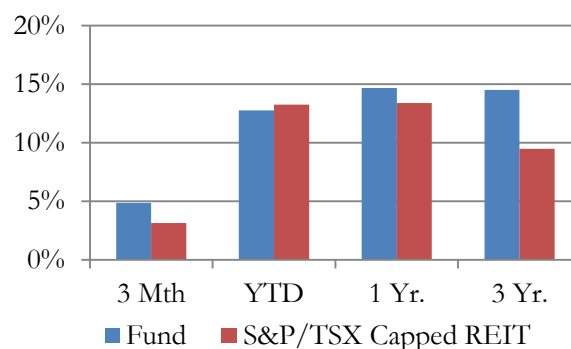
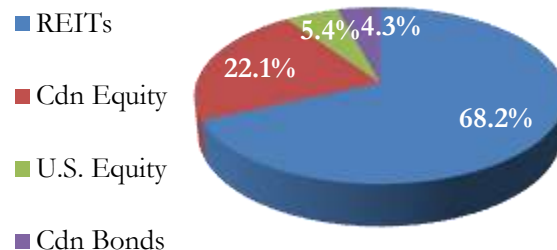
The fund can invest up to 49% of its holdings outside of Canada, and they have been taking advantage of that. At the end of October, it had 45% invested in the U.S., up significantly over the past few years. The main reason for that is management has struggled to find suitable opportunities in Canada, and have had to look abroad. At the end of October, it was fully invested, with a modest 1% cash balance.

It pays a monthly distribution of \$0.05 per unit, which at current prices is a yield of approximately 2.8%. My biggest concern of the fund is its cost, with an MER of 2.72%. This is above the category average. While the cost is high, the return generated so far, has more than offset it. While I don't believe that the historic level of returns are sustainable going forward, I still expect that it will continue to deliver above average returns with below average risk.

First Asset REIT Income Fund

Fund Company	First Asset Funds
Fund Type	Real Estate Equity
Rating	A
Style	Value
Risk Level	Medium to High
Load Status	Optional
RRSP/RRIF Suitability	Fair
Manager	Lee Goldman since June 2010
MER	2.50%
Fund Code	FAF 5803 – Front End Units FAF 5800 – DSC Units
Minimum Investment	\$500

Asset Mix



ANALYSIS: As an asset class, REITs were hit pretty hard during the “taper tantrum” in May of 2013, with the S&P/TSX Capped REIT Index dropping by nearly 17% between May and August. They have since fought their way back, and recouped the losses and then some. During that selloff, the First Asset REIT Income Fund was down by 9.7%, but has since rebounded by more than 23%, significantly outperforming the benchmark.

Manager Lee Goldman runs a concentrated portfolio of predominantly Canadian REITs and real estate operating companies. He can also invest up to 30% of the fund outside of Canada. While the top holdings contain some familiar names such as RioCan, Boardwalk, and H&R REIT, the bulk of the portfolio is made up of lesser known names. Unlike most of his peers, Mr. Goldman focuses on small and medium sized companies, which make up more than 90% of the fund, compared with 80% for the REIT index.

Whenever you see a fund that is heavily focused in smaller companies, one of the big concerns is liquidity and how that will affect the managers’ ability to continue to execute their investment process. That is not

likely to be a concern for this fund in the near to medium term. At the end of October, assets were only \$30 million. This should give the managers continued flexibility to invest in small cap names without running into too much trouble.

The manager continues to like names with geographic exposure outside of Canada that have lower payout and leverage ratios, and are less dependent on the capital markets to execute their business strategy. He is also finding that many real estate investments continue to trade at discounts to their net asset value.

While the longer term performance has been good, more recent numbers are less impressive. However, factoring in the strong downside protection and the portfolio that looks much different from the index and its peer group make this an interesting alternative for investors seeking real estate exposure in their portfolios. While I like the fund, I would still exercise some caution given its focus on smaller names, and relatively short operating history. I believe it is only suitable for those who are comfortable taking on a higher level of risk.