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# Top Funds Report

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## Market Volatility Spooks Investors

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*Many looking for best way to preserve capital while still earn modest returns*

Recently, I was having a conversation with an advisor friend, and the topic of the current market environment came up. He, like many investors and advisors is very focused on generating modest returns, in a very risk managed fashion. His goal is to minimize risk and maximize gains.

That is a very difficult task these days. This is as challenging an environment as I have seen in my 20 plus years in the investment business. My friend's basic question was what is the best way to preserve capital for his clients at the moment? In other words, where do you hide?

The unfortunate reality is that there aren't a lot of places that you can hide. Sure, you can move to cash, put everything you own under your mattress, or put it all in a coffee can and bury it in the backyard where the dog won't find it. Those may be "safe" options, but while you are protecting your downside, you are sacrificing any potential upside, and actually losing to inflation.

That's what makes it so difficult. On one hand, you want to protect yourself, but know you need to be invested. Yet there are so many concerns overhanging the markets.

In Canada, the biggest issue we have right now is the low price of oil, which is expected to stay low for a while, hurting the western provinces. The positive is with the dollar falling and lower oil putting more money in the pockets of consumers, the outlook for the U.S. looks good, which makes a somewhat positive case for Ontario, Quebec and BC. That of course assumes that the current government doesn't drive us into the ground...

In the U.S., my biggest fear is valuation. While absolute numbers look on the high side, looking at the fundamentals compared with other areas like bonds, Europe, China, the rest of the EM, and even Canada, the higher multiples might be justified. It's not so much the U.S. is that good, but that it looks to be the least bad place to be, and probably the best option for the short term.

Europe is a basket case, China is in a bit of trouble (but I think they'll be fine in the end...) and the whole EM region is getting painted with the same brush as Russia and Brazil. So really, unless you have a very strong stomach and are comfortable with a roller coaster ride, you might want to avoid these areas in the short term.

It should come as no surprise, but bonds are a very tricky place to be right now. Obviously government bonds are expected to feel some pressure as the U.S. Fed moves closer to raising rates. Although, we've been saying that for three years. The economic growth numbers are positive, but not exactly shooting the lights out. Employment is growing, but again, not at a pace that would be expected to lead to any meaningful wage inflation. Combine that with oil in the dumper helping to keep prices in check, inflation is not likely to shoot higher at any point in time. Looking at the big picture, it's not as though the numbers are screaming for a rate hike. So while some predict they may move in the early spring, I'm thinking mid-year, at the earliest.

That said, I certainly wouldn't want to be long duration. Sure, if we see a flight to safety trade in

bonds, there is some potential for capital gains, but really most of the risks are to the downside.

Even investing in shorter duration bonds is tricky. When rates move higher, most of the impact is likely to be seen at the short end of the curve. Short rates are expected to move more than mid and long rates, so even at the short end, you're not totally out of the woods, and losses would be expected even in many of the higher quality short term bond funds.

In the high yield space, particularly in the U.S., it doesn't really look all that pretty right now. About 18% of the high yield indices are now energy related, which pushes the risk of default up higher. There is also a lot of money flowing out of high yield right now, which makes things difficult, particularly for those managers who like to invest in a lot of non-benchmark type issues, which can be illiquid in times of uncertainty. That said, while I am expecting more volatility in the short term, the medium term outlook is more positive, with an improving economy to help push default risk down, and higher yields to help cushion the effect of any interest rate hikes.

The reality is that nobody knows what is going to happen - Not me, not the PMs and traders, not the guys on BNN, and certainly not my Magic 8-Ball. So what do you do about it? Well, we play the probabilities. To do that, it is a matter of focusing on the basics. My tips for protecting capital in this period of uncertainty are:

**Understand your investment objectives, risk tolerance and timer horizon.** This will give you an idea of what your portfolio should look like.

**Create a well-diversified portfolio** covering a wide range of fixed income strategies, as well as a broad mix of equities that is in line with your investment objectives, risk tolerance and time horizon.

**Within your fixed income investments, look for managers that are active and not afraid to make a call** and position the portfolio for a

volatile and rising rate environment. **Dynamic Advantage Bond** and **Manulife Strategic Income** are two of my favourites. High Yield is an option, but only if you have the stomach for the potential of "equity like" volatility in the near term.

**In the equity space, focus on managers who are active in their approach, different from the benchmark, and focus on quality.** I would likely overweight the U.S., but I wouldn't bet the farm on it. I also don't think I'd invest in a pure U.S. equity fund right now, since it is really tough to find a manager that can outpace the index more often than not. In Canada, we're lucky that we have "Canadian Focused Funds" which can invest up to half outside of Canada, which is a good way to gain some U.S. exposure. I'd likely use one of these for my Canadian exposure in the near term. Another way to get U.S. exposure is through a global equity fund.

I think that by having a well-diversified portfolio, not getting too caught up in the day to day noise, you'll do fine over the long term.

My current investment outlook is:

|                  | Under-weight | Neutral | Over-weight |
|------------------|--------------|---------|-------------|
| <b>Cash</b>      |              | X       |             |
| <b>Bonds</b>     | X            |         |             |
| Government       | X            |         |             |
| Corporate        |              | X       |             |
| High Yield       | X            |         |             |
| Global Bonds     |              |         | X           |
| Real Ret. Bonds  | X            |         |             |
| <b>Equities</b>  |              |         | X           |
| Canada           |              | X       |             |
| U.S.             |              |         | X           |
| International    |              | X       |             |
| Emerging Markets | X            |         |             |

Please send your comments to [feedback@paterson-associates.ca](mailto:feedback@paterson-associates.ca).

# Funds You Asked For

*This month, I take a look at this year's winners and losers...*

**Fidelity Income Allocation Fund (FID 294 – Front End Units, FID 594 – DSC Units)** – Over the past several years, the balanced funds at Fidelity have improved dramatically. They are now run much like a fund of funds, investing in underlying pools run by some of Fidelity's top managers.

The fund's asset mix is managed by Geoff Stein, who was recently joined by David Wolf, formerly of the Bank of Canada. They monitor the macro outlook, market fundamentals, and investor sentiment, and adjust the asset mixes of the portfolios accordingly. It is rare to see the asset mix stray too far from target, but it does occasionally happen when they have strong conviction in an idea or theme.

For this fund, the target asset mix is 30% equity and 70% fixed income. There is some flexibility around this mix, where they can go +/- 20% from the target. At the end of November, it was pretty much on target, with 29% in equities, 63% in fixed income, and 6.5% in cash.

In addition to the more traditional asset classes, they have the ability to tap into Fidelity's massive global team to access to a wide range of other strategies including high yield, convertible debt, and floating rate notes.

Performance across all time periods has been top quartile. For the three years ending December 31, it gained an annualized 7.85%, handily outpacing both the index and its peer group.

Since Mr. Stein took over in 2011, volatility has been average, however the downside protection has been excellent. For the past three years, the fund has only experienced about half the drop in the benchmark.

Going forward, the managers favour U.S. equities based on the economy's slow and steady

upward trend. They are worried that global demand for commodities will act as a headwind for Canadian equities.

Within the fixed income sleeve, they have some exposure to U.S. high yield and U.S. convertible bonds, which are expected to hold up better in a rising rate environment, despite the increased credit risk.

On balance, I really like this fund. My biggest worry is that with more than 60% invested in fixed income investments, of which the vast majority is investment grade, repeating past performance will be a challenge with upward pressure on rates. However, with the excellent underlying management teams, combined with the strong asset allocation oversight, I expect this fund to outpace many of its peers on a risk adjusted basis. Still, I would likely lean more towards the **Fidelity Monthly Income Fund** over this offering because of its higher equity weight.

**Brandes Emerging Markets Equity Fund (BIP 171 – Front End Units, BIP 271 – DSC Units)** – With a one year loss of 1.15%, 2014 proved to be a tough year for this fund, lagging both the index and most of its peers. In comparison, the MSCI Emerging Market Index lost 1.8% in U.S. dollar terms, but gained more than 7% in Canadian dollar terms, thanks to a falling loonie.

The fund is managed by Brandes' investment committee using a bottom up, value driven process that looks for companies that are out of favour with investors and whose share price has been beaten down by the markets. They look for well managed companies that are trading at a significant discount to what they believe it is really worth. As a result, the portfolio has country and sector exposures that look nothing like that of the benchmark.

It is well diversified holding just under 70 names with the top ten making up just over 30% of the fund. Portfolio turnover is relatively modest.

Despite struggling of late, I fully expect that they will remain true to their value, almost contrarian style. The drawback to that is the fund will be prone to periods of underperformance, much like we are seeing now.

In a recent commentary, the managers stated that portfolio positioning was the main reason for its recent underperformance. Specifically, overweight allocations to Russian and Brazil have caused much of the pain.

Despite this, they remain committed to their investment thesis, particularly in Russia. They believe that Russia offers some of the most undervalued businesses in the world. Still, they are aware of the macro environment, and are watching their holdings closely. They believe the risk reward tradeoff is remains attractive over the long term.

Brazil is a different story, but troublesome just the same. Brazilian equities had a big selloff after government deficits ballooned to record highs after the latest budget. Add to that many of their key trading partners, namely China, Europe, and Argentina are struggling, and the macro picture looks grim.

Brandes' focus remains on finding undervalued companies, and not making buy or sell decisions based on the macro outlook. This strategy has the potential to reap rewards over the long term, however investors need to have the stomach to withstand periods of underperformance, and going against the grain.

Given the disciplined process used in this fund, I believe it is a good choice for those comfortable with the higher volatility. If you are not, you may want to consider an alternate fund or avoiding emerging markets in general. I will continue to monitor this fund.

**Templeton Global Smaller Companies Fund (TML 707 – Front End Units, TML 737 – DSC Units)** – On January 15, it was announced that Harlan Hodes would be replacing Martin Cobb as the lead portfolio manager on the fund. Mr. Cobb will remain with the firm, but as an analyst with responsibility for the chemical and materials sectors.

I see this as a positive. To be blunt, the fund struggled under Mr. Cobb's leadership, who took over in early 2011 after the departure of long time manager Brad Radin. For the past three years, the fund gained an annualized 13.9%, significantly underperforming the 22.1% rise in the MSCI World Small Mid Cap Index.

I had been less than impressed with this fund for quite some time. I found that Mr. Cobb, at least in my opinion, took an exceptionally long time to transition the portfolio after he took over. Returns were below average, and volatility increased from the previous management team. It failed to keep pace in rising markets, and underperformed dramatically when they fell.

Mr. Hodes joined Templeton in 2001 and has been dedicated to small-cap equities, managing a number of small-cap products. In fact, prior to this change, Templeton says he was responsible for managing nearly 90% of all Templeton small cap assets.

It is expected that there will be no change to the investment philosophy, strategy or process of the fund because of this change. It will still be managed using a disciplined, multi step, value focused process and they are still selecting names from the same database of buy candidates.

My hope is that under Mr. Hodes' leadership, the fund's performance can turn around. While I am encouraged by the change, I will continue to monitor it, looking for signs of a turnaround.

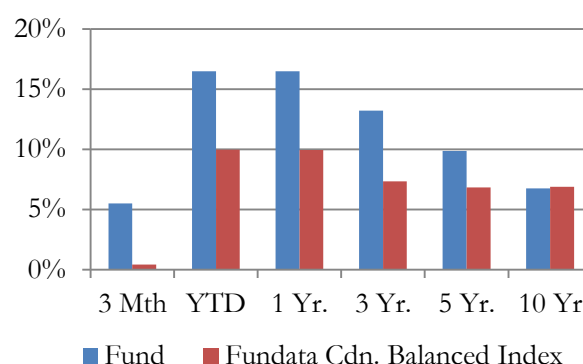
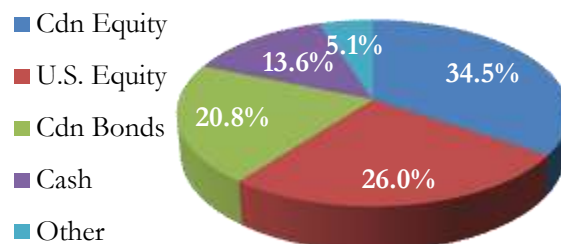
***If there is a fund that you would like reviewed, please email it to me at***

***[feedback@paterson-associates.ca](mailto:feedback@paterson-associates.ca)***

# Manulife Monthly High Income Fund

|                              |                                                               |
|------------------------------|---------------------------------------------------------------|
| <b>Fund Company</b>          | Manulife Mutual Funds                                         |
| <b>Fund Type</b>             | Canadian Neutral Balanced                                     |
| <b>Rating</b>                | A                                                             |
| <b>Style</b>                 | Large Cap Blend                                               |
| <b>Risk Level</b>            | Low – Medium                                                  |
| <b>Load Status</b>           | Optional                                                      |
| <b>RRSP/RRIF Suitability</b> | Excellent                                                     |
| <b>Manager</b>               | Alan Wicks since Sept 1997<br>Jonathan Popper since Sept 1997 |
| <b>MER</b>                   | 2.11%                                                         |
| <b>Fund Code</b>             | MMF 583 – Front End Units<br>MMF 483 – DSC Units              |
| <b>Minimum Investment</b>    | \$500                                                         |

**Asset Mix**



**ANALYSIS:** This is a fund that has been on my radar for a few quarters, and I recently had the chance to review it in more detail. It is a Canadian neutral balanced fund that has been managed by the team of Alan Wicks and Jonathan Popper since its inception in 1997.

The equity approach is rooted in a value philosophy that looks for businesses that generate high and sustainable profits that are trading at attractive valuations. Their process favours companies that have high barriers to entry, strong market share, and a high return on assets. They like management teams that have a demonstrated history of prudent capital allocation and strong corporate governance policies.

The fixed income sleeve is managed using a combination top down economic review combined with a bottom up credit analysis. The process looks to generate returns by focusing on sector allocation, credit quality and individual credit selection. They also emphasize risk management by managing the portfolios yield curve and duration exposure.

At the end of December it held 15% in cash, 35% in Canadian equities, 30% in U.S. equities and 20% in bonds. The equity sleeve is defensively positioned with consumer names making up 30%. It is dramatically underweight energy, materials, and financials which results in a portfolio that is dramatically different than the index.

Performance, particularly since 2011, has been excellent, posting an annualized three year return of 13.2% to the end of December. Perhaps even more impressive has been the volatility profile, which has been below both the benchmark and the category average. It has also done a great job at protecting capital in down markets.

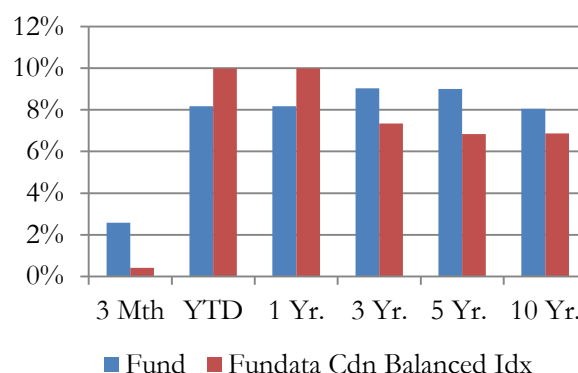
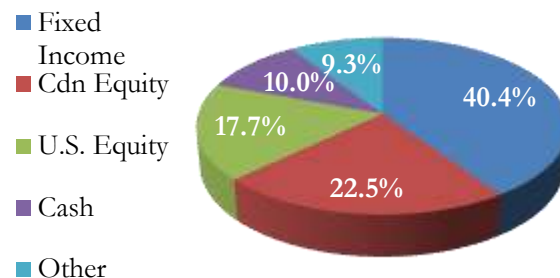
The lack of exposure to Europe and Asia is expected to help keep volatility in check, however, if a rally does take hold in Europe, it may lag some of its peers. The fixed income portion of the fund is defensively positioned and expected to hold up relatively well when rates do start to move higher.

I see this as a great one ticket solution.

# Fidelity Monthly Income Fund

|                              |                                                             |
|------------------------------|-------------------------------------------------------------|
| <b>Fund Company</b>          | Fidelity Investments Canada                                 |
| <b>Fund Type</b>             | Canadian Neutral Balanced                                   |
| <b>Rating</b>                | A                                                           |
| <b>Style</b>                 | Large Cap Value                                             |
| <b>Risk Level</b>            | Low - Medium                                                |
| <b>Load Status</b>           | Optional                                                    |
| <b>RRSP/RRIF Suitability</b> | Good                                                        |
| <b>Manager</b>               | Geoff Stein since April 2011<br>David Wolf since March 2014 |
| <b>MER</b>                   | 2.10%                                                       |
| <b>Fund Code</b>             | FID 269 – Front End Units<br>FID 569 – DSC Units            |
| <b>Minimum Investment</b>    | \$500                                                       |

**Asset Mix**



**ANALYSIS:** I have been a fan of this fund since just after Geoff Stein took responsibility for setting the asset mix. The recent addition of David Wolf, a former advisor to the Bank of Canada certainly won't hurt this fund going forward either. While at the Bank, Mr. Wolf was the main editor of the quarterly Monetary Policy Report and worked with the governing council that sets the Bank's overnight rate. Not a bad little resume, and will no doubt be able to bring some valuable insight to the asset allocation committee and Fidelity's roster of managers.

The fund is managed much like a fund of funds, investing in a mix of Fidelity managed pools run by some of the firm's top managers, including one of my favourites, Daniel Dupont.

In addition to the main asset classes, Mr. Stein also has access to a number of other mandates, such as high yield, convertible debt, and floating rate notes, thanks to Fidelity's massive global reach.

At the end of November, it had more than 40% invested in bonds. It is very well diversified, with exposure to a diversified basket of fixed income including both Canadian and U.S. investment grade debt, U.S. high yield, emerging market debt, and a small allocation to floating rate notes. Currency exposure is typically hedged to Canadian dollars.

The equity portfolio is a mix of value focused names and higher yielding equities. They are currently overweight consumer staples names like Empire and Safeway. It is underweight materials and energy.

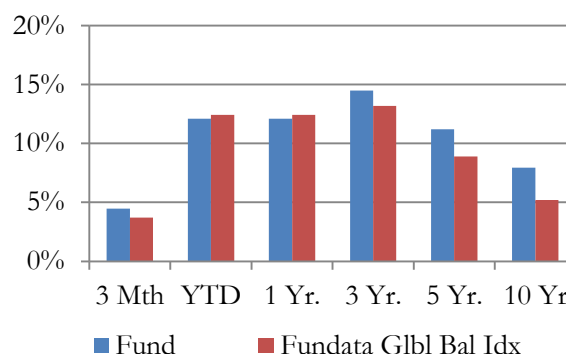
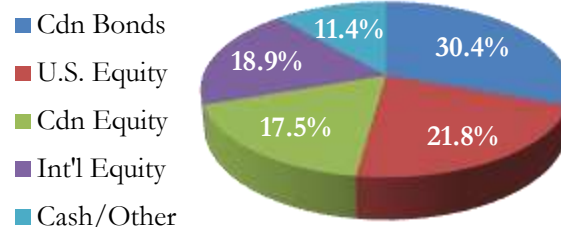
They remain positive on the U.S. and have an underweight position in Canadian equities. They believe the Canadian economy is going to face headwinds with lower demand for commodities.

The biggest worry with this fund is its higher level of interest rate sensitivity, which may act as a headwind when rates start to rise. Still, with its emphasis on risk management and strong oversight, this remains a great fund for most investors.

# Mawer Balanced Fund

|                              |                               |
|------------------------------|-------------------------------|
| <b>Fund Company</b>          | Mawer Investment Management   |
| <b>Fund Type</b>             | Global Neutral Balanced       |
| <b>Rating</b>                | B                             |
| <b>Style</b>                 | Blend                         |
| <b>Risk Level</b>            | Medium                        |
| <b>Load Status</b>           | No Load                       |
| <b>RRSP/RRIF Suitability</b> | Excellent                     |
| <b>Manager</b>               | Greg Peterson since June 2006 |
| <b>MER</b>                   | 0.96%                         |
| <b>Fund Code</b>             | MAW 104 – No Load Units       |
| <b>Minimum Investment</b>    | \$5,000                       |

**Asset Mix**



**ANALYSIS:** This has been one of the strongest balanced funds around for many year, consistently outperforming its peer group on both an absolute and risk adjusted basis.

It is very simple fund, investing in other Mawer managed mutual funds. It is a very well diversified portfolio, with 11% in cash, 30% in fixed income, 18% in Canadian equity, 22% in U.S. equities and the balance in international equities. Mr. Peterson manages the asset mix, and tends to make any changes in a very measured and gradual fashion.

Each of the underlying funds are managed using Mawer's disciplined, research driven, bottom up process that looks to find well managed, wealth creating companies that are trading at less than they are worth. This approach is very team focused, with portfolio managers and analysts constantly challenging ideas. Another interesting aspect is the stress testing of valuations the team conducts helping to provide an extra layer of insight to the companies they own.

The quality of the underlying funds is top notch, with two exceptions. The first is the **Mawer U.S. Equity Fund**. It continues to struggle to differentiate itself from its peers. It tends to lag the market when it's going up, and underperforms when it is falling. It has failed to add any value to the S&P 500, and has been more volatile. I expect it to be in the middle of the pack, and don't see anything that leads me to believe this is a consistent top performer.

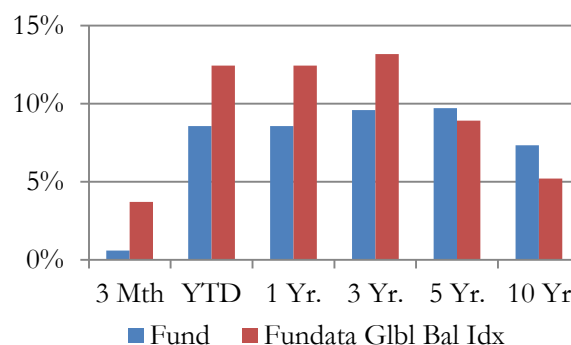
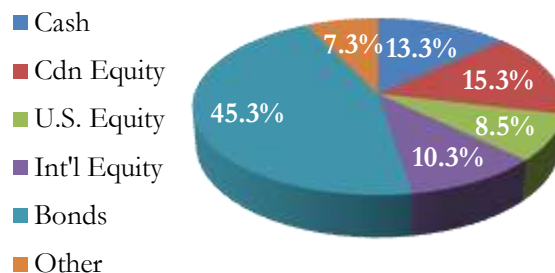
Second would be the **Mawer Canadian Bond Fund**, which looks quite like its index by most measures. It holds only 40% in corporate bonds, with the balance in governments. This positioning results in a high level of interest rate sensitivity, which is highly likely to cause underperformance when rates start moving higher.

Still, this remains one of the best choices for investors looking for a one ticket solution. It offers a very disciplined management process, and a rock bottom MER of 0.96%. Even adding in 1% for dealer compensation this fund is still cheap.

# CI Signature High Income Fund

|                              |                                                  |
|------------------------------|--------------------------------------------------|
| <b>Fund Company</b>          | CI Investments Inc.                              |
| <b>Fund Type</b>             | Global Neutral Balanced                          |
| <b>Rating</b>                | A                                                |
| <b>Style</b>                 | Large Cap Blend                                  |
| <b>Risk Level</b>            | Low to Medium                                    |
| <b>Load Status</b>           | Optional                                         |
| <b>RRSP/RRIF Suitability</b> | Excellent                                        |
| <b>Manager</b>               | Eric Bushell since Dec. 2010                     |
| <b>MER</b>                   | 1.60%                                            |
| <b>Fund Code</b>             | CIG 686 – Front End Units<br>CIG 786 – DSC Units |
| <b>Minimum Investment</b>    | \$500                                            |

**Asset Mix**



**ANALYSIS:** When I think of best in class balanced funds this one is usually at the top of my list. Managed by the Signature team at CI, it has consistently been one of the strongest performers in the category, yet at the same time has tended to be one of the least volatile.

For the five years ending December 31, it gained an annualized 9.7%, handily outpacing its benchmark and peer group. Even more impressive is that this was done with significantly less volatility. It has also done an excellent job at protecting capital in down markets, with a down capture ratio that is negative. This indicates it was likely positive when the index fell.

The portfolio is a mix of high yielding equities and high yield bonds. Historically, it could invest up to 49% outside of Canada, but that was recently changed to 70%, allowing the managers even greater flexibility. This may come in handy once we see interest rates start to trend higher, giving the managers the ability to find more opportunities abroad. It should also help to reduce the interest rate sensitivity of the

equity portfolio which is was highly concentrated in REITs and energy income plays.

Since the summer, they have been selling many of their energy names, not because they saw the swoon in oil coming, but because they felt these names were overvalued. REITs had also had a great run, and gave the team an opportunity to take some profits.

At the end of the year, the fund held approximately 16% in cash and 3.5% in short term bonds. They are using this significant cash balance for two things. The first is to help dampen the heightened volatility caused by the energy selloff and the continued troubles in Europe. Second, it serves as “dry powder” allowing them to step in and pick up quality names at bargain prices after a meaningful selloff.

The fund pays a monthly distribution of \$0.07 per unit, which works out to an annualized yield of approximately 5.7%. This makes it a solid choice for those looking for modest cash flow, while providing the opportunity to generate attractive risk adjusted returns over the long term.