

Top Funds Report

Oil Hits Canadian Economy

GDP growth turns negative in January. Believed to be a precursor to dismal Q1 numbers.

With oil continuing to struggle, the impact is starting to be felt across the entire Canadian economy. Earlier this month, Statistics Canada reported that GDP shrank by 0.1% in January, a stunning reversal of December's impressive 0.3% rise. If there is a bright spot in all of this, it is that it could have been worse. Many economists had been predicting a drop in GDP of 0.2%.

These numbers support comments made by Bank of Canada Governor Stephen Poloz, who expects the growth numbers for the first quarter to be "atrocious". That might be a bit harsh, but there is little doubt they will be disappointing.

I'm not so negative. The lower dollar, combined with an increase in economic growth south of the border will help to shore up other areas of our economy. Unfortunately, with the oil shock happening as quickly as it did, it may take a quarter or two before things start to turn around.

While I am not expecting any major upward pressure on bond yields, I would not be taking an overweight position in bonds. That said, I am more comfortable taking on additional duration risk now, however, I would still keep it in line with the index or shorter.

On the equity side, I remain concerned with Canada. Even with the recent selloff, energy makes up more than 20% of the S&P/TSX Composite Index. There is no doubt that energy will rebound, but the question is when. Until then, I expect to see higher than normal levels of volatility in the Canadian market.

U.S. equities have been my top pick for a while now, and remain so, but just barely. Valuation levels are high when compared to Canadian or EAFE stocks. Yet, given the potential growth picture in the U.S. compared to other regions around the world, these valuations may be somewhat warranted.

European equities appear to be in the midst of a rally thanks to a stabilizing economy and the liquidity provided by the European Central Bank's (ECB) latest bond buying program. I still think there is some upside potential, but still view it as a shorter term opportunistic trade, rather than a longer term investment.

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 deeper look at three funds from Renaissance, Redwood, and BMO...

Renaissance Optimal Income Portfolio (ATL 048 – Front End Units, ATL 050 – DSC Units)

–Despite being made up of a mix of largely middle of the road funds, the fund of fund continues to offer investors strong risk adjusted returns and cash flow, all at a reasonable price.

The portfolio is a fairly static mix of Renaissance offered funds. The target asset mix is 60% fixed income and 40% high yielding equities. This stays consistent, with turnover averaging less than 2% a year for the past five years.

Performance has been excellent, gaining an annualized 7.6% for the past five years, outpacing a blended benchmark (40% S&P/TSX, 60% FTSE/TMX Universe Bond) by an average of 88 basis points per year. Volatility has been higher than the peer group, largely because the equity weight in this fund is at the maximum for the category. Even with the higher volatility, it holds up well on a risk adjusted basis.

It pays a monthly distribution of \$0.035 per unit. At current prices, this works out to an annualized yield of approximately 3.9%. If you are looking for more cash flow, there are T-6 and T-8 versions available.

There is no question the returns have been excellent, but as interest rates move higher, I expect it to face increasing headwinds because of its very high level of interest rate sensitivity.

To help address this, the managers recently added a 5% weight to the **Renaissance Floating Rate Income Fund**. Floating rate notes pay a coupon that fluctuates with the prevailing interest rates, making them a great hedge against rising rates.

Still, the of the 60% fixed income exposure, the half of it that is invested in the **Renaissance Canadian Bond Fund** which has a duration of

7.8 years, which is slightly longer than the FTSE/TMX Universe Bond Index. This means that once Canadian yields start moving higher, this portion of the portfolio is likely to struggle.

The other bond holdings, namely the **Renaissance High Yield Bond Fund** and **Renaissance Global Bond Fund** are both expected to hold up better thanks to their more diversified geographic makeup and higher yields. This tends to make them less sensitive to rates.

There is also a high degree of interest rate sensitivity in the equity holdings, particularly in the **Renaissance Canadian Dividend Fund**. As is expected from dividend focused mandates, it is heavily concentrated in financials and energy names. As rates rise, many of the more interest sensitive names are expected to struggle.

The **Renaissance Global Infrastructure Fund** is likely to continue to do well. It invests companies exposed to long life, income generating infrastructure plays. A great feature of many infrastructure projects is they often have built in contractual protection against inflation, making them a great hedge, while still providing the opportunity for capital growth and income.

On balance, I remain positive on the Renaissance Optimal Income Portfolio. I believe it has the potential to deliver attractive relative returns. However, investors will need to dramatically reduce their return expectations as we move forward.

Still, it remains a good choice for those looking for a conservatively positioned balanced fund that offers a well-diversified, income focused portfolio at a reasonable cost.

Redwood Emerging Markets Dividend Fund (RAM 204 – Front End Units) – When you

think about the emerging markets, you generally think high risk, volatile investments. Typically, that's the case, but the **Redwood Emerging Markets Dividend Fund** is a fund that may get you to rethink that.

What makes this fund so different is the fact that it focuses on dividend paying companies in the emerging markets that have the potential to not only maintain, but also grow their dividends. With this focus, you get a portfolio of higher quality companies and a less volatile return stream than more traditional EM funds.

To find these companies, manager Edward Lam and the analysts at Somerset Capital Management use a disciplined, bottom up process that starts with a series of screens designed to identify financially sound companies that meet certain market cap and liquidity requirements. They then do a detailed fundamental overview of the company including meeting with management, analyzing financial statements, and determining their estimate of fair value. Before any name can be added to the fund, it must be vetted by the entire team, and risks must be identified and measured, including currency, economic, political and liquidity risks.

The portfolio is fairly well diversified, holding around 50 names, with the top ten making up about 36% of the fund. Typical position sizes will be between 2% and 3%. Ideally, sector weights are kept below 20%, and there can be no more than 20% invested in any country. They can invest in companies of any size, and at the end of January, had about 50% in large cap names, with the rest in small and mid-caps.

The portfolio is much different than the index, with significant exposure to financials, technology, and consumer names. Combined, these three sectors make up nearly three quarters of the fund. Cash is typically capped at a maximum of 10% of the fund, but recently has been higher than that. According to management, this has been because they are a little hesitant to

invest the cash balance at the moment given the valuation picture and near term outlook. They would rather hold a higher cash balance and wait for a more opportune time to invest.

They take a longer term view in their analysis, which helps explain why portfolio turnover has averaged less than 50% for the past three years.

Performance, on an absolute basis has been middle of the pack. For the three years ending March 31, it gained an annualized 8.6%, compared with 9% for the MSCI Emerging Markets Index. However, as expected from a dividend mandate, volatility has been much lower than the index and peer group. It has also done an excellent job at protecting capital in down markets. A drawback to this approach is that it is very likely to lag in a rising market. That's happened so far this year, with the fund gaining 9.7% while the index is up nearly 12%.

Another drawback is its cost. It carries a management fee of 2.50%, plus there is the potential for the manager to be paid a performance fee based on their performance against the benchmark. The most recent MER is listed at 3.42%, which is well above the category average of 2.79%.

I see this fund as a good way to gain exposure to the emerging markets without taking on as much volatility risk. But you will pay for it with a higher MER and lower upside participation. If this is something you're comfortable with, this is an interesting fund to consider. However, if you are looking for higher upside potential, you'll want to look at one of the more traditional emerging market funds available.

BMO Monthly Dividend Fund (GGF 411 – Front End Units, GGF 188 – DSC Units) – Preferred shares, which make up more than 60% of this fund, are often thought of as having a high degree of interest rate sensitivity. Like bonds, the price of preferreds tend to move in the opposite direction of interest rates. So when the Bank of

Canada Governor Stephen Poloz shocked the markets by cutting the Bank's key overnight lending rate by 25 basis points, most people assumed that would be a good thing for this fund.

Unfortunately they were wrong. The fund lost 2.67% in the quarter, largely for two reasons, first, its preferred holdings were hit hard in the quarter, and the equity portfolio is largely overweight in energy, which was lower on plummeting oil prices.

Delving deeper into the preferred share portion of the portfolio helps explain why the fund was down in the quarter. The reality is the preferred market is more diverse than you might think. In Canada, there are really four types of preferreds; straight perpetual, retractable, floating rate, and fixed rate resets. Perpetual and fixed rate resets are the most prevalent, making up more than 92% of the preferred share market in Canada.

Perpetual preferreds are the most bond like because they pay a fixed dividend as long as it is outstanding. So when rates moved lower, they did what was expected, and rallied higher. Unfortunately the fund was underweight perpetuals.

By far, the most popular type of preferred in Canada, and the fund, is the fixed rate reset. With a fixed rate reset, the dividend rate is reset every five years or so, and often uses the Bank of Canada overnight rate as its baseline. So, when the overnight rate is cut, and many fixed rate resets soon to be reset, they were punished, dropping by more than 7% in the quarter. This was also a key reason for the drop in this fund.

While the 2.67% loss looks disappointing, it is in line with its benchmark, which was down by 2.6% in the quarter. I have also maintained that this is a great safe harbour in periods of equity market volatility because of its high weighting in preferreds. I still believe that to be true.

Looking ahead, while many believed the Bank of Canada was certain to cut rates again after

January's surprise, that's not necessarily the case. While the shorter term impact of falling oil has been severe, it is not out of line with the Bank's expectations. They are monitoring the situation and will adjust rates as they see fit for the conditions. Assuming the economy unfolds as expected, the Bank will likely keep rates on hold as the output gap starts to close.

This does not bode particularly well for fixed rate reset preferreds, as the lower overnight rate will put pressure on reset rates. That said, I wouldn't expect further selloffs as most of the bad news has already been built in. With the equity sleeve of the portfolio, it is invested in big, blue chip dividend paying companies like the banks, energy producers, telcos and other utilities. While not expected to generate big gains, they should provide steady growth and a nice dividend stream.

One potential risk is we may see a cut to the distribution if there is a drop in the underlying yield of the portfolio. Currently, the fund pays \$0.04 per unit, which equals an annualized 4.5% at current prices, and roughly in line with the underlying yield of the fund.

On balance, I remain cautious on this fund. I don't see any major catalyst that will push it sharply higher, but barring a sharp move in rates, either way, I don't foresee any major drops. I expect it to continue to deliver low, but relatively stable returns going forward.

It remains a good fund for more conservative investors seeking some modest exposure to the equity markets. It should provide better downside protection than a pure dividend fund, but will likely underperform in a rising market environment.

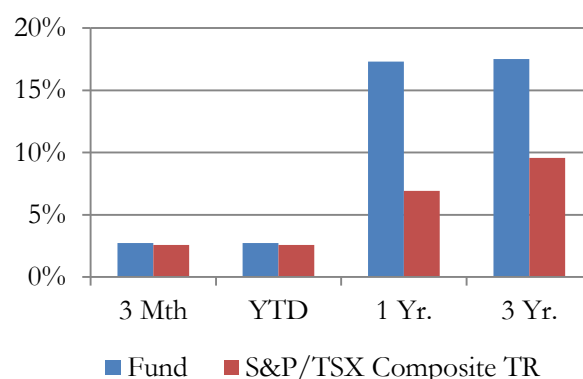
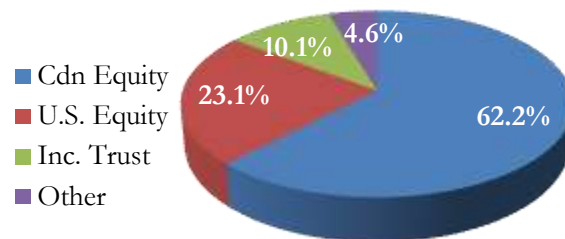
If there is a fund that you would like reviewed, please email it to me at

feedback@paterson-associates.ca

Manulife Dividend Income Fund

Fund Company	Manulife Mutual Funds
Fund Type	Cdn Dividend & Equity Income
Rating	A
Style	All Cap Blend
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Excellent
Manager	Alan Wicks since March 2012 Conrad Dabiet since March '12
MER	2.33%
Fund Code	MMF 4529 – Front End Units MMF 4429 – DSC Units
Minimum Investment	\$500

Asset Mix



ANALYSIS: While the retail version of this fund is relatively new, it has been operating as an institutional mandate since June 2004.

The goal is to build a portfolio of businesses that are creating value at a pace faster than the broader equity markets. To do this, they use a bottom up, fundamentally driven process that seeks out businesses of any size that have high returns on invested capital. Each potential investment candidate is scored on a number of factors, including stability and level of their earnings power, and managerial skill and ownership, and financial leverage. A deeper due diligence review is conducted on the most attractive opportunities. This includes meetings with management and generating an estimate of fair value. They also determine buy and sell prices.

Once a company is in the portfolio, they actively manage position sizes based on real time valuation levels. The closer a name is to its buy price, the greater the weight it has in the fund. Surprisingly,

turnover levels have been modest, averaging around 70% for the past three years.

The portfolio is fairly well diversified, holding more than 70 names, with the top ten making up about 30% of the fund. The portfolio is much different than other dividend mandates, with an underweight in energy and financials. It can invest outside of Canada, and has about 30% in the U.S. at the moment. They will also hedge part of their currency exposure.

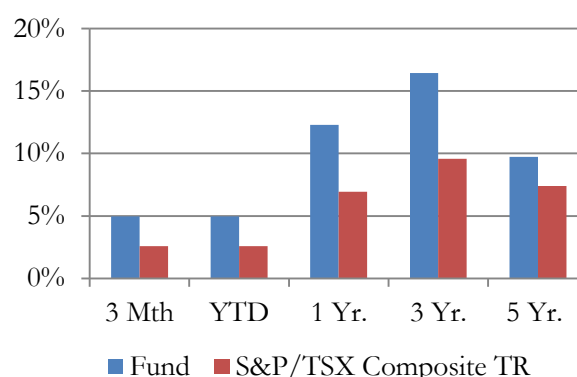
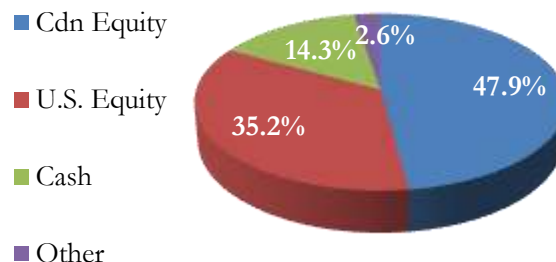
Performance has been very strong, gaining 17.5% for the past three years compared with the 9.3% rise of the S&P/TSX. Even more impressive is this has been done with a level of volatility that is less than half the index. It has also done a great job protecting capital, with a downside capture of less than 5%.

I don't see the absolute levels of return likely to be repeated, but I expect that it will be able to produce above average returns with less risk going forward. I see this as a great core holding for investors looking for Canadian equity exposure.

Sentry Diversified Equity Fund

Fund Company	Sentry Investments
Fund Type	Canadian Focused Equity
Rating	A
Style	All Cap Blend
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Excellent
Manager	Michael Simpson since Jan. '13
MER	2.80%
Fund Code	NCE 722 – Front End Units NCE 322 – DSC Units
Minimum Investment	\$500

Asset Mix



ANALYSIS: This is a fund that is tough to classify. I see it almost as a blend between the large cap focused **Sentry Canadian Income Fund** and the **Sentry Small and Mid Cap Income Fund**.

It is managed using the same investment process that looks for companies that have a number of key characteristics including 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. The biggest difference is it has an average company size that is somewhere between the two funds.

It is very much a bottom up approach that results in a portfolio that looks much different from the benchmark. It is underweight financials and real estate, while overweight industrial, healthcare and consumer names. It is fairly diversified, holding around 50 names with the top ten making up a little more than 30% of the fund. Mr. Simpson is very active in managing the fund, with

portfolio turnover levels averaging well in excess of 200% for the past five years.

Performance has been very strong, gaining 16.4% over the past three years, outpacing both the index and the peer group. Perhaps more impressive is this has been done with levels of volatility that are well below average.

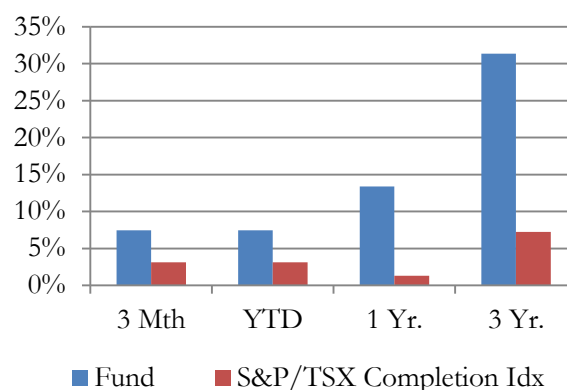
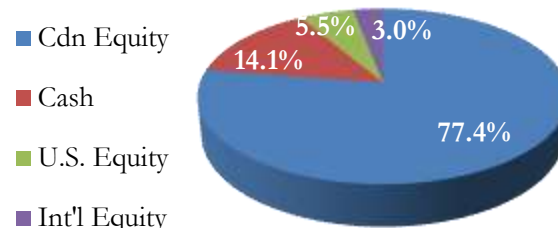
They have also done an excellent job at protecting capital in down markets. Typically, the fund has experienced less than 40% of the downside of the broader market, while still participating in more than three quarters of the upside.

Considering the above, it is a solid fund offering, and based on its manager and process I would expect it to continue to deliver above average returns with lower than average risk. I am not quite sure how to use this in a portfolio though, with its all cap mandate. Given it's small to mid-cap skew, I would be reluctant to use it as a core holding, but I it could be used as a portion of your equity sleeve.

Cambridge Pure Canadian Equity Fund

Fund Company	CI Investments
Fund Type	Cdn Small / Mid Cap Equity
Rating	A
Style	Mid Cap Blend
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Greg Dean since August 2012 Stephen Groff since Aug. 2012
MER	2.42%
Fund Code	CIG 11109 – Front End Units CIG 11159 – DSC Units
Minimum Investment	\$500

Asset Mix



ANALYSIS: This offering is managed by the team of Stephen Groff and Greg Dean, using the same investment process used on other Cambridge managed funds. Their process is driven by a few key beliefs, including a strong commitment to active management, a focus on absolute return and downside protection, and they eat what they cook, meaning each of the managers at Cambridge has a significant portion of their own net worth invested in the funds they manage.

The portfolio is a combination of longer term, higher quality holdings, and more opportunistic names where there is a near term catalyst the managers believe can unlock shareholder value, such as companies that are expected to benefit from a cyclical recovery or an entrenched macro theme.

The investment process uses top down macro analysis to set the sector, geographic, and cap mixture of the fund. Security selection is done on a fundamental, bottom up basis that looks for companies that have a demonstrated history of strong capital allocation, a sustainable competitive advantage, and a management team that is

strongly aligned with shareholders. Another interesting aspect of the Cambridge process is they pay attention to the correlation between holdings, which helps to provide better diversification, and helps protect the downside.

This results is a high conviction portfolio, holding around 35 names. Their approach is active, with portfolio turnover averaging well above 100%.

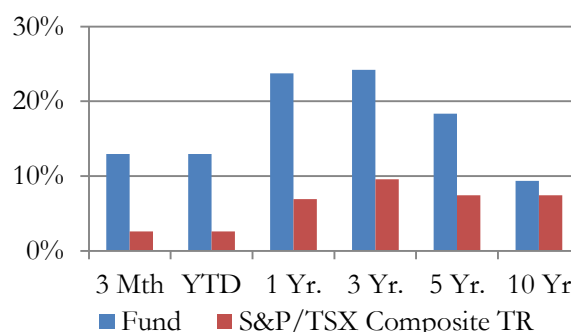
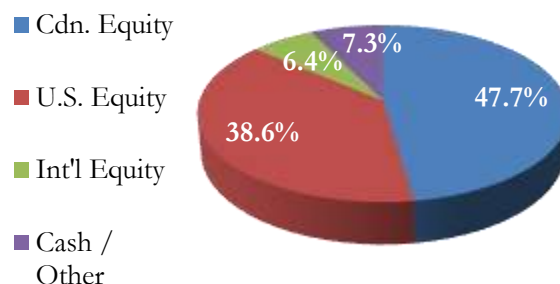
Performance has been excellent, gaining more than 31% for the three years ending March 31, handily outpacing the index and peer group. Their focus on capital preservation has really paid off, with the fund having a negative down capture ratio, meaning that in general, it gained when other small caps were down.

This is a great small and mid-cap focused fund, but don't look for it to continue to deliver double digit returns going forward. Returns are expected to moderate to more normalized levels. Still, I would expect that over a longer term period, it will be well above average with volatility that is in line or lower than average.

Fidelity Canadian Growth Company Fund

Fund Company	Fidelity Investments Canada
Fund Type	Canadian Focused Equity
Rating	A
Style	Large Cap Growth
Risk Level	Medium High
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Mark Schmehl since March '11
MER	2.29%
Fund Code	FID 265 – Front End Units FID 565 – DSC Units
Minimum Investment	\$500

Asset Mix



ANALYSIS: Since stepping into the manager's chair in March 2011, Mark Schmehl has done an excellent job. For the four years ending March 31, it gained an annualized 17.4%, handily outpacing the fund's benchmark. This puts it firmly in the top quartile, making it one of the best performing funds during the since Mr. Schmehl took the reins.

This is a portfolio of medium and large sized companies that he believes have a sustainable competitive advantage and a growth rate that is substantially higher than their competitors. To find these companies, a fundamentally driven, bottom up investment process that looks for well managed companies that have strong free cash flows, healthy balance sheets, and a clearly defined growth drive in place.

It is very actively managed, with a portfolio turnover rate that is well above 200% in the past four years. It can invest up to 49% outside of Canada and they are taking full advantage of that. As of February 31, the fund was invested 50% in Canadian equities and 49% abroad. It is very heavily weighted towards healthcare

and technology, which combined make up nearly half the fund. Consumer names are also well represented.

Given the fund's growth focus, it is not surprising to see it dramatically underweight in energy, materials, and financials. Despite the sector concentration, the fund is reasonably diversified, holding just under 80 names, with the top ten making up nearly 40%.

Volatility has increased in the past four years, and is now above average. But given the growth focus and mid to large cap mix, it is not unexpected. With the fund's sector concentration, I expect that volatility will remain above average, and we could see a sharp pullback if there is a hiccup in either tech or healthcare.

It is because of this that I would be reluctant to suggest it be suitable as a core holding for most investors. Instead, I see this as a potential compliment to a more conservative equity fund in a well-diversified portfolio. Within the Fidelity family, my pick for that more conservative pick would be the **Fidelity Canadian Large Cap Fund**, which is a more concentrated, value focused offering managed by Daniel Dupont. Combined, the two funds could make a great mix