Top Funds Report

Investment Markets Mixed in May

Canadian equities under pressure from weaker commodities

May was a mixed month in the equity markets, with U.S. equities rising, while Canadian, European and Asian markets finished lower in U.S. dollar terms. However, with the Canadian dollar continuing its slide against the greenback, investors in unhedged investments saw modest gains in Canadian dollar terms.

In Canada, the S&P/TSX Composite Index lost 1.2%. Energy was a drag, as oil names were under pressure on news that OPEC production had hit a two and a half year high. Financials and real estate also faced headwinds as yields in longer dated bonds moved higher.

Even with the long end of the curve seeing yields move higher, Canadian bonds were largely positive. The FTSE/TMX Canadian Universe Bond Index gained 0.20% while the FTSE/TMX Canadian Short Term Bond Index rose by 0.4% as yields on the short end of the curve finished the month lower.

Rates in Canada remain a question mark, as economic numbers continue to show an economy that is not yet firing on all cylinders. Under this scenario, Bank of Canada Governor Stephen Poloz will find it difficult to start increasing the Bank's key overnight lending rate.

Contrast that to the U.S., where Federal Reserve Chair Janet Yellen began to prepare the markets for the inevitability of higher rates in the U.S. in a speech last week. While she confirmed rates are moving higher, she was a bit cagey on when rates will rise. That said, the market seems to be thinking September. If the Fed moves, and the Bank of Canada stands pat, it is highly likely we'll continue to see more weakness in the Canadian dollar.

With a high probability of a weaker dollar, I continue to favour unhedged foreign equity investments. The falling Canadian dollar can provide a boost to returns.

For global bond investments, I still recommend funds and ETFs that fully hedge the currency exposure. Currency fluctuation can be a significant source of volatility, and given the defensive purpose of fixed income, I would prefer to use lower volatility instruments.

My current investment outlook is:

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

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

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Funds You Asked For

This month, I highlight a number of ETFs on my Focus List…

iShares MSCI World (TSX: XWD) – This is designed to track the performance of the MSCI World Index, net of fees, in Canadian dollar terms. The index is largely regarded as the global equity benchmark. It provides exposure to large and mid-cap equity exposure across 23 developed market countries. It covers approximately 85% of the free float adjusted market capitalization in each, making it a decent proxy.

Unfortunately, there aren't a lot of Canadian traded ETFs that cover a global index. Still, even if there were more index options, this would still be my pick, given its place as the global equity benchmark. Costs are a little higher than I'd like to see, with an MER of 0.46%. Even at this price, it is an excellent pick for do it yourself investors with modest portfolio sizes. However, if you are investing a larger amount, you may want to buy 60% XUS and 40% ZEA, which will give you the same investment exposure for a combined MER of 0.17%. This only makes sense if the cost savings from the lower MER will offset the additional trading costs of having to buy 2 ETFs.

PowerShares Tactical Bond ETF (TSX: PTB) – With the U.S. Federal Reserve widely expected to finally begin moving interest rates higher in September, volatility in rates is likely to emerge. In a volatile environment, a more tactical approach can help mitigate some of that volatility and outperform. Based on that premise, I believe this rules based, tactically managed ETF should outpace its more traditionally constructed, index focused peers. At the end of April, slightly more than half was invested in investment grade corporate bonds, 31% in long term government bonds, and 11% in high yield. Credit quality is strong, with less than 2% invested in non-investment grade issues. Duration sits at 6.77 years, which is slightly below the FTSE/TMX Canadian Universe Bond Index. This exposure to long-term bonds helped in the earlier part of the year, but has dragged performance of late. While I do expect this to outperform XBB, I don't believe it will do so until we start to see a marked increase in bond market volatility.

iShares 1-5 Year Laddered Corporate Bond (TSX: CBO) –Investing in a laddered portfolio of credits with maturities between one and five years, it offers both a higher yield and shorter duration to the **iShares Canadian Short Term Bond Index ETF**. Barring a complete collapse in the credit markets, I would expect that higher yielding corporate bond names will outperform government issues, even in the shorter part of the curve. That makes this my top pick in the short term space as we head into the summer.

PowerShares FTSE RAFI Canadian Fundamental (TSX: PXC) – The theory of a fundamentally constructed ETF is very sound. Instead of building the portfolio based solely on the market capitalization of a stock, as is done in traditional indexing, fundamental ETFs use factors that are believed to better predict outperformance. These factors include sales, cash flow, book value, and dividends. The main criticism with a traditional cap weighted index is

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the potential for overconcentration, as bigger companies take up a disproportionate weight in the portfolio. Fundamental indexing reduces that likelihood, at least at the stock level. They certainly can't make that claim at the sector level. I nearly fell out of my chair when doing my latest review on this ETF and noticed that the weight in energy was 27%, compared with 22% for the cap weighted XIC. Financial Services are also significantly overweight, representing 39%, compared with 29% in XIC. Combined, there is two thirds of the portfolio invested in two sectors, compared with just half of the broader market. That is one heck of a bet for a supposedly diversified portfolio. Yes, the valuation metrics of PXC are better than XIC, but it's difficult to ignore the concentration risk in the portfolio. If you are comfortable with this concentration, then I believe this ETF will do well over the long term. However, if you are uncomfortable with the risks, particularly with the uncertainty around energy, you will want to avoid it, and if you hold it, you will likely want to sell it.

BMO MSCI EAFE Index (C$ Hedged) ETF (TSX: ZDM) – Earlier in the year, the valuation levels of EAFE equities looked quite compelling. That's not the case so much anymore, after an impressive 8.7% gain in the past three months helped close that valuation gap. Most of these gains were driven by the European Central Bank's stimulus program was launched in March, and recent economic data that shows growth is returning to many European economies. At the end of April, Morningstar reported that the MSCI EAFE Index had a price to earnings ratio of 18.1, which is slightly below the S&P 500, but above the S&P/TSX Composite Index. While there still may be some legs in this trade in the short term, we will need to see further evidence of a sustained turnaround. There are also worries that a disagreement between Greece and its lenders could result in the country defaulting on an upcoming payment. This uncertainty has been weighing on stocks of late, and could be a serious headwind in the future. For that reason, I am suggesting caution in the near term.

iShares Core S&P 500 Index ETF (TSX: XSP) – The outlook for the Canadian economy is uncertain, and the valuation of EAFE names are not quite as compelling as they were a few months ago, making U.S. equities once again a strong contender. For U.S. exposure, this ETF remains my top pick. It is designed to track the S&P 500 and it fully hedges its currency exposure, so you receive the same return that a U.S. domiciled investor would have received. Intuitively that makes sense, but currency can play a huge role in returns.

For example, in our last Focus List review for the three months ending in January, XSP lost 0.7%, while the average U.S. equity mutual fund had gained an impressive 9.1%. The reason for this huge difference in performance was solely the result of currency, with the Canadian dollar dropping by nearly 12% against the U.S. greenback. Funds and ETFs that did not hedge their currency exposure benefitted from this drop. In the most recent three month period, the opposite happened, with the Canadian dollar gaining nearly 5%. This currency gain ate nearly all of the rise in the market for funds that were unhedged. Looking specifically at XSP, it rose by 4.9%, while the unhedged XSP lost 0.3%.

With the Fed poised to bump rates in the fall and the Bank of Canada likely to stand pat, we may

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see increasing volatility in the currency, with more pressure likely to the downside. The question now becomes do you hedge or not? Unfortunately there is no right answer to that question and really comes down to your personal preference. If you feel strongly the dollar will fall, then you are better off using XUS over XSP as it provides the same investment exposure, but without the currency hedging. If you expect the dollar to rise, XSP is the way to go. Personally, currency markets are unpredictable and I don't have a strong sense on what way the dollar will move, making XSP my pick for now.

BMO Equal Weight REITs Index ETF (TSX: ZRE) – After a strong January, Canadian REITs have struggled to capitalize on that momentum, remaining flat. The main reason for this is the interest rate environment. January's gain was the result of the Bank of Canada's surprise cut in rates. Since then, we've seen some upward pressure on yields, which has made it tough for REITs to make any real headway. REITs are attractive because of the juicy yields they kick off, so when rates rise, they become less attractive. While the near term outlook remains cloudy based on the uncertainty caused by the interest rate picture, the medium and long term fundamentals make REITs an attractive investment for investors looking for cash flow and modest growth over the long term. Within the REIT space, this is my top ETF pick because it offers more diversified exposure to the Canadian REIT universe than either iShares or Vanguard because of its equal weighting. It also offers a more attractive yield than XRE or VRE. If you hold it, be ready for some significant volatility, which can be great buying opportunities.

Steadyhand Global Equity Fund (SIF 140) – After a very rough 2014, it looks like the fund's contrarian, value focused style is starting to reward investors. To the end of May, it has gained 15.3%, outpacing the MSCI World Index.

Much of this outperformance can be attributed to the fund's Japanese holdings. At March 31, it held nearly a third of the portfolio in Japan, and another 16% in other Asian names. They like Japan for a few reasons, the biggest of which being the decline in the Yen, which makes Japanese exporters extremely competitive. The portfolio holds many Japanese exporters including Panasonic, Toyota, and Yamaha Motor.

Japan is also starting to show signs of an economic recovery, which is a boost to many domestic focused names held in the portfolio, including East Japan Railway, Nippon Telegraph and Telephone, and Nomura Holdings.

European names have also had a strong run, thanks largely to the positive reception of the European Central Bank's latest stimulus efforts. The fund has about 40% invested in Europe.

The portfolio metrics are quite favourable, with valuations well below the index. This should bode well for the longer term outlook.

While I'm encouraged by this turnaround, I'm still reluctant to recommend the fund. It continues to be more volatile than the index, and I still believe there are more attractive global equity options available.

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

feedback@paterson-associates.ca**.**

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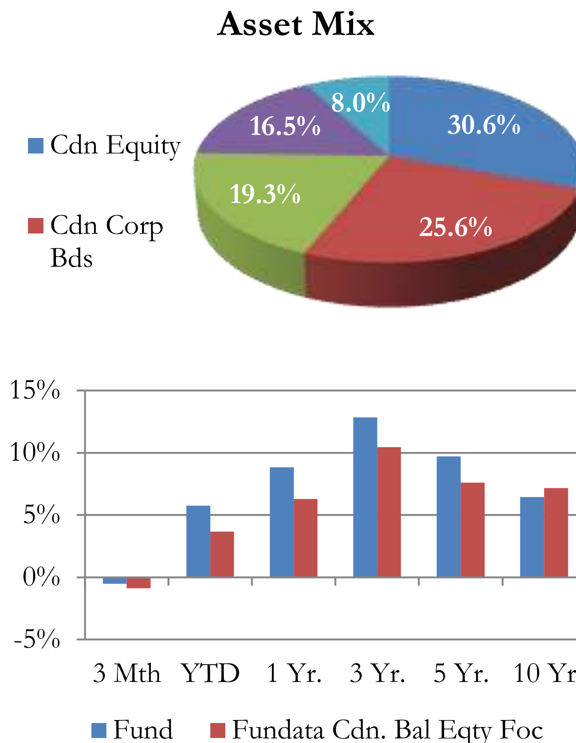
Beutel Goodman Balanced Fund

Fund Company	Beutel Goodman & Company
Fund Type	Canadian Equity Balanced
Rating	A
Style	Strategic
Risk Level	Low Medium
Load Status	No Load
RRSP/RRIF Suitability	Excellent
Manager	Mark Thomson since Sept 99
MER	1.20%
Fund Code	BTG 772
Minimum Investment	$5,000



ANALYSIS: This is essentially a fund of Beutel Goodman managed funds including **Beutel Goodman Canadian Equity** and **Beutel Goodman Income**. It invests in the American and International Equity Funds to gain its foreign equity exposure.

Mark Thomson, who also runs the Canadian Equity fund is responsible for the asset mix. It has a target mix of 40% bonds and 60% equities. It is not expected to stray too far from this mix, and any deviations will be based on the expected return opportunities within each of the underlying asset classes. At the end of May, it held about 30% in bonds, which is consistent with negative outlook for fixed income.

The bond sleeve is managed using a mix of top down macro analysis and bottom up security selection. The macro analysis helps the managers to set the mix and term structure of the bond sleeve. At the end of March, the duration was 1.2 years shorter than the FTSE TMX Canada Universe Index. About half the bond exposure was in corporate bonds, with the balance in government issues.

The equities are run using a disciplined, bottom up, value focused process that looks for well-managed, highly competitive companies that are trading at significant discounts to what they are really worth. They are conservative in their approach, with valuation metrics lower than the benchmark and peer group. It is underweight the volatile energy and materials sectors.

Performance has been quite strong, boasting top quartile performance across all periods. Volatility has been in line with its benchmark, and below its peers. If there is a drawback to this strategy, it is that it may underperform in a sharply rising market. In 2009, it gained 14.1%, trailing its peers by a wide margin. However, in 2008, it lost slightly more than half what the peer group did, making it much easier to recoup.

This is an excellent core balanced fund for advisors and do-it-yourself investors alike. The DIY series carries a 1.20%, and the advisor series, which pays a 1% trailer carries a higher MER of 1.99%.

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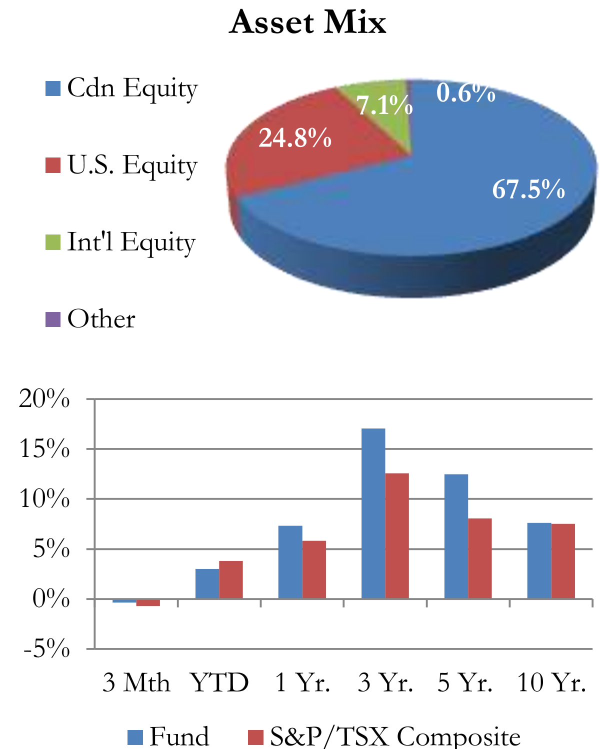
Beutel Goodman Canadian Dividend Fund

Fund Company	Beutel Goodman & Company
Fund Type	Cdn Dividend & Equity Income
Rating	B
Style	Large Cap Value
Risk Level	Medium
Load Status	No Load
RRSP/RRIF Suitability	Excellent
Manager	Stephen Arpin since Nov. 2005 Mark Thomson since May 2007
MER	1.47%
Fund Code	BTG 875 – No Load Units
Minimum Investment	$5,000



ANALYSIS: Dividend funds have been a favourite with investors, and with offerings like this, it's not hard to see why. Managed by a team lead by Stephen Arpin and Mark Thomson, it invests in a concentrated portfolio of dividend paying, blue-chip stocks that are trading below their estimate of its true worth.

To find these stocks, the team uses a disciplined, bottom up, value focused process that looks for well-managed, highly competitive companies that are trading at significant discounts to what they are really worth. They are conservative in their approach, with valuation metrics lower than the benchmark and peer group, and a yield that is significantly higher.

The sector mix is a lot of what you would expect for a dividend fund. It is overweight in financial names, with four of the five big banks in the top ten. It is also overweight in telecom including Rogers, and Verizon.

The portfolio is concentrated, holding just under 30 stocks. The top ten holdings represent more than half the fund.

They use a very interesting sell discipline. When a stock hits their target price, they will immediately sell one third of the holding. This also triggers a review of the company to see if a higher target price is warranted. If it is, they will hold the stock until the new target price is reached. If it is not warranted, they will sell the position.

Performance has been excellent, finishing in the upper half of the category in eight of the past ten calendar years. The years it was below average were 2005 and 2009 when markets rose sharply, and the conservative positioning caused it to lag. More impressive is it has also done an excellent job at protecting capital, participating in only 36% of the drop in the S&P/TSX Composite, on average, over the past five years.

One area of concern may be the high level of interest rate sensitivity in the portfolio, given the concentration in financials. Still, I believe this can be a great core holding for most investors, offering decent growth potential with modest volatility and strong downside protection.

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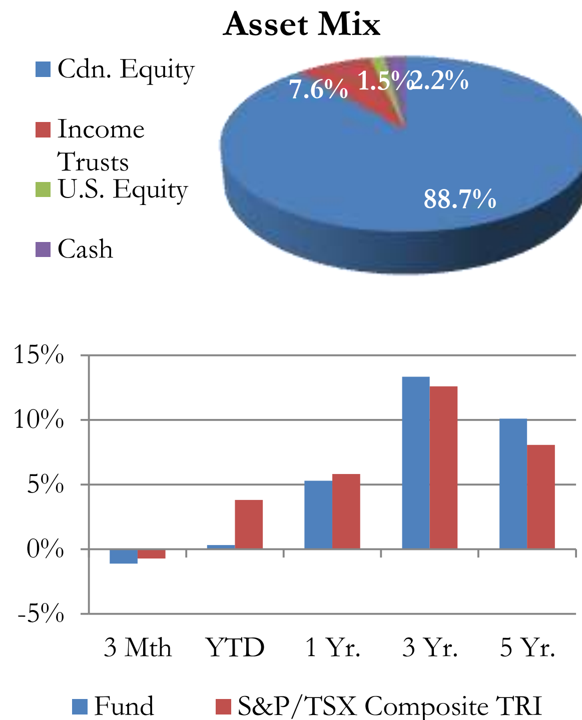
Horizons Active Canadian Dividend ETF

Fund Company	Horizons AlphaPro
Fund Type	Canadian Dividend & Income Equity
Rating	N/A
Style	Blend
Risk Level	Medium
Load Status	N/A
RRSP/RRIF Suitability	Excellent
Manager	Sri Iyer Fiona Wilson
MER	0.79%
Fund Code	TSX - HAL
Minimum Investment	N/A



ANALYSIS: This actively managed dividend ETF is managed by Sri Iyer and his team at Guardian Capital, using a proprietary, multi factor quantitative model that screens the Canadian equity universe looking for positive rates of change in the fundamentals of companies. The model looks at 31 key factors including growth, payout ratios, efficiency, valuation and investor sentiment. Each of the factors is weighted, with growth, payout and sustainability factors being the most important for this strategy. The model is run on a daily basis, with the highest ranked stocks receiving a "buy" rating, and lower ranked securities rated as "sell". The team will conduct a fundamental review to validate any of the potential buy candidates to ensure the rating is appropriate.

The result is a well-diversified portfolio that will typically hold between 50 and 60 names. The sector mix is the byproduct of the bottom up stock selection process. To ensure sufficient diversification, it must have exposure to at least seven of the ten GIC sectors at all times. The maximum sector weight is capped at 25% of the fund.

The process is quite active, with portfolio turnover that has been well above 100% since the fund's inception. A stock is sold when its rating falls into the bottom 30% of the universe.

I really like the investment process used by the managers. It is disciplined and repeatable. It focuses more on rates of change rather than the value. I also like that it takes a lot of the potential emotion out of the process, yet has the fundamental oversight of the investment team. In other words, it's not simply a black box strategy.

I would expect this ETF to deliver average to above average returns, with lower than average volatility. It is also quite different than its bench-mark. This of course can be a double edged sword, and could potentially result in periods where it underperforms for an extended period of time. Still, I believe it can be a great core equity holding for most investors.

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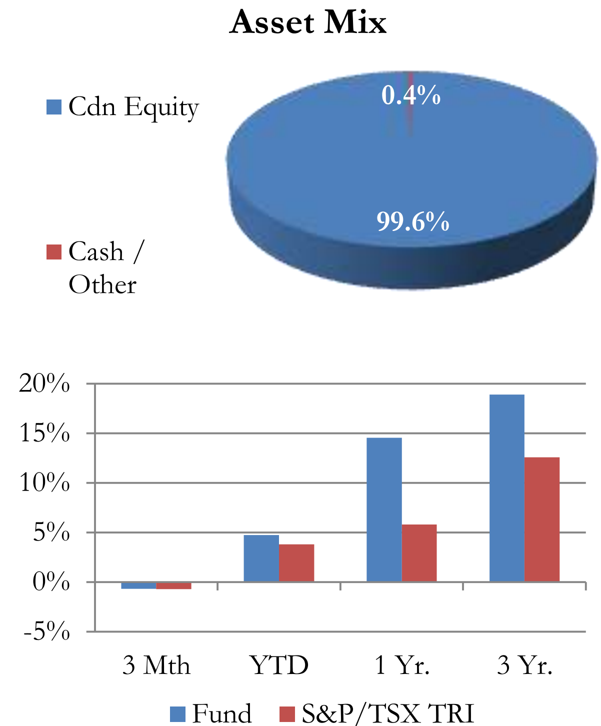
First Asset Morningstar Cdn Momentum

Fund Company	First Asset Investment Mgmt.
Fund Type	Canadian Equity
Rating	N/A
Style	Momentum
Risk Level	Medium - High
Load Status	N/A
RRSP/RRIF Suitability	Good
Manager	First Asset
MER	0.67%
Fund Code	TSX - WXM
Minimum Investment	N/A



ANALYSIS: While not technically actively managed, this ETF uses a proprietary rules based approach designed by Morningstar to invest in a focused portfolio of Canadian stocks that exhibit favourable momentum characteristics. The stocks that trade on the Toronto Stock Exchange are rated and ranked on six fundamental factors. These factors are return on equity, earnings revisions, earnings surprises, and price changes over a three, nine and 12 month period. Once complete, the stocks are ranked first to worst, with the top 30 making up the ETF. The model is rerun on a quarterly basis, with necessary changes being made.

Performance has been excellent, handily outpacing the S&P/TSX Composite Index over a one and three year period, with levels of volatility that are in line with the broader market. This is somewhat interesting, given that the underlying holdings tend to skew towards mid-cap names. While the ETF has only been around for a little over three years, the model on which it is based has a track record dating back to December 2000. The model has also shown strong levels of outperformance.

Given the momentum focus of the ETF, valuation levels are on the high side when compared with the broader market. However, this may be somewhat justified by the higher levels of earnings growth shown by the portfolio, both on a historic and forward looking basis.

I would expect that this ETF to deliver above average returns with levels of volatility that are at or above the broader market. My reasoning is that with the concentrated, mid-cap focused portfolio, the potential for above average volatility exists. I would also be reluctant to use this as a core holding. Instead, it may be an interesting way to get some mid-cap exposure in your portfolio. It is also a good candidate to be used as a return enhancer in an otherwise well-diversified portfolio.

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