Top Funds Report

2015 was a Year to Forget

Volatility returned with a vengeance, dampening investor confidence…

2015 was one of the more challenging years in recent memory. It had a little bit of everything for investors, but perhaps the most impactful was the return of extreme market volatility.

Global equity markets were largely flat in U.S. dollar terms. The S&P 500 gained a modest 1.4%, while the MSCI EAFE Index was down by 0.4%. However, when you factor in the sharp decline in the Canadian dollar, the unhedged returns were much higher, with the S&P 500 rising by 21.6% and the MSCI EAFE gaining nearly 20%.

Driving the dollar lower were two key items; the continued selloff in the price of oil, and the divergent interest rate policies between Canada and the U.S.

Looking at energy, oil fell from around $53 per barrel to finish the year at just over $37. This also had a dramatic effect on the Canadian equity market, which saw the S&P/TSX Composite fall by more than 8% on a total return basis.

In December, the U.S. Federal Reserve finally moved on interest rates, bumping their key rate up by 0.25%. In Canada, with the domestic economy suffering, thanks mainly to the energy sector, the Bank of Canada made two rate cuts, with pundits expecting more to be made in 2016. This divergence has certainly created a significant headwind for the Canadian dollar.

Looking ahead, 2016 is shaping up to be another challenging year. Both the S&P 500 and TSX Composite are down nearly 9% to January 20.

Lower than expected growth numbers out of China continue to weigh on investors, and has significantly eroded investor confidence. The U.S., while still positive is still not growing at a pace that will pull the rest of the world higher.

In this environment, there are very few places to hide. It is times like these that require you to do a "gut check" to make sure you have a portfolio that will allow you to meet your investment objectives over the long term, while still allowing you to sleep at night. Now is a good time to take profits and perhaps some risk off the table.

I remain cautious, but believe those with a well-diversified portfolio can weather the storm.

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		

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Best & Worst of 2015

Here is a recap of some of the highlights and lowlights of last year

Looking at the headlines, there is little debate that 2015 was a challenging year for investors, and just a couple weeks into 2016, it looks like it will be more of the same. I thought it might be interesting to take a look at the best and the worst of the year.

The Worst

Not surprisingly, the worst performing sectors were energy related, namely energy equity and natural resources. Somewhat surprising was the preferred equity category, which sold off sharply on falling interest rates, of all things. Some of the most disappointing funds for the year included:

Trimark Energy Class (AIM 2163 – Front End Units, AIM 2151 – DSC Units) – All energy funds were hit pretty hard in 2015, and unfortunately this was hit hardest, losing more than 38%. There were a few reasons for this underperformance, including its higher exposure to small and mid-cap names which were sold off more violently than their larger cap brethren. It also had a higher portion of the fund invested in Canadian names compared to its peers, resulting in less of a currency boost.

While I see 2015 as a bit of an anomaly for this fund, I believe there are better options available. My picks for those looking for pure energy exposure would be **Canoe Energy Income Fund (GOC 2001 – Front End Units)** or **Canoe Energy Fund (GOC 501 – Front End Units)**, Both are managed by Ravi Tahmazian, who uses a macro analysis to find the subsectors in the energy space that he believes are well positioned for the expected environment. He focuses not only on oil and gas, but also pipelines, renewables, and energy service companies. He looks for companies where management has their interests aligned with the investors. He analyzes the quality of the business, its balance sheet and properties. It's pretty Canadian focused, which given the manager's background is a good thing. Although, at the end of November, he held about 20% in U.S. names.

The manager is not afraid to move into cash when he feels there are no suitable investment opportunities, or the sector is poised for a fall. He will also invest in bonds when the opportunity is available. In the Income fund, he has about 25% in bonds, and just under 20% in the Energy Fund.

I like the manager. He has a lot of experience in the industry, and has done a stellar job with these funds since he took over. He has managed to outpace many of his rivals, and do so with less volatility and stronger downside protection. Still, the funds are significantly more volatile than the broader equity markets.

I also like that while he doesn't play an active role with the fund, manager Rob Taylor is at Canoe. This is a big positive for me, given Mr. Taylor's success at BMO running their global energy mandate. Should anything happen to Mr. Tahmazian, Mr. Taylor could step in and manage the fund without missing a beat.

I'd probably lean towards the Energy Income Fund because it tends to invest in slightly larger companies that pay a dividend. It's currently yielding just under 5% or so. It also pays a monthly distribution of $0.039 per unit.

Front Street Growth Fund (FSC 202 – Front End Units, FSC 201 – DSC Units) – With a one year loss of just under 38%, this concentrated, energy focused, small cap offering lagged its peers by a pretty big margin. Looking at some of its holdings, it's not hard to see why. Baytex Energy has a one year loss of -81%, Journey Energy is down 74%, and MEG Energy is down 72%. This type of performance is not out of character for Front Street. They tend to take concentrated positions, and make a lot of big bets. When they win, they win big, like they did in 2009 when they were up more than 111%. Even in 2008 the fund gained 16.3%, while most other equity funds sold off. But it is also prone to big losses, and has lost money in every years since 2010.

Looking at the risk reward characteristics of this fund, I believe there are better alternatives available for investors looking for resource exposure in their portfolios. Even though they are highly energy focused, I would still most likely lean towards one of the Canoe funds mentioned above.

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PowerShares Canadian Preferred Share Index Class (AIM 56203 – Front End Units) – Preferred shares were long thought to be less volatile than common equity. Well at least they were until 2015, when investors sold off their preferred holdings indiscriminately on worries that the lower interest rates would affect the coupon rates of their preferred shares. Hit hardest were the fixed reset preferred shares, which have a coupon rate that is reset periodically, and uses the Bank of Canada rate as its benchmark. So with two cuts in 2015, and it looking increasingly likely one or more is on the way in 2016, preferreds appeared to be much less attractive.

With a loss of nearly 17%, this fund was the worst performer in the category for 2015. One of the big reasons for this underperformance is also one of its most attractive features – it is designed to track an index. It provides exposure to the 50 largest, and most liquid preferred share issues in Canada.

The downside of this, particularly in volatile markets is it is fully invested, and carries virtually no cash. Therefore, it is fully exposed to the movements of the market. Also, there is no manager making any sort of a tactical call, so there is nowhere to hide when things get rocky.

While I believe the recent selloff in the preferred market is overdone, I would likely lean towards one of the more actively managed offerings. Two that would warrant a closer look would be the **Dynamic Preferred Yield Class (DYN 2900 – Front End Units)**, which is managed by Marc-Andre Gaudreau, invests in a mix of Canadian and U.S. traded preferreds. Launched in April 2013, there isn't a ton of history to review, but early results, combined with the manager's longer term track record, look encouraging. Another option in the space is the **National Bank Preferred Equity Income Fund**, which has been managed by Benjamin Jasmin for the past three years. It has one of the longest track records in the category, and carries one of the lowest MER's at 1.46%.

The Best

While there were some pretty big losers, there were also a few winners. Healthcare was one of the best performing sectors, while U.S. and foreign equity funds posted decent gains, with a falling Canadian dollar providing a tailwind. Some of the best performing funds for the year included:

TD Health Sciences (TDB 976 – No Load Units, TDB 320 – Front End Units) – Healthcare, particularly in Canada was one of the bright spots of the year, with the S&P/TSX Health Care Index gaining an impressive 22%, while the S&P Global 1200 Health Care Sector Index rose by a more modest 6.0%. Factoring in the drop in the Canadian dollar, and the unhedged return to Canadian investors would have been in the ballpark of 26%.

Posting a gain of nearly 33% in Canadian dollar terms, this was the best performing healthcare mutual fund for the year.

It invests in companies that are involved in the research, development, production, or distribution of products or services related to health care, medicine, or the life sciences. To qualify for selection, companies must derive at least 50% of their assets, revenues, or operating profits from those activities. The manager tends to focus in the U.S. where more than 90% of the fund is invested.

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

While I like the fund and the sector for the long term, I remain concerned about valuations. According to Morningstar, the fund is trading at more than 21 times future earnings, and more than 14 times cash flow. In comparison, the S&P 500 trades at 17 times forward earnings and 10 times cash flow. Another factor to consider is a substantial portion of the 2015 gains were the result of a 20% jump in the U.S. dollar relative to the Canadian dollar - again, something that is unlikely to be repeated. I'm not saying to avoid the fund, but be aware that it is unlikely that historic returns can be repeated from these levels. That said, if you're comfortable with the risks and are looking for direct health care exposure, this is my top pick.

Manulife Global Small Cap (MMF 4505 – Front End Units, MMF 4405 – DSC Units) – With a one year gain of 30.7%, this was the top performing global small cap fund in 2015. But this was no fluke.

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The fund, launched in April 2008 is identical to the highly regarded **Mawer Global Small Cap Fund (MAW 150 – No Load Units).** For the five years ending December 31, it has gained nearly 21 per year on an annualized basis, making it one of the best performing funds. In fact, except for 2010, it has been an above average performer in each calendar year.

Mawer has recently adopted the tag line “Be boring. Make money”, and looking at their meat and potatoes approach, it fits. The fund’s management team, headed by Paul Moroz, uses a highly disciplined, research focused, bottom up investment process that looks for companies with strong business models that earn a high return on capital, largely because of a sustainable competitive advantage. They also spend a great deal of time focusing on the company’s management. Once they have identified a potential investment candidate, they build out and stress test financial models under a number of different scenarios. They are also careful to make sure that they are buying a company at a level that is well below their estimate of its true worth.

The result is a portfolio that is dramatically different than its benchmark or peers. At the end of December, it was overweight industrials, technology and consumer staples. It’s well diversified, holding nearly 80 names with the top ten making up about 40% of the fund.

While I don’t expect the absolute performance numbers to be repeated on a go forward basis, I believe the investment process gives it the potential to be an above average performer over the long term, with strong downside protection, even with an MER of 2.48%. The only real drawback to the fund is that it has been capped since 2013 and is unlikely to reopen anytime soon.

For those looking for global small / mid cap exposure, the **Trimark Global Endeavour Fund (AIM 1593 – Front End Units)** or the **Fidelity NorthStar Fund (FID 253 – Front End Units)** are a couple of decent options.

TD U.S. Blue Chip Equity Fund (TDB 977 – No Load Units, TDB 340 – Front End Units) – It is pretty tough for a U.S. large cap fund to outpace the S&P 500, but this fund did that in 2015, and has for the past five years. While the S&P 500 has earned an annualized 20% for the past five years, this fund is up more than 21% (in Canadian dollar terms).

As impressive as these numbers are, I wouldn’t bet on them being sustainable over the long term. While the manager uses a fundamentally driven, bottom up investment process, it has a decided growth focus to it. Growth has been in favour recently, but in time, market leadership is expected to shift to more value focused names, resulting in some underperformance from this offering. Also, a significant decline in the value of the Canadian dollar relative to the U.S. greenback has boosted absolute numbers. While there may be some further weakness in the Canadian dollar, it is unlikely we will see the returns repeated.

It is currently overweight healthcare, tech, and consumer discretionary. These sectors have had a tremendous run, pushing the fund’s valuation metrics to the high side, with price to earnings, price to cash flow, and price to book ratios that far exceed the index and peer group. The flip side of this is these sectors also shows the strongest rate of earnings growth, both on a historical and forward looking basis. Factoring in the growth projections of the underlying portfolio, it may not be as overvalued as appears in isolation.

Another concern I have is the fund tends to be significantly more volatile than the broader market and its peers. For the past five years, the S&P 500 has had a standard deviation of 9.2%, while the fund was 12.0%. It tends to outperform when the index is positive, but underperforms by a greater margin when it falls.

Looking ahead, I still believe this will be one of the stronger U.S. equity funds over the long term. That said, I think you are better off using a low cost index product that tracks the S&P 500, more often than not. For that, I would look at the **TD U.S. Index Fund (TDB 661 –No Load Units)**, which track the S&P and has a 0.55% MER. Alternatively, you could use the currency hedged version **(TDB 655)**. It costs a bit more at 0.89%, but will take currency moves out of the equation. If you prefer an ETF, **XSP** or **XUS** are excellent options too with very low MERs.

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

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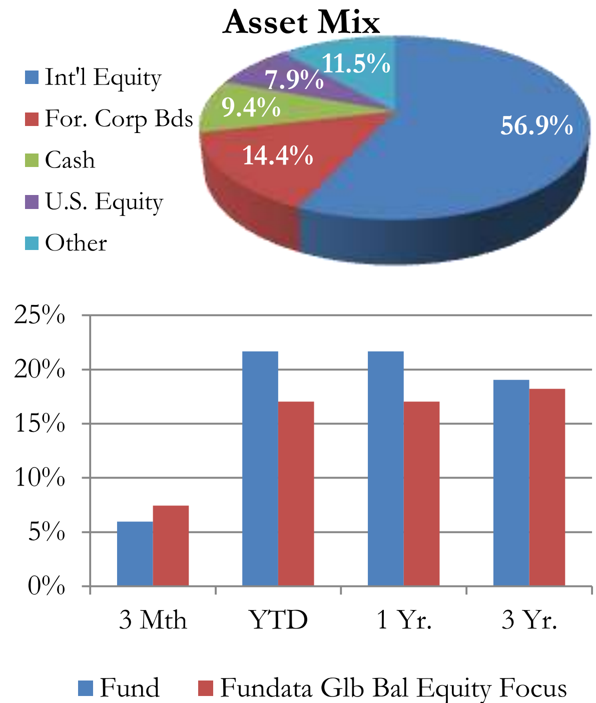
Manulife Global Small Cap Balanced Fund

Fund Company	Manulife Mutual Funds
Fund Type	Global Equity Balanced
Rating	A
Style	Small Cap Growth
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Excellent
Manager	Paul Moroz since August 2011
MER	2.46%
Fund Code	MMF 4518 – Front End Units MMF 4418 – DSC Units
Minimum Investment	$500



ANALYSIS: This is a somewhat unique balanced fund in that the equity sleeve is highly focused on small and mid-cap funds. It invests in primarily in the **Manulife Global Small Cap Fund**, and the **Manulife Strategic Income Fund**, two very excellent funds in their own right. The target mix is set at 75% in equities, 25% in fixed income. At the end of December, it was overweight equities, holding nearly 80% stocks and just over 20% in fixed income.

The equities are selected using a highly disciplined, research focused, bottom up investment process that looks for companies with strong business models that earn a high return on capital, largely because of a sustainable competitive advantage. They also spend a great deal of time focusing on the company's management. Once they have identified a potential investment candidate, they build out and stress test financial models under a number of different scenarios. They are also careful to make sure that they are buying a company at a level that is well below their estimate of its true worth.

The fixed income exposure is tactically managed that looks to manage four key risks for investors; interest rate risk, credit risk, currency risk, and liquidity risk. The duration is in the 3.25 to 3.75 year range, which is significantly below the broader bond market.

Combined, this mix provides investors with excellent risk adjusted returns, with a portfolio that will look nothing like a more traditional balanced fund.

Since its launch in August 2011, it has finished in the upper half of the category in every calendar year, and has a three year annualized return of 19.0%, handily outpacing the benchmark and its peer group.

Volatility has been below average, and it has provided nearly all the upside of the benchmark, with just over a third of the downside.

I don't expect the absolute return numbers to be repeated, but I would expect it to deliver above average risk adjusted returns going forward. Unfortunately for investors, the fund is capped, so if you don't own it, you're out of luck at the moment.

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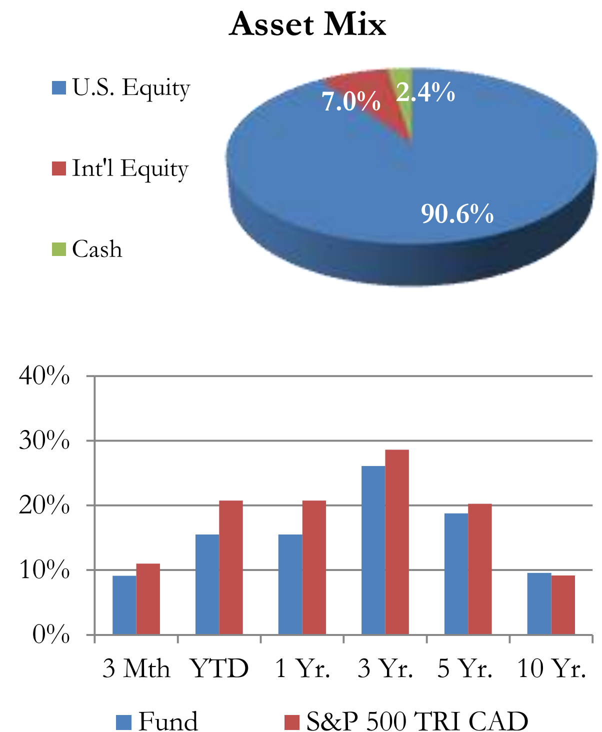
Beutel Goodman American Equity Fund

Fund Company	Beutel Goodman & Company
Fund Type	U.S. Equity
Rating	D
Style	Large Cap Value
Risk Level	Medium
Load Status	No Load
RRSP/RRIF Suitability	Good
Manager	Glenn Fortin since June 1997 Gavin Ivory since Feb. 2006
MER	1.47%
Fund Code	BTG 774 – No Load Units BTG 308 – Dealer Sold Units
Minimum Investment	$5,000



ANALYSIS: Historically, the U.S. has been one of the toughest markets to beat on a consistent basis. That said, this is one of the higher quality funds and tends to be in the running more often than not.

It is managed using a highly disciplined, bottom up value approach that places emphasis on capital preservation, with a focus on delivering absolute returns and managing risks. To achieve this, the managers look for high quality, well managed, dividend paying companies that have a history of generating stable cash flows and have earned a level of return that is greater than the company's cost of capital.

Given the value bias, any company considered for inclusion in the portfolio must not only be undervalued, but have the potential to grow their share price closer to its intrinsic value within a three year period. When evaluating a company, they pay particular attention to the price to earnings, price to cash flow and price to book ratios in the context of not only the company's historical numbers, but also compared to the market and what the management believes to be the company's sustainable earnings growth rate.

The result is a concentrated portfolio of U.S. based large cap companies that are leaders in their field. As of December 31, it held just under 30 stocks with a top ten making up over half the fund.

They are patient in implementing their process, with portfolio turnover averaging 33% for the past five years. That said, they are not afraid to use periods of heightened volatility as an opportunity to improve the quality of the portfolio. This happened in 2008 and again in the first half of 2012 when several new names were added to the portfolio.

Performance has been excellent, gaining an annualized return of 18.8% for the past five years, slightly trailing both the S&P 500, but outpacing the category average. It also has decent downside protection, holding up well in 2008, losing less than half of the index's 23% drop. Volatility has been lower than the category average, but has matched the broader market. For those looking for actively managed U.S. equity, this is one of my favourites.

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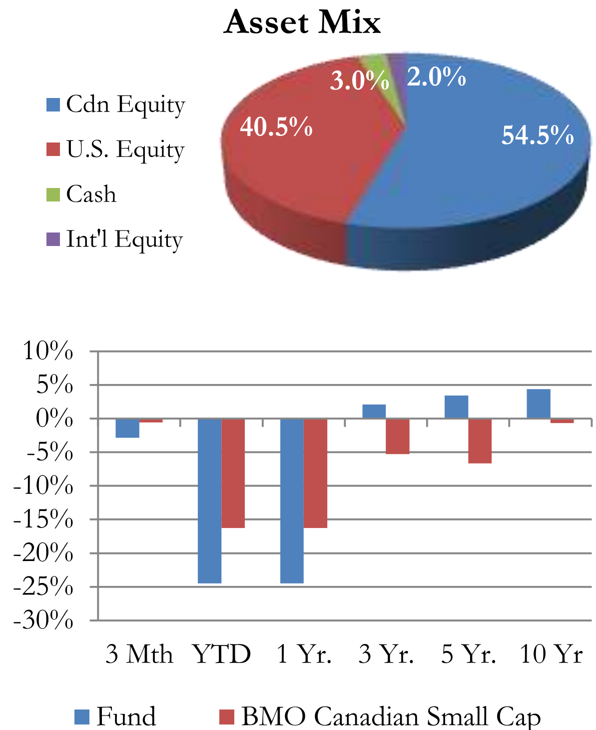
Trimark Canadian Small Companies Fund

Fund Company	Invesco Canada Ltd.
Fund Type	Cdn Foc Small Mid Cap Equity
Rating	B
Style	Small Cap Value
Risk Level	Medium High
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Jason Whiting since Apr 2011 Rob Mikalachki since Dec '00
MER	2.69%
Fund Code	AIM 1683 – Front End Units AIM 1681 – DSC Units
Minimum Investment	$500



ANALYSIS: This high conviction, Canadian small and mid-cap fund had been a staple on my Recommended List of Funds until a year ago, when I removed it because it was closed to new investors.

From a timing standpoint, this makes me look pretty good, given the fund struggled in 2015, posting a 24.5% loss, and was one of the weakest performing funds in the category. I spoke with Jason Whiting in early January about the fund. He attributed the poor performance in 2015 to a couple of things.

The first was their decision to start adding to energy names in the latter half of the year. The companies in which they invested met all their key buy criteria; high quality businesses, strong management teams, and compelling valuation metrics. They sought out energy names that had much less sensitivity to the price of oil and had strong balance sheets and predictable cash flows. Unfortunately, they were all dragged lower in the continuing energy swoon.

Another area that hurt the fund over the past year was its exposure to some specialty finance companies in the U.S. that were also sold off heavily. Mr. Whiting still has confidence in the business and management, and sees strong valuations after the selloff. Again, he believes it was a matter of being too early.

But that highlights a key element of the investment process. They take a longer term view and focus on quality. Because they see risk as the permanent loss of capital, they tend to put more emphasis on risk management over short term returns. This can result in periods where they look wrong in the short term, but given patience, their theses tend to play out over the longer term, generating solid risk adjusted returns.

I see this as a solid small cap offering for those with a longer term time horizon, and who are comfortable with a higher level of volatility. The past year was a tough one, with a level of downside capture that was nearly double the fund's historical average. I will continue to watch the fund for signs of improvement.

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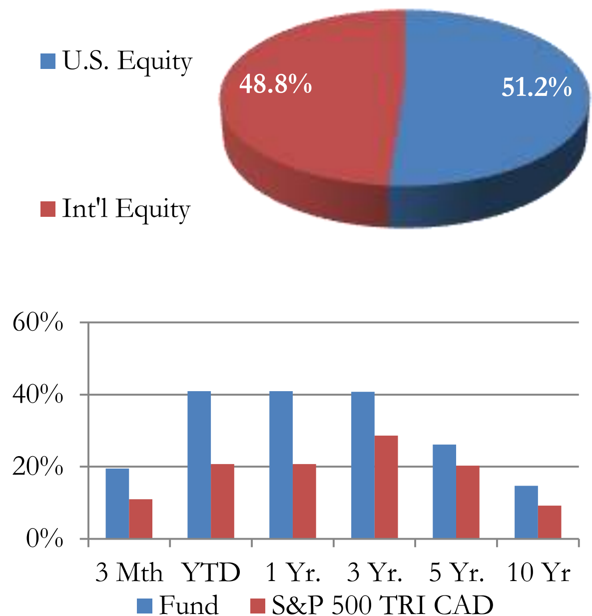
TD Science & Technology Fund

Fund Company	TD Asset Management
Fund Type	Sector Equity
Rating	C
Style	Large Cap Growth
Risk Level	High
Load Status	No Load / Optional
RRSP/RRIF Suitability	Fair
Manager	Josh Spencer since January 2013
MER	2.80%
Fund Code	TDB 645 – No Load Units TDB 322 – Front End Units
Minimum Investment	$500



ANALYSIS: One of the more interesting sectors to watch has always been the technology sector. There are constantly new ideas being developed and innovative products being brought to market. While this is all "cool", there can be a higher degree of risk, making it an ideal candidate for a mutual fund or ETF.

One of my favourite funds in the sector has been this T. Rowe Price managed offering. It invests in companies from around the world that are involved in the development, advancement and use of technology. At the end of December, it held over half the fund in U.S. funds, about 20% in Europe, and nearly 18% in China.

It holds just under 50 stocks, with the top ten making up nearly 60% of the portfolio. The top ten is littered with names like Alphabet (formerly Google), Priceline, and Amazon.

Performance has been very strong, gaining an annualized 26% for the five years ending December 31, compared with the S&P 500's gain of 20.4%. A good chunk of that was currency, with the U.S. dollar version gaining just under 18% annualized, compared with 12.6% for the broader market.

Given the nature of the sector, volatility has been higher, with a level of volatility that is significantly higher than the broader market. In 2008, it lost nearly 31% in Canadian dollar terms, while the S&P 500 was down 21%. However, it tends to bounce higher when markets rally. For example, in 2009, it bounced by an impressive 51%, while the S&P 500 rose by 7.4%.

The manager uses a very active process and has a level of portfolio turnover that has averaged well over 100% for the past five years. Further, the managers tend to use periods of volatility to step in and pick up quality names at attractive prices.

Despite carrying an MER of 2.82%, this is one of my picks in the category. That said, I would generally be reluctant to add additional technology exposure to a portfolio for anyone except the most aggressive investors.

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