

Top Funds Report

Markets Rally Higher on Oil

Energy looks to find some stability. Potential for more volatility remains...

Canadian equity markets have been on the rebound since mid-January. On January 20, the S&P/TSX Composite closed at 11,843.11, and since then has gained more than 15%, closing at 13,621.3 on March 17.

Perhaps not coincidentally, it was also on January 20 that saw what now looks like the start of a decent recovery in the price of oil. After closing at \$26.55, oil rallied nicely, gaining more than 26% in a couple of weeks. Profit taking and short covering took hold, bringing oil back down to the \$26.21 level in mid-February. Since then, oil has been on a tear, and as of March 17, was up more than 53%, closing above the \$40 mark.

Other major equity markets have followed oil higher, with both the S&P 500 and MSCI EAFE Indices hitting lows on February 11 and rallying higher ever since.

Many experts are now predicting we'll see this oil rally take a breather as investors take some money off the table. However, most expect we will see it hit \$50 in a relatively short period of time.

All of this paints a somewhat more positive tone for equities, and specifically Canadian equities. Even with the year and a half selloff in oil, the energy sector is still the second largest, making up 18% of the index.

With oil seeming to have found a bit of footing, I am more positive on Canadian equities than I was last month. As a result, I am bringing my Canadian equity weight back to Neutral from Underweight last month. I still see the potential

for higher than normal volatility, and continue to remain somewhat cautious.

In the U.S., the Federal Reserve decided to hold rates steady at their latest meeting. While this was widely expected, comments they will be more gradual in the pace of their rate increases may not have been, and this news was cheered by the markets.

With the U.S. on hold, this gives the Bank of Canada a bit of breathing room, and I would not expect them to move rates in either direction in the near term. This bodes well for Canadian bonds and I favour higher yielding, investment grade issues, over governments.

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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ETF Focus List Review

This month, I review some of the funds on my Recommended List

PowerShares Senior Loan CAD Hedged ETF (TSX: BKL) – With worries a slowing economy could result in higher default rates, high yield bonds and leveraged loans were sold off, pushing yields and credit spreads higher. For the three months ending January 31, BKL lost nearly 2%, but managed to finish in the upper half of its peer group. This loss was even with the U.S. Federal Reserve finally moving rates higher in December. This was the worst performing fixed income ETF on the Focus List, and was the only one to finish in negative territory.

Again, I reiterate that this recent selloff highlights that these types of investments are NOT suitable as a core holding in your portfolio, despite what fund companies will have you believe. Instead, they are really only suited to higher risk investors who are comfortable taking on additional risk of loss over the short term, in return for the potential for reduced interest rate sensitivity.

As I look ahead, I still believe that this is the best choice in the category for those looking for an ETF that provides exposure to floating rate loans. That said, I am lukewarm at best on the asset class in the near to even medium term. Many of the loans held have interest rate floors in place that remain above the current short term yields, meaning we will need to see rates move even higher before the true value of these funds is realized. Until then, because the overwhelming majority of bank loans are unrated, investors will instead be focusing on the risk of default, which I expect will result in higher than average levels of volatility. If higher volatility is a concern, you

will likely want to avoid floating rate notes and bank loan focused investments for the next little while. Longer term, particularly when we start to see some meaningful movement higher on interest rates, these types of investments can play a role in a well-diversified portfolio.

iShares Canadian Universe Bond Index ETF (TSX: XBB) – With the Bank of Canada expected to keep interest rates on hold for the next little while, bonds are likely to remain a positive contributor to portfolio performance. This ETF is my top pick at the moment. It provides exposure to a diversified portfolio of Canadian government and investment grade corporate bonds. It is a high quality portfolio, with about 70% invested in government issues, and the balance in corporates. Its duration is fairly long, coming in at 7.42 years at the end of February. The higher the duration, the more sensitive it is to the movements in underlying interest rates. This is not a concern at the moment, but when rates start to move higher, it is likely to experience heightened volatility and the potential for some modest short term losses. But for now, with an MER of 0.33%, this is a great, low cost way to get high quality Canadian bond exposure.

BMO Low Volatility Canadian Equity ETF (TSX: ZLB) – Low volatility funds and ETFs have become rather popular with investors lately, and it's not hard to see why. Who doesn't love the idea of getting returns that will come pretty close to the broader market, but with a lot less downside? It sounds too good to be true, and

while the track records are still relatively short, the early results are very encouraging.

This was the best performing Canadian ETF on the Focus List over the period, falling 1.3%, compared with a drop of 4.8% for the S&P/TSX Composite Index. The longer term numbers are also rather impressive. For the three years ending January 31, it gained 16.4%, compared with 3.4% for the index. More impressive however, is this was done with a level of volatility that was about three quarters of the market, and it posted a downside capture ratio that was negative, which means that on average, when the broader market was down, this ETF was positive.

As impressive as this level of outperformance has been, it is not sustainable. One key reason is the ETF has very little exposure to the hard hit energy sector, and no exposure to materials, which has been the biggest drags on the S&P/TSX Composite. Once we see energy stabilize and start to rebound, this ETF is likely to lag the broader Canadian market.

Another worry I have relates to the valuation levels of the underlying portfolio. According to Morningstar, the price to earnings ratio of ZLB is 19.4 times. In comparison, the S&P/TSX Composite is trading at a more modest 15.5 times earnings. It is a similar story for other key valuation metrics, with ZCS exceeding the market on a price to book, and price to cash flow basis. Turning to earnings, the historic earnings growth rate of ZCS lags the index, and the forecasted earnings growth is significantly lower than the market. In other words, investors have significantly bid up the price of these lower beta names, and they now trade at levels that are not justified by both the current and expected level of earnings.

That is not to say a significant selloff is imminent. On the contrary. Instead, looking at the sector makeup, I would expect it to continue to hold up well in periods of higher than normal volatility. However, when the markets turn positive, this ETF would be expected to lag, in some cases significantly, while earnings catch up with valuations. If you have held this ETF for any period of time, I would strongly encourage you to take some money off the table, by rebalancing your portfolio and taking some profits.

iShares S&P/TSX Completion Index ETF (TSX: XMD) – It is rather tough to find a good small / mid-cap ETF with a focus on Canadian equities. There are really only about four that are considered to be Canadian Small / Mid Cap Equity ETFs. Sadly, this is the best option. Essentially, it provides exposure to the Canadian traded companies that are part of the S&P/TSX Composite Index, but are not part of the S&P/TSX 60 Index. Because of this, it tends to skew somewhat mid-cap, with an average that is about five times that of the S&P/TSX Small Cap Index. If you absolutely require an ETF for your small / mid cap exposure, this would be the one to use. However, if you are willing to consider mutual funds, I believe you may be better off looking at something like **CI Cambridge Pure Canadian Equity Fund (CIG 11109)**, **IA Clarington Canadian Small Cap Fund (CCM 520)**, or the **Sentry Small Mid Cap Income Fund (NCE 721)**. Each of those offers what I believe to be a more compelling risk reward profile than this or any of the other available small / mid cap ETFs.

Vanguard U.S. Total Market Index ETF (CAD-hedged) (TSX: VUS) – Of the U.S. equity ETFs on the Focus List, this was the worst

performer for the three months ending January 31, falling by 7.8%, compared with a drop of 6.6% for the **iShares Core S&P 500 Index ETF (TSX: XSP)**. The main reason for this performance differential is VUS provides exposure to the entire U.S. equity market. Holding approximately 3,700 individual securities, about one third of the portfolio is invested in small and mid-sized companies. In comparison, XSP holds around 500 names, with virtually no exposure to small caps, and less than 20% invested in mid-cap names. During the period, small and mid-cap companies underperformed. While the shorter term outlook may be cloudy for small and mid-cap names, the longer term outlook remains strong, making this a great way to get broader U.S. equity exposure. Near term, I favour XSP, but only marginally. Longer term, I believe the additional exposure to small and mid-sized companies should allow this to provide slightly better returns.

iShares International Fundamental Index ETF (TSX: CIE) – I have to admit I really like the theory behind fundamental ETFs. The goal of a fundamental approach is to weight companies in the index based on their financial health, rather than by their size. Ideally, because of this focus on quality, it should provide a return that is comparable to a market cap weighted index, with less volatility. In this case, the top 1000 listed companies that trade outside the U.S. are ranked by four fundamental criteria; sales, cash flows, book value, and dividends. Unfortunately, the reality hasn't quite lived up to the theory. While the longer term performance of this ETF has been comparable to the MSCI EAFE Index, it has also been more volatile, with a standard deviation that is above the index. Further, it has consistently

underperformed the index in falling markets. The valuation metrics of this portfolio appear to be more favourable than the broader market. However, according to Morningstar, the forward looking growth numbers are also lower, which indicates it may not be quite as favourably valued as it appears on the surface. I like the theory of this, but am monitoring it further in the short term for a deepening divergence in returns or an uptick in overall volatility.

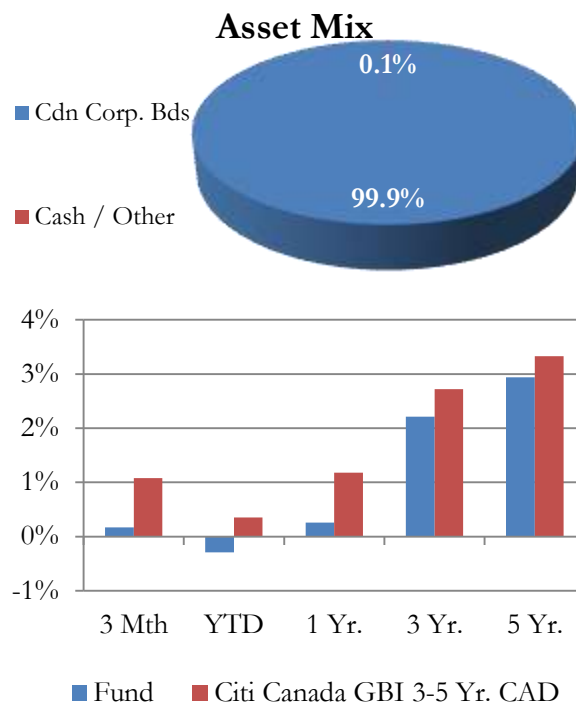
iShares Gold Bullion ETF (TSX: CGL) – Gold has been on a bit of a tear since early December, jumping more than 18%. Much of this gain has come from investors' lack of faith in the ability of central banks around the world to get the global economy growing in a meaningful way. With negative interest rates becoming a possibility to a larger number of countries, investors are starting to look for places to park some of their excess cash, and for some, that is gold. While I'm not a gold bug per se, there may be some more room for bullion to move higher. Further, once growth does take hold, the possibility for inflation is also expected to grow, which would be another positive for gold. This ETF is a good way to gain exposure to gold. Given that gold trades in U.S. dollars, the currency exposure of the ETF is fully hedged. If you want to gain this exposure in an unhedged fashion, you may want to consider CGL.C. Alternatively, you could consider the **Royal Canadian Mint Canadian Gold Reserves Exchange Traded Receipt (TSX: MNT)**, which is similar and carries a management fee of 0.35%. There is no currency hedging with this ETR.

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

feedback@paterson-associates.ca.

BMO Short Corporate Bond Index ETF

Fund Company	BMO Asset Management
Fund Type	Cdn Short Term Fixed Income
Rating	N/A
Style	Cap Weighted Index
Risk Level	Low
Load Status	N/A
RRSP/RRIF Suitability	Excellent
Manager	BMO Asset Management
MER	0.20%
Fund Code	TSX: ZCS
Minimum Investment	N/A



ANALYSIS: The bond market continues to be a challenging place for investors. Coming into 2016, it was near certainty that the Federal Reserve would be moving rates higher several times over the year. However, it now appears that there is only a modest probability that we will see much in the way of increase rates. Closer to home, odds are we may see the Bank of Canada move lower before moving higher.

In this environment, I am adding this short term bond ETF and removing the iShares 1-5 Year Laddered Corporate Bond Index ETF (TSX: CBO). There are a few reasons I am making this change. The first is ZCS offers a slightly higher yield to maturity, which is expected to allow for a higher return, in the event we see rates remain flat.

Another reason for the change is ZCS has a slightly higher duration, coming in at 2.83 years, compared with 2.79 years for CBO.

Given the expectation that Canadian rates are on hold for the near term, and potentially moving lower, I am favouring the slightly higher duration because of its increased sensitivity to interest rates. A third reason for the change is the lower cost of ZCS.

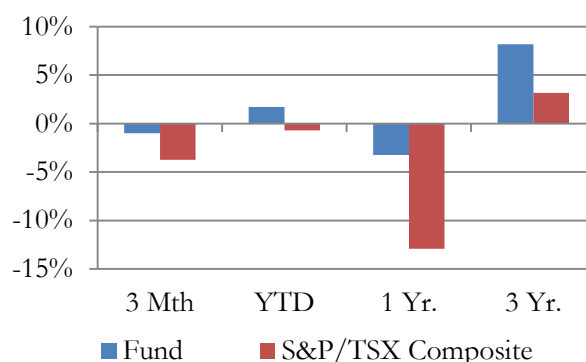
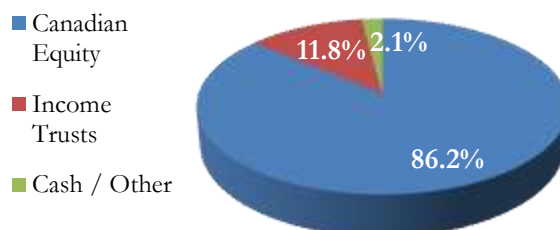
Finally, according to Morningstar, CBO tends to trade at a higher premium to its underlying net asset value than ZCS, making it more expensive. For the past 12 months, ZCS has traded at a premium of 0.03% compared with 0.07% for CBO. Ideally, you will want to avoid paying a significant premium for an ETF, particularly in a low return asset class. While premiums may be unavoidable in many ETFs, you can take steps to try to minimize this additional cost.

Combined, these factors lead me to favour ZCS over CBO in the near to medium term.

RBC QUBE Low Volatility Cdn. Equity

Fund Company	RBC Global Asset Management
Fund Type	Canadian Equity
Rating	A
Style	Large Cap Growth
Risk Level	Medium
Load Status	No Load / Optional
RRSP/RRIF Suitability	Good
Manager	Bill Tilford since Nov. 2012
MER	1.97%
Fund Code	RBF 489 – No Load Units RBF 719 – Front End Units
Minimum Investment	\$500

Asset Mix



ANALYSIS: Low volatility funds have become quite popular of late, as many look for ways to protect their nest eggs from the market.

While there isn't a lot of track record on many of these funds, this RBC offering has shown a lot of promise. Managed by a team headed up by Bill Tilford, the investment process is very quant focused that looks to minimize the fluctuations of the portfolio while still providing strong returns.

The process starts by rating and ranking each stock on a number of different fundamental criteria that are both forward and backward looking. The team then reviews a number of stability measures, which are also scored.

The team then generates a risk forecast for each stock, which is then used as an input in the manager's portfolio optimization model. The portfolio is optimized twice – once using a more traditional approach and the second time using more predictive factors. The final step is a more

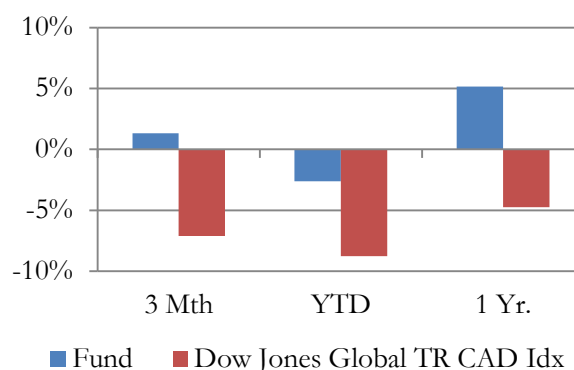
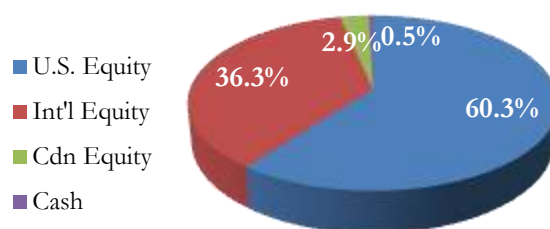
fundamental review that is completed by the team.

The result is a large cap focused portfolio, holding around 70 names. Given the emphasis on low volatility, it is not surprising to see it significantly overweight in defensive sectors like utilities, consumer staples and telecom. A drawback to this is investors have bid up the value of these sectors significantly, resulting in a portfolio that is much more richly valued than the broader market. That will make it tough, although not impossible to repeat the recent level of outperformance the fund has experienced. While the broader Canadian market dropped nearly 13%, this fund eked out a small gain. However, as we see stability return to the energy market, expect this fund to lag. Also, it would be expected to lag in most market rallies. Still, for more conservative investors looking for core equity exposure, this might be worth taking a look at.

RBC QUBE Low Volatility Gbl. Equity

Fund Company	RBC Global Asset Management
Fund Type	Global Equity
Rating	TBD
Style	Large Cap Blend
Risk Level	Medium
Load Status	No Load / Optional
RRSP/RRIF Suitability	Good
Manager	Bill Tilford since Nov. 2012
MER	2.23%
Fund Code	RBF 487 – No Load Units RBF 717 – Front End Units
Minimum Investment	\$500

Asset Mix



ANALYSIS: Low volatility funds have become quite popular of late, as many look for ways to protect their nest eggs from the market.

Despite less than three years of track record, this RBC offering has shown a lot of promise. Managed by a team headed up by Bill Tilford, the investment process is very quant focused that looks to minimize the fluctuations of the portfolio while maximizing risk adjusted returns.

The process starts by rating and ranking each stock on a number of different fundamental criteria that are both forward and backward looking. The team then reviews a number of stability measures, which are also scored.

The team then generates a risk forecast for each stock, which is then used as an input in the manager's portfolio optimization model. The portfolio is optimized twice – once using a more traditional approach and the second time using

more predictive factors. The final step is a fundamental review completed by the team.

The result is a large cap focused portfolio, holding nearly 200 names. Given the emphasis on low volatility, it is not surprising to see it significantly overweight in defensive sectors like utilities, consumer staples and telecom. While the Canadian version is quite richly valued, this global offering is more fairly valued. Still, I believe it will still be a tough task for the fund to sustain its level of outperformance.

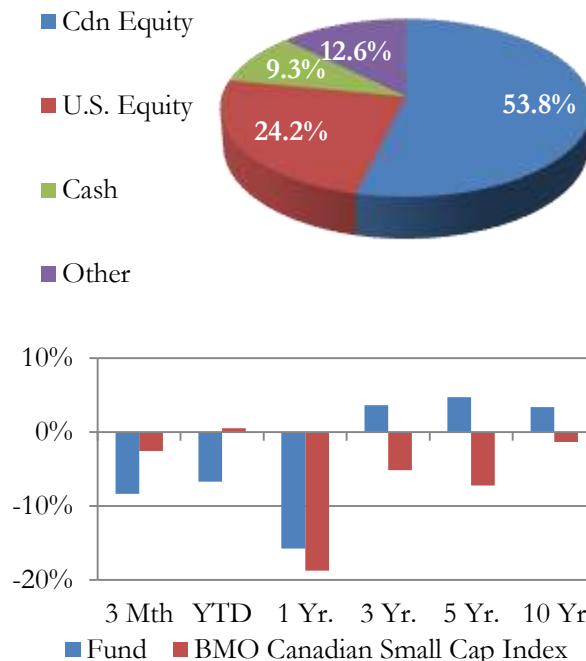
Over the past year, the MSCI World Index was down 3.2% in Canadian dollar terms, while this fund posted a rather respectable 5.1% gain. Year to date, the market is off by 8.8% and this fund has held up well, dropping 1.4%

As with its Canadian counterpart, I think it is worth considering if you are looking for conservative global exposure, and are comfortable with underperforming in a rising market.

Trimark Canadian Endeavour Fund

Fund Company	Invesco Canada Ltd.
Fund Type	Cdn Foc Small / Mid Cap Equity
Rating	A
Style	All Cap Blend
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Clayton Zacharias since Aug 07 Martin Uptigrove since Aug 07 Alan Mannik since January 2016
MER	2.21%
Fund Code	AIM 1553 – Front End Units AIM 1551 – DSC Units
Minimum Investment	\$500

Asset Mix



ANALYSIS: Like its global counterpart, this fund invests in a concentrated portfolio of companies of any size. The big difference, apart from a different management team is while the global fund has a true go anywhere mandate, this offering must invest no less than 51% in Canada.

Like other Trimark branded funds, the managers look for well managed companies, generating strong levels of free cash flow, and sustainable barriers to entry that are trading at levels below what they believe it is worth. While the focus is in Canada, they have the flexibility to look abroad for opportunities.

Companies in the fund tend to skew more towards the mid and small cap end of the spectrum, although there are a few larger names including Power Corp., CI, and Cisco Systems.

Given the bottom up process, and emphasis on cash flow, the sector mix is often different than

the index. At the end of February, it was overweight healthcare, industrials, technology and energy, and had no exposure to telecom, consumer staples or utilities. It was also underweight materials. They are also not afraid to hold cash when no opportunities are available, and at the end of February held slightly more than 10% in cash.

Longer term performance has been strong, outpacing many of its peers and finishing well in the top quartile from 2009 to 2013. It struggled in 2015, underperforming largely on their energy holdings. They were a bit early into the space, and that has hurt short term, but is expected to payoff once we see some stability return to the energy market. It has done a decent job in protecting capital in down markets.

I like the fund, but would be reluctant to use it as a core holding, given the significant small and mid-cap exposure. It may fit in a portfolio as a piece of your overall equity sleeve as a potential return enhancer and risk diversified, given its lower correlation to the broader equity market.