

Top Funds Report

Fed Stands Pat. Markets Worry over Brexit

Worries over interest rates and fallout over potential Brexit increases volatility levels...

As the June 23 vote on Britain's future with the European Union approaches, investors have become increasingly worried, pushing volatility levels higher. The result has been a modest selloff in global equity markets, with the S&P/TSX Composite Index falling nearly 4% from its mid-June high, while the S&P 500 is off around 3%. Understandably, European markets have been hit a bit harder, with the MSCI European Index dropping nearly 9%, and the MSCI EAFE Index seeing a 7% drawdown.

As of June 17, the leave side had a slight lead, with polls showing 48% favoured exiting the EU, 43% wanting to stay and the rest undecided. Regardless of which side wins, there will be fallout, although I would expect most of the fallout to be more political than economic.

Once the dust settles, many of Europe's problems will still be there, with lackluster job growth, high debt levels, and sluggish economic growth. Those factors, combined with the increasing volatility levels have caused me to underweight my exposure to European equities. While valuation levels in North American remain elevated, I still see the U.S. as the strongest opportunity in the near term. With stability returning to the oil market, Canadian equities appear to be somewhat more positive.

This uncertainty has also seen a nice rally in the traditional safe haven investments such as government bonds and gold. Since the start of June, gold has rallied, gaining more than 7%. Government bonds have also shown some strength with the yield on the U.S. ten-year

dropping from 1.85% on June 1, closing at 1.57% on June 16.

Within fixed income, I continue to favour high quality, actively managed bond portfolios over the indices. I remain comfortable with the index like duration calls of **PH&N Total Return Bond**, and **TD Canadian Core Plus Bond Fund** over more conservatively positioned options.

With equities, I continue to favour concentrated, high conviction, quality focused portfolios that look much different than their respective benchmarks. I expect we will see periods of above average volatility, taking us on a wild ride. I am underweighting the most volatile regions.

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
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Brexit – Crisis or Opportunity

Uncertainty weighs on global markets creating volatility and opportunity...

I received a call from an advisor the other day asking me how I would “trade the Brexit situation”. Well first of all, I’m not a trader, so I wouldn’t even try. But more to the point, my whole investment philosophy is based on the concept of minimizing risk. One of the biggest risks we face in investing is the unknown. In this scenario, we do not know what the outcome of the vote will be, and it is too close to call.

As we head into the June 23 vote, investors have become increasingly jittery, as the Leave side has moved ahead in the polls. Equity market volatility has increased, and the British pound has been driven lower. While markets and traders are speculating on how the vote will unfold, we won’t know until all the votes are counted.

If, as many expect, Britain opts to stay in the EU, things will very likely return to normal, although it is expected that growth will have taken a modest hit because of the uncertainty caused in the lead up to the vote. In the short term, UK and European stocks will be expected to take a bit of a hit, but over the long term, I would expect it to be nothing more than a blip. I would not expect much in the way of further fallout.

If Britain decides to leave, we are entering uncharted territory. Many expect there to be significant fallout in Britain and Europe that may spread across the globe. It could also serve as the catalyst for other nations to exit the EU, creating even more uncertainty. While some slowdown would be expected, we have no way of knowing how severe it will be, how long it will last, and how quickly things can turn around.

So, how would I position a portfolio to benefit from this? If you believe the vote will be to stay,

go long the pound, and European banks. If you think the vote will be to leave, then avoid European and British equities, and go long gold and government bonds, the traditional safe haven trades in periods of uncertainty. But the reality is we don’t know how this will play out and the odds of you being wrong, regardless of the side you pick is very high.

My preferred option would be to stick to the basics and make sure the portfolio is in line with the investment objectives and risk tolerance of the investor. Invest in high quality, well-managed, high active share funds that have management teams that continue to focus on earnings outlooks and valuations on your behalf and position the portfolios in the most appropriate way to benefit from that. Focus on those managers with a demonstrated history of protecting investor capital in good times and bad. If you’re looking for some ideas, please check out my Recommended List of Funds.

Make sure the portfolio is well diversified across asset classes and in a mix that is in line with the investor’s specific needs. Obviously, more conservative investors will want to have higher exposures to cash and fixed income than those that are more growth focused.

And finally, even before the heightened volatility from this Brexit crisis, my fund valuation model has been favouring U.S. and Canadian equities at the expense of European and Asian funds, based on volatility, valuation and growth outlook. This has resulted in a modest overweight to North America over other parts of the world, and I continue to favour developed markets over emerging markets.

Funds of Note

This month, I take a look at some of the funds on my ETF Focus List...

iShares Canadian Short Term Bond Index ETF (TSX: XSB) – Short term bonds underperformed in the period, as stability in the commodity sector put upward pressure on Canadian short term rates. For the three months ending April 30, the yield on the Canada two-year bond rose from 0.42% to 0.68%, while the Canada five year finished the period at 0.87%, up from 0.67%. Despite this bump, XSB managed to end the period modestly higher.

Going forward, this remains my top short term pick for volatile times, given its mix of government and investment grade corporate bonds. While I believe the **BMO Short Term Corporate Bond Fund (TSX: ZCS)** will do marginally better over the long term, with its higher yield, XSB has slightly higher quality holdings and is expected to hold up better in periods of uncertainty on a flight to safety type trade. Further, the exposure to government bonds will also lessen concerns around liquidity, compared to a more corporate credit focused ETF. If downside protection is the most important factor for your short term bond exposure, I believe this is a great ETF for that. If you're looking for a stronger total return profile, then ZCS would be expected to do better over the long term.

PowerShares FTSE RAFI Canadian Fundamental Index ETF (TSX: PXC) – This rules based ETF is built using a process that rates and ranks the Canadian universe of stocks on key fundamental factors including sales, cash flow, book value, and dividends. The stocks are each

ranked by the four fundamental measures, which results in a total score for each company. They are then ranked by their scores from best to worst, and the top 100 or so make up the ETF. Stock weights are determined by the fundamental score, with the better ranked stocks making up a higher weight in the ETF. There are no constraints on sector weights, which is where I begin to get a little worried about this particular ETF. It has a very high level concentration in the financials and energy sectors, which combined make up nearly 65% of the portfolio. I can be comfortable with this in a specialized mandate, it concerns with a more broadly focused ETF.

The counterargument is these are the sectors that are currently exhibiting the favourable valuation criteria, so over the long run, it should not be an issue. I am on board with that from a theoretical standpoint, but as we saw through most of 2015, with energy selling off dramatically, this ETF struggled, falling nearly 10% over the year. Year to date, with some stability returning to the energy markets, it has rebounded, recovering substantially all of the drop of 2015. So far in 2016, it has risen by nearly 13%, and for the three months ending April 30, it gained nearly 15%. Even with this rise, valuation levels remain rather attractive when compared to its peers. Looking at the forecasted growth numbers, they are strong, making this a reasonably compelling ETF from a pure numbers perspective.

I believe this ETF should do as well as a traditional cap weighted index over the long term. However, the level of concentration

remains a concern, and has the potential to result in periods of higher than average volatility. I expect that volatility levels will remain higher than normal for the near term. I continue to monitor the ETF for increasing concentration and any further erosion in the risk reward metrics.

iShares U.S. Fundamental Index ETF (TSX: CLU) – Like the PowerShares FTSE RAFI Canadian Fundamental Index ETF (TSX: PXC) highlighted above, this ETF is constructed using the same fundamentally driven, rules based process, ranking stocks on a number of fundamental criteria. Apart from investing in U.S. traded stocks, this ETF holds roughly 1,000 names, ten times that of its Canadian counterpart. The concentration issue that is prevalent in the Canadian fundamental ETFs is not seen in the U.S. versions. While there is still an overweight in energy and financials, the combined weight is roughly half that of PXC.

As in Canada, the valuation levels are more appealing than the cap weighted XSP, however the forward looking growth estimates favour XSP. Over the long term, I expect this to deliver comparable returns to XSP, but with modestly lower levels of volatility, resulting in slightly better risk adjusted returns. Still, I would likely favour XSP based on its significantly lower cost.

iShares MSCI EAFE Minimum Volatility Index ETF (TSX: XMI) – In most markets, low volatility ETFs have performed as advertised, outperforming the traditional cap based indices when markets fall. This ETF has broken that trend, falling 5.3% in Canadian dollar terms while the MSCI EAFE Index was down 3.9% during the same period. Much of the underperformance can be attributed to its

healthcare and technology names, many of which struggled in the past few months. Another concern is that like other low volatility offerings, its valuation numbers are very stretched relative to the broader market and other international equity ETFs, yet its holdings have a lower level of forward looking growth expectations. Given that, I am expecting to see underperformance over the near to medium term while valuation levels catch up with the underlying fundamentals.

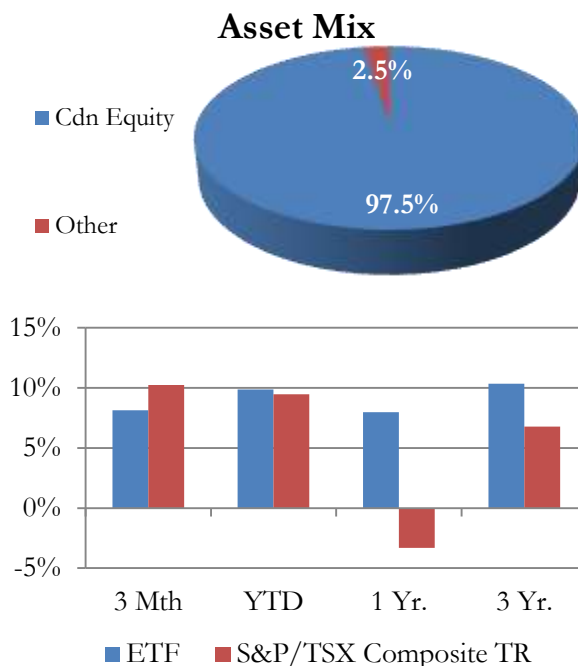
BMO Global Infrastructure Index ETF (TSX: ZGI) – Infrastructure names continued to struggle, with ZGI posting a very modest 0.3% drop in the three months ending April 30. This despite the strong rebound in the energy sector, which makes up nearly 40% of this fund. As we look forward, the outlook for infrastructure continues to improve. Economic growth globally appears to be more balanced, and many nations are now posting positive, albeit modest levels of growth. Global central banks also remain very accommodative with their monetary policy, which should prove to be a positive to many infrastructure names. Further, a number of countries, a great example being Canada, have had governments step up to the table with announced infrastructure spending. We are also seeing some stability return to the energy markets. Still, there is much uncertainty in the sector, and until that begins to settle, we may see further bouts of above average volatility. I remain cautious on infrastructure in the near term, but see the longer term outlook as quite strong. In the ETF space, this remains my top pick.

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

feedback@paterson-associates.ca.

PowerShares S&P/TSX Cmp Low Vol ETF

Fund Company	PowerShares Canada
Fund Type	Canadian Equity
Rating	A
Style	Mid Cap Value
Risk Level	Medium
Load Status	N/A
RRSP/RRIF Suitability	Good
Manager	PowerShares Management Team
MER	0.33%
Fund Code	TSX: TLV
Minimum Investment	N/A



ANALYSIS: The problem I see with many of the low volatility mandates is that investors have bid up the valuation levels of many of the stocks held in these products to very high levels. For example, according to Morningstar, the P/E ratio of the **BMO Low Volatility Canadian Equity ETF (TSX: ZLB)** is 21.4 times forward earnings. In comparison, the S&P/TSX 60 Index trades at approximately 15 times forward earnings. While ZLB has significantly outperformed the other Canadian low vol ETFs, I don't see how that is sustainable at these levels of valuation. In comparison, this PowerShares ETF trades at a valuation level that is more in line with the broader market. Further, if you consider the forward looking growth rates, TLV looks to have a more positive outlook than ZLB, making the valuation levels that much more compelling.

There are a couple of other reasons to favour TLV over ZLB. One is TLV is rebalanced on a quarterly basis, making it potentially more

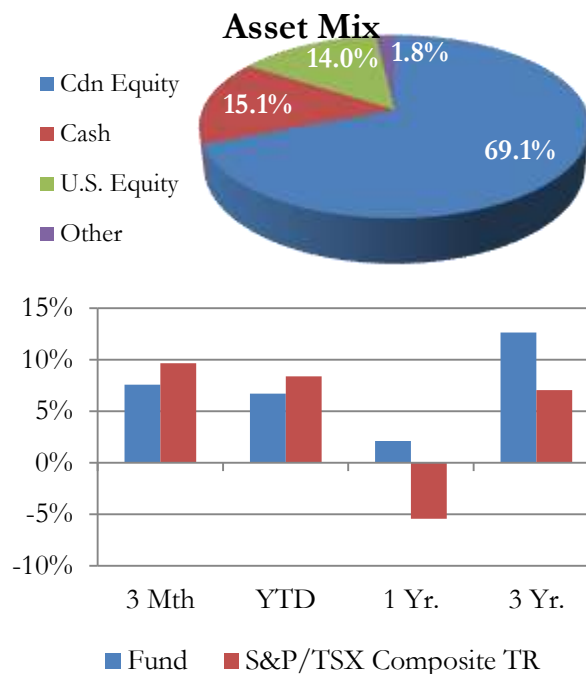
responsive to the market than other low vol ETFs. Another reason to like this is its lower cost.

A drawback to TLV lies in the sector constraints, or lack thereof. There are no maximum limits on the sector exposure. With no constraints, it has the potential to get pretty concentrated, as is the case now, running about 27% in financials, and 31% in real estate, more concentrated than its peers. A higher concentration portfolio can be a double edged sword, and can either help or hurt depending on what way the market moves.

The bottom line is I believe that TLV is better positioned to outpace its peers. While ZLB may continue to outperform in the shorter term based on momentum factors. Historically, valuations typically regress back to the mean, making it highly likely it will experience a sustained period of underperformance in time. Considering all factors, I believe that TLV is better positioned than other low vol ETFs currently.

PowerShares Canadian Dividend ETF

Fund Company	PowerShares Canada
Fund Type	Cdn Dividend & Income Equity
Rating	A
Style	Large Cap Value
Risk Level	Medium
Load Status	N/A
RRSP/RRIF Suitability	Good
Manager	PowerShares Management Team
MER	0.55%
Fund Code	TSX: PDC
Minimum Investment	N/A



ANALYSIS: In Canada, it has been shown that over time, roughly 65% to 70% of the total return of equities comes from reinvested dividends. That makes for a very compelling case to have dividend stocks a key part of your portfolio. With that in mind, I reviewed a number high quality, dividend focused ETFs, and this is one that stood out as pretty attractive relative to its peers.

It invests in highly liquid Canadian stocks that have paid a stable or rising dividend over the past five years. It screens for dividends, and then holds the 45 largest stocks ranked by market capitalization. It is an adjusted market cap index, meaning it will make some adjustments to make sure one or two companies don't dominate the portfolio. The index is reconstituted each year and rebalanced on a quarterly basis.

I like this over the **iShares S&P/TSX Canadian Aristocrats Index ETF (TSX: CDZ)** for a few reasons. PDC tends to focus more on larger

names than CDZ, which is reflected by an average market cap that is nearly four times larger. The valuation and forward looking earnings numbers appear more favourable to PDC, giving it the edge over the long term growth potential. The dividend yield of PDC is also slightly higher, allowing investors to receive a higher income while they wait for stock price appreciation. Costs for PDC are also slightly less, with an MER that 12 basis points lower.

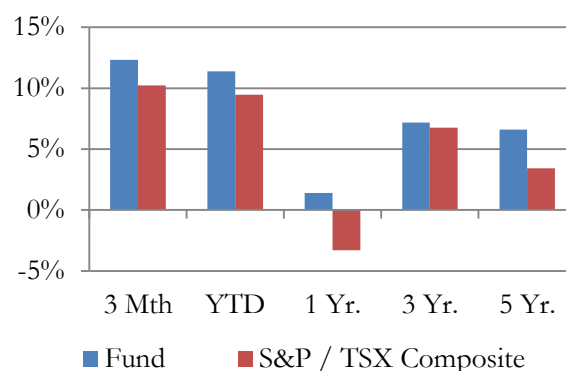
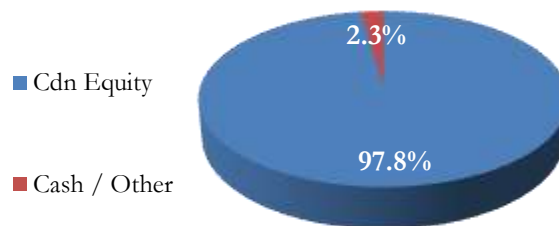
My big concern with PDC is its concentration in financials. At the end of April, it held more than 40% in financials and another 13% in REITs. The risk here is the potential impact to the banks if we see a meaningful slowdown in the Canadian housing market. More than 30% of the fund is directly invested in the banks, compared with a little more than 10% in CDZ.

Still, after my review, I see PDC as the most attractive option in the near to medium term.

Leith Wheeler Canadian Dividend Fund

Fund Company	Leith Wheeler Investment Counsel
Fund Type	Cdn Dividend & Income Equity
Rating	A
Style	Large Cap Value
Risk Level	Medium
Load Status	No Load
RRSP/RRIF Suitability	Good
Manager	Leith Wheeler Canadian Equity Team
MER	1.49%
Fund Code	LWF 019 – No Load Units
Minimum Investment	\$25,000

Asset Mix



ANALYSIS: Leith Wheeler is one of those companies you don't hear a lot about. Since 1982, this employee owned shop has quietly gone about its business of managing money for a wide range of Canadian retail, private client, and institutional investors.

This dividend focused offering is managed by the same team using the same process used for the highly regarded **Leith Wheeler Canadian Equity Fund (LWF 002)**. They use a value focused, bottom up, value drive approach that looks for high quality, conservatively financed companies that generate attractive returns on capital, and are trading below what they believe it to be worth.

The portfolio is concentrated, holding around 40 names, with the top ten making up nearly 45% of the fund. Given the dividend focus, it is not surprising to see the fund overweight in high

yielding financial, REIT and utility names, with very little exposure to materials, and healthcare.

The managers tend to be a little more active with this fund than they are with the broader Canadian equity mandate. Over the past five years, portfolio turnover has been roughly double that of their flagship fund, averaging more than 75% per year.

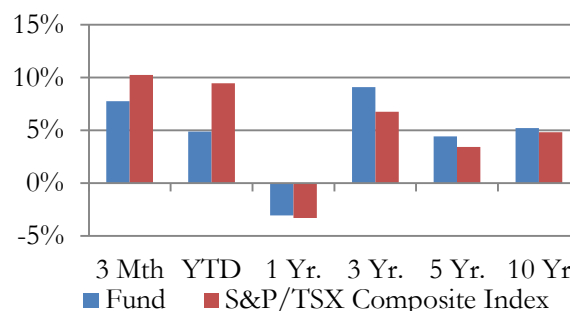
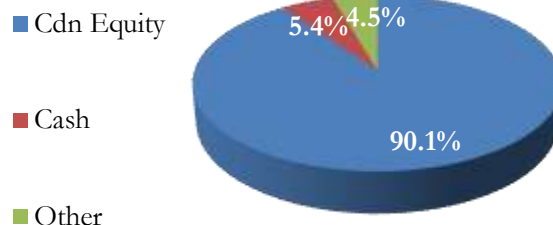
Performance has been strong, gaining an annualized 6.6% for the five years ending May 31 while the broader S&P/TSX Composite Index rose by only 3.4%. Volatility has been in line with the market. Capital protection has been strong, with the fund participating in less than two thirds of the market downside.

Perhaps the biggest drawback to this fund is its high minimum investment of \$25,000, putting it out of reach for those with smaller accounts. Still, for those with modest account balances, it is a great core Canadian equity offering.

Fidelity Canadian Disciplined Equity Fund

Fund Company	Fidelity Investments
Fund Type	Canadian Equity
Rating	B
Style	Large Cap Growth
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Andrew Marchese since Mar. 09
MER	2.28%
Fund Code	FID 224 – Front End Units FID 524 – DSC Units
Minimum Investment	\$500

Asset Mix



ANALYSIS: This Canadian equity fund is somewhat unique in that it is run using a sector neutral approach, meaning it strives to have the same sector exposure as its benchmark, the S&P/TSX Composite Index. With the sector mix taken care of, it is the manager's ability to find good stocks that will be the key driver of return.

In building the portfolio the manager relies heavily on Fidelity's team of analysts covering the Canadian market. He tends to like stocks that have a history of delivering above average earnings growth, and strong cash flow generation that are trading at a valuation level they believe is reasonable. They can invest in companies of any size, but it tends to heavily favour large cap names, which at the end of April made up more than three quarters of the portfolio.

Not surprisingly, the portfolio holds many of the names found in the S&P/TSX Composite Index such as Royal Bank, TD Bank, and Suncor. Somewhat surprisingly, it has no exposure some

index heavyweights, including Bank of Nova Scotia, Bank of Montreal, and BCE.

The portfolio is fairly concentrated, holding approximately 60 names, with the top ten making up more than 45% of the fund.

Performance has been decent, gaining 4.4% for the five years ending May 31, compared with a more modest 3.4% gain for the index. Volatility has been modestly lower than the broader market, and the fund has done a solid job in protecting capital. It has participated in about 90% of the upside movement of the market, yet only participated in about 80% of the drawdowns.

I have to admit I'm mixed on this fund. The track record and process show that the managers have the ability to add some value through their stock picking ability. The downside is the sector neutral mandate effectively handcuffs the managers, preventing them from overweighting or underweighting certain sectors. Still, this can be a solid decent holding for medium risk investors.