

Top Funds Report

Third Quarter Finishes Higher

Despite uncertainty over Brexit, markets remained calm, rewarding patient investors with gains...

With the Brexit vote results fresh in the minds of investors, we entered the third quarter with concern that market volatility would be higher than normal. Fortunately, much of this worry was overblown, and the markets were rather calm over the summer.

It was a strong quarter for both equities and fixed income investments, with all major markets showing gains. Leading the way higher was the MSCI EAFE Index, gaining 7.4% on strength in Asia. U.S. and Canadian equities rose by 5.5%. Small and mid-cap names rallied nicely, outpacing their large cap brethren.

The bond markets also experienced relative calm, after a brief flight to safety rally near the end of the second quarter. The Canadian bond market rose by 1.2%, with corporate and high yield bonds outpacing governments.

As we head into the final quarter of the year, the environment is expected to remain challenging, with investors focused on the outcome of the U.S. Presidential election, the U.S. Federal Reserve, valuation levels, and the tepid pace of global economic growth.

While I note many reasons to remain cautious, there are no obvious reasons to be fearful. As always, now is an excellent time to revisit your asset mix and manager selection to ensure they remain consistent with your goals and risk tolerances. It is also a great time to rebalance your portfolios to bring them back in line with the target asset mix. Following a disciplined

rebalancing program has been shown to help improve risk adjusted returns over the long term.

I am reminded of the old adage that to make money in the investment markets, it is all about “time in the markets, rather than timing the markets.” It is much more important to have an investment plan that involves a portfolio that is in line with your investment objectives and risk tolerance that you can be comfortable with in all market conditions, rather than trying to perfectly time your entry and exit points from different asset classes and investments over time. The more you tinker with this plan, the more likely you are to make a mistake that could hurt you over the long term.

My current investment outlook remains steady:

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

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

Funds of Note

This month, I highlight some cost reductions and interesting new products...

Fee Reductions on Flagship Brandes and Sionna Funds – In late July, Bridgehouse Asset Management, distributors of Brandes, Sionna, and Lazard mutual funds in Canada, announced they were making some cuts to the management fees on a few of their funds.

The cuts are meaningful, particularly on the Brandes funds, where the MERs are expected to be approximately 40 bps cheaper.

The announced cuts were:

Fund	Fee Cut	Current MER	Target MER
Brandes Global Equity Sr. A	0.35%	2.78%	2.37%
Brandes Global Equity Sr. F	0.35%	1.64%	1.24%
Brandes Int'l Equity Srs. A	0.35%	2.78%	2.37%
Brandes Int'l Equity Srs. F	0.35%	1.65%	1.24%
Brandes Gbl Opportunities A	0.20%	2.78%	2.37%
Brandes Gbl Opportunities F	0.20%	1.65%	1.41%
Sionna Cdn Equity Fund A	0.30%	2.66%	2.32%
Sionna Cdn Equity F	0.30%	1.53%	1.19%

Source: Bridgehouse Asset Management

While the magnitude of the cuts is significant, the new target MERs are still a touch on the high side. The average MER of global equity funds in my coverage universe is 2.48%, and for Canadian equity funds, it is 2.21%. At best, these cuts bring the funds to around the category average. Ideally, I would like to see further cuts made to improve

the competitiveness of these, and other Bridgehouse offered funds.

First Asset Investment Grade Bond ETF (TSX: FIL) – In August of this year, First Asset converted its closed end fund, **Marret Investment Grade Bond Fund (TSX: MIG.UN)** into this ETF.

Besides a new structure and a rebranding, it is very much like the former closed end fund. It remains an actively managed bond fund that will focus mainly on investment grade corporate bonds. It is managed by Paul Sandhu, a Vice President and Portfolio Manager with Marret Asset Management.

While the focus is on Canada, it has the ability to invest in the U.S. and Europe. In a recent call, Mr. Sandhu expects the U.S. exposure will be increased over the next quarter, and is likely to represent between 15% to 20% of the portfolio. He likes the U.S. because it is an area of the bond market where an active strategy can be rewarded with excess returns.

The manager is afforded a lot of leeway in the portfolio. He can invest up to 20% of the fund in high yield bonds that are rated BB- or better. There are a few high conviction scenarios where the high yield exposure will be tactically increased. They include situations where they can take advantage of a new issue discount to buy a credit and sell it at a higher price in a relatively short period of time, when they can buy a bond they expect to be upgraded to investment grade, or if valuations are so compelling.

On the other end of the quality spectrum, they can move the fund entirely into government bonds if they believe valuations are very

extended. They did this in other mandates in 2006 and 2007.

Currency exposure is expected to be fully hedged to minimize risk. However, they do have the ability to keep up to 20% of the foreign currency exposure unhedged, and will do so only when they see a compelling opportunity to profit.

The duration exposure will be actively managed, and it is expected the manager will short government bond futures or invest in credit default swaps to do this. They believe these instruments are a more effective way to manage the duration exposure. At the end of September, the duration was 5.1 years, well below the 7.6 years of the broader Canadian bond market.

Yield to maturity is listed at 2.94%, which is well above the 1.8% yield of the broader market.

Performance has lagged its other actively managed peers. For the three years ending September 30, it gained 4.1%, while the gains on the other actively managed bond ETFs ranged between 5.2% and 5.6%. In comparison, the FTSE TMX Canadian Universe Bond Index was up 6%. Volatility has been in line with both the Canadian bond universe index and its peer group.

Another drawback I see to this ETF is cost. It carries a management fee of 0.65%, which is well above the more passive bond ETFs, and modestly above the other actively managed bond ETFs.

Given the active process used in the management, combined with the challenging bond environment, this ETF has the potential to outperform its passive benchmark. However, I am reluctant to recommend it given the poor relative and absolute historic performance. I will continue to monitor this ETF.

Mackenzie High Diversification Funds and Maximum Diversification ETFs – In the spring, Mackenzie Financial began launching some interesting new funds managed by Paris based

asset manager TOBAM. The firm was founded in 2005 by Yves Choueifat, and today is employee owned with two minority shareholders, CalPERS, and Amundi. The team is made up of 47 investment professionals, who manage more than \$15 billion across 11 different mandates.

What makes these funds so interesting is the underlying investment philosophy and approach used. TOBAM uses what they call “Maximum Diversification” that seeks out the most diversified portfolio possible for a given market. To do this, they have devised a mathematical formula that measures the portfolio’s diversification. Their process, looks to maximize this ratio. This approach is so unique that the firm has been granted patents in the U.S., Japan, and Australia, and has one pending in Canada.

To better understand this process, we first need to take a look at how diversification works in a portfolio. Whenever we combine investments that are less than perfectly correlated in a portfolio, there is a reduction in the volatility (as measured by standard deviation) that is larger than the simple weighted average would suggest. This is a result of the correlation, and the volatility reduction is dependent on the level of correlation. The less correlated the investments are, the larger the reduction in volatility.

Instinctively, this makes sense because when investments are highly correlated, their returns are often very similar, meaning that when one is up, most are up. However, when investments are less correlated, there is less of a relationship in the return patterns, resulting in a less volatile combination, and often more important, better downside protection in volatile periods.

What TOBAM seeks to do is maximize the difference between the simple weighted average of the risk, and the calculated risk of the combination. By doing so, they believe they can outperform the traditional cap weighted indices

with less overall risk. In their view, this higher return is the result of the portfolio better capturing the risk premium of the equity market.

Because the correlation among investments is a key driver to the portfolio construction process, stock specific risk can be reduced. Since there is a lower level of correlation among the portfolio constituents, the impact of any one name is likely to be minimized, as the rest of the portfolio will have lower correlation to the holding, meaning the return streams are not likely to be related.

The portfolio construction process is very quantitatively driven, and consists of a number of different screens. The first is to identify potential investment candidates. To be included, a stock must be eligible for inclusion in the most appropriate FTSE Index, and must meet certain liquidity criteria. Stocks are also screened using an SRI filter that weeds out companies involved in weapons, tobacco, or severe violations of human rights, ethics, or environmental damage.

Once securities are identified, the portfolio is constructed in three basic steps. First, the correlation between all eligible securities is determined. Next, the firm creates a portfolio that will maximize the diversification ratio. The final step is to make some refinements based on some risk management measures including maximum position sizes, geography, and liquidity.

This process is run on a quarterly basis, with the goal of reducing portfolio turnover.

The portfolios are designed to outperform their respective benchmarks by between 2% and 3% on a gross of fee basis, with approximately 20% less volatility.

Many of the portfolios have been live since 2011, and the company has provided back tested data going back to 2002. The live data thus far looks encouraging, and the back tests look very strong. Obviously we can't put our full faith in the back

tests as they are merely simulations of how the portfolios are likely to have behaved, and not actual, audited results.

So far, Mackenzie has launched five mutual funds and five ETFs under this High Diversification banner. The mutual funds are:

- **Mackenzie High Diversification Canadian Equity Class**
- **Mackenzie High Diversification U.S. Equity Fund**
- **Mackenzie High Diversification Global Equity Fund**
- **Mackenzie High Diversification International Equity Fund**
- **Mackenzie High Diversification European Equity Fund**

The ETFs are:

- **Mackenzie Maximum Diversification All World Developed Index ETF**
- **Mackenzie Maximum Diversification All World Developed ex-North America Index ETF**
- **Mackenzie Maximum Diversification Developed Europe Index ETF**
- **Mackenzie Maximum Diversification Canada Index ETF**
- **Mackenzie Maximum Diversification US Index ETF**

I am very intrigued by these new offerings, as the investment theory is very much in line with my investment philosophy and views. However, with only a short live track record, I am reluctant to jump on board. Instead, I will monitor these funds and ETFs closely to see how they perform in the real world, paying close attention to both returns and volatility. Stay tuned...

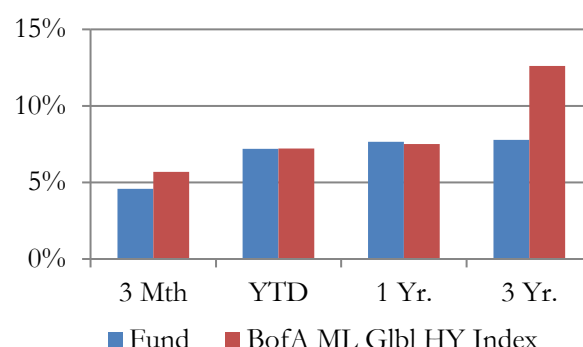
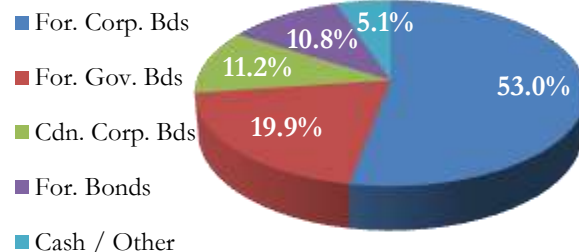
If there is a fund that you would like reviewed, please email it to me at

feedback@paterson-associates.ca.

RBC Strategic Income Bond Fund

Fund Company	RBC Global Asset Management
Fund Type	High Yield Fixed Income
Rating	B
Style	Fund of Funds
Risk Level	Low to Medium
Load Status	No Load / Optional
RRSP/RRIF Suitability	Good
Manager	Sarah Riopelle since August '13
MER	1.85%
Fund Code	RBF 482 – No Load Units RBF 722 – Front End Units RBF 822 – DSC Units
Minimum Investment	\$500

Asset Mix



ANALYSIS: Having just passed its three-year anniversary, this one-ticket bond portfolio has delivered strong results for investors. To do this, it invests in a number of bond funds offered by RBC, providing exposure to investment grade corporate bonds, high yield bonds, emerging market debt, and convertible bonds.

The underlying funds are high quality offerings, with the cornerstone, **RBC Global Corporate Bond Fund**, having a place on my Recommended List of Funds. In addition to the bond exposure, it also has a 10% weight in emerging market currencies and short term interest rates.

Sarah Riopelle is responsible for managing the mix of the funds, with input from the RBC Global Asset Management Investment Policy Committee. While Ms. Riopelle has some tactical discretion over the fund mix, it will be kept within 10% of

the fund's neutral mix. Any tactical shifts are expected to be incremental, as RBC believes that further allowances would create too much risk relative to the overall potential return.

Returns have been strong, outpacing its peers with a 7.5% gain for the three years ending September 30. Volatility has been significantly lower than the high yield index or its peers.

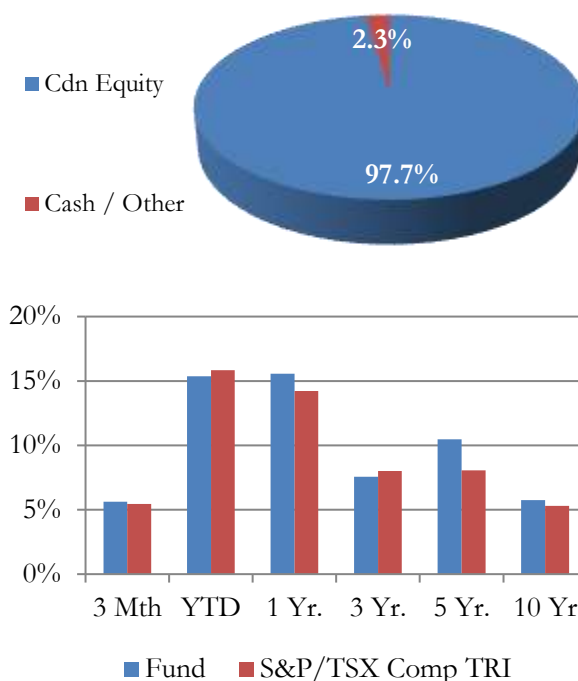
It pays a modest distribution of \$0.03 per month, which translates into an annualized yield of approximately 3.3%. According to RBC, the yield-to-maturity of the portfolio is just under 4%. Costs are about average, with an MER of 1.85%.

While the results have thus far been encouraging, I'm still leaning towards a more tactical mandate. I will watch it closely, and see it as a solid, way for investors to access non-core bond exposure in a well-diversified way.

Franklin Bissett Canadian Equity Fund

Fund Company	Franklin Templeton Investments
Fund Type	Canadian Equity
Rating	B
Style	Large Cap GARP
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Garey Aitken since Jan 2002 Tim Caulfield since Jan 2011
MER	2.46%
Fund Code	TML 202 – Front End Units TML 302 – DSC Units
Minimum Investment	\$500

Asset Mix



ANALYSIS: Calgary based Franklin Bissett is one of those investment shops you don't hear a lot about. Yet every day, they quietly go about their business of building quality focused, high conviction, active portfolios for investors. This Canadian equity fund would be the firm's flagship.

Launched in 2002, it is managed using a bottom up, fundamentally driven, GARP approach that looks for well-managed companies that offer sustainable profitability, strong earnings and cash flow growth, a durable business model, and a management team with a history of sound capital allocation decisions.

To find these companies, managers Garey Aitken and Tim Caulfield use a multistep process. The first step is to identify potential investment candidates, looking for business with high levels of return on invested capital that are trading at a discount. They will then learn about the business, industry, and management. Next, they conduct

their own analysis to determine a company's intrinsic value, using very conservative assumptions. Finally, if appropriate, it will be added to the portfolio.

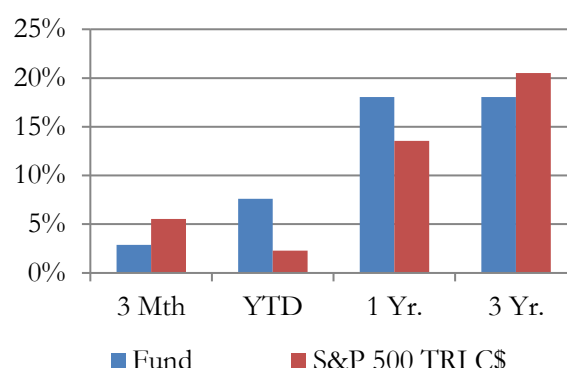
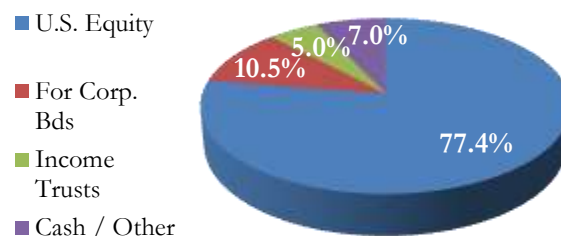
Their approach is very patient, which is evidenced by their very low levels of portfolio turnover, which has averaged less than 20% for the past five years. The portfolio holds approximately 50 names, with the top ten making up more than 40%. Sector mix is the byproduct of the available opportunities, and can often times look much different than index. At the end of June, it had significant exposure to financials, energy and industrials. It was underweight materials.

Performance has been solid, modestly outperforming the index, with marginally less volatility. This is impressive, given the 2.46% MER, which is around the category average. This is a core Canadian equity fund definitely worth taking a look at.

Renaissance U.S. Equity Income Fund

Fund Company	CIBC Asset Management
Fund Type	U.S. Equity
Rating	D
Style	Large Cap Value
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Phil Davidson since Sept 2013 Kevin Toney since Sept 2013
MER	2.23%
Fund Code	ATL 2486 – Front End Units ATL 2488 – DSC Units
Minimum Investment	\$500

Asset Mix



ANALYSIS: The U.S. equity market has historically been one of the most difficult to outperform. Although the retail version of this fund has only been around for three years, the longer term institutional track record show this offering has some promise to do so on a risk adjusted basis.

It invests mainly in U.S. equities, but will typically have between 15% and 25% in convertible bonds. The investment process is a bottom up, value focused one that looks to find good businesses that are out of favour for what they managers call “transitory” reasons. To be considered, a company must have a strong balance sheet, high quality assets, and defensible franchises. Valuation is a key consideration, but so too is the downside risk of any investment. They will typically avoid “deep value” names, as they believe there is too much risk in a back from the brink or reinvention story.

The goal is to deliver a portfolio that has the potential to generate strong returns, with less day to day fluctuation than the market. To date, they have done that, with volatility numbers that are lower than the broader market. The fund has also done an excellent job at protecting capital, participating in only 60% of the downward movement of the markets for the past three years.

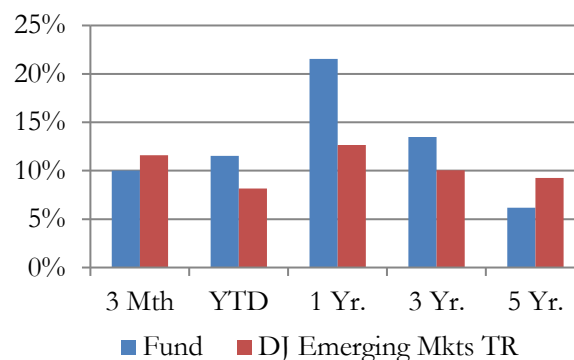
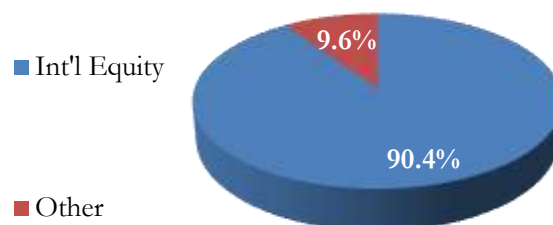
Yield is a consideration, and look for an average yield that is above than the market. At the end of June, the internal yield of the portfolio was listed at 3.3%, compared with 2.1% for the S&P 500.

Absolute performance has lagged the S&P 500 for the past three years, but the lower volatility has resulted in better risk adjusted numbers. This isn’t a fund I would ever expect to shoot the lights out. But if you’re looking for a more conservative way to access U.S. equities, this may be a fund worth a deeper look.

Trimark Emerging Markets Class

Fund Company	Invesco Canada
Fund Type	Emerging Markets Equity
Rating	C
Style	Large Cap Blend
Risk Level	High
Load Status	Optional
RRSP/RRIF Suitability	Fair
Manager	Jeff Feng since April 2013 Jeff Peden since April 2013
MER	2.80%
Fund Code	AIM 2143 – Front End Units AIM 2141 – DSC Units
Minimum Investment	\$500

Asset Mix



ANALYSIS: Since taking the reins of this emerging markets fund in 2013, Jeff Feng and Matt Peden have done an excellent job, outpacing both their competition, and their benchmark. For the three years ending August 31, the fund gained an annualized 13.5%, while the MSCI Emerging Markets Index rose by more than 9%.

A key reason for this outperformance is the disciplined investment process used, which looks to find well managed, high quality businesses that have sustainable competitive advantages, and are trading at a discount to what they believe it to be worth. A typical company in the portfolio will generate significant free cash flow, have strong organic growth rates, and high returns on capital.

Building the portfolio is very much a bottom up endeavor, and the team is consciously benchmark agnostic. Country allocation and sector mix is largely the byproduct of the security selection process. That said, the process tends to favour

more growth focused sectors such as technology, consumer names, and healthcare. At the end of August, consumer staples represented more than a quarter of the fund, technology was 18%, and consumer discretionary was just over 15%.

Volatility is in line with the market, and it has outperformed in both rising and falling markets. They are patient, long-term investors, with portfolio turnover averaging between 20% and 30% per year.

While recent performance may have been excellent, the portfolio looks nothing like its benchmark, meaning that it is likely there will be a dislocation in performance between this fund and the benchmark. This can be a positive, as it has been in recent years, but could also be a headwind.

Still, for those looking for a well-managed, active, concentrated portfolio of quality emerging markets companies, this is a fund that is definitely worth taking a look at.