Top Funds Report

Equity Markets Surprise with strong 2016

Outlook for 2017 more challenging with new President and likely Fed moves...

To say that 2016 was an interesting year, would be a bit of an understatement. It was a year that gave us Brexit, the death of a number of beloved celebrities, the election of a celebrity President in the U.S., a hike in U.S. interest rates, and on balance, another decent year for investors.

Heading into the last full trading week of the year, most global equity markets are in positive territory. The S&P/TSX Composite Index is up by more than 20%, the S&P 500 has gained nearly 13% in U.S. dollar terms, and the MSCI EAFE Index is flat.

In Canada, much of the gain has been the result of a rally in energy, financials, and materials, the key sectors of the market. It was a similar story in the U.S., with financials spiking on the surprising Trump victory. The MSCI EAFE Index has struggled on weakness in Asia. In virtually all markets, valuations are well above long-term averages, and priced for perfection.

Canadian bonds are higher by less than 1% as yields have pushed higher as traders expect the new U.S. regime's policies will be somewhat inflationary. Adding to that is the Fed, which moved last week to increase rates for only the second time since the financial crisis. During the announcement, it was noted that the Fed expects three increases in 2017.

Looking ahead, I am very reluctant to predict what will unfold next year. With Trump as president, I'm not sure how anyone can. That said, the one thing I do expect is continued uncertainty. This uncertainty is likely to result in continued higher levels of volatility. Because of this, I will continue to favour quality investments over more beta driven, speculative names.

In the fixed income space, 2017 is likely to be one of the most challenging in recent memory. The Bank of Canada is likely to remain on hold, while the Fed will be more active. For Canadian bonds, I am looking for disciplined, high quality managers who are not afraid to be active in their duration and credit calls. While a passive strategy is appealing form a cost perspective, I think we're heading into an environment, where a manager can really earn their fees.

I don't think 2017 will be as exciting as 2016, it will certainly be a challenging one for investors. My current outlook is:

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

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

Funds of Note

This month, I highlight funds and ETFs from Invesco and more…

Invesco Canadian Bond Fund (AIM 1653 – Front End Units, AIM 1651 – DSC Units) – Historically, the fixed income team at Invesco was its own entity. It was a standalone unit that was responsible for managing its own funds. Results have been a mixed bag, with most funds running middle of the pack.

In November, it was announced that the Canadian fixed income team was going to be fully integrated with Invesco's global fixed income team. I see this as a potential positive for all Canadian Invesco fixed income funds.

It expands the available resources considerably. The Canadian unit will be part of a much deeper credit platform with 165 investment professionals covering more than 3,500 issuers across all fixed income segments. There is a macro team that will assist by providing in-depth analysis on big picture themes to help with portfolio positioning, and a deeper understanding of the outlook for rates and currency. Finally, there is a strategy team that helps turn these ideas into asset mix and risk positioning ideas. The return numbers look impressive, with more than 90% of their funds in the top half of the peer group for the past one and three year periods, and 96% posting above average gains for the past five years.

Turning to the **Invesco Canadian Bond Fund**, it will remain a core focused offering that invests in a mix of government and corporate bonds. It invests primarily in Canadian issues, but can invest up to 30% abroad. At the end of September, 13% was in foreign securities.

The split between government and corporates was tilted slightly towards corporates. Credit quality was very high, with nearly all the holdings rating investment grade, with less than 4% in high yield.

Performance has been middle of the pack, gaining 3.7% for the past three years, modestly underperforming its peers. Shorter term numbers are similar, finishing middle of the pack. Volatility is slightly below the index and peers.

Costs are a touch on the high side, with an MER of 1.43% for the Series A units, that include full dealer compensation. DIY and fee based units are available at lower cost levels.

I am optimistic that the change to become a more integrated part of the global Invesco Fixed Income team will prove to be a positive for this fund. I will continue to watch this integration closely and will be watching the full suite of Invesco fixed income funds for improvement.

iShares Diversified Monthly Income ETF (TSX: XTR) – For investors looking for a simple, low cost, diversified income generating ETF, this iShares offering pays a regular monthly distribution that has been set at $0.05 per month. At recent prices, this works out to an annualized yield of approximately 5.3%.

The focus is heavily tilted towards Canada, which makes up more than 71% of the ETFs exposure. Nearly a quarter is invested in the U.S., with the balance being cash and "other".

Portfolio turnover has been very modest on a historic basis, so the asset mix is not expected to change dramatically from one quarter to another.

At the end of November, the asset mix was nearly 60% in fixed income, and 40% in equity investments. The equity sleeve is heavily tilted towards higher yielding ETFs including the **iShares S&P U.S. Dividend Growers Index (TSX: CUD)**, **iShares S&P/TSX Equity Income Index (TSX: XEI)**, and **iShares Canadian Select Dividend ETF (TSX: XDV)**. It also has direct exposure to REITs and Utilities. This results in a high level of interest rate sensitivity, which has been a drag on the portfolio in the recent months. The U.S. Dividend, REIT and Utilities exposure has detracted from returns in recent months.

Turning to the fixed income sleeve, it is a diversified mix that includes exposure to corporate, high yield, government, and short term bonds. The average credit quality is high, averaging BBB, and the duration is well below the market, coming in at 4.35 years. In comparison, the broader Canadian bond market has a duration of 7.4 years. This lower duration will result in slightly less sensitivity to interest rates, but it is still highly dependent on rates.

Now that the U.S. Federal Reserve has increased interest rates, it is very likely we will see continued high levels of volatility in rates, including those here in Canada. This will translate into higher levels of volatility for this ETF, and its underlying constituents, making for a bumpy ride for investors.

I am typically not a fan of prepackaged balanced funds as I believe most investors and advisors can do a better job creating their own. But for those looking for simplicity, this isn't a bad option. Costs are reasonable, with an MER of 0.56%, it offers an attractive distribution yield, and it is fairly well diversified. The drawback is the high level of interest rate sensitivity, and the potential for increased volatility as we move into a more uncertain interest rate environment.

First Asset Morningstar Canadian Momentum Index ETF (TSX: WXM) –The ETF is founded on the premise that outperforming stocks tend to continue to outperform, and looks for stocks that have above average returns on equity, upward earnings estimate revisions, and strong technical price momentum indicators. In its first few years, performance was very strong, handily outpacing the broader market and many of its peers. More recently, this trend has shifted, and it has lagged. Year-to-date to the end of November, it has gained 6% while the S&P/TSX Composite has risen by more than 19%. So what has changed?

Nothing has fundamentally changed with the ETF, but a few things hurt over the past year. It's technology, materials and financial names were subpar. It is underweight in the hot energy and materials sector was a headwind. Finally, poor stock selection in the mid cap names also hurt.

Looking ahead, this strategy is still expected to do well over the long term, but there are going to be periods when it dramatically outperforms and dramatically underperforms. Momentum tend to run into trouble at market inflection points, and many believe we may be near an inflection point now. That may help explain why we are seeing performance that is out of step with recent trends.

Looking at valuation numbers of this portfolio, it appears to be way overvalued. According to Morningstar, it's trading at a P/E of 23 times, compared with 17 times for the broader market. However, if considering forward looking growth rates, WXM has a forecasted growth of nearly 27% compared to the market of just over 8%. Factoring in the earnings outlook, valuation is not nearly as out of line as they appear in isolation.

Over the long term, stock prices follow earnings, while in the short term, it's all driven by sentiment. Based on that, it is possible that more underperformance is imaginable in the short-term. If your time horizon is short, you may want to reconsider this ETF. If you're looking longer term, I remain comfortable with and believe it can deliver above average returns with average or slightly above average levels of volatility.

iShares MSCI EAFE Minimum Volatility Index ETF (TSX: XMI) – The selling point to a low volatility strategy is it is supposed to hold up better in market drawdowns. Apparently, this ETF missed that memo, dropping 3.3% for the three months ending October 31, making it one of the worst performers in the broader International equity category.

Even with this selloff, valuations remain extended, with a P/E of 17.3 times, compared with the MSCI EAFE Index, which trades at 15.2 times. The growth outlook is muted, largely the result of its defensive positioning, with overweight allocations to utilities, consumer staples, and healthcare. It is also overweight real estate, which is expected to struggle in the face of rising rates. It has virtually no exposure to energy, which has done well, with the news of a recent OPEC agreement that sets the framework for a production cut that is widely expected to push the price of energy higher.

Considering these factors, I would expect to see continued weakness in this low volatility portfolio. Investors would likely be better off with the **BMO MSCI EAFE Index ETF**. It is available in two versions; **ZDM** which has all currency exposure hedged back to Canadian dollars, and the unhedged **ZEA**. Your outlook in the Canadian dollar will help you decide which of these options is most appropriate for you.

Vanguard FTSE Emerging Markets All Cap ETF (TSX: VEE) – Throughout the campaign, President-elect Trump talked about making America great again, and has threatened to tear up or renegotiate many of America's trade deals. Add to this a rise in populism, increasing protectionism in the U.S. and Europe, a stronger U.S. dollar, and the near-term outlook for many trade reliant emerging market nations has dimmed considerably. I would also expect to see an increase in volatility in the short term.

Despite the weaker near term outlook, the longer-term outlook remains largely unchanged. Many developing nations are undergoing significant structural reforms that will see tremendous growth opportunities. Further, valuation levels of many emerging market companies is significantly more attractive than more developed stocks and the medium to long-term outlook becomes more appealing. Still, I am downgrading emerging markets from Neutral to Underweight.

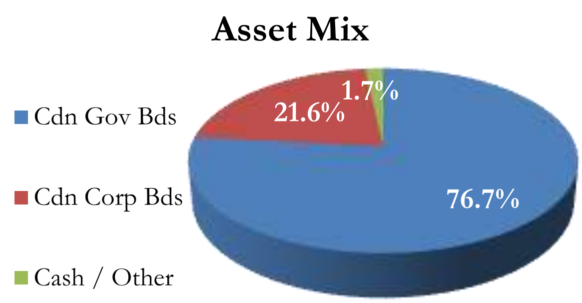
For those looking for low cost passive exposure to the emerging markets, this ETF is my top pick. However, given the inefficiencies in the emerging markets, I tend to favour a high quality actively managed mutual fund over a cap weighted passive strategy. Funds I'm liking now include **Brandes Emerging Markets Value**, **Trimark Emerging Markets**, and **RBC Emerging Markets Equity**.

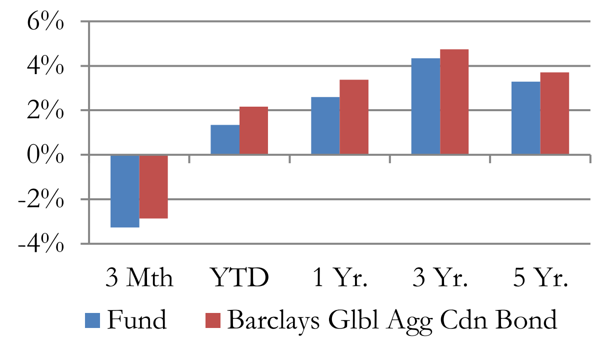
If there is a fund that you would like reviewed, please email it to me at

feedback@paterson-associates.ca.

Vanguard Aggregate Bond ETF

Fund Company	Vanguard Investments Canada
Fund Type	Canadian Fixed Income
Rating	D
Style	Capitalization Weighted
Risk Level	Low
Load Status	N/A
RRSP/RRIF Suitability	Excellent
Manager	Vanguard
MER	0.13%
Fund Code	TSX: VAB
Minimum Investment	N/A





ANALYSIS: This TSX traded ETF provides broad exposure to the Canadian bond market. It is designed to track the Bloomberg Barclays Global Aggregate Canadian Float Adjusted Bond Index, net of fees. The index is cap weighted and holds a mix of government and investment grade corporate bonds of Canadian issuers.

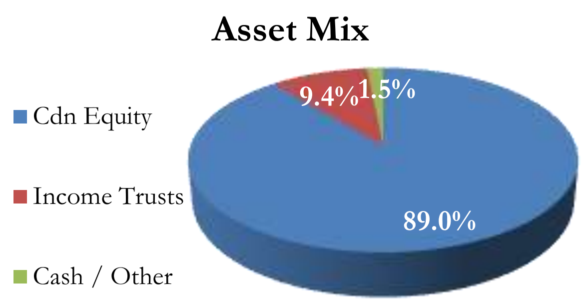
It is much like the **iShares Canadian Universe Bond Index (TSX: XBB)**, with some differences. VAB has a higher exposure to government bonds, holding around 80% in governments, while XBB holds 70%. Because of this, the average credit quality is higher with VAB. A drawback is the interest rate sensitivity is higher, with the duration of VAB being 7.8 years, compared to 7.3 years for XBB. In practical terms, this means VAB is likely to be hit modestly harder in the event of a bump in yields. Given the market volatility of the past few weeks, this has played out as expected, with XBB dropping by 2.05% in November, while VAB was down 2.18%.

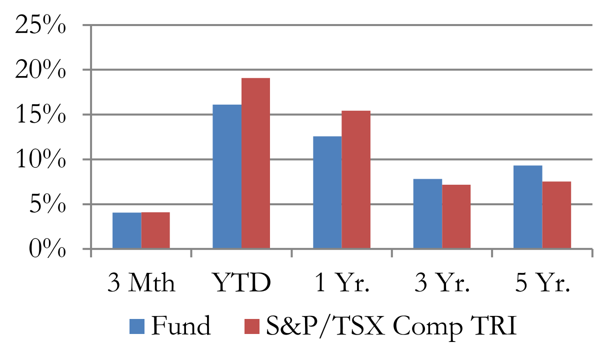
With the Fed moving rates higher, and a few more increases expected in 2017, volatility in the bond markets, both in the U.S., and here in Canada, is likely to remain high. In this environment, expected returns become muted, and costs matter even more. The MER on VAB is listed at 0.13%, compared with 0.34% for XBB. I believe over the longer term, the lower cost offset the higher volatility, and interest rate sensitivity, allowing VAB to provide a slight level of outperformance.

As we move forward and the pace of economic growth picks up, the potential for higher yields will increase. As this occurs, you may want to reduce the interest rate sensitivity of your portfolio. To do this, consider increasing your allocation to short term bonds, corporate and high yield bonds, or looking towards a high quality, actively managed bond fund that allows the manager significant flexibility. This can help reduce the headwinds created as bond yields rise.

Horizons Active Canadian Dividend ETF

Fund Company	Horizons AlphaPro Mgmt
Fund Type	Cdn Dividend & Income Equity
Rating	A
Style	All Cap Blend
Risk Level	Medium
Load Status	N/A
RRSP/RRIF Suitability	Good
Manager	Guardian Capital
MER	0.79%
Fund Code	TSX: HAL
Minimum Investment	N/A





ANALYSIS: Managed by Sri Iyer and his Systematic Strategies team at Guardian Capital, this ETF looks to find Canadian companies that have the ability to pay, sustain, and grow their dividends. To find these, the team runs the Canadian equity universe through screens that analyze 31 different factors, looking for positive rates of change. These factors focus on growth, payout ratios, efficiency, valuation, and investor sentiment. Further, the team also conducts a fundamental review to validate any of the potential buy candidates to ensure the rating is appropriate.

The portfolio is well-diversified, holding around 60 names, with the top ten making up just under 30% of the ETF. It invests in companies of any size. Roughly 45% is invested in big cap names, with the balance invested in small and mid-caps. The sector mix is dramatically different than the broader Canadian market, with an overweight in consumer cyclicals, utilities, telecom, and energy. It is underweight financials and energy. Despite this overweight to the higher yielding sectors, valuation metrics look more attractive than the broader market and the peer group.

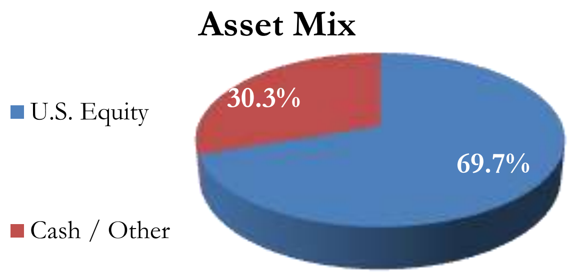
This positioning has led to underperformance in the short-term, but over the long term, it outpaced the broader S&P/TSX Composite Index. Volatility has been in line with the index.

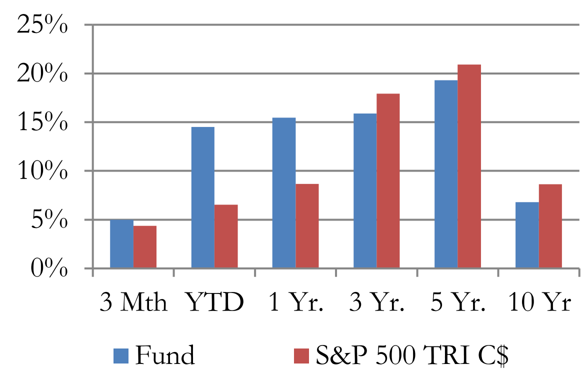
Going forward, the managers remain defensive. They are placing a greater emphasis on companies that offer higher earnings and cash flow visibility, and higher than average dividend yields. This would be expected to allow for better downside protection if we see a large pullback in the market.

I like the process used by the management team. It has resulted in a portfolio that I believe is better diversified than the broader Canadian market. The drawback is its cost, with an MER of 0.79%, which is well above the 0.06% MER of the **iShares Core S&P/TSX Capped Composite Index ETF (TSX: XIC)**. Even with this higher cost, I believe the ETF has the potential to deliver index like returns with better downside protection over the long-term.

Norrep U.S. Dividend Plus Class

Fund Company	Norrep Investments
Fund Type	U.S. Equity
Rating	B
Style	Mid-Cap Value
Risk Level	Medium – High
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Kamran Khan since Aug 2006
MER	4.89% (including perf. Fee)
Fund Code	NRP 601 - Front End Units NRP 602 – Low Load Units
Minimum Investment	$5,000





ANALYSIS: The S&P 500 is one of the most difficult indices to beat, which is why you're usually better off using a low cost, passive strategy. In some cases however, a fund can offer something different, making it an interesting way to access U.S. equities.

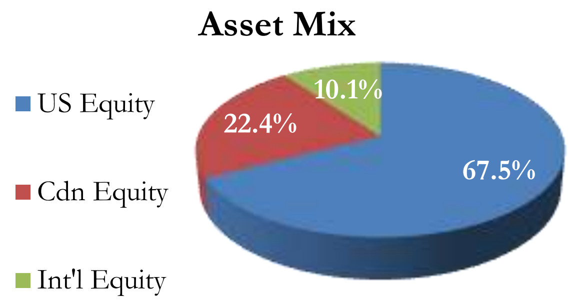
This is one such fund. Manager Kamran Khan uses a unique approach that incorporates a traditional long-only, bottom up value focused process, with a conservative option writing strategy designed to protect capital and generate income. He has built a concentrated portfolio of U.S. based companies that have strong fundamentals, and good earnings and price momentum, that are trading at an attractive level. He looks for companies of any size, but currently favours more small and mid-cap names. He prefers the small names because there are more opportunities to add alpha, relative to the large cap space. He will typically hold 25 to 30 names, with the sector mix being the result of the available opportunities. He is somewhat active in his approach, and will trade out of names based on conviction and valuation. Annual portfolio turnover has been in the 70% to 90% range.

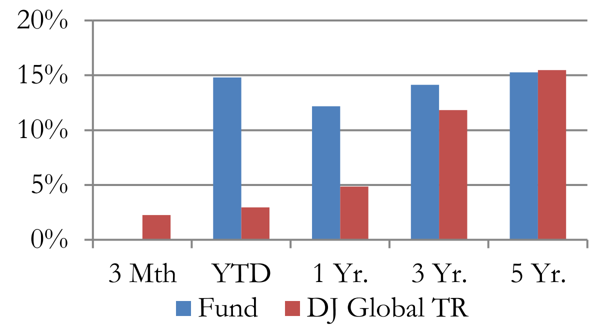
The option writing strategy is two pronged. Cash covered puts are written on stocks they are interested in buying, but at a lower price. Writing puts generates premium income, and if called, they are adding a name they want in the portfolio. Covered calls are written on names that are approaching full valuation. This creates premium income, and if they are called away, it is on a name they were likely to sell anyway.

I expect this fund to lag in a rising market, but hold up better than its peers when things get rocky. Eliminating the performance fee will reduce the substantial MER, making this a more attractive option. I'm still likely to favour a low cost passive option for my U.S. equity exposure, but if you're looking for something different, this is one fund worth taking a deeper look at.

BMO Global Infrastructure Index ETF

Fund Company	BMO Asset Management Inc.
Fund Type	Infrastructure Equity
Rating	B
Style	Large Cap Blend
Risk Level	Medium
Load Status	N/A
RRSP/RRIF Suitability	Good
Manager	BMO Asset Management Inc.
MER	0.61%
Fund Code	TSX: ZGI
Minimum Investment	N/A





ANALYSIS: With both Canada and the U.S. looking to dramatically increase infrastructure spending over the next decade, the medium to long-term outlook for infrastructure is positive.

This ETF invests in companies active in the development, ownership, lease, or management of infrastructure assets. It is a cap weighted, passive portfolio that tracks the Dow Jones Brookfield Global Infrastructure North America Listed Index. It is North American focused, with two-thirds invested in the U.S., 22% in Canada, 9% in the UK, and the balance in Mexico and Brazil. From a sector perspective, utilities and energy make up more than 82% of the portfolio.

Performance has been strong, gaining nearly 15% to the end of November. In comparison, actively managed infrastructure mutual funds are lagging by about 1000 basis point. For example, the **Sentry Global Infrastructure Fund (Series F)** is up 6.4%, while other infrastructure funds are up between 5% and 6%. Volatility has been higher, but the excess return has more than compensated.

Perhaps not surprisingly, given the strong performance numbers, valuations look stretched compared with its actively managed brethren. Morningstar reports that the P/E ratio of the portfolio is nearly 29 times earnings, while the other funds are trading between 20 and 27 times earnings. Factoring in modest growth projections, the valuation levels still appear to be stretched when compared to the broader market, but are on the lower end of the other infrastructure options.

Costs are reasonable, with an MER of 0.61%. In comparison, an actively managed infrastructure mutual fund will carry an MER of between 1.4% and 1.7% in a fee based version. Clearly, the ETF offers a considerable cost savings.

Infrastructure is one of those specialized areas of the market where a high-quality, active manager should be able to outperform, because of potential inefficiencies. Unfortunately, to date, the mutual fund options have largely disappointed, making this a solid choice for those looking for infrastructure exposure in their portfolios.