

Top Funds Report

Decent January thanks to Trump Bump

Equities higher, but non-Canadian holdings lower on dollar strength. Valuations remain a concern...

Equity markets continued to celebrate Trump's victory, with the S&P 500 continuing its charge higher, gaining nearly 2% in U.S. dollar terms. Currency markets were not in such a celebratory mood, as traders worried Trump's protectionist agenda would hurt global trade. Adding to their pessimism was the view that the new administration wants to talk the dollar down to help make U.S. exports more competitive. It worked, with the U.S. dollar losing ground against many currencies, giving up more than 3% on the loonie. For Canadian investors, this meant that any unhedged U.S. currency positions lost ground. In Canadian dollar terms, the S&P 500 was lower by 1.3%.

Closer to home, the S&P/TSX Composite gained 0.85%, with strength coming from the materials sector, which rallied higher on a 5% jump in gold. The heavyweight financial sector also gained ground, as many expect a reduced regulatory burden for banks in the U.S., which is also a positive for Canadian banks, most of which have sizeable U.S. operations.

In the bond market, a spike in yields early in the month pulled the broader market down, with the FTSE/TMX Canadian Universe Bond Index losing 0.1%. Corporate bonds bucked the trend gaining ground as spreads tightened marginally. Short term issues outperformed long term issues.

Looking ahead, I remain very concerned about market valuations. On February 16, the S&P 500 was trading at 21.6 times trailing earnings, and 18 times forward earnings. This remains well above the ten-year average of just over 14 times.

To put it in perspective, if we see a reversion to the longer-term average, there would be more than a 20% drop in the index. However, with interest rates still hovering near historic lows, some higher equity valuations are warranted, but current levels might be a bit ahead of fundamentals.

Still, I continue to favour equities over fixed income. I remain neutral on Canada, U.S., and International equities, and am underweight emerging markets, at least for now. Within fixed income, I prefer shorter duration over longer duration, and corporate bonds over governments. I remain defensive, and am watching the situation rather closely.

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 some of the funds from my Recommended List of Funds...

Dynamic Advantage Bond Fund (DYN 258–Front End Units, DYN 688 – DSC Units) – The fourth quarter was a challenging one for bond investors, with yields spiking sharply. In Canada, the yield on the benchmark Government of Canada five-year bond rose by 49 basis points, ending the quarter at 1.11%. It was a similar story for the Canada ten-year which rose by 72 basis points, ending the quarter at 1.72%. This had a marked effect on bond prices, as the FTSE/TMX Bond Universe Index fell by nearly 3.5% on the quarter. Understandably, with their longer duration, long bonds took the brunt, dropping by 7.6% while short term bonds were off by half a percent.

It is for periods like these that this conservatively positioned bond fund remains on my Recommended List. The managers had remained cautious throughout the year, maintaining a duration of approximately 3 years, well below the broader market, which carries a duration of around 7.3 years. Given the recent selloff, they have added some interest rate risk, bringing the portfolio's duration up to 4 years, which is still well below the index. They are remaining conservative in anticipation of a further sell off, and improved valuation metrics.

The Fund held nearly half in corporate bonds, with a higher quality bias, but expects to use volatility to increase exposure to lower rated investment grade bonds, based on valuation. For high yield, they are keeping portfolio weights near the lower end of the range, and will add to higher quality issues when the market sells off. At the end of December, they had 7% in high yield issues.

The government exposure is modest, at roughly 25%. Of this, the overwhelming majority is in

provincial bonds, which offer a higher yield than their federal brethren. There is a 15% weight in real return bonds, which may help, should Trump's policies prove to be inflationary.

I continue to like this fund, particularly as we enter what is expected to be an even more challenging fixed income environment. Given the lower duration and conservative positioning, I expect it to lag in flat or falling yield environments. But when things get choppy in bond-land, it is expected to hold up much better than its peers. This remains a great option for more conservative investors looking for traditional bond exposure.

CI Signature Select Canadian Fund (CIG 677 – Front End Units, CIG 777 – DSC Units) – Throughout its history, this has been one of the more consistent performing funds around. Managed by Eric Bushell and his Signature team, it is managed using an approach that blends a top down macro analysis with bottom up security selection.

The first step in the process is for the team to develop a comprehensive global outlook for the markets, which takes such factors as economic growth, interest rates, capital market conditions and geopolitical risks into account. Using this review as a framework, the geographical exposure and sector mix is determined based on the regions and industries that are expected to outperform in the anticipated environment. At the end of December, they continue to favour equities, with an overweight allocation to healthcare and consumer names. They are underweight the commodity focused materials and energy sectors, as well as industrials and real estate. Geographically, about half the fund is

invested in Canadian equities, 28% in U.S. equities, and 18% in International names.

The stock selection process is completed by the team's sector specialists who will conduct a holistic review on the company, studying its entire capital structure. This helps them to gain a better understanding of where the best risk adjusted investment opportunities are. A typical company in the portfolio will be financially strong, operate in a business where there are high barriers to entry, have strong brand recognition and be reasonably valued relative to the growth potential. The top holdings are littered with many familiar names, including the big Canadian banks, Manulife, Suncor, and Rogers Communications.

The manager is not afraid to use cash as a way to be defensive in periods of elevated valuations or above average volatility. At the end of December, it held 2.5% in cash, up from nothing at the end of September. The investment process is somewhat active, and portfolio turnover tends to increase in periods of volatility, as they can pick up attractive names at great prices.

Performance has been strong, gaining 6.2% in the quarter, making it the best performing Canadian equity fund on our list. Longer term, numbers have been good, gaining 9.6% for the five years ending December 31, compared with the S&P/TSX Composite, which gained 8.25%. Volatility has been modestly lower than the index, and it has done a better job protecting capital in down markets, experiencing approximately 70% of the market decline over the past five-year period.

I continue to like this fund for the long term. There is a very deep management team at the helm, using a disciplined, repeatable, and holistic investment process. This remains a great core equity holding for most investors.

Fidelity Small Cap America Fund (FID 261 – Front End Units, FID 561 – DSC Units) – In early December, I had the opportunity to sit down with manager Steve MacMillan to discuss this fund, its recent performance, and the market environment. The fund has struggled in the past year, losing 1.4% while the Russell 2000 Index, gained 17.7% in Canadian dollar terms.

In our conversation, Mr. MacMillan noted that if he were to have done better in 2016, it would have meant he would have had to change his investment process and invest in a portfolio that had a much lower quality bias, and much more cyclical exposure. Given his focus on risk management, this was not something he could do. He reiterated he remains true to his investment process and while the recent performance has stung, he has not made any changes to his investment philosophy or process.

One question I asked was if the recent influx of new money had any effect on how he managed the fund. Mr. MacMillan said that new money had very little impact on his management approach. When he took over the fund in 2011, he made a couple of key changes to the fund. First, he reduced the number of fund holdings, taking a more concentrated approach. He now holds around 40 names in the portfolio, down from around 200 when he took over. He also increased the average market cap of the Fund, bringing it much closer to a mid-cap fund. The result was a much higher quality, more liquid portfolio, which has helped him more effectively deal with running a larger asset base.

From a process perspective, he takes a longer-term outlook than many managers, typically looking three to five years out. The result is a level of portfolio turnover that is rather low. In a given year, he will typically only add four to six names. When evaluating a company, he starts by focusing on the risk, specifically the downside risk. He looks for high quality companies that

have a history of delivering significant levels of free cash flow, and high return on invested capital. He also looks for low earnings variability and reasonable valuations. According to Mr. MacMillan, at the end of November, the average return on equity in the portfolio was approximately 18%, and was trading at a multiple of 15 times earnings, compared with more than 20 for the benchmark.

This quality focused investment process leads to a portfolio that does not have a lot of cyclical exposure in it. He generally avoids energy, materials, and cyclical industrials. He also tends to shy away from biotechs and semiconductors. His criteria tends to favour stable industrials, consumer discretionary, and healthcare.

In building the portfolio, position sizes are dependent on risks. He will look at a number of factors, including volatility of earnings, valuation, risk and return, and liquidity. The higher the conviction based on those factors, typically the higher the weight the stock will have in the portfolio. While he prefers to buy undervalued names, he is not a deep value managers, and his process is really more a balance between risk and expected return. In other words, he won't buy a stock just because it is cheap. Rather, there must be the ability to compound earnings into the future, and the valuation must still be attractive. Based on this approach, he has found that his losing stocks have historically been smaller weights in the portfolio, helping to further minimize the downside risk of the fund.

Cash has been running higher than normal in recent quarters, finishing the year at 17%, up from 10% at the end of September. Ideally, he would like to run around 5% in cash, but is not afraid to carry more when valuations are elevated. He'd much rather sit on cash than make an investment that doesn't meet his criteria.

The recent underperformance has largely been driven by the market, which has been experiencing a cyclical rebound. Given the lack of cyclical exposure in the Fund, this underperformance is understandable. He continues to focus only on those opportunities that meet his criteria.

Even with the recent underperformance, I continue to like the fund, and believe it to be a great holding for the long term. I have concerns about the valuation in general of U.S. small caps, and expect to see more volatility and underperformance from both the fund, and the asset class. If you have held the fund for a while, you may want to take some profits, reducing your exposure to the fund, and generally rebalance your portfolio to bring it back into alignment with your long-term target asset mix.

Scotia Global Balanced Fund (BNS 311 – No Load Units) – Until August of 2016, this fund had been managed by the Signature team at CI Investments. In August, management duties were transferred over to 1832 Asset Management, who also manage the mutual funds offered by Dynamic Funds, and other Scotia products. Since the change, performance has lagged both its benchmark and peer group, with the fund losing 0.3% over the past year, and gaining 0.4% in the past six months. While the time period is far too short to make any sort of a call on the performance, even before the change, this was a balanced fund that was middle of the pack at best. Whether the new management team can improve on this remains to be seen. In the meantime, there are many other global balanced funds that, at least in my opinion offer a more favourable risk reward outlook.

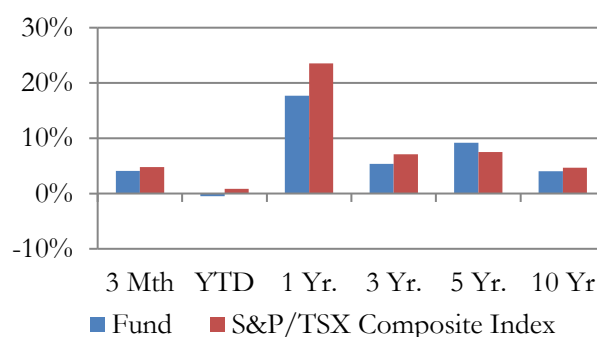
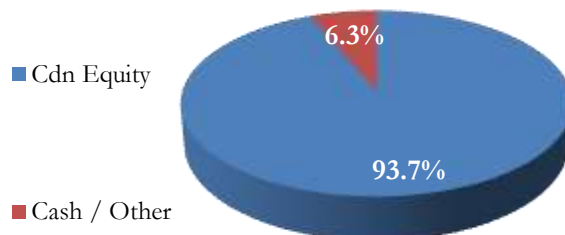
If there is a fund that you would like reviewed, please email it to me at

feedback@paterson-associates.ca

NEI Ethical Canadian Equity Fund

Fund Company	NEI Investments
Fund Type	Canadian Equity
Rating	B
Style	Large Cap Value
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Darren Dansereau since June 09 Joe Jugovic since June 2009
MER	2.59%
Fund Code	NWT 072 – Front End Units NWT 172 – DSC Units
Minimum Investment	\$500

Asset Mix



ANALYSIS: Ethical, or socially responsible investing has been growing in popularity recently as more people look to do the right thing with their investment dollars. This offering, managed by Calgary based QV Investments is one of the oldest, and best managed SRI options around.

QV runs this fund pretty much the same way they run all their equity mandates, with an investment process that focuses on strong companies with strong management.

QV takes a long-term view when analyzing a company, and looks for companies with strong balance sheets, excellent cash flow, sustainable barriers to entry, and competitive strengths. They like to see management teams that have a stake in the business, as this helps to better align their interests with their investors. Once they have identified a potential investment, NEI will

review to make sure it meets their criteria for Sustainable Investing.

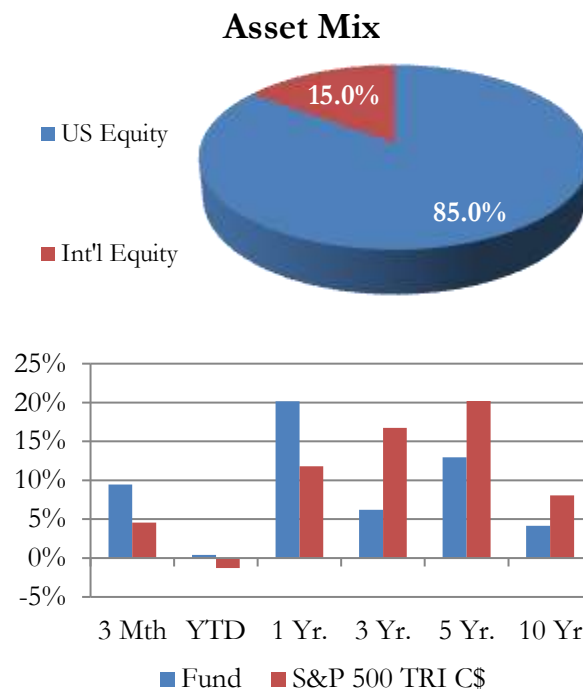
The sector mix, perhaps surprisingly, isn't a lot different from many more traditional funds. It has nearly 18% invested in energy, which may surprise some. However, the firms they invest in take a responsible approach in the space. For example, Suncor is focused on climate change, while AltaGas is working with first nations in a very inclusive way.

Performance has been strong, with a five-year gain of 9.2% for the past five years, outpacing the S&P/TSX Composite Index. It has lagged of late, on its underweight cyclical holdings. Volatility has been less than the broader market, and the downside protection has been strong.

This is a great example that SRI investing doesn't have to mean sub-par investment performance.

RBC O'Shaughnessy U.S. Value Fund

Fund Company	RBC Global Asset Management
Fund Type	U.S. Equity
Rating	D
Style	Rules based
Risk Level	Medium High
Load Status	Optional / No Load
RRSP/RRIF Suitability	Good
Manager	Jim O'Shaughnessy since 1997
MER	1.55%
Fund Code	RBF 552 – No Load Units RBF 776 – Front End Units
Minimum Investment	\$500



ANALYSIS: In managing the fund, Jim. O'Shaughnessy and his team start with the entire U.S. equity universe of more than 3,300 names, and looks for those with above average market capitalizations. They exclude REITs, MLPs, and utility stocks from this screen, which brings the investible universe down to approximately 700 securities. Next, screens are run that measure a company's financial strength, earnings quality, and earnings growth. Those names that don't meet the requirements are eliminated. Finally, they rank the stocks based on shareholder yield, which is a measure of a company's dividend yield, share buybacks, and debt reduction. The names with the best yield will typically make up the portfolio.

With its focus on value, the portfolio valuation numbers look considerably more attractive than the S&P 500 on every metric. For example, according to Morningstar, the Fund trades at a price to earnings ratio of 12.7 times earnings, compared with the index, which trades at 18.5 times. Further,

the dividend yield of the portfolio is higher with the Fund, providing a source of return to investors.

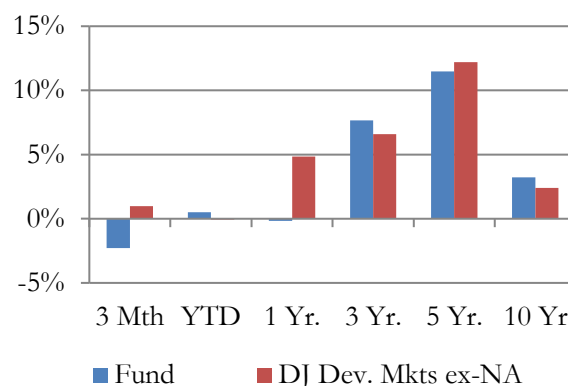
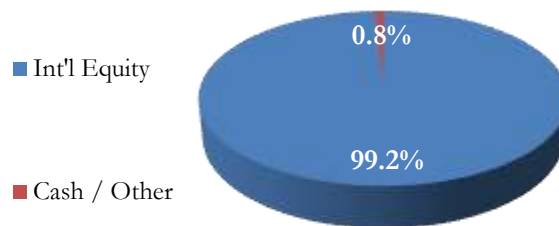
Performance has been somewhat disappointing over the long term, but a good portion of that can be attributed to the currency hedge that is in place. For example, for the five years ending January 31, the Fund was up by nearly 13%, on a fully hedged basis. Given the changes in currency, there may have been approximately 600 basis points in performance resulting from the currency move.

The Fund has done well recently as value names have begun to outperform after several years of lagging. They recently rebalanced offers higher levels of return on capital, lower reliance on external financing, and more attractive valuations than the benchmark and peers. Also helping to make this a more attractive option is the MER, which at 1.49%, is well below average. Given this, I expect it to do well over the longer term, but would expect volatility levels to remain higher than both the index and the peer group.

Manulife World Investment Class

Fund Company	Manulife Investments
Fund Type	International Equity
Rating	B
Style	Large Cap Blend
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	David Ragan since August '13 Jim Hall since August 2013
MER	2.55%
Fund Code	MMF 4336 – Front End Units MMF 4436 – DSC Units
Minimum Investment	\$500

Asset Mix



ANALYSIS: This is basically the highly regarded **Mawer International Equity Fund** in a different wrapper. The key difference between the two is this is targeted at investment advisors, carrying a higher management fee, and embedded dealer compensation. This Fund carries an MER of 2.55%, which is higher than Mawer's version.

Even with this higher fee, this is consistently one of the stronger international equity funds around. However, even strong funds run into a rough patch, and 2016, and specifically the last half was a rough one for this fund (and Mawer as well...). In the fourth quarter, it was off by 6.4%, compared with the MSCI EAFE Index, which was up by 1.7%, in Canadian dollar terms.

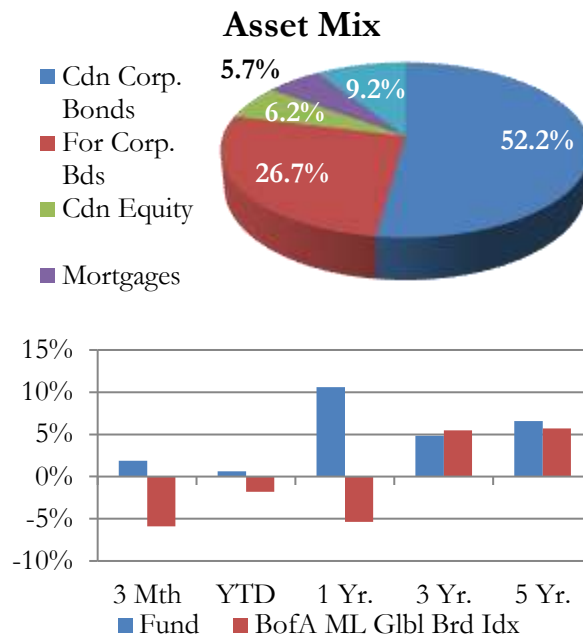
The key reason for this underperformance is the market's rotation out of higher quality sectors this fund is partial to, such as consumer staples, and into more cyclical sectors like energy, materials, and financials. Further, within the financial

sector, it has been largely the lower quality names that have rallied higher. For example, Deutsche Bank, which Mawer doesn't own, gained 43% in the quarter. In a recent commentary, Mawer noted they are avoiding European banks because they don't meet their investment criteria. The competitive and regulatory environment in Europe make it very difficult for them to earn a sustainable return on equity. Even with the more attractive valuation levels, the uncertainty makes them unattractive.

Looking ahead, we may see some further underperformance, but I believe the disciplined investment process will help to deliver above average returns over the long term. As with any fund that follows a disciplined approach, there will be periods where the performance diverges significantly from the benchmark and the peer group. I believe we are in one of those for the near term.

Lysander-Canso Corporate Value Bond

Fund Company	Lysander Funds Ltd.
Fund Type	Global Fixed Income
Rating	A
Style	Deep Value Credit
Risk Level	Low – Medium
Load Status	Front End
RRSP/RRIF Suitability	Good
Manager	Canso Management Team
MER	1.52%
Fund Code	LYZ 801A – Front End Units
Minimum Investment	\$5,000



ANALYSIS: In the bond space, there are few shops that are as well respected as Canso, the managers of this “go anywhere”, unconstrained, value focused bond fund. Using a very thorough, fundamentally driven credit analysis process, the team looks to build a concentrated portfolio of investment grade and high yield bonds. Canso has a lot of bench strength in their 28-member investment team, which provides them the ability to look at credit a little differently than some of their peers.

They start with a fundamental review to understand the company’s cash flow picture, which helps them assess the probability of being repaid. Next, they delve deep into the covenants, so they understand their rights, should things go south. With this info, the team creates their own internal credit rating for the bond, and determines their maximum loss score, which is essentially their worst-case scenario.

Now they understand the credit, they like to invest in those that are trading at or below what they

estimate to be the recovery value of the bond, and avoiding those they believe are overvalued. They are active in their approach, and will manage credit quality based on the risks of the market.

At the end of December, the portfolio duration was 2 years, well below the 7.2 years of the broader Canadian bond market. Its yield to maturity is 3.4%, while the index yields a modest 2.2%. Just under half is invested in high yield bonds, and financials make up 56% of the Fund. Communications and energy are two other large sectors, representing a combined 30%. It holds 126 individual positions.

Performance has been strong, gaining 6.6% for the past five years, outpacing the 4.1% rise in the index. Perhaps more impressive, is this has been done with only slightly higher volatility. However, given the unconstrained mandate, volatility could end up being higher if markets get dicey.

This is a solid pick for investors looking to complement their existing bond holdings with an active, uncorrelated credit focused fund.