Top Funds Report

February sees some calm return to markets

Equities around the globe move higher, volatility touches multi-year lows. Valuations remain a concern...

February was a good month for investors, with gains across the board. Equity markets were the big winners, with the foreign markets leading the way. The S&P 500 rose by nearly 4% in U.S. dollar terms, while the MSCI EAFE Index gained 1.5%. With the U.S. greenback gaining on the loonie, returns in Canadian dollar terms were even better, with the S&P 500 jumping by more than 5.6%, while EAFE was up by 3.2%.

Closer to home, weakness in the energy and materials sectors created a headwind for the S&P/TSX Composite, which finished the month 0.2% higher.

In the fixed income markets, both corporate and government bonds moved higher, as yields drifted lower. The FTSE/TMX Canadian Universe Bond Index rose by 0.96%, with credit modestly outpacing governments. Long bonds were the big winners, gaining 1.75%.

Inflation in Canada moved higher, rising by 2.1% for the twelve months ending January 1, with January showing a gain of 0.7%. Most of this increase was the result of a new carbon tax introduced in two provinces, which pushed the price of gasoline higher.

Looking ahead, I remain positive, but cautious. There are signs the economy remains on track for a recovery. However, the outlook for inflation remains firmly in check. In this environment, Canadian rates are likely on hold for the near term, at least. With the U.S. Federal Reserve moving rates higher at their March meeting, and at least one more rate hike priced in, the potential for volatility in the interest rate markets remains high. I remain slightly underweight fixed income, and am somewhat defensive in my positioning.

I am modestly overweight equities, and continue to favour Canadian and U.S. equities over European and Asian stocks. I believe with the U.S. economy creating jobs, and renewed investor interest at home, the U.S. is poised to deliver better results, despite the elevated levels of valuation. Still, I remain defensive and am focusing on managers with an emphasis on quality names trading at reasonable valuations.

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		

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Funds of Note

This month, I highlight some of the ETFs from my latest Focus List…

PowerShares Senior Loan Index ETF (TSX: BKL.F) – One of the appeals of floating rate investments is there is very little duration risk because the interest rate earned fluctuates with a reference rate, quite often LIBOR. This makes them attractive in periods of rising yields, and that was the case over the past few months.

For the three months ending January 31, this ETF rose by more than 1.4%, while the FTSE/TMX Short Term Bond Index fell by 0.33%, and the broader FTSE/TMX Canada Universe Bond Index was off nearly 2.7%. The drop in the indices was the result of a rise in yields, which have been quite volatile in the aftermath of the U.S. presidential election. The combination of the U.S. Federal Reserve increasing rates in December, combined with market expectations of Trump's economic plans likely to result in higher inflation pushed global yields up. In Canada, the benchmark Government of Canada five-year bond saw its yield rise from 0.69%, ending January substantially higher at 1.11%. It was a similar story with other rates, with the three-month LIBOR rate jumping from 0.88% to 1.03% in the same period.

With the underlying reference rate on the rise, so too were the prices of many of the loans in the portfolio. The gain in the portfolio was significantly lower than the rise in the underlying yield in the portfolio. This is because many of the loans had a rate floor in place, meaning the lowest rate the loan would pay was set at a predetermined level. In most cases, this floor rate was set at 1%, so even though there was a sharp rise in the reference rate, the coupon rates on many of the loans wouldn't move higher until LIBOR crossed 1%. Now that LIBOR is above this threshold, Invesco estimates that nearly 95% of floating rate loans meet or exceed their floor, making them true floaters once again.

Looking ahead, most market participants are expected at least two, or maybe more moves from the U.S. Federal Reserve. Regardless of whether that plays out or not, it is widely expected there will be increased volatility in the interest rate markets. That should prove to be a positive for floating rate products, particularly if we see further upward pressure on yields.

This remains my top ETF pick. It offers broad exposure to floating rate loans, has a yield to maturity of 4.4%, and is available at a reasonable cost. This can be a solid addition to the fixed income sleeve of your well-diversified portfolio.

PowerShares Tactical Bond ETF (TSX: PTB) – This is a tactically managed portfolio that invests in a mix of underlying fixed income ETFs. Because of this tactical approach, I believe it has the potential to outperform a passive bond index, particularly in periods of market volatility. That happened in the past three months, with a modest outperformance of the broader FTSE/TMX Canada Universe Bond Index.

At the end of January, a little more than half was invested in short term, investment grade bonds, which outperformed. This helped the modest outperformance. Also, contributing to the return was the 14% weight in high yield bonds, which

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was the only sleeve of the portfolio that finished the period in positive territory.

This did what I expected it to do – outperform in a volatile market. The tactical management from Invesco's Intactive team looks to provide risk managed exposure to the various segments of the fixed income market. This can help the fund hold up better in periods of volatility. The drawback comes from the team's consistency in executing the strategy. So far, it has been decent, but unspectacular. Performance has matched the broader market over the past three years, with comparable volatility, but has lagged in the past year. Another drawback is its cost, which carries an MER of 0.52%, compared with 0.13% for **Vanguard's Aggregate Bond Index ETF (TSX: VAB).** Still, I see this having the potential to outperform in a volatile market, helping to more than offset its higher cost.

PowerShares FTSE RAFI Canadian Fundamental Index ETF (TSX: PXC) – This has been one of the better performers for the past couple quarters. With a gain of 7.15% for the three months ending January 31, it handily outpaced the market and its peer group. For the year, it has gained 33.8%, more than 1000 basis points above the S&P/TSX Composite.

Instead of weighting its holdings based on the market capitalization of the underlying companies, as is the case with most traditional passive ETFs, the holdings are weighted based on how they are rated on four key fundamental factors; cash dividends, free cash flow, sales, and book value. Each company is rated on these factors, and the scores are totaled. The companies that score the best are given a larger weight in the portfolio than those that rank poorly. This results in a mix that is much different than the broader market, with more attractive fundamentals.

The portfolio offers a very compelling valuation picture, trading at a price to earnings ratio well below the index or its peers, with a dividend yield that is more attractive. The sector mix is overweight to the three main sectors; financials, energy, and materials. It is underweight industrials, and consumer names. The portfolio is more tilted towards large cap stocks than the index, carrying an average market capitalization of nearly double the S&P/TSX Composite Index.

Apart from a few blips along the way, the longer-term performance numbers have been decent. To the end of January, the five-year annualized return was 9.2%, compared with 7.5% for the S&P/TSX Composite Index. Volatility has been higher than the market over the past three years, which means it lagged on a risk adjusted basis.

Research has shown that over the long-term, a fundamentally built portfolio can outperform a cap weighted index. There may be shorter term periods where it lags. I don't dispute the research, but I do have a couple of concerns around this ETF. The first is the level of concentration. The Canadian equity market is already heavily concentrated in three sectors. Combined, financials, energy, and materials make up nearly 80% of the ETF, compared with 65% for the broader market. While the fundamental factors may prove to be correct, that is a big bet on those sectors. For those comfortable taking that bet, this is a good way to play the Canadian equity market. However, those worried about concentration may want to look elsewhere.

Another concern I have is cost. It carries an MER of 0.51% compared with just 0.06% for the

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iShares Core S&P/TSX Capped Composite Index ETF (TSX: XIC). To date, the additional cost has been more than offset by the incremental return. However, the higher cost may create a significant headwind over the long-term.

On balance, this is a solid choice, but you need to be comfortable with the concentration. It has a high degree of cyclicality. Over the long term, I expect that to pay off, but in the short term there is the potential for higher levels of volatility.

iShares U.S. Fundamental Index ETF (NEO: CLU) – On February 21, 2017, this ETF was delisted from the Toronto Stock Exchange, and began trading on the Aequitas NEO Exchange on February 22. The Aequitas NEO Exchange was founded in March 2015 and is owned by a group that includes OMERS Capital Markets, Barclays Corp, and Royal Bank of Canada.

This change does not affect its underlying investment portfolio. It will still look to replicate the performance of the FTSE RAFI U.S. 1000 Index, an index built based on fundamental factors, rather than market cap. The factors used to determine the portfolio are dividends, free cash flow, sales, and book value. The stocks are scored on these factors, and ranked based on their relative attractiveness, with the more attractive names making up a larger portion of the index.

I don't expect this change to have a marked impact, but I will continue to monitor it to ensure there is ample liquidity and trading volume.

For the three months ending January 31, it performed very well, and was the best performing U.S. equity ETF on the Focus List. It gained 8.9%, compared with a rise of 7.8% for the S&P 500. Unlike its Canadian counterpart PXC, the longer-term numbers aren't quite as impressive. For the past five years, it has gained 13.4%, while the index rose by 13.6%. Further, the volatility of CLU has been a touch higher than the broader market.

While there is a strong case for fundamental indexing, I still see the S&P 500 as the best way to get U.S equity exposure. This is particularly so given the cost differential. XSP carries an MER of 0.11% while this ETF costs 0.73%. If there was a lower fee, this would be a more attractive offering. Still, it provides the potential to beat or exceed the benchmark over the long-term with comparable levels of volatility.

iShares International Fundamental Index ETF (NEO: CIE) – Like CLU discussed above, this switched exchanges in February, moving from the TSX to the new NEO Exchange.

Where it trades on does not affect its investment objective or portfolio. It will still look to replicate the performance of the FTSE RAFI Developed ex-U.S. 1000 Index, a fundamentally constructed index. The factors used to weight the underlying portfolio are dividends, free cash flow, sales, and book value. The stocks are scored on these factors, and then ranked based on their relative attractiveness, with the more attractive names making up a larger portion of the index.

While I don't expect this change to have a marked impact on the ETF, I will continue to monitor it to ensure there is ample liquidity and trading volume.

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

feedback@paterson-associates.ca

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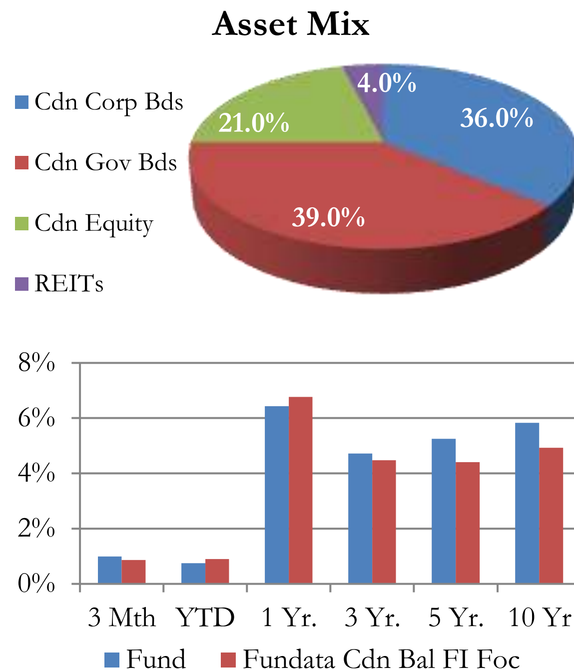
Steadyhand Income Fund

Fund Company	Steadyhand Investments
Fund Type	Cdn Fixed Income Balanced
Rating	C
Style	Blend
Risk Level	Low to Medium
Load Status	No Load
RRSP/RRIF Suitability	Excellent
Manager	Brian Eby since February 2007
MER	1.04%
Fund Code	SIF 120 – No Load Units
Minimum Investment	$10,000



ANALYSIS: Despite a recent bout of underperformance, this has been one of the best fixed income focused balanced funds over the long-term. For the three years ending February 28, it has gained an annualized 4.7%, outpacing most of its peers. Looking out further, over a ten-year period, it has gained an annualized 5.9%, making it one of the top funds in the category.

The fund has a target asset mix of 75% bonds, and 25% high yielding equities. This is not static, and it will change based on their outlook.

On the bond side, the managers are flexible, and invest in governments or corporates, wherever the best opportunities are. Over the past two years, they have increased the quality of the portfolio, which has seen it shift from overweight corporates, to a rough equal weight between government and corporates. They can also access high yield bonds through the **CC&L High Yield Bond Fund**. They have 5% in the fund, which is conservatively positioned, with half invested in investment grade, and half in high yield.

On the equity side, given their focus on yield, they hold a lot of financials, REITs, telecos, and consumer defensives. As a result, the underlying dividend yield was well above the index and peer group. It is an all-cap portfolio, meaning they can invest in companies of any size, although at the end of the year, they favoured large caps. A consequence has been a higher interest rate sensitivity in the equity sleeve. CC&L has been reducing this, but it remains a bit high.

Recent performance has lagged. Some of that can be attributed to the higher government bond exposure, and the lack of foreign content. The fund has very little exposure to foreign stocks, which have outpaced Canadian equities of late.

Still, given the investor focus, team, track record, low cost, and disciplined investment process, this remains an excellent long-term pick.

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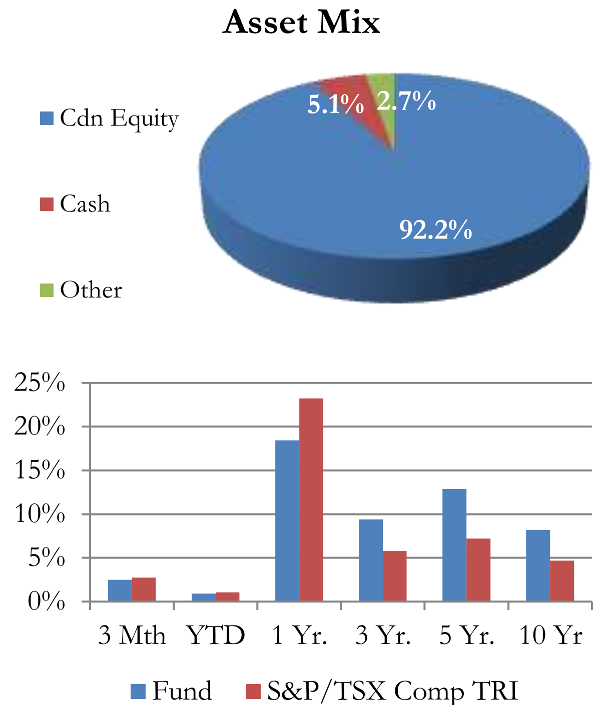
Mawer Canadian Equity Fund

Fund Company	Mawer Investment Management
Fund Type	Canadian Equity
Rating	A
Style	GARP
Risk Level	Medium
Load Status	No Load
RRSP/RRIF Suitability	Excellent
Manager	Jim Hall since December 1999 Vijay Viswanathan since Sep 11
MER	1.22%
Fund Code	MAW 106 – No Load Units
Minimum Investment	$5,000



ANALYSIS: This has been one of my favourite Canadian equity funds for some time now, with Mawer's disciplined, research driven approach being one of the main reasons why.

The investment process is a fundamental, bottom up, GARP approach that looks for wealth creating companies that trade at a discount to what they believe it to be worth. They take a very long term, patient approach. Their culture is research focused, and all assumptions made in the investment process are put through a rigorous stress test and scenario analysis before any decision is made.

They are benchmark agnostic, with the sector mix being the result of the stock selection process. The fund will often look much different than the S&P/TSX Composite, and at the end of January was underweight energy, materials and financials, which helps explain its recent underperformance.

It is well-diversified, holding just over 40 names, with the top ten making up just under 40% of the fund. It has a large cap focus, however, about a third of the fund is in small and mid-cap names.

Performance has been excellent, with a five-year annualized gain of 12.9% to the end of February, compared with 7.2% for the index. Shorter term however has seen the fund lag. With its positioning and quality focus it underperformed its peers in 2016, the first time it has done so since 2010.

It has been less volatile than the index and peer group, and has done an excellent job in protecting capital in down markets. Per Morningstar, the downside capture ratio for the past three and five years was 40% and 33% respectively. This means that on average, the fund experienced much less downside than the index.

There is a lot to like about this fund. It has an excellent management team, using a disciplined, repeatable, and risk focused investment process. Combined, this is an excellent core holding that has the potential to deliver above average gains.

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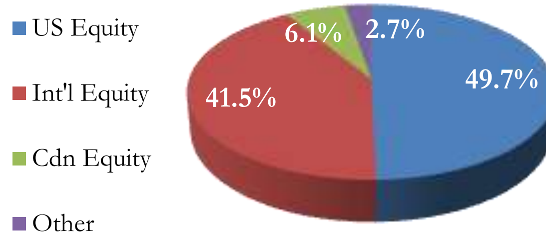
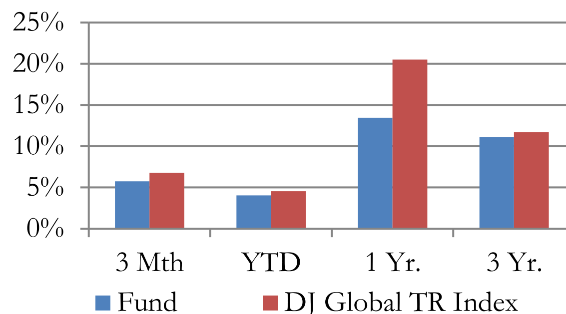
SEI Global Managed Volatility Fund

Fund Company	SEI Investments Canada
Fund Type	Global Equity
Rating	C
Style	Large Cap Value
Risk Level	Medium
Load Status	Front End
RRSP/RRIF Suitability	Good
Manager	SEI Investments
MER	2.03%
Fund Code	PCA 630 – Front End Units
Minimum Investment	$1,000





ANALYSIS: Low volatility funds continue to be a popular choice with investors and advisors. One of the worries I have had with these funds is many are trading at valuation levels that are well above the broader market. That is one of the appealing factors of this SEI offering, which according to Morningstar, is trading at valuations well below the broader market and its peer group.

Despite having been in the business for 40 plus years and advising on more than $750 billion USD, SEI is not exactly a household name. That is because they have focused on providing investment solutions targeted mainly at institutions. In Canada, they have a modest retail presence, and offer several multi-manager, standalone, and portfolio solutions aimed at financial advisors.

This offering is a multi-manager fund that looks to find stocks the management teams believe will be less volatile than the overall market. There are currently two managers in the fund, each using different, but complimentary processes. The first uses a value focused approach that looks for stocks that are not only expected to be less volatile, but also are viewed as cheap and out of favour, with near term potential. The second manager uses a model that is a balance between value, momentum and quality. The teams don't just look for low vol names, but also pay attention to correlation between the stocks. The mix between managers is adjusted based on the expected relative attractiveness of each style.

Not only has this been one of the stronger low vol offerings, it has also done very well compared to the broader global equity category. As would be expected, volatility has been below average, and it has shown good downside protection in a falling market.

I see this as one of the more attractive low vol offerings in the global equity category. The diversified, multi-manager approach, combined with the reasonable valuation and growth outlook leads me to favour this offering over many of its peers.

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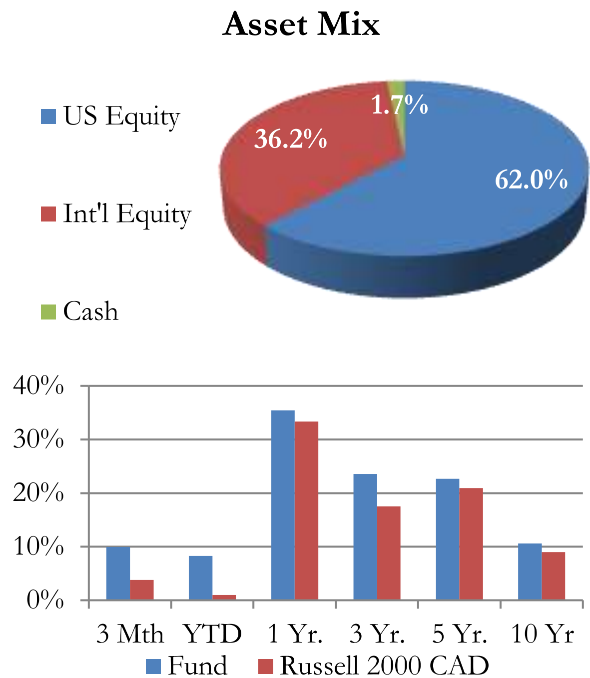
Fidelity Global Technology Fund

Fund Company	Fidelity Investments Canada
Fund Type	Sector Equity
Rating	C
Style	All Cap Growth
Risk Level	Medium High
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	HyunHo Sohn since March 2013
MER	2.38% (front end units)
Fund Code	FID 297 – Front End Units FID 597 – DSC Units
Minimum Investment	$500



ANALYSIS: There is no denying that technology plays a key role in the U.S. economy, both in terms of innovation and invention, as well as the available investment opportunities. Technology is the largest sector in the S&P 500, representing nearly 20% of the market capitalization.

Investing in technology is not without its risks, as anyone who lived through the tech bubble can attest. In the 1999 – 2000 period, investors bid tech names up to unprecedented heights, only to see them come crashing down to earth. In fact, many tech focused funds have not yet made up those losses, even after their recent strong gains.

This has been one of the more attractive technology funds, particularly in the past three years. Manager HyunHo Sohn took over the management duties in early 2013, and looks for long-term structural winners that are trading at attractive valuations. Still, make no mistake about it, this is a growth fund. It trades at valuation levels that are high compared to the broader market, but are on the lower end, relative to other tech focused funds.

The portfolio is reasonably diversified, holding approximately 65 tech companies. It has a global mandate, and at the end of January, had about 62% invested in the U.S., 10% in Japan, with the rest spread across Asia and Europe.

It holds a lot of household names, including Apple, Alphabet, the parent company of Google, and chip-maker Intel. About a quarter of the fund is invested in software, 18% in chipmakers, 18% in software, with the balance in hardware and equipment makers.

For the three years ending February 28, it gained an annualized 23.6%, trailing only the TD Science & Tech Fund in the category. However, volatility has been lower than the TD offering, resulting in better risk adjusted returns.

For those looking to add some tech exposure to their funds, this is one to consider.

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