

Top Funds Report

March sees strong gains for investors

Another solid month pushes valuations even higher. Looking for strong earnings to justify current levels...

March was a solid month for investors with gains across the board. The FTSE/TMX Canadian Universe Bond Index gained 0.41%, as yield remained largely unchanged in the month. Corporate and long term bonds outperformed, largely because of their higher yield to maturities.

Turning to equities, the S&P/TSX Composite was positive, generating 1.3% for investors. Global equities were also strong, with the S&P 500 gaining 0.25% and the MSCI EAFE Index rose by 3.4% in Canadian dollar terms. The best performing region was Europe, which gained 4.7% on improving economic numbers.

I remain cautiously optimistic as there appears to be a period of synchronized global growth underway. In Canada, inflation remains relatively tame, with the latest CPI numbers coming in at 2% annualized, but if you back out food and energy, the numbers were even more muted at 1.7%. With very little inflation, it looks like the Bank of Canada will be on the sidelines for the near term, although the uptick in economic activity is on their radar. Some are now predicting a rate bump later this year, which is well ahead of previous expectations.

In the U.S., the economy has been showing some signs of strength, with improving consumer and business confidence, an uptick in manufacturing and non-manufacturing activity, initial jobless claims recently hitting a 45-year low, and many companies raising wages. Earnings growth has also been on the upswing, although growth levels remain well below historic averages. Some fear that if the U.S. Federal Reserve is too aggressive

in their rate hikes, there will be a further damper on these already below trend growth rates.

Globally, European business surveys are at their highest levels in 6 years and productivity and industrial activity continues to grow, while China and other Asian economies are stabilizing.

There are still risks that need to be monitored. Perhaps the biggest, is the valuation levels, particularly of U.S. stocks. They are trading well above normal, and we will need to see a strong upswing in corporate earnings to justify the current levels. Looking at Europe and Asia, I am becoming more optimistic, but am looking for further confirmation to support this outlook.

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

Active vs. Passive in Bear Markets

Does active management earn its fees in down markets?

The other day, I was talking with an advisor, and as it often does, the subject of conversation turned to the equity markets and the current level of valuation. Regardless of the metric, valuations appear to be above historical averages, which increases the likelihood of a market pullback. The question then becomes, when this selloff happens, are you better with an actively managed fund or with a passive index product, like an index fund or an ETF.

Intuitively, it would make sense that an actively managed fund would outperform a passive investment strategy when the market sells off. The rationale is an active manager is better able to navigate the volatility through several available tools, including defensive security selection and carrying higher cash levels.

To study this, I looked at it a couple of different ways. First, I went back through various bear markets on the major indices, and compared the performance of the index with the category average for the period. The results are mixed at best. In Canada, there have been five drops of more than 20% in the index. Of these, active funds outperformed three times, and have underperformed twice. In the U.S., there have been two such selloffs, and the results are split, while for the MSCI EAFE, active mandates have, on average, lagged the index in both bear markets.

The next way I studied this was to see how the active mandates stacked up against the indices in the two most recent down years; 2008 and 2011. In this scenario, I did a very simple analysis and looked at the number of funds that beat the index. The table below shows the results:

	2011	2008
Canadian Equities	31.9%	43.4%
U.S. Equities	8.8%	19.7%
International Equities	22.7%	20.0%
Global Equities	18.0%	22.0%

Source: Morningstar Advisor Workstation

Again, the results are somewhat disappointing, with well less than half the actively managed funds outperforming their passive benchmark in a period of a drawdown.

A third way I looked at this was to analyze the downside capture ratios of the mutual funds in each category to determine how many funds have shown they preserve capital better than the index in down markets. As a refresher, the down capture ratio calculates how much of the negative performance a fund has experienced over the period reviewed. A down capture ratio of less than 100% means the fund holds up better in down markets, while a reading of more than 100% indicates it loses more than the index in a negative market.

The table below shows the number of funds with down capture ratios of less than 100% in each of the respective categories:

	3 Yr.	5 Yr.	10 Yr.
Canadian Equities	58.7%	69.5%	54.8%
U.S. Equities	24.2%	13.6%	18.7%
International Equities	60.0%	61.5%	50.0%
Global Equities	61.8%	54.5%	51.1%

Source: Morningstar Advisor Workstation

Looking at pure down market returns, active strategies hold up better than the indices, except in the U.S.

If down capture ratios are much better than the index, why don't the overall returns of active strategies hold up better than the indices in bear markets? The simple answer is most of the funds will lag the index, in some cases substantially coming out of a bear market, so the result is net underperformance for the active strategies.

Bottom Line:

The numbers show that active strategies, on average, lag index strategies in bear markets. This is not surprising, and is consistent with other analysis I have done around active investment management. On average, active funds tend to underperform. But that doesn't mean active strategies should be avoided. On the contrary, the key is to find high quality, well managed funds that have the potential to deliver above average risk adjusted returns in all market conditions. Active strategies are likely to work better in less efficient markets where managers can exploit inefficiencies for the betterment of the investor.

Funds of Note

This month, I highlight some of the best equity funds for volatile markets...

On the previous page, (page 2), I looked at whether actively managed funds outperformed more passive strategies in down markets. Spoiler alert; the conclusion was that on average active funds tend to lag the passive indices. However, high quality, well managed, funds can add value in volatile markets. I thought it would be a good idea to highlight excellent funds that offer strong downside protection, as well as the potential to grow your capital over the long term. I looked at picks from the core fund categories.

Canadian Equity Funds

In the Canadian mutual fund industry, a Canadian equity fund is defined as one that has at least 90% of its assets invested in Canadian equities.

RBC QUBE Low Volatility Canadian Equity Fund (RBF 719 – Front End Units) – Low volatility funds have been extremely popular with investors, and this has been one of the better performing options. The investment process is largely quantitative, and looks to minimize volatility without sacrificing long-term growth potential. While it lagged in the past year, the three-year number is firmly in the top quartile, with a level of volatility that is about three quarters of the broader market. Capital protection has been excellent, experiencing less than 20% of the downside for the past three years. Perhaps more appealing, unlike many other low vol funds, valuation levels are more in line with the broader market.

Mawer Canadian Equity Fund (MAW 106 – No Load Units) – Over the past five years, this

Fund has delivered 97% of the upside of the market, while experiencing less than 40% of the downside, with less volatility. The management team focuses on finding high-quality companies with strong business models that will allow them to hold up in volatile times. Risk management is a key consideration and stress testing and scenario analysis are integral to the process. The firm continues to improve its risk monitoring and portfolio management.

Canadian Focused Equity Funds

A Canadian Focused Equity Fund is defined as one that has between 50% and 90% Canadian equities. Some picks in this category include:

Mackenzie Canadian Growth Fund (MFC 650 – Front End Units) – This concentrated offering has done an excellent job for investors over the past several years. For the past three and five years, it has been one of the top performing Canadian equity funds, handily outpacing the index and peer group. Much of this outperformance comes from its U.S. holdings, combined with its concentrated portfolio that looks nothing like the index. It has delivered roughly 100% of the return of the market, with less than 5% of the downside, over the past three years. A drawback is with its growth focus, it has been slightly more volatile, but to date, the excess return has more than offset that.

Brandes Canadian Equity Fund (BIP 121 – Front End Units) – While the Mackenzie offering above is a growth fund, this the opposite; a more diversified, deep value fund,

that skews a bit more mid-cap. Over the past five years, it has delivered more than 120% of the upside of the market, while experiencing less than a quarter of the downside. It is more volatile than the market, and did get pounded in 2008, falling more than 45%. This time around, the portfolio valuations are significantly more attractive than the broader market and peer group, providing what I believe to be a bigger margin of safety. Still, if the volatility is a concern, you may want to consider one of the other picks.

U.S. Equity Funds

Beutel Goodman American Equity Fund (BTG 774 – No Load Units) – This has been one of the very few funds to outpace the S&P 500 over the past five and ten-year period. More impressive is this has been done with less volatility than the index or peer group. It has delivered just shy of 100% of the upside, and between 80% and 85% of the downside. The managers take a value based approach, and look for companies they believe can deliver a minimum 50% return over a three-year period. In addition to their conservative valuation methodology, they also use a disciplined, and unique sell discipline to take profits and manage risk. Valuations remain below the index, with decent forward looking growth rates, providing a reasonable margin of safety that should help protect capital in a market selloff.

International Equity Funds

Trimark International Companies Fund (AIM 1733 – Front End Units) – Managed by the team of Michael Hatcher and Jeff Feng, this is a high conviction portfolio of quality companies with strong management, free cash flow

generation, excellent organic growth, and sustainable competitive advantages. The result is a fund that delivers strong upside, yet holds up well when markets fall. Valuations look a little rich, but expected growth rates make up for it.

Mawer International Equity Fund (MAW 102 – No Load Units) – This is consistently one of the best international equity funds around. Managers are disciplined on finding quality, wealth creating companies trading at reasonable valuations. Investors are rewarded with excellent absolute and risk-adjusted returns, and decent capital protection in down markets.

Global Equity Funds

Dynamic Global Dividend Fund (DYN 031 – Front End Units) – Managed by David Fingold using a bottom up process that looks to find high quality companies with strong balance sheets and margins, and returns that are well above average. Over the past three years, performance has been better than the peer group, with average volatility. Over the long term, it has done a decent job of protecting capital in down markets.

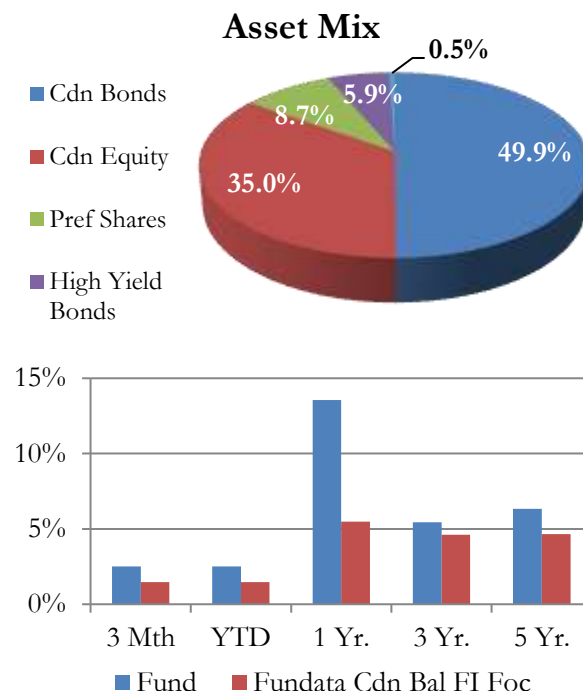
Mackenzie Ivy Foreign Equity Fund (MFC 081 – Front End Units) – Managed by a team led by Paul Musson, this has been my go-to global equity fund for volatile markets. It is concentrated, looks nothing like the index, and the manager is not afraid to hold cash when valuations get out of whack. Recent performance has struggled in the beta driven rally, but over the long-term, I am confident it can deliver decent returns with below average volatility.

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

feedback@paterson-associates.ca

Leith Wheeler Income Advantage Fund

Fund Company	Leith Wheeler Investment Cnsl
Fund Type	Cdn Fixed Income Balanced
Rating	A
Style	Blend
Risk Level	Low to Medium
Load Status	No Load
RRSP/RRIF Suitability	Excellent
Manager	LW Investment Team
MER	0.85%
Fund Code	LWF 017 – No Load Units LWF 030 – Fee Based Units
Minimum Investment	\$25,000



ANALYSIS: Those looking for a stable source of tax efficient monthly income with the potential for some capital growth may want to consider this Leith Wheeler offering. Over the past five-years, the no load units have generated an annualized return of nearly 6.4%, handily outpacing both the index and peer group.

The fund invests in a mix of bonds, preferred shares, and dividend paying stocks. It has a lot of flexibility and can invest in companies of any size. It also has the flexibility to explore opportunities outside of Canada.

It is a more conservative option, and will typically favour fixed income investments. At the end of March, it held 55% in bonds, 10% in preferreds, 1% in cash, and the balance in equities. The majority of the equity exposure will be through holding units of the highly-regarded **Leith Wheeler Canadian Dividend Fund**,

which uses a fundamental, bottom up, value focused approach to find higher yielding dividend stocks. Foreign exposure is limited to 20%, although given the focus on tax advantaged income, it is expected most of the equity exposure will be Canadian. At the end of March, less than 4% was invested abroad.

The fixed income sleeve will be a mix of investment grade and high yield. High yield represented approximately 6%, while investment grade was 49%.

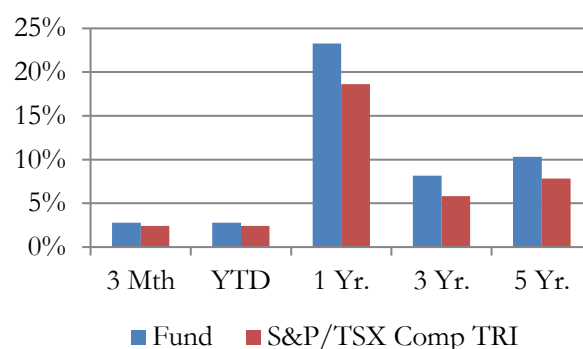
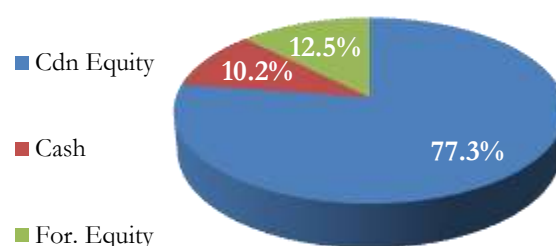
The drawback to this fund is it has been slightly more volatile than the peer group over the past three and five-year period. Even with the higher volatility, it has outpaced its competition on a risk adjusted basis.

This can be a great balanced fund for those looking for a good mix of tax advantaged returns and capital gains.

EdgePoint Canadian Portfolio

Fund Company	EdgePoint Wealth Management
Fund Type	Canadian Equity
Rating	A
Style	Blend
Risk Level	Medium - High
Load Status	Optional
RRSP/RRIF Suitability	Excellent
Manager	EdgePoint Management Team
MER	2.15%
Fund Code	EDG 108 – Front End Units EDG 308 – Low Load Units
Minimum Investment	\$15,000

Asset Mix



ANALYSIS: This is EdgePoint's Canadian equity offering that invests in companies of any size, primarily in Canada that have strong competitive positions, excellent long-term growth prospectus, and strong management teams. Valuation is a key component of their process, as they look to buy companies at prices that are below what they believe it is worth. While the focus is on Canadian names, they can invest abroad, but usually won't put more than 15% in foreign names.

The portfolio is built on a bottom up basis, with sector weights being the byproduct of the stock selection process. The result is a portfolio that looks nothing like the index. To help ensure proper diversification, they look to diversify across business ideas.

It is a concentrated, yet diversified portfolio, typically holding around 65 names, with the top ten representing just under 45% of the fund. Their time horizon is longer term, typically five or more years, and they are patient, allowing their investment

thesis to play out. Portfolio turnover has been very modest, averaging less than 30% for the past five years. They will sell a company for a couple reasons. First is the investment thesis is no longer valid, and second, they are able to find a better idea for the portfolio. They are constantly looking to upgrade and will sell a name to make room when a better idea becomes available.

Performance has been excellent, on both an absolute and risk adjusted basis. For the past five years, it's gained an annualized 10.3%, outpacing the index and peer group. Volatility has been above average, which is not surprising given the all cap nature of the portfolio.

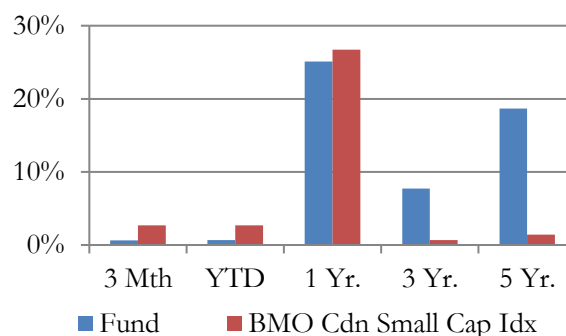
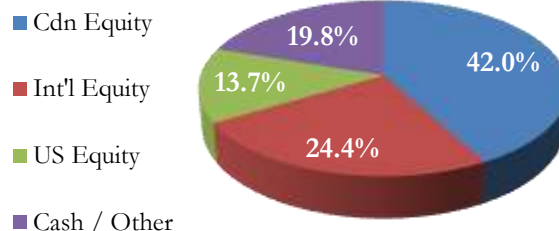
Costs are quite competitive, with an MER of 2.15% for the front-end units, which is well below the category average.

This is a great core Canadian equity offering, for those who can stomach the potential for higher volatility.

CI Cambridge Canadian Growth Companies

Fund Company	CI Investments
Fund Type	Cdn Focused Small / Mid Cap
Rating	A
Style	Mid-Cap Growth
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Greg Dean since September '12
MER	2.44%
Fund Code	CIG 11108 – Front End Units CIG 11358 – Low Load Units
Minimum Investment	\$500

Asset Mix



ANALYSIS: Apart from a blip in 2015, this Fund has posted absolute and risk-adjusted performance numbers that have been well above average. For the five-years ending March 31, it gained an annualized 18.7%, while the S&P/TSX Completion Index rose by 5.8%.

The Fund is actively managed and benchmark agnostic. Unlike the **CI Cambridge Pure Canadian Equity Fund**, this mandate has more flexibility, and can invest up to 49% of the Fund outside of Canada. Regardless of the geography, the managers look for companies that have a management team that is aligned with shareholders, a history of sound capital allocation, and a strong competitive advantage.

The investment process is very much a bottom up approach, and the portfolio tends to be divided into a couple of buckets. The first bucket is core holdings, which they consider to be longer term, well managed, attractive investments. The second bucket is what they consider to be opportunistic

holdings, which they view as short term trading opportunities that are the result of a mispricing in the market. The allocation between the two will be the result of the available opportunity set.

The approach tends to skew a bit more to the growth side of the spectrum, as they are looking to find companies that have the potential to move their share prices upwards. That said, valuation is still a consideration, and they want to avoid overpaying for that potential growth.

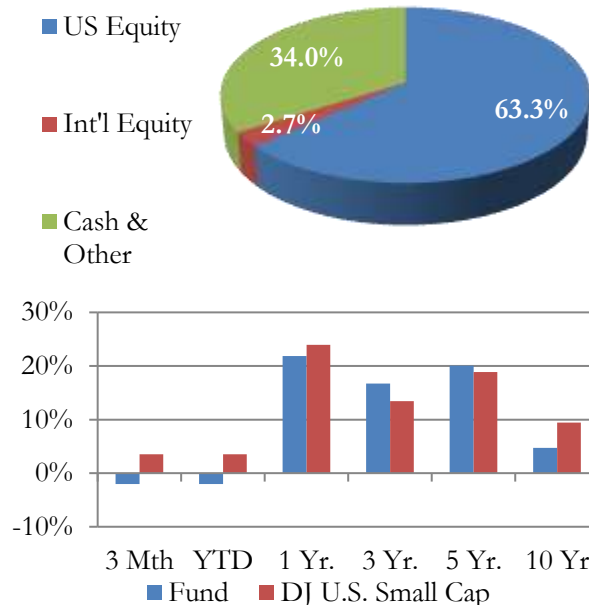
They tend to carry more cash than some of their peers. There are a couple of reasons for this, first, to play some defense in volatile times, and second, to make sure they have sufficient “dry powder” to take advantage of opportunities as they arise. At the end of March, cash sat at just under 20%.

Volatility can run a bit higher than average, but if you have the stomach for it, this can be an excellent addition to a well-diversified portfolio.

Brandes U.S. Small Cap Equity Fund

Fund Company	Bridgehouse Asset Managers
Fund Type	U.S. Small Cap Equity
Rating	A
Style	Small Cap Value
Risk Level	Medium High
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Brandes Investment Team
MER	2.38% (front end units)
Fund Code	BIP 142 – Front End Units BIP 217 – Low Load Units
Minimum Investment	\$1,000

Asset Mix



ANALYSIS: Managed by the Brandes Investment Committee using a fundamentally driven, bottom up, Graham and Dodd, value focused approach, this U.S. focused small / mid cap fund looks to build a diversified portfolio of businesses that are trading well below their estimate of true value, with the potential for capital growth. At the end of March, it held just under 40 names, with the top ten making up just over 30%

The focus is on companies that are below \$1.5 billion in market cap. Given the bottom up approach, the sector mix is the result of the stock selection process, and it will often look nothing like its benchmark. At the end of March, it was significantly overweight in industrials, and consumer cyclicals, with no utilities, or communications, with little exposure to materials.

The team is disciplined in their approach, and will only invest in opportunities that meet their strict valuation criteria. At the end of March, they held nearly 30% in cash. Given the value focus, it's not

surprising that the valuation metrics in the portfolio are extremely attractive, compared with the broader market and its peer group. The fund's price to book ratio was around half that of the benchmark, providing ample margin of safety.

Performance has been very strong, posting a five-year annualized return of more than 20%, compared with an 18% rise in the Russell 2000. Volatility has been well below the index, and it has done an excellent job protecting capital in down markets, experiencing around half the markets declines over the past five years.

The biggest drawback to the Fund is its cost, which is 2.72%, which is well above the category average. Given the significant variance between the portfolio and the benchmark, it may also be subject to periods of performance dislocation. A notable example is 2008 when the Fund lost nearly 50%, lagging the peer group by nearly 2000 basis points. Still, this can be part of a well-diversified portfolio as a potential return enhancer.