

Top Funds Report

Global markets mostly higher

Toronto continues to be held by banks and oil. Government bonds outpaced corporate issues...

Markets were mixed in what turned out to be a relatively uneventful May, at least in comparison with the last couple of months. The S&P/TSX Composite Index sank by 1.3% on weakness in energy and financial names. Foreign equity markets were mostly higher, with Europe leading the way, as the MSCI Europe Index gained 5.1% in U.S. dollar terms. U.S. equities were positive, with a modest 1.4% rise in the S&P 500 in U.S. dollar terms. Asian markets were mixed.

Investor confidence in the two largest sectors of the Canadian market continued to weigh. Energy names faced headwinds as the oil price fell by more than 2% as increasing U.S. production raised supply worries. Also hurting the sector was Canadian dollar strength, which saw the loonie gain 1.2% in the month.

In the financial sector, banks were again under pressure as the fallout from the Home Capital selloff continued to be on the minds of investors. Looking ahead, it appears the worst is over, at least for the near term. Home Capital has been able to reach a settlement with the regulators, which paves the way for a resolution, most likely in the way of a takeover. This has helped bring some stability to the banking sector, which is up nearly 1.5% so far in June (to June 19).

Canadian bonds continued their rally with the FTSE/TMX Canadian Universe Index gaining an impressive 0.86%, bringing the year-to-date gain to nearly 3.6%. Much of the gain was the result of a drop in yields, which saw the Canada ten-year fall from 1.54% to end the month at 1.41%. Government bonds outperformed corporates,

which saw headwinds on two fronts; weakness in financials, which were sold off in the aftermath of Home Capital, and from a record issuance, which flooded the market with increased supply of new issues. The result was a widening in credit spreads which held corporate bonds back.

Valuations remain high, and I expect to see either a period of below trend returns or a pullback in the summer or fall. Volatility measures have been extremely low, but I believe we will see a spike in the next several months. Still, my investment outlook remains intact. I continue to favour equities over fixed income, and quality over “junk”.

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.

Investing for the Crash

Valuations could lead to market turbulence. A strategy and discipline required to weather the storm

In recent weeks, there has been a lot of talk about the potential for a big market correction as we head into the summer and the fall, which has historically been the most volatile period for stocks. There are many reasons for some concern, with valuation levels leading the pack. While lower rates may help justify inflated valuations, it's difficult to believe that price to earnings ratios of more than 21 times is sustainable into the future, particularly when the longer-term average is closer to 15. If we get a regression to the historic average, that's a nearly 30% drop in value.

One notable supporter of a correction is Harry Dent, the economist who called the collapse of Japan, the dot-com bubble, and the 2007 housing bust. Mr. Dent is now predicting what he calls, a "once in a lifetime crash" in the next three years. He has long been known for his bold predictions, and his current expectation that stocks will drop between 70% and 90% in the next three years. If that were to happen, we'd see the S&P 500 fall from its current level, roughly 2430, to between 243 and 729.

The foundation for Mr. Dent's bold forecast is demographics, and specifically that the baby boomers are now getting older and starting to die. According to his research, the generations after the boomers are not large enough to replace the boomer's spending and consumption, which is disastrous to the economy and markets.

Another factor cited was the high level of debt carried by consumers. There was some deleveraging that happened after the 2008 financial collapse, but today, debt levels have again reached worrisome heights. In the U.S., consumer debt is now at levels in line with 2008. Here at home, consumer debt reached 167% of disposable income in the first quarter of 2017. Should we see any meaningful increase in interest rates, the cost of carrying these elevated debt loads will also increase, eating away at consumers' spending power, creating a drag on economic growth.

There are also concerns around the fragility of the global real estate market, and geopolitical concerns, which on top of the demographics and debt levels, creates an almost "perfect storm" for a major market correction.

Now before you pack up the car, head to Costco to load up on canned goods and shotgun shells and move to a cabin in the woods, I'd suggest you take a deep breath, and relax. The forecasts by commentators such as Mr. Dent are designed to create headlines, and ultimately sell books and newsletter subscriptions. Yes, markets are overvalued, yes, debt levels are high, yes, the housing market is potentially in a bit of trouble, and yes, there are lots of worries around the world. But that does not mean that there will be an

unprecedented market crash. We have seen much of this before. While we are unlikely to see a crash, it is highly likely we will see a pullback or at least some period of below trend growth. Unfortunately, there is no way to tell in advance how this will play out, or when it will play out. As John Maynard Keynes is believed to have said, "Markets can stay irrational longer than you can stay solvent."

As an investor, times like these can be challenging, to put it mildly. However, it is times like these where we must stick to our discipline and focus on the bigger picture. A crash may be coming but it's far from a certainty, and to position portfolios for such a binary outcome may end up doing more harm than good.

Instead, it is best to look at our investment goals and figure out how much risk we are comfortable with. People rarely worry about risk and volatility when things are going well. Then when things get bad, they tend to overreact and make choices that often hurt more than they help. We must realize that market corrections are part of investing, but if we have built a portfolio that is in line with our needs, they are certainly very manageable, particularly over the long term.

I continue to keep my asset mixes in line with the longer-term averages. Equities are expensive now, but looking out over a five-year time horizon, they are still expected to deliver a higher level of return than bonds. Turning to bonds, while the return expectations may be muted, they still need to be a healthy part of your portfolio. If we see a market correction, it is the bonds in your portfolio that will act as a ballast to help protect your capital. In most corrections, bonds move up, while stocks move lower.

With your investment selection, I would suggest you focus on higher quality securities, trading at reasonable valuation levels. Look for funds and ETFs that focus on strong underlying businesses, as it is these businesses that are expected to withstand any correction better than those highly levered companies.

If you have had your portfolio invested for some time, it's a good idea to rebalance back to your target asset mix. This takes some profits off the table, and reduces your risk over the long term. Finally, if you are extremely worried about a market correction, you could always get more defensive by holding a bit more cash, and reducing your equity exposure by adding to your investment grade bond holdings.

There is no perfect solution for uncertain times, but having a strategy and the discipline to stay the course will likely lead to better long-term results than making bets on the unknown.

Funds of Note

This month, I highlight some of the ETFs on my latest Focused List...

BMO Monthly Income ETF (TSX: ZMI) – This income focused balanced ETF continues to tick along, providing decent returns for investors, all while generating a nice cash flow to investors, which is currently yielding around 4% annualized. To deliver this, it has a neutral, or target asset mix that is roughly equally weighted between bonds and equities. At the end of April, it was modestly overweight equities, which made up about 53% of the portfolio.

A knock on this in the past had been that with the income focus, the valuation levels had reached a point that were cause for some modest concern. Since our last update, valuations have retreated, and are now more in line with the benchmark. A contributing factor to this would have been the reduction to low volatility equities, which were nearly 6% of the portfolio at the end of January. They have since been reduced to around 2.5%.

Looking ahead, If you're looking for a reasonably priced, income focused, "one ticket" balanced ETF, this fits the bill reasonably well. It offers decent returns, modest volatility and a cost that is reasonable, with an MER of 0.61%.

PowerShares S&P/TSX Composite Low Volatility ETF (TSX: TLV) – It was a good period for low volatility funds and ETFs, and particularly so for this PowerShares offering. With a gain of nearly 6%, it handily outpaced the broader Canadian market. A big reason for this outperformance was its underweight in energy, materials, and financials, three sectors that struggled during the past three months. Combined, these three sectors make up nearly two thirds of the index, but represent less than 30% of this ETF. Instead, it is significantly overweight to real estate, communications, and utilities, sectors which gained 5.4%, 9.3%, and 4.7% respectively.

One of the concerns I have had of late with many low volatility products has been their high levels of valuation. Many had been trading well above even the elevated levels of the broader markets. Looking at this

ETF, according to Morningstar, it is trading about 8% below the S&P/TSX Composite Index on both a price to earnings basis, and price to cash flow basis. Further, the dividend yield is far superior that offered by the market, making this a somewhat attractive offering.

From a volatility perspective, this has certainly lived up to its promise, with a three, and a five-year standard deviation that is significantly lower than the index and the peer group. Performance has also been excellent, gaining a nearly annualized 12% for the past five years, compared to the S&P/TSX Composite which has generated around 9.2% annualized. While I am doubtful the outperformance can be sustained going forward, I do believe that it should be able to deliver market like returns, and I remain confident this can be done with a lower level of volatility. This, combined with a more than reasonable MER of 0.34% make this an ETF to consider for those looking for Canadian equity exposure.

First Asset Morningstar Canadian Momentum ETF (TSX: WXM) – Momentum names had a heck of a run over the three months ending April 30th, with this First Asset offering gaining 4.2% over the period, making it the second best Canadian equity performer on our list. It was largely its overweight in the consumer and technology sectors that helped drive returns higher. Telecom and utilities were also strong contributors during the period, although these are not sectors you would typically expect to see in a momentum focused fund. Still, Rogers, Quebecor, and BCE were all net positive contributors.

Valuation levels look a bit rich when compared to the broader market, however, when we consider the significantly higher levels of earnings growth, things look a more reasonable. This momentum strategy can invest in companies of any size, but tends to favour mid-caps. This focus also helps to explain why the volatility has historically been a little higher than the broader market.

Over the long-term, I expect this ETF can deliver a rate of return that is in line with, or higher than the broader markets. However, I also expect it to remain a bit more volatile, and that there will be periods where the performance is out of step with the major indices. I don't view this as a core holding, but instead, I see it as a potential return enhancer when included in an otherwise well diversified portfolio. A drawback is that it's a bit pricey, with an MER of 0.68%, however it is something that is not easily replicated by the average investor.

iShares Core S&P 500 Index ETF (TSX: XSP) – U.S. equities have had a heck of a run since the November election, and continued that in the three months ending April 30, with a gain of 5% in U.S. dollar terms. Valuations continue to sit at levels well above other regions, trading at a price to forward earnings ratio of more than 19 times. In comparison, the S&P/TSX Composite Index is trading around 16.5 times forward earnings, and the MSCI EAFE Index is around 15.7 times. These levels are not sustainable, and the euphoria that followed Trump's victory is now starting to fade. Controversy continues to follow Mr. Trump, and there have been a few campaign promises that have failed to gain enough support to pass. This is causing some market participants to take a pause. I expect there will be some correction, unfortunately, when that will happen cannot be predicted. Now may be a good time to think about taking some profits in your U.S. equity holdings, and looking at other areas, including Canada and Europe.

iShares MSCI EAFE Minimum Volatility Index ETF (TSX: XMI) – Low volatility ETFs had a great run, and this international offering is no exception, gaining nearly 12%. For the past three years, it has gained nearly 13%, outpacing the broader MSCI EAFE Index, which gained 9.7% in Canadian dollar terms. While the absolute results have been decent, this has not had the same type of success that the **PowerShares S&P/TSX Composite Low Volatility ETF (TSX: TLV)** discussed above, has had. Volatility for XMI has been lower than the MSCI EAFE Index, it has not been significantly lower. Further, looking at the valuation levels, it trades at levels below the U.S. markets, but are still higher than its benchmark. This causes me concern, because with the higher valuation levels, I don't have confidence

this can keep pace with the broader index in the near to medium term. If you have held this for a while, you may want to consider taking some profits. If you have an average or higher risk tolerance, you may also want to consider moving to the more broad-based index, such as ZEA or XEF. Both offer comparable exposure at a more attractive valuation level.

Vanguard FTSE Emerging Markets All Cap ETF (TSX: VEE) – After a tough 2016, emerging markets had a nice bounce back as China, Korea, India, and Mexico all had strong showings, as economic numbers look to be on the upswing. Profitability is on the rebound, and valuations are very attractive when compared to their developed market peers. However, the region is not without its trouble spots. Brazil continues to struggle, political turmoil in Turkey, and rising debt levels in China are beginning to weigh. There are also some concerns over the impact of a potential border adjustment tax that may be levied by the U.S., which could hurt many developing nations, including Mexico, Columbia, China, and Singapore.

In this environment, I am optimistic on the outlook for the emerging markets, but cautiously so. Despite the valuation gap, and the earnings growth outlook for many developing nations, I am not confident enough to suggest an overweight position. Instead, I remain neutral in my allocation to the region. This is not an area of the market that is suitable for those with below average appetites for risk, and is only something you should consider if you are comfortable with the potential volatility.

I am also somewhat reluctant to use a pure passive strategy in the asset class, and instead favour a more quality focused, actively managed fund. However, for those looking for low cost exposure to emerging market equities, this remains one of the most attractive ways to do so. As mentioned above, this is not a core holding, but rather used as a potential return enhancer for an otherwise well diversified portfolio.

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

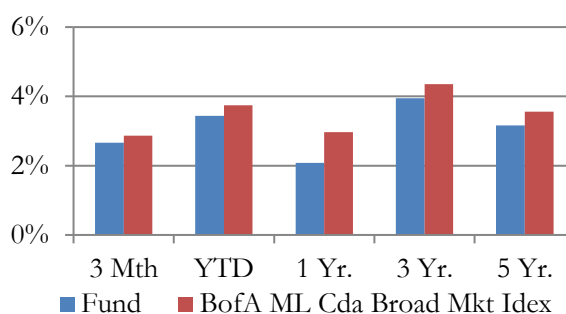
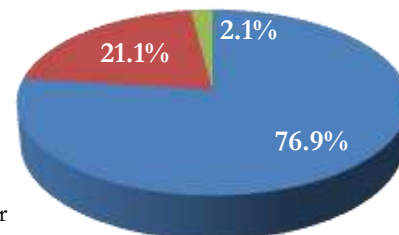
feedback@paterson-associates.ca

Vanguard Canadian Aggregate Bond ETF

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

Asset Mix

- Cdn Gov Bonds
- Cdn Corp. Bonds
- Cash / Other



ANALYSIS: Bonds did fairly well over the three months ending April 30 as Canadian yields drifted lower across the board. At the short end of the curve, the yield on the Canadian five-year benchmark bond fell from 1.11% to 1.00%, while the ten-year dropped from 1.75% to 1.54%. At the long end, yields fell from 2.41% to end the period at 2.16%. Because bond prices move in the opposite direction of yields, bonds rallied higher with this ETF, which represents a broad spectrum of Canadian bonds, gaining a very respectable 2.9%.

In the past few weeks, Canadian yields have continued to drift lower, despite many market participants correctly forecasting that the U.S. Federal Reserve would bump rates higher at their June meeting.

There is some evidence mounting that shows the Canadian economy is picking up some steam, and the Bank of Canada Governor Stephen Poloz

has started hinting rates will begin moving up this year. In a recent note, Benjamin Tal, Deputy Chief Economist at CIBC World Markets said they expect the BoC is likely to start hiking rates in the fourth quarter of this year. Even if they do move sooner than expected, I don't think we'll see Canadian rates moving sharply higher in the near term. Regardless, the mid-to-long-term return expectation for bonds remains muted.

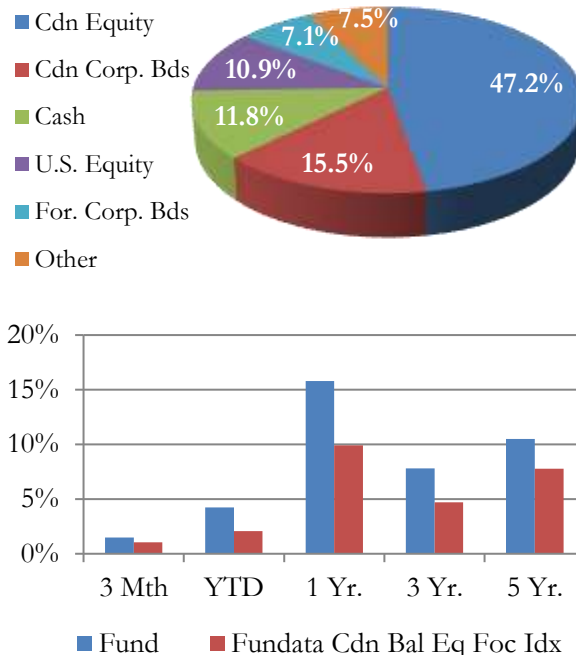
In this environment, I remain cautious, but still believe the benefits of including bonds in your portfolio outweigh the risks now.

This remains an excellent way to access the broader Canadian bond market, particularly given the 0.13% MER. However, iShares recently announced they were cutting the management fee on the **iShares Canadian Universe Bond Index ETF (TSX: XBB)** from 0.25% to 0.09%, which will certainly give us reason to re-examine. Stay tuned...

EdgePoint Cdn Growth & Income Portfolio

Fund Company	EdgePoint Wealth Management
Fund Type	Canadian Equity Balanced
Rating	A
Style	Mid-Cap Blend
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Excellent
Manager	EdgePoint Management Team
MER	1.70% - Front End Units 1.90% Low Load Units
Fund Code	EDG 188 – Front End Units EDG 388 – Low Load Units
Minimum Investment	\$15,000

Asset Mix



ANALYSIS: With their straightforward approach, Toronto based EdgePoint has been a favourite for a while. They keep things simple with four funds; a Canadian equity and global equity fund, and Canadian and global balanced fund. This is their Canadian balanced offering.

The investment approach is also very simple and to the point. They don't view investing as buying shares of a company, instead, they view it as buying an ownership interest in the company, and they look to acquire this ownership at a price below what they believe it to be worth.

For equities, they use a fundamental, bottom up approach that looks for companies of any size that have strong competitive positions, excellent long-term growth prospectus, and strong management teams. They take a long-term view, typically looking out three to five years, but will use periods of short-term volatility to improve the portfolio.

On the fixed income side, they take a similar approach. They look for securities they believe can deliver an attractive total return, but which they can buy at a price well below what it is worth. They tend to focus on Corporate bonds, and can invest in both investment grade and high yield.

The mix between stocks and bonds can vary widely depending on their relative attractiveness. The fixed income exposure can range between 25% and 60%. At the end of March, they had 32% in bonds, 62% in equities, and around 6% in cash.

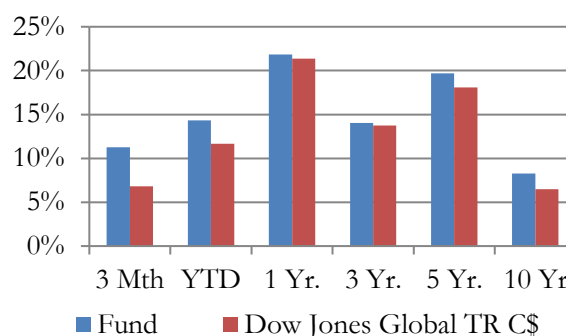
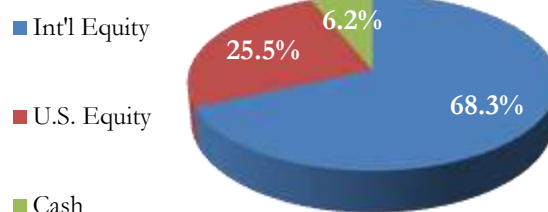
Performance has been excellent. For the five years ending May 31, it gained 10.5%, handily outpacing its benchmark and peer group. Given the all-cap approach of the equity sleeve, volatility has been higher than average. But even with this higher volatility, risk adjusted returns have outpaced.

Looking ahead, I see this trend continuing with above average returns, but higher volatility.

CI Black Creek Global Leaders Fund

Fund Company	CI Investments
Fund Type	Global Equity
Rating	D
Style	Large Cap Blend
Risk Level	Medium / High
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Bill Kanko since June 2006
MER	2.48%
Fund Code	CIG 11106 – Front End Units CIG 11356 – Low Load Units
Minimum Investment	\$500

Asset Mix



ANALYSIS: Looking back over the past ten-years, this is a fund that has certainly lived up to its name as a leader in the global equity category. With an annualized gain of 8.3%, it has handily outpaced the MSCI World Index, and leaving most of its peer group in the dust.

It is a concentrated, go anywhere fund, that invests in companies of any size. The management team, headed by Bill Kanko looks for market leading companies that are gaining market share and have sustainable competitive advantages, that are trading at levels well below what they believe it to be worth.

Their approach is based on “independent thought”, and they must be able to identify a proprietary investment thesis that is different from the market’s view of the company. Before any new idea is added to the portfolio, not only must it offer a more attractive valuation profile, the managers must also understand why the stock is better than something already in the portfolio.

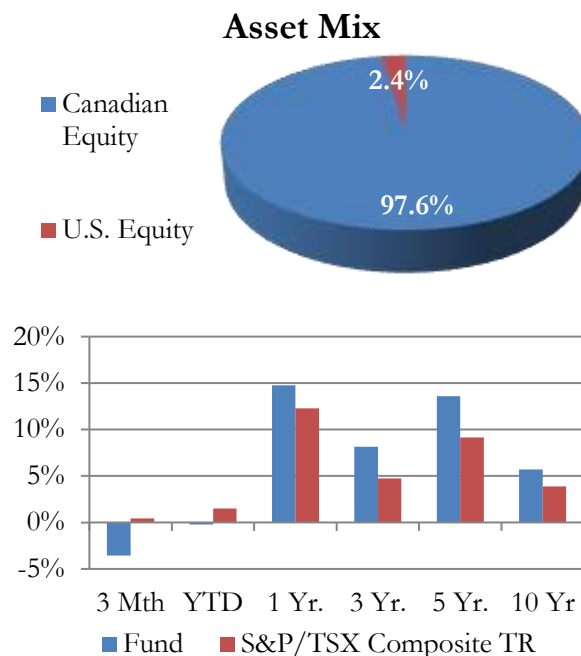
It is a bottom up process, which means the geographic exposure and sector mix will be the result of the security selection. The result is a portfolio that looks much different than its benchmark or peer group. Geographically, it has significantly less invested in the U.S., which makes up just over a third of the portfolio, compared to more than 62% of the index. Instead, it is overweight Europe, China, and India. From a sector perspective, it is overweight consumer discretionary and industrial names, and is underweight the more defensive sectors such as consumer staples, healthcare and utilities.

A drawback to the concentrated portfolio is its volatility, which has been higher than the index or peers. Historically, it has outpaced in rising markets, and lagged in falling markets.

Because of this volatility, I would be hesitant to use it as a core. Instead, I see it as a nice compliment to a more diversified global fund.

iShares S&P/TSX Capped Financials ETF

Fund Company	BlackRock Asset Management
Fund Type	Financial Services Equity
Rating	C
Style	Large Cap Value
Risk Level	Medium
Load Status	N/A
RRSP/RRIF Suitability	Good
Manager	iShares Management Team
MER	0.61%
Fund Code	TSX: XFN
Minimum Investment	N/A



ANALYSIS: Financials have long been the cornerstone of the Canadian equity markets with the big five banks making up more than 20% of the total market capitalization of the S&P/TSX Composite Index. The financial services sector has been a stellar performer over the long-term, outpacing the broader market by a decent margin.

Shorter-term however, things have not been quite as rosy for the financials, particularly the banks. In April, troubles at alternative mortgage lender Home Capital Group came to light which saw the stock plummet. Investors sold off heavily after the Ontario Securities Commission announced it had filed disclosure allegations against the firm and key management.

Many worried that this was just the tip of the iceberg and there were other Canadian lending institutions, including the big banks, that could be hurt by troubled mortgage loans. The result was the Canadian banks faced selling pressure, with financials losing ground in April and May. Things seem to have stabilized so far in June.

Whether this is the end of the selloff remains to be seen. Canadians continue to carry very high levels of debt which could result in problems should we see higher interest rates, or a slowdown in the economy. Since the initial selloff, financials have drifted lower. Valuations are now below the broader market, but there are some questions around the near-term earnings outlook. We are also seeing tangible signs of a slowdown in the Canadian housing market, after government actions in Vancouver and Ontario appear to have put a chill on those markets.

Looking ahead, I see more near-term headwinds for the banks. If you have realized gains from your XFN holdings, you may want to consider taking some money off the table and trim your position. If you have a longer-term outlook, a higher appetite for risk, and are looking to add some financial services exposure to your portfolio, it may be a decent time to start dipping your toes in the sector. This remains one of the best ways to play the broader financial industry in Canada.