

Top Funds Report

Equities mixed, higher yields drag bonds

Worries over a Bank of Canada rate hike pulls down bonds, pushed up dollar...

Equity markets were mixed in June, with Asia, led by China leading the way, with a 4.2% gain in U.S. dollar terms. Here at home, the S&P/TSX Composite fell by 0.75% on continued weakness in energy. Financials stabilized after the Home Capital meltdown in May, gaining 2.2%. The S&P 500 rose by 0.6%, but when the surge in the Canadian dollar was considered, lost 3.3% on the month. Small caps posted strong gains, with the Russell 2000 rising 3.5% in U.S. dollars, only to lose 0.6% CAD once we consider the currency.

In the bond market, upward pressure on yields pulled prices lower, with the FTSE/TMX Canadian Universe losing 1.2%. June was a tough month, as Bank of Canada Governor Stephen Poloz appeared to do an about face on rates, with it becoming very likely he would hike at the July meeting. This not only put upward pressure on yields, but it also drove the Canadian dollar higher. While there was talk that another rate hike is likely, it's not a certainty given the drag the rising dollar may have on trade, combined with potential fallout from the upcoming NAFTA negotiations. Inflation also remains well contained, at least for the near term.

As we head into the second half of the year, a repeat of the first half equity returns seems unlikely. Looking at valuations, the U.S. equity markets remain richly valued, with the S&P 500 now trading at more than 21 times forward earnings, compared with the long-term average of around 15 times. Many other developed markets continue to trade well above their longer-term averages, which when combined

with the prospect of higher interest rates and modest growth rates make it difficult to see a significant amount of further upside. In fact, I would estimate most of the risk to be to the downside in the near term.

That doesn't mean it's inevitable we will see a big market drawdown, but a period of relative underperformance is more likely. Valuations remain high, and I expect to see either 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.

Fnds of Note

This month, I highlight some of the winners and losers from the first half of the year...

With the first half of the year now in the books, I thought it might be interesting to look back on the winners and losers. Overall, it was a solid start, with the MSCI All Country World Index gaining a very respectable 11.8% in U.S. dollar terms. If we factor in the nearly 4% rise in the Canadian dollar compared with the U.S. greenback, the gain was a more modest 8.0% in Canadian dollar terms.

Emerging Markets led the pack higher, gaining 14.5% (CAD). Other winners included China, and Europe, gaining 13.0% and 12.0% respectively. This was a boost for international equities, which saw a rise of 10.3% in the MSCI EAFE Index.

Closer to home, the results were more muted. The S&P 500 which has been on an upward trajectory since Trump's November election win, gained nearly 10% in U.S. dollar terms, only to see that trimmed to 5.9% considering the strength in the Canadian dollar.

In Canada, the S&P/TSX Composite Index finished June roughly where it was in December, with a modest 0.8% rise. The biggest headwind was energy, which fell by more than 21% in the first six months as oil fell by more than 14% as traders worried oversupply would continue to flood the market. This was surprising in light of a deal that saw production cuts among OPEC and a number of other producers.

Another drag on the Canadian market was the financial sector. In April and May, we saw a scandal at alternative mortgage lender Home Capital hit the front pages. Investors sold off heavily after the Ontario Securities Commission announced it had filed disclosure allegations against the firm and key management. While it appears to have come out of nowhere, this has roots going back to 2014 when management noted irregularities on several mortgage applications. They began an investigation and found many mortgage brokers were falsifying applications.

The fact this fraud occurred is not the issue, but rather management failed to disclose this to shareholders and regulators is. As investors caught wind of this, there was a classic "run on the bank" as those with GICs and high interest savings accounts rushed to get

their money out. As deposits dried up, the viability of the firm came into question. Many worried this was just the tip of the iceberg and there were other Canadian lending institutions, including banks, that could be in a similar scenario.

Fortunately, in the weeks since, calmer heads seem to have prevailed, and some stability has returned to the financial sector. Even with this turmoil, the S&P/TSX Financial sector gained a very modest 2.6%.

Below are some of the best and worst performing funds so far this year.

Dynamic Power Global Growth Class (DYN 014 – Front End Units, DYN 614 – Low Load Units) – Managed by Noah Blackstein, this is a very concentrated, "go anywhere", high octane global equity fund. It holds approximately 20 names, with nearly 60% invested in technology. A little more than a quarter is invested in consumer discretionary stocks, with the balance in consumer staples.

More than half is invested in China, with the rest split between North America, Europe, and Latin America. Most of the holdings are in larger companies, still, there is a healthy exposure to small and mid-cap stocks. Mr. Blackstein is active, with portfolio turnover levels well north of 200% per year.

When it wins, as it has in the first half of the year, it wins big. But, when it loses, it loses big. Volatility is off the charts, making this, at least in my opinion, unsuitable as a core holding for most investors. Still, for those comfortable with the higher risk and are looking for a fund that has the potential to juice returns over the long term, this is one you'll likely want to consider.

Sprott Energy Fund (SPR 006 – Front End Units, SPR 016 – Low Load Units) – With the energy sector under pressure in the first half of the year, it's not surprising to see an energy fund as our worst performer. Beyond the oil price weakness, there were other factors that hurt this fund. First, it is very concentrated, holding less than 15 names. In a concentrated portfolio, there is nowhere to hide. All

of the top holdings suffered big losses, including Fairmont Santrol Holdings, which is down 68% year to date, Hi-Crush Partners is down 49%, and U.S. Silica Holdings is down 39%. In fact, the best performing name is down 19% YTD. Another headwind for the fund was its 70% exposure to the U.S. With the Canadian dollar showing gains, unhedged currency exposure dragged returns. Despite the rough start to the year, this remains a decent energy fund. But with any concentrated portfolio, you run the risk of any gains and losses being amplified, which can hurt in down markets.

Top Performing Funds

Beutel Goodman Long Term Bond Fund (BTG 311 – Front End Units) – In the fixed income space, Beutel Goodman has consistently been one of the better offerings. Managed by the same team as the highly regarded **Beutel Goodman Income Fund**, the difference is this invests in corporate and government bonds with a term to maturity of between nine and 25 years. At the end of June, it had 63% in governments, and 30% in corporates. Long bonds handily outpaced their short-term peers because while short term yields were under pressure, long-term yields fell. The yield on the long-term Canada bond was 2.31% at the start of the year, and ended June at 2.13%. Factor in a lower than average MER, and you have a recipe for outperformance.

PowerShares Canadian Preferred Share Fund (AIM 56203 – Front End Units) – There have been a few factors driving preferred shares higher in the past few months. Higher interest rates mean that those preferreds that carry reset provisions will reset with a higher coupon rate, which drives investor interest. There has also been a higher level of institutional interest in the preferred share market, which has provided additional support. Finally, fund flows into preferred share mutual funds and ETFs have fueled demand for prefs. Speaking of ETFs, this fund is nearly identical to a **PowerShares Canadian Preferred Share Index ETF (TSX: PPS)** which looks to replicate the performance of the NASDAQ Select Canadian Preferred Share Index. It provides exposure to more than 100 Canadian preferred shares, and carries a management fee of 1.77% for the advisor sold units or 0.61% for the fee based units. While the lower cost of the passive fund is appealing,

I prefer an actively managed fund. There are some interesting active funds available including Natixis, BMO, and National Bank.

Manulife Dividend Income Fund (MMF 4529 – Front End Units, MMF 4729 – DSC Units) – With a gain of 7.3% in the first half of the year, this Canadian focused dividend offering handily outpaced both the index and peer group. It is managed by the team of Alan Wicks, Conrad Dabiet, and Jonathan Popper using a bottom up, fundamentally driven process that seeks out businesses of any size that have high returns on invested capital. It is much different than other dividend mandates, with an underweight in energy and financials. It can invest outside of Canada, and has about 18% in the U.S. at the end of June. They will also hedge part of their currency exposure, which helped in the past few weeks. This has been one of my favourite Canadian dividend funds for some time now, and the recent short-term outperformance is consistent with the longer-term numbers the team has put up. My analysis shows this is a fund that has the potential to produce above average returns with less risk.

TD U.S. Blue Chip Equity (TDB 310 – Front End Units, TDB 370 – Low Load Units) – Technology and consumer names have had a strong run in the past few months, and this growth focused fund has overweight exposure to both. The top ten are littered with household names such as Amazon, Facebook, Alphabet, and Microsoft. The manager looks for dominant players in their field, with above-average, sustainable growth prospects, and the ability to deliver and grow free cash flow. It invests in very large companies, most of which have market capitalizations in the upper quintile of the market. This has been one of my top picks for few years, and if I had to pick a concern it would be that valuation levels remain well above those of the index and peer group. Part of this is offset by the higher growth rates, but there will need to be an adjustment at some point to begin things back in line. Still, it remains a strong pick for those with an above average risk tolerance.

AGF Global Select Fund (AGF 795 – Front End Units, AGF 258 – Low Load Units) – Back in the olden days, this fund used to be known as the **AGF Aggressive Global Stock Fund**. Looking at the fund and how it is managed, that name could still apply,

given its volatility levels, which are well above the index and peer group. Much like the TD U.S. Blue Chip highlighted above, this is a growth focused offering with an emphasis on technology and consumer discretionary stocks. Combined, those two sectors make up more than half the portfolio. The top holdings are all recognizable names including Amazon, Sony, and LG. Performance over the past three years has been excellent, gaining 15% and finishing firmly in the top quartile. Valuation levels are extreme, but are somewhat offset by the higher than average growth rates of many of the names in the portfolio. Another concern I have is its MER, which is listed at 3.29%. Given the volatility, valuation, and cost, I'd likely look for an alternative way to access global growth stocks.

Worst Performing Funds

Russell Investments Short Term Income Class (FRC 1841 – Front End Units, FRC 1839 – Low Load Units) – There was upward pressure on short-term bond yields in the first half of the year, with the yield on the benchmark Government of Canada Five-year bond rising from 1.11% on December 31, to 1.38% on June 30. Most of this movement happened in the final two weeks of June, when it became apparent the Bank of Canada was likely to move rates higher in July. Because of this likely increase, short-term bonds faced headwinds, and this was the hardest hit fund, losing 0.73% in the first half. This is a corporate class version of the firm's pooled offering, which is a multi-manager fund that invests in a mix of short-term fixed income offerings. This version has been a laggard, and is consistently in the lower half of the category. While the tax advantaged income is attractive, it does not offset the inferior performance. There are several more attractive options available.

Fidelity Floating Rate High Income (FID 2187 – Front End Units, FID 2176 – Low Load Units) – This invests in floating rate investments issued by large and small corporations, predominantly in the U.S. In the first half of the year, it lost 2.1%, thanks to a sharp appreciation in the Canadian dollar. Backing out the currency effect, it was positive, with a 1.35% gain. Because the coupon rate paid by these notes is tied to the market rate of interest, this is an interesting asset class to be in with rates likely to rise in the next several quarters. A drawback to this

version of the fund is the unhedged currency exposure, which makes it too volatile for my tastes. Fortunately, Fidelity has a currency hedged version available that holds up nicely with its peers. There are also other solid offerings from IA Clarington, Invesco, AGF, and Manulife.

Trimark Canadian Opportunity Fund (AIM 29033 – Front End Units, AIM 29035 – Low Load Units) – Managed by a team headed by Alan Mannik, this is a concentrated portfolio of 25 to 35 Canadian companies. It struggled in the first half, losing 4.5%, making it one of the worst performing funds in the category. The biggest drags were its energy names, which saw significant selloffs. Unfortunately, this poor year-to-date showing is not a one off, as the longer-term numbers are also disappointing. I'm generally a fan of the Trimark style, process and philosophy, however this fund consistently falls short.

Scotia U.S. Opportunities Fund (BNS 391 – No Load Units) – U.S. equities have historically been the most difficult to outperform, and this fund has struggled to keep pace. Even with the respected Cecilia Mo taking the reins in 2014 it has lagged, with a three-year return of 6.3%, well below category average. Many of its top names have been underwater, with Kroger, Dollar Tree and Molson Coors being the biggest laggards. In the U.S. equity space, there are only a handful of options more attractive than a passive ETF. This is not on that list.

Portland Value Fund (PTL 270 – Front End Units, PTL 280 – Low Load Units) – Managed by Michael Lee-Chin of AIC fame, this fund invests in a concentrated portfolio of global companies in growing industries trading well below their true value. They also look for catalysts or potential activist opportunities that could drive share prices higher. Energy names hurt in the first half of the year. It's an interesting concept, but still unproven, as the fund is a little less than two years old. Since inception, it is well into negative territory. Given that, I'd likely prefer other concentrated fund, such as **Mackenzie Ivy Foreign Equity** over this newer entrant.

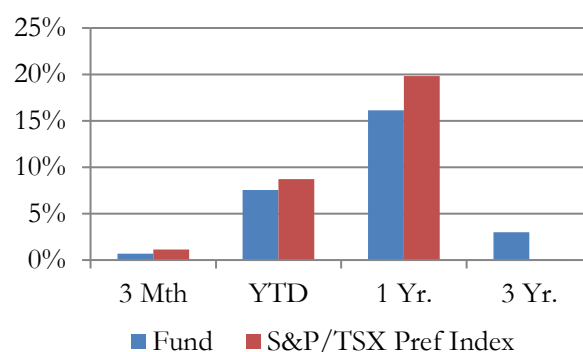
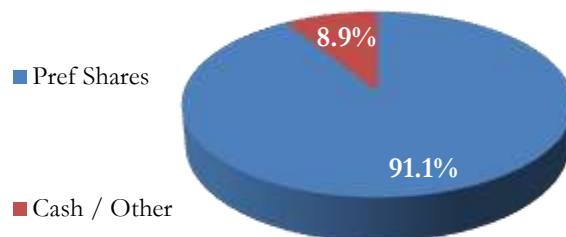
If there is a fund that you would like reviewed, please email it to me at

feedback@paterson-associates.ca

Natixis Canadian Preferred Share

Fund Company	NGAM Canada
Fund Type	Preferred Share Fixed Income
Rating	B
Style	Market Capitalization Weighted
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Jeff Harold since August 2013 Dax Letham since
MER	1.61%
Fund Code	NXG 5321 – Front End Units NXG 5326 – Low Load Units
Minimum Investment	\$5,000

Asset Mix



ANALYSIS: Since hitting a low February 2016, preferred shares have been on a tear, gaining 35%. This rebound has recovered most of the losses the asset class suffered in 2014 and 2015 after the Bank of Canada surprised the markets with a cut to their key overnight lending rate.

This J. Zechner managed offering invests in a diversified portfolio of preferred shares, but has the flexibility to hold cash or bonds depending on market conditions. The investment process is a mix of top down economic analysis combined with rigorous, bottom up credit analysis. The economic analysis provides an overview of the expected economic and interest rate framework, and also helps provide insight into different industries.

This helps set the stage for the bottom up fundamental credit analysis which involves understanding the financial health of the business, assessing its various risks, and management.

Given the potential illiquidity of the preferred market, knowing the valuation of each company is critical. This also helps the team assess the relative attractiveness of the preferred compared with a fixed income investment.

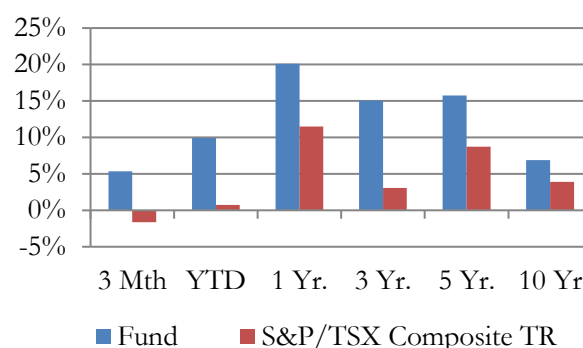
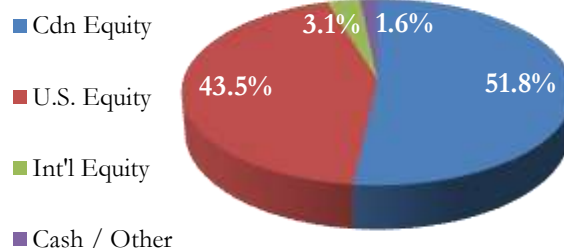
The portfolio is diversified, with the maximum position weight being capped at 5%. There is also diversification across sectors and preferred type (i.e. perpetuals, floaters, resets.) They are active in their approach and will position the portfolio to best benefit.

Absolute performance has been less than exciting, with an annualized gain of 3%, however, on a relative and risk adjusted basis, it leads the category. Given the inefficiency in the preferred market, I believe you want an active manager over the passive index exposure, and given the team, the process, small asset base, and 1.61% MER, this is a very attractive option for the long-term.

Mackenzie Canadian Growth Fund

Fund Company	Mackenzie Investments
Fund Type	Canadian Focused Equity
Rating	A
Style	Large Cap Growth
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Excellent
Manager	Dina DeGeer since August 1995 David Arpin since January 2013
MER	2.46%
Fund Code	MFC 650 – Front End Units MFC 7028 – Low Load Units
Minimum Investment	\$500

Asset Mix



ANALYSIS: At the halfway point in the year, this growth focused offering has posted strong numbers, gaining 9.9%, compared with a very modest 0.7% rise in the S&P/TSX Composite Index. This outperformance is not a fluke, based on the longer-term numbers posted by the team headed by Dina DeGeer. For the five years ending June 30, it gained a very respectable 15.8%, while the benchmark rose by an annualized 8.7%.

The team looks to build a concentrated portfolio of 30 to 35 business of any size that are growing faster than the economy and its competition. They look for well-managed niche players with unique competitive advantages, and a history of strong free cash flow generation.

Once a potential investment candidate is found, the team creates a valuation model based on free cash flow. This model is used to help determine the estimated fair value for the company, and before any security is added to the portfolio, it must be

trading at a minimum of 10% below their estimate of fair value. This is in place to help make sure they don't overpay for future growth.

The portfolio is well diversified, and looks nothing like its benchmark. It is underweight the big three Canadian sectors; financials, energy, and materials, and carries and overweight in technology, healthcare and consumer focused names. It can invest up to 49% outside of Canada, and at the end of April was taking advantage of that, with 47% in the U.S. Currency is opportunistically hedged.

Performance has been above average, but so too has volatility. Still, the excess return generated has more than offset the higher risk.

Looking ahead, the investment process is well defined and repeatable. I am doubtful the absolute levels or return are sustainable, but I would expect this fund to continue to be able to deliver strong relative risk adjusted returns over the long-term.

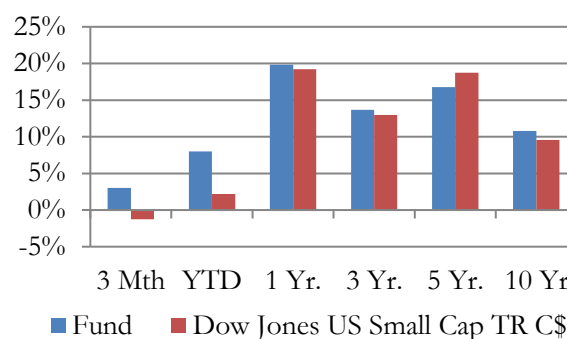
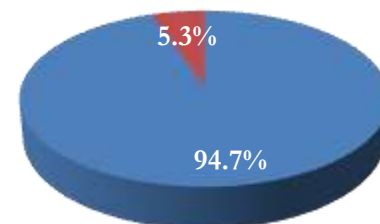
Mackenzie U.S. Mid Cap Growth Fund

Fund Company	Mackenzie Investments
Fund Type	U.S. Small Mid Cap Equity
Rating	B
Style	Mid-Cap Growth
Risk Level	Medium / High
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Phil Taller since November '02
MER	2.54%
Fund Code	MFC 1564 – Front End Units MFC 7103 – Low Load Units
Minimum Investment	\$500

Asset Mix

■ U.S. Equity

■ Cash / Other



ANALYSIS: Managed by a team headed by Phil Taller, this fund invests in a concentrated portfolio of well-managed, innovative companies they believe have above average growth potential.

The stock selection process is purely bottom up, however, there is a macro overlay that is used to help identify companies that they believe are well positioned to benefit from bigger, secular trends. Some of the trends in the portfolio now include companies that are benefiting from increasing productivity growth, making investments in information technology, involved in cloud software, medical technology and innovation, data, and serving the savvier U.S. consumer.

Once they have identified a potential investment opportunity, they will do a more detailed fundamental review that involves balance sheet analysis and putting the financials through their proprietary valuation model that helps them understand the true value of the company. This

focus on valuation helps to avoid paying too much for the potential growth.

Once they decide to move forward with a stock, the weight in the portfolio is based on their conviction and the valuation, with more attractively valued names holding a larger weight in the fund. The portfolio holds around 40 names, with the top ten making up around 40%.

It looks much different than its benchmark, with overweights in industrials, technology, and healthcare. Since the start of the year, they have been reducing the cyclical exposure of the fund, and now have no exposure to energy or materials.

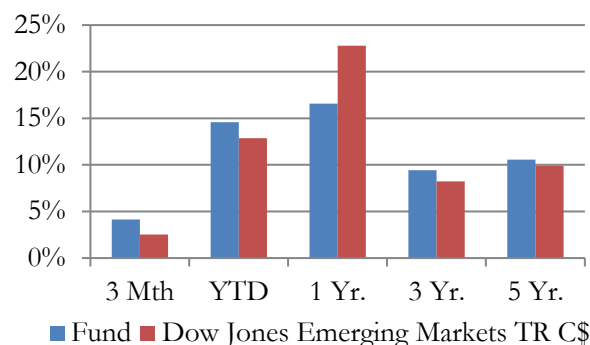
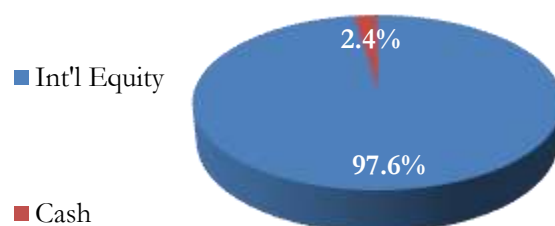
Performance has been strong, with a five-year gain of 16.8%, which has outpaced its peers, but lagged the Russell 2000. Volatility has been below average, resulting in strong risk adjusted returns.

For those looking for growth focused U.S. small and mid-cap exposure, this is a fund to consider.

RBC Emerging Markets Equity Fund

Fund Company	RBC Global Asset Management
Fund Type	Emerging Markets Equity
Rating	C
Style	Large Cap Growth
Risk Level	Medium to High
Load Status	Optional
RRSP/RRIF Suitability	Fair
Manager	Philippe Langham since Dec 2009
MER	2.45%
Fund Code	RBF 798 – Front End Units RBF 099 – Low Load Units
Minimum Investment	\$500

Asset Mix



ANALYSIS: With valuation levels in developed markets trading well above historical averages, emerging markets look downright cheap in comparison. The S&P 500 is trading at 21 times forward earnings, while the MSCI Emerging Markets Index trades at less than 15 times. Further, growth rates in many countries in the developing world far exceed those offered by the more developed countries. Factor in positive demographics, less dependence on commodities, and increasing investor interest and the case for adding emerging markets becomes compelling.

Given the complexity of the emerging markets, you will likely want an active manager at the helm over a cheap passive ETF, and in the past few years, this RBC offering has been one of the more attractive funds available. It has delivered above average returns with less volatility than the index or peers, resulting in better risk adjusted returns.

To do this, manager Phillip Langham and his team look for companies that have a history of

delivering high cash flow return on investment. The investment process combines a top down thematic analysis and bottom up security selection.

The first thing they determine are the themes that are expected to drive growth in the region. Recent trends have included the increased domestic consumption, automation, and infrastructure. Once they know the themes, this helps them narrow their focus to the industries and companies that can benefit. They then begin the detailed fundamental analysis that helps them understand the company, it's industry, and most importantly, it's cash flow return on investment.

The portfolio will typically hold between 50 and 60 names, and will be diversified across country, sector, and theme. Their approach is long-term and they typically take a five to ten-year outlook.

Performance has been strong, both on an absolute and risk adjusted basis, and is one of the more attractive emerging market funds available.