Top Funds Report

Déjà vu All Over Again!

A Bank of Canada rate hike and worries over more, push bonds lower, dollar higher, and equities mixed...

July was a continuation of June, with bonds down on worries over higher interest rates, and equity market were mixed with a stronger Canadian dollar acting as a further headwind

July saw Bank of Canada Governor Steven Poloz pull the trigger, pushing the Bank's key overnight lending rate higher by 0.25%. This move has sent yields up, with the yield on the Canada five-year bond move from 1.38% on June 30, to 1.65% on July 31. There was similar movement across the yield curve, with the Canada ten-year moving from 1.75% to 2.06%, and the long bond moved from 2.13% to 2.47%. This rise in yields pushed bond prices lower, with the long end of the curve taking most of the damage.

The FTSE/TMX Long-Term Bond Index fell by 4.3%, while short-term bonds were down 0.4%. Government bonds, with their higher interest rate sensitivity were hit harder than their higher yielding corporate brethren. The FTSE/TMX All Corporate Bond Index was off by 1.4%, while Government bonds lost 2.1%.

The S&P/TSX Composite Index was mostly flat, with a very modest 0.1% drop. Strength in energy and materials couldn't offset weakness in consumer names, industrials, and health care. In the U.S., corporate earnings have been stronger than expected, job growth remains strong, and inflation is well contained. This saw the S&P 500 gain 2.1% in U.S. dollar terms, but another sharp appreciation in the Canadian dollar resulted in a loss of 1.7% once the currency effect was taken into account.

The dollar moved from $0.7713 US to $0.8001 US in the month, on strength in energy and higher interest rates. This meant that again, any investment with an unhedged currency position experienced significant headwind from the dollar. This saw many global markets see gains in U.S. dollar terms, only to see them turn to losses in Canadian dollar terms. The MSCI EAFE Index gained 2.9% in U.S. dollar terms, but lost 0.8% in Canadian dollar terms. The MSCI World Index gained 2.4% in U.S. dollars, only to be down 1.3% in Canadian dollars.

As we head into potentially the most volatile part of the year, I continue to emphasize quality and defense in both equity and fixed income funds.

My current outlook is:

	Under-weight	Neutral	Over-weight
Cash		**X**	
Bonds	**X**		
Government		X	
Corporate		X	
High Yield		X	
Global Bonds		X	
Real Ret. Bonds	X		
Equities			**X**
Canada		X	
U.S.		X	
International		X	
Emerging Markets		X	

Please send your comments to feedback@paterson-associates.ca.

Funds of Note

This month, I highlight some of the funds on my Recommended List…

Dynamic Advantage Bond Fund (DYN 258– Front End Units, DYN 538 – Low Load Units) – The Fund again lagged its peers over the quarter, but managed to outperform in June as bond yields shot higher after an abrupt about face from Bank of Canada Governor Steven Poloz. For the quarter, the Fund eked out a modest 0.1% rise, while the FTSE/TMX Canadian Universe Bond Index rose by 1.1%. However, in June, while the index dropped by nearly 1.2%, this Fund lost 0.75%, or 64% of the downside. In July, it was a similar scenario, with the index losing 1.9%, while the Fund lost 0.76%, or only 40% of the downside.

This recent performance highlights why I have liked this Fund. Unfortunately, it appears I was much too early in my call, as the conservative positioning has certainly cost it return in the falling yield environment. As we head into the fall, it appears as if the Canadian bond market is expecting another two or three rate hikes from the Bank of Canada, and these are already priced in to bond prices. In this environment, higher volatility is likely, and these are the market conditions where this Fund should really shine. I will be watching it very closely to make sure it performs as expected. If I see a significant deviation from expectations, it will be removed from the Recommended List.

CI Signature High Income Fund (CIG 686– Front End Units, CIG 1786 – Low Load Units) – This tactical balanced offering which is managed by Eric Bushell and the Signature Global Asset Management team has long been one of my favourite balanced funds. However, in recent quarters, I have noticed some modest erosion in the risk adjusted returns, which I believe can be explained by the focus on quality and yield, which have been out of favour of late.

The Fund invests in a mix of income focused equities and fixed income, with a decided focus on corporate bonds. It has a tactical mandate, and can invest anywhere in the world. At the end of June, it has 60% invested in the U.S., 23% invested in Canada, with the rest globally. The investment approach is somewhat style agnostic, and involves an analysis of an investment candidate's entire capital structure. This provides a very holistic view of the company, and allows the managers to be opportunistic, and invest in the most attractive part of the company. In addition to the fundamental review, the team focuses on many qualitative aspects of the company, such as management, disclosure, and governance. The team also develops a comprehensive outlook for economic growth, interest rates, capital market conditions, and geopolitical tensions, which helps identify the asset classes and sectors that are most likely to benefit.

In the equity sleeve, the focus is on higher yielding instruments including REITs, and infrastructure, as well as more traditional dividend paying stocks. According to Morningstar, the underlying yield of the Fund's equity holdings was approximately 4.75%, which is well above the index and peer group. While the stock selection process is bottom up focused, the sector mix is consistent with a yield focused portfolio, with overweights in Real Estate, utilities, and energy infrastructure plays. They like the infrastructure as an asset class, because they quite often will have revenue streams that move up with inflation.

On the fixed income side, the focus is on corporate bonds. They can invest in government bonds, but will typically only do so when they are being very defensive. Given the outlook for rising interest rates, they expect credit spreads to tighten, particularly in high yield bonds, which is why they have taken a significant weight in the non-investment grade space. They also hold some floating rate preferred shares, and some floating rate loans. This will help lessen the duration exposure of the portfolio, protecting against any further yield hikes.

As we head into the fall, the managers expect continued global growth, but given Central Banks newfound enthusiasm for tightening, combined with high valuations, and low market volatility, there is a very high probability we may see a return of market volatility. If that higher volatility scenario plays out, I would expect to see the fixed income sleeve hit harder, given its larger exposure to high yield bonds. However, the quality and yield focus of the equity sleeve should hold up better than many of the highly levered, richly valued names that have been responsible for much of the recent market moves. Over the long term, I expect the Fund to continue to deliver average or better returns with lower levels of volatility.

Guardian Global Dividend Growth Fund (GCG 570– Front End Units) – The Fund has struggled in the past few quarters, significantly underperforming the MSCI World Index. For the year ending June 30, the Fund gained 7.3%, while the index gained nearly 18.5%. Much of this underperformance happened in the second half of 2016, although it continues to lag in the first half of 2017.

Recently, I had the opportunity to speak with Fiona Wilson, one of the portfolio managers on the Fund's investment team. According to Ms. Wilson, a key reason for this underperformance has been that the sectors driving most of the gains, namely technology, contain a significant number of stocks the Fund cannot invest in, because they pay no dividend, or offer a yield that is well below the minimum threshold for inclusion in this dividend focused fund. The fund was unable to invest in nearly 40% of the top gaining tech names because of this yield constraint. One prominent driver they cannot invest in would be Amazon, which gained 35% in the past year, but paid no dividend. Facebook is another strong driver of index returns, with a one-year gain of more than 32%, but again, pays no dividend, preventing the Fund from holding it.

Another factor is that it has been lesser quality, higher beta, lower yielding names that have been responsible for the lion's share of the market gains, and dividends, and specifically dividend growth strategies have been out of favour for the past several quarters. A feature of this strategy is it tends to be rather defensive, and holds up better in more volatile markets. Markets have been very calm of late, with measure of market volatility touching on historic lows.

Combined, there is an almost perfect storm which is causing the underperformance for this Fund. Looking at the underlying portfolio metrics of the Fund, it trades at more attractive valuation levels, with higher levels of expected earnings growth than the index or peer group.

It is expected that as we start to see a more normalized interest rate environment, and the equity markets return to having fundamentals, rather than liquidity drive share prices, the Fund will be expected to see improving performance. Further, if we see an uptick in volatility in the fall, this Fund would be expected to hold up better than the index and peer group. This bodes well for future expected returns, unfortunately the timing remains uncertain.

I understand the investment process and see the underlying portfolio metrics as a positive. While the Fund has underperformed, I will continue to exercise patience for the next quarter or two and keep the Fund **UNDER REVIEW**. I will monitor it closely, looking for any meaningful change in its expected risk reward metrics, or its valuation or growth outlook.

Fidelity NorthStar Fund (FID 253– Front End Units, FID 053 – Low Load Units) – In the past few quarters, the cash position in the Fidelity NorthStar Fund has risen substantially. At the end of June, it held nearly 40% in cash, with the overwhelming majority of this coming from the portion of the portfolio that is managed by Dan Dupont. Mr. Dupont is a disciplined value manager who focuses on mitigating downside risk. In the current environment, he is having difficulty finding high quality, well managed companies, that are trading at a price that he is comfortable paying.

In a recent commentary piece, Mr. Dupont noted that he is finding that debt levels of many companies are high compared with their level of profitability. At these debt levels, higher interest rates will create higher costs for companies, which will negatively affect their profitability and cash flow levels. Another worry was profit levels remain elevated by historic levels, and they tend to mean revert in time. But perhaps his biggest concern was valuation, which is significantly higher than historic averages. While there are individual securities that are reasonably priced, they are more difficult to find.

To help manage this high cash balance, Mr. Dupont has been investing in select merger arbitrage opportunities. How this works is when two companies announce a merger, the target company will often be trading at a discount to the deal price. By purchasing the stock of the target company at a discount on those deals with a very high probability of closing, he is able to lock in a modest profit for the fund in a reasonably short period of time. This is not expected to be a significant alpha driver for the Fund, but more of a way to earn a rate of return that is in excess of the current rate paid on cash.

Also note, the cash levels are very high in the **Fidelity Canadian Large Cap Fund**, also managed by Mr. Dupont. At the end of June, it held around 20% in cash, which is the maximum it is allowed based on its investment policy statement. I'm certain that if he could go above this limit, he would.

While I agree with Mr. Dupont that valuations are elevated, the significant high cash balance is starting to become a concern in the NorthStar Fund. I will watch things closely. In the event that we do see any meaningful market correction, both NorthStar and Fidelity Canadian Large Cap Fund would be expected to hold up better than the index and peer group.

RBC O'Shaughnessy U.S. Value Fund (RBF 776 – Front End Units, RBF 134 – Low Load Units) – With a year-to-date gain of more than 10% to the end of July, this has been one of the stronger U.S. equity funds available. While some of that is certainly the result of the manager's rules based, fundamental, value focused approach being in favour during a few months, most of it has to do with the fully hedged currency position.

To the end of July, the Canadian dollar has risen from $0.7438 on December 31 to close out July at $0.8001, a gain of nearly 7.6%. Unless we see continued rate hikes by the Bank of Canada, or a sharp jump in the price of oil, I would expect most of the currency gains have already happened.

Even still, I think this is a solid fund for those looking for rules based U.S. equity exposure. The process rates and ranks U.S. stocks on sales, cash flows, valuation, and shareholder yield.

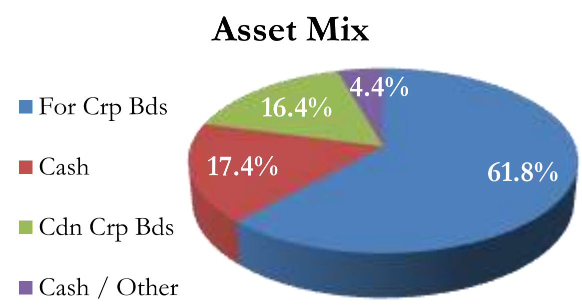
Long-term results are solid, but performance can be out of step with the index and peer group.

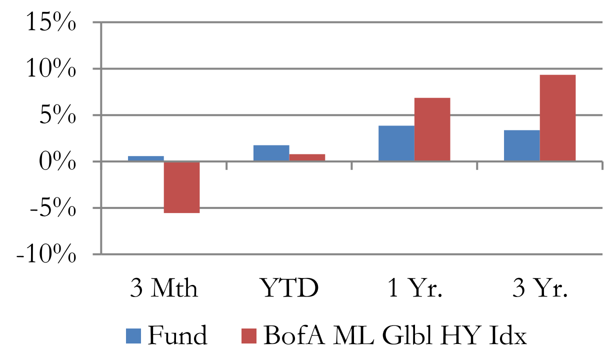
If there is a fund that you would like reviewed, please email it to me at

feedback@paterson-associates.ca

IA Clarington Floating Rate Income Fund

Fund Company	IA Clarington Investments
Fund Type	Floating Rate Loans
Rating	A
Style	Bottom up Credit
Risk Level	Low - Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Jeff Sujitno since November '13
MER	1.84%
Fund Code	CCM 9940 – Front End Units CCM 9942 – Low Load Units
Minimum Investment	$500





ANALYSIS: With the recent upward pressure on yields, floating rate notes and loans are an effective way to help protect portfolios. These instruments pay a rate of interest that floats with a market interest rate, usually LIBOR. My favourite fund in the floating rate space is this offering managed by Jeff Sujitno since its launch in 2013. His approach is very simple and is best described as "clipping coupons". He looks for loans offering an attractive coupon rate, and are trading at a discount to par.

The investment process starts with a top down macro analysis, which helps him and his team understand the market trends, and risks, and helps set up their outlook. Security selection is done using a fundamentally driven, bottom up credit analysis that focuses on cash flow generation, sustainability of revenues, balance sheet strength, and quality of management.

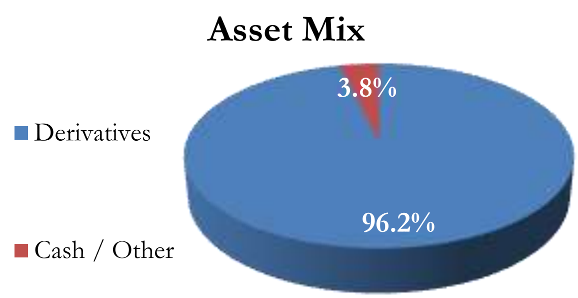
The Fund is typically 70% to 80% invested in floating rate debt, with the balance in high yield bonds and other asset backed securities. It is well-diversified, holding between 100 and 125 securities. It invests mainly in U.S. traded issues, and all currency exposure is hedged.

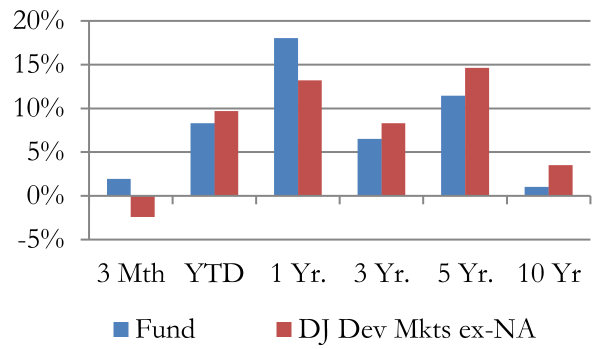
Performance has been modest, gaining 3.3% for the three years ending June 30, putting it right around the category average. However, with the quality focused, income centric approach, volatility has been the lowest in the category for the past three years, resulting in a leading risk adjusted return. It's not cheap, with an MER of 1.84% for the advisor series. However, in a fee based account costs are a bit more reasonable, coming in at 1.16%

I like the space and particularly this Fund. But be warned, this is NOT a money market substitute, nor is it a replacement for traditional fixed income. Instead, it is best used as a piece of a well-diversified portfolio as a compliment to the more traditional asset classes to diversify risk in a portfolio.

National Bank International Index (CN)

Fund Company	National Bank Investments
Fund Type	International Equity
Rating	B
Style	Large Cap Blend
Risk Level	Medium
Load Status	No Load
RRSP/RRIF Suitability	Excellent
Manager	Hugo Sarkisisan since June '09
MER	0.67%
Fund Code	NBC 877 – No Load Units
Minimum Investment	$500





ANALYSIS: Equity valuations, particularly in the U.S. remain well above historic norms. The S&P 500 is now trading at more than 20 times forward earnings. The S&P/TSX Composite is trading at nearly 17 times. One area where valuations appear to be considerably more reasonable is in Europe and Asia. The MSCI EAFE Index now trades at just under 13 times earnings, well below Canada or the U.S.

Turning to the fundamentals of the region, Europe and Asia are well positioned for decent economic growth, which is expected to see strong profit growth. According to estimates, the pace of earnings growth in the EAFE region are expected to modestly outpace both Canada and the U.S. in the near-term. Combined, this makes EAFE a potentially attractive place to invest.

There are a few great actively managed mutual funds that invest in international stocks, including **Trimark International Companies**, **Mawer International Equity**, and **CI Black Creek International Equity**. However, for those looking for a lower cost, passive mutual fund solution, this National Bank offering is a sound choice. It is designed to track the return of the MSCI EAFE Index, net of fees. Costs are reasonable, with an MER of 0.67%. The investment exposure is through futures contracts, rather than the individual stocks.

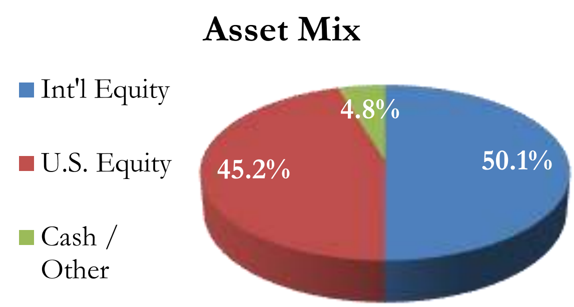
An interesting feature of this fund is the currency exposure is fully hedged, which is why it has soundly outperformed over the past quarter. Many of the other Funds in the category do not hedge, which has resulted in headwinds as the Canadian dollar has risen against the U.S. dollar.

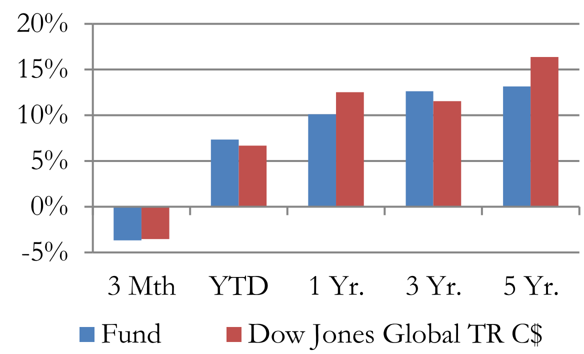
If you believe the Canadian dollar has further to rise, then you'll want to have fully hedged exposure like this fund offers. If you believe the dollar will fall, then an unhedged version is likely a better choice.

Given the valuation levels and reasonable cost, this can be a good solution for those looking for passive exposure to European and Asian stocks.

Mackenzie Global Dividend Fund

Fund Company	Mackenzie Investments
Fund Type	Global Equity
Rating	D
Style	Large Cap Growth
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Darren McKiernan since Dec 13 Eugene Profis since Nov 2014
MER	2.51%
Fund Code	MFC 2710 – Front End Units MFC 7143 – Low Load Units
Minimum Investment	$500





ANALYSIS: Darren McKiernan took over the reins of this Fund in December 2013 and has done an excellent job, posting above average result. For the past three-years (to July 31), the Fund is up 12.6%, outpacing the index and peer group, and has posted above average numbers in each calendar year.

To do this, he uses a fundamentally driven, bottom up stock selection process that looks to find high quality, dividend paying companies that generate stable levels of free cash flow, have a return on capital that is above the cost of capital, and where possible, a thematic tail wind to help drive gains.

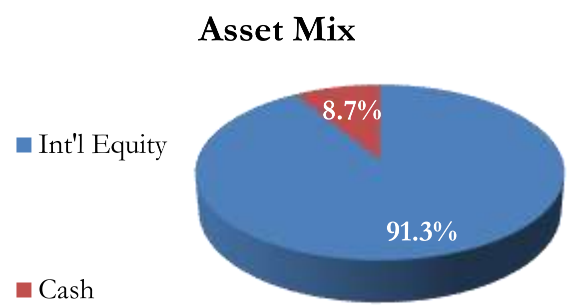
Each stock is reviewed using a similar set of metrics, but the Manager will adjust each slightly to reflect the specifics of the various sectors. In addition, a discounted cash flow model is run to help determine the intrinsic value for the stock. With this information, the manager will look to buy quality companies at prices well below what their analysis shows it is worth.

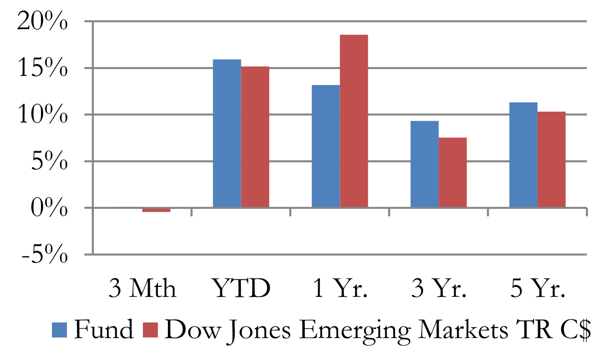
The portfolio is built on a stock by stock basis, and the sector mix will be the result of this stock selection process. The position size will be dependent on the profit potential, diversification benefits, and overall manager conviction. Typically, a small initial position is taken, and the Manager will then build on that. The maximum weight of any one stock is set at 6%. At the end of June, the Fund held 74 names, and was overweight financials, industrials, consumer staples, and healthcare. It was underweight real estate, consumer discretionary, energy, and utilities.

One concern I have is its valuation levels. When compared to its global dividend peers, the valuation ratios are very high, particularly when the forward-looking growth rates are taken into consideration. This indicates the manager may have to make some changes to the portfolio, or face a period of below trend returns. Still, I see this as a solid global equity offering for the long-term.

Trimark Emerging Markets Fund

Fund Company	Invesco Canada
Fund Type	Emerging Markets Equity
Rating	B
Style	Large Cap Growth
Risk Level	Medium to High
Load Status	Optional
RRSP/RRIF Suitability	Fair
Manager	Jeff Feng since April 2013 Matt Peden since April 2013
MER	2.79%
Fund Code	AIM 2141 – Front End Units AIM 2145 – Low Load Units
Minimum Investment	$500





ANALYSIS: With valuation levels in developed markets trading well above historical averages, emerging markets look downright cheap in comparison. Factor in positive demographics, less dependence on commodities, and increasing investor interest and the case for adding emerging markets exposure becomes very strong.

This is one of the most attractive funds in the space. It is managed much like other Trimark funds where they view investing not like they are merely trading stocks, but rather taking an ownership interest in those companies.

The focus is on identifying well-managed, high quality companies. The process is fundamentally driven, bottom up. They look for companies they believe can generate and grow above average levels of free cash flow, are growing organically, can generate a high return on invested capital through a full market cycle, and have a sustainable competitive advantage.

Valuation is important, but this is not a value fund in the traditional sense. They are willing to pay a higher price for an exceptional business.

There is a consumer focus to the portfolio, with more than 50% invested in consumer-focused names. They like these areas because as the emerging markets evolve, there will be a growing middle class that will increase their spending.

Performance has been excellent, and it has outpaced both its benchmark and peers on both an absolute and risk adjusted basis. Volatility has been in line with the index and category average, but given the quality focus of the portfolio, this has the potential to be lower in time.

My biggest concern is its cost, with an MER of 2.79% for the advisor units. This is above the category average. If you are buying the fee based or the do-it-yourself units, the cost is lower, coming in a 1.68%, and 1.67% respectively.