

Top Funds Report

Muted returns mask volatility in August

Geopolitical worries offset good news of synchronized global growth...

Historically, August has been a sleeper of a month for investors, as many take time away to enjoy the last few weeks of summer. If one only looked at the investment returns, you may believe this August was no different, as many global markets finished the month roughly where they started. However, digging deeper the month was anything but dull.

Starting with the good news, it became clear that the global economy was enjoying synchronized global growth for the first time since the onset of the global financial crisis. Unfortunately, geopolitical concerns took center stage, as the U.S. and North Korea started a war of words that had some worried Armageddon was imminent. Fortunately, calmer heads prevailed, and markets were largely flat to mixed.

The S&P/TSX Composite Index gained 0.7%, the S&P 500 was up 0.3% in U.S. dollar terms, but managed to bounce higher on a slightly stronger U.S. dollar, ending up 0.7% in Canadian dollar terms. The MSCI EAFE Index was largely flat, but enjoyed a modest gain for Canadian investors thanks to a change in the currency. Canadian bonds posted gains, as bond yields fell on flight to safety worries and a muted inflation outlook.

Looking ahead, we are entering a potentially volatile period. Historically, September and October have been the two most volatile months for investors. With equity valuations near the high end of historic ranges, and the potential for another bout of geopolitical uncertainty looming large, it is not unlikely we may experience periods of high volatility in the next couple of

months. While increased volatility is a possibility, it is far from a certainty, and to make radical shifts to the portfolios may end up doing more harm over the long-term than remaining defensively positioned as we are.

In the fixed income markets, there is the potential for higher volatility with speculation around rates expected to be on the upswing. If we do see any meaningful equity market volatility, I would expect the bond market, particularly government bonds to benefit from the flight to safety trade. For equities, I continue to favour quality, reasonably valued portfolios over the higher beta names that have been moving markets higher.

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 ETF Focus List...

PowerShares Senior Loan CAD Hedged ETF (TSX: BKL.F) – After the Bank of Canada caught most of the market by surprise with their abrupt about face on interest rates during the period, there was upward pressure on Canadian rates, particularly at the short end of the yield curve. During the period, global and high yield bonds were the best performers. On our ETF Focus List, it was this, which provides exposure to 100 large, liquid, senior floating rate loans.

These loans pay a rate of interest that floats with a market interest rate, usually LIBOR. In most cases, this coupon rate is reset monthly, essentially eliminating duration risk. The days to reset is 20 days, meaning that on average, the coupon paid will change every 20 days.

These loans are typically non-investment grade or unrated credits that are often well-collateralized with seniority in the capital structure, providing protection against potential defaults. At the end of August 21% was in BBB- rated, 75% in non-investment grade, and only 4% in unrated issues.

While the bias for yields in Canada is likely to be higher in the near term, south of the border the outlook is more muted. In a flat rate environment, I wouldn't expect to see significant capital gains, but rather a rate of return that is more in line with the coupon rate. As of August 25, the coupon yield of BKL.F was listed at 4.18%, with an MER of 0.81%.

Another benefit of floating rate investments is they tend to have low correlation to the traditional asset classes, making them strong diversifiers when part of a well-diversified portfolio.

Currency exposure is fully hedged, which has proven helpful in recent months when we have seen the Canadian dollar rise sharply against the greenback. Currency has been a very significant headwind for any investments that have unhedged currency positions.

In the ETF space, this is the most attractive option. Given the complexity of the asset class, I would most likely lean towards an actively managed offering, with the **IA Clarington Floating Rate Income Fund** managed by Jeff Sujitno being my top pick.

Vanguard Canadian Short Term Bond ETF (TSX: VSB) – Historically, short-term bonds have been thought of as a safe place to park funds and reduce interest rate sensitivity. However, the past few months have shown that while the risks may be lower than a more traditional bond investment, there is still a potential for loss.

Short-term yields started feeling pressure in June, after the Bank of Canada made comments, hinting that a rate hike was an almost sure thing at the July meeting. Yields jumped higher, and continued to rise until the July meeting, and closed on July 31 sharply higher. The yield on the Canada two-year bond was 0.70% on May 1, and closed on July 31 at 1.30%, a jump of more than 85%. Not surprisingly, this hurt the short end of the yield curve, with the FTSE/TMX Short-Term Bond Index falling by 1.2%, with most of the damage occurring in June. The markets had bounced back nicely in August, and had largely settled, however saw another drop after the Bank of Canada rate hike in September.

Despite this recent selloff, short-term bonds can still play a key role in a more conservative portfolio, and this Vanguard offering is currently my top short-term bond ETF. It is designed to track the Bloomberg Barclays global Aggregate Canadian Government/Credit 1–5 Year Float Adjusted Bond Index. Costs are very reasonable, with an MER of 0.11%. It should be noted that BlackRock recently cut the management fee on the **iShares Core Canadian Short-Term Bond ETF (TSX: XSB)** from 0.25% to 0.09%, which is expected to increase returns.

The portfolio holds 70% in government issues, 28% in corporates, and the rest in other. It offers a modest yield-to-maturity of 1.8%, which is just below the 1.9% of XSB. Duration is listed at 2.8 years, which is the same as XSB. Credit quality is extremely high, with less than 1% being unrated.

Given the recent fee cut by BlackRock, combined with the higher yield-to-maturity, I will be taking another look at XSB in the coming quarters to better understand the potential improvement to the risk reward metrics.

PowerShares S&P/TSX Composite Low Volatility ETF (TSX: TLV) – One of the key selling points of low volatility funds is they are designed to outperform in flat and falling equity market environments, and certainly held true in the most recent period. For the three months ending July 31, the broader S&P/TSX Composite was down by 2.1%, while this low vol offering was lower by 1.5%, despite an MER of 0.34%.

This ETF invests in the 50 least volatile stocks in the S&P/TSX Composite Index with the stocks with lower volatility stocks making up a higher weighting. It is rebalanced on a quarterly basis. The portfolio looks different from the broader

index, with a significant overweight in real estate, telecom and utilities, with underweights in energy, and materials. A worry about this portfolio would be concentration, as financials and real estate make up a combined 54%. Another difference in the portfolio is it skews a bit more mid-cap than the index, with 51% in mid-caps, compared with 22% for the TSX.

A knock on low volatility funds a few quarters ago was the valuation levels were high when compared to the broader equity markets. That has been largely corrected, and TLV is now trading at levels that are more attractive than the index. At the end of August, Morningstar listed the price to earnings ratio at 15.2 times, compared with 16.6 for the S&P/TSX Composite. Other valuation ratios, including price to book, and price to cash flow were also more attractive. The growth picture is a more muted than the broader index, but given the more attractive valuation levels, I believe this is more than offset.

Considering the above, this remains my top pick for those looking for low volatility Canadian equity exposure.

iShares Core S&P 500 Index (CAD Hedged) ETF (TSX: XSP) – The S&P 500 continues to be one of the most difficult markets to outperform, and this period was no different. Of the U.S. focused ETFs on our List, this was the best performer, gaining 3.75%, outpacing the **iShares U.S. Fundamental Index (C\$ Hedged) ETF (NEO: CLU)**, which earned 2.74%.

Much of this outperformance can be attributed to XSP's greater exposure to some of the key market drivers, namely Apple, Amazon, Facebook, Netflix, and Microsoft. Combined, these five names contributed nearly half of the

outperformance of XSP over CLU. While recent performance of these stocks has been very strong, valuation levels have become stretched making a repeat very unlikely. Even factoring in the above average growth rates, the valuation levels do not appear sustainable. This is likely to result in a pullback or a period of below average gains, while fundamentals catch up to valuations.

Even still, this remains my top pick for U.S. equity exposure. While its valuations look modestly better, the growth outlook for CLU is muted compared with either XSP or the **Vanguard U.S. Total Market ETF (CAD Hedged) (TSX: VUS)**. I slightly prefer XSP over VUS because VUS has a greater exposure to small and mid-cap names, which may be prone to higher levels of volatility.

In the past, I have mentioned XUS, which has the same investment exposure as XSP, without the currency hedge in place. While this may have been a decent option in the past, I would be hesitant to invest now, with it likely the interest rate paths in Canada and the U.S. will continue to diverge, creating further strength in the Canadian dollar. As the dollar continues to gain, XUS will become a more attractive option to capture any weakening in the Canadian dollar, while still maintaining excellent U.S. equity exposure.

BMO MSCI EAFE Index (CAD Hedged) ETF (TSX: ZDM) – It's hedged currency positioning was a key reason this ETF was the top performing International / Global ETF on our Focus List. While this ETF gained 2.4%, ZEA, which provides the identical investment exposure, but with the currency unhedged, was down by 2.6%.

In the near term, with the Bank of Canada more likely to raise rates than the U.S. Federal Reserve,

I expect there is a strong potential for further appreciation in the Canadian dollar, making hedged currency preferable. Given that, this is my top international / global ETF.

iShares S&P/TSX Capped Financials ETF (TSX: XFN) – With the aftermath of the Home Capital scandal looking as though it is in the rearview mirror, at least for now, financial stocks rebounded, with XFN gaining 0.55% for the three months ending July 31. While this is respectable, the sector still hasn't recovered from the selloff experience in March, April, and May.

Now that the dust has settled, we now see this was an isolated incident and not endemic of a larger problem we can again focus on the factors that drive profitability. There is some concern about the broader housing market, and recent government actions have helped to cool, at least temporarily, some of the markets that were overheating. In time, this can be a good thing, and help the sector realize a soft landing. Further, with Canadian interest rates starting to move higher, margins at the banks are expected to improve. Comparing the sector to the broader Canadian market, valuation, profitability, fundamental, and growth metrics all look stronger for financials. Further, the dividend yield is superior, with a current yield of 3.65%, compared to the S&P/TSX Composite, which yields 2.96%. All this points to an attractive medium to long-term outlook for the financial sector.

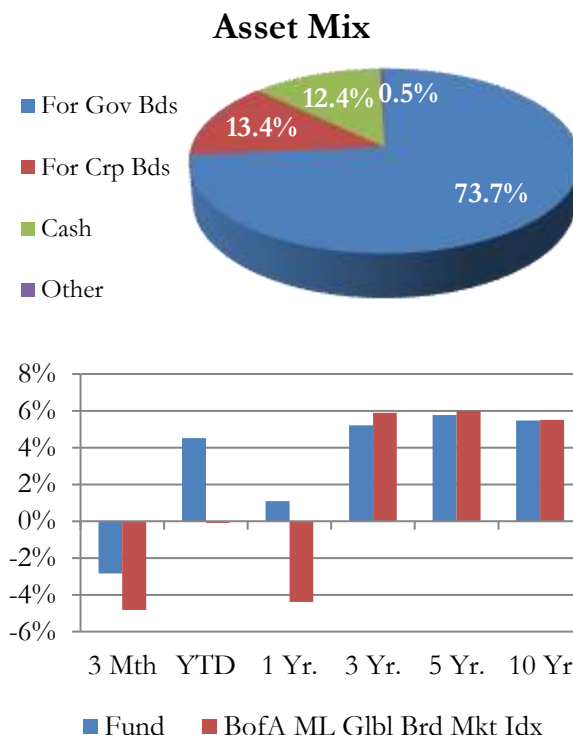
I would not use this as a core equity holding, but instead would suggest it be used as a part of an otherwise well-diversified portfolio.

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

feedback@paterson-associates.ca

Renaissance Global Bond Fund

Fund Company	CIBC Asset Management
Fund Type	Global Fixed Income
Rating	B
Style	Top Down Value
Risk Level	Low - Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	David Hoffman since Nov 2006 Stephen Smith since Nov 2006
MER	2.06%
Fund Code	ATL 1028 – Front End Units ATL 2872 – Low Load Units
Minimum Investment	\$500



ANALYSIS: With Canadian interest rates likely moving higher in the next few months, many investors are looking elsewhere for fixed income exposure. This actively managed global bond fund is one of the more compelling funds around.

It is managed using a value based approach that looks to find securities that offer the highest real yield that are trading at discounted valuations. The process starts with a top down macro analysis that scans the globe looking for attractive real yields, and currencies that can benefit from the economic environment. They look for attractive points on the yield curve that will allow for profit opportunities.

They are very active in their approach, and positioning across securities, countries and currencies will change often. Unlike some of their global bond peers, they focus more on government bonds, only occasionally invest in credit. They will also manage currency exposure as a profit center.

At the end of August, it was defensively positioned, with a yield to maturity of 3.5% and a duration of approximately 5.2 years. This is higher than what is offered by the Canadian bond market.

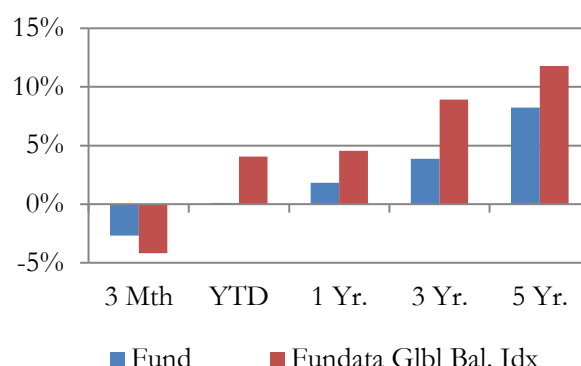
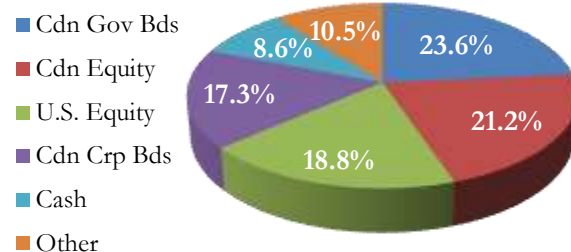
Performance, particularly over the long-term has been strong. For the five years ending August 31, the Fund gained an annualized 5.8%, outpacing the index and peers. Year-to-date, it's up 4.5%, well above the category average. It is not without its drawbacks. It has historically been more volatile than many of its global bond peers and Canadian focused bonds. It is running at a level of volatility that is nearly twice that of the FTSE TMX Bond Universe. It is also somewhat pricey, with an MER of 2.06% for the full freight advisor focused units.

Even with the higher cost and volatility this can be a solid way to gain global bond exposure. It has an excellent management team behind, using a disciplined and proven investment process

CI Cambridge Asset Allocation

Fund Company	CI Investments
Fund Type	Tactical Balanced
Rating	B
Style	Tactical
Risk Level	Low to Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Brandon Snow since June 2011 Bob Swanson since June 2011
MER	2.44%
Fund Code	CIG 2322 – Front End Units CIG 1522 – Low Load Units
Minimum Investment	\$500

Asset Mix



ANALYSIS: Looking back over the past five years, one of the stronger tactical balanced offerings has been the Cambridge Asset Allocation Fund. Brandon Snow manages the equity sleeve of the portfolio, while Bob Swanson oversees the macro positioning.

The neutral asset mix is 60% equity, 40% bonds. At the end of August, it held 10% in cash, with the rest evenly split between equities and bonds.

Equities are managed using Cambridge's disciplined investment process that looks for companies that offer strong long-term growth potential and are trading at attractive valuation levels. The equity sleeve is structured into two segments, a core, which invests longer-term, quality focused investments they are likely to hold for several months to several years, and a more opportunistic segment, that invests in shorter term, more tactical plays. These could be more macro driven, or company specific.

Fixed income exposure is predominantly obtained through holding units in other Cambridge managed bond funds.

Positioning is defensive, with underweight equity and a modest overweight to bonds. The bond mix is more conservative than the market.

Longer-term performance, particularly on a risk adjusted basis has been excellent. For the five years ending August 31, it returned an annualized 8.2% finishing in the top quartile. Volatility has been lower than both the index and peer group, and it has held up better than average in down markets.

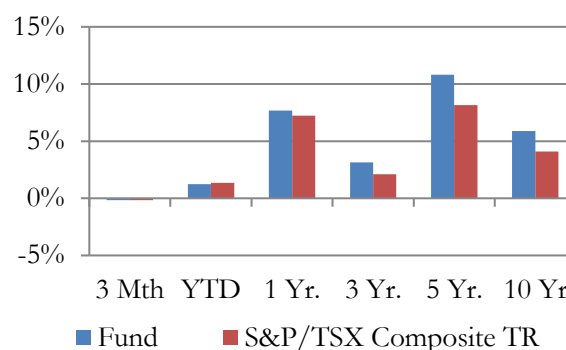
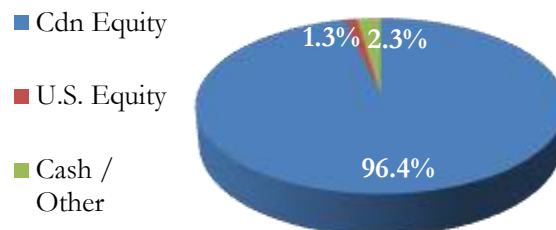
With equity valuation levels remaining at the higher end of historic ranges, and yields poised to rise, it is expected the portfolio will remain defensively positioned.

Given the team and process in place, this remains an excellent balanced offering.

Beutel Goodman Canadian Equity

Fund Company	Beutel Goodman & Company
Fund Type	Canadian Equity
Rating	A
Style	Large Cap Blend
Risk Level	Medium
Load Status	No Load / Front End
RRSP/RRIF Suitability	Excellent
Manager	Mark Thomson since June 1999 Stephen Arpin since July 1994
MER	1.39% (No Load Units)
Fund Code	BTG 770 – No Load Units BTG 300 – Front End Units
Minimum Investment	\$5,000

Asset Mix



ANALYSIS: I have followed Beutel Goodman closely for a few years, and have been a fan. Earlier this year, I had the opportunity to sit down with members of their portfolio management team to learn more about their process. Those meetings only reinforced my view on the firm and its funds.

One fund we spoke at length about was this concentrated, Canadian equity fund. It is managed using a bottom up, fundamentally driven, value tilted investment approach. While they favour large cap companies that are leaders in their industry, they will consider small and mid-cap names that show the potential to become industry leaders. This exposure is obtained by buying units of the highly regarded **Beutel Goodman Small Cap Fund**.

In addition to trading at least 30% below their estimate of its worth, any company must have recurring, dependable earnings, free cash flow, and competitive advantages in their industry. They must also have the ability to close the valuation gap within three years.

The result is a concentrated portfolio holding just over 30 names, with the top ten making up more than half of the fund. It is overweight financial and consumer names, and underweight energy and materials. Portfolio turnover has been quite low, averaging well below 20% for the past five years.

They have an interesting sell discipline. Once a holding hits its price target, they automatically sell one third of the holding, and undertake an updated detailed review. If the review shows an increased price target is justified, they will hold the remaining shares. If it is not, they will immediately exit the position.

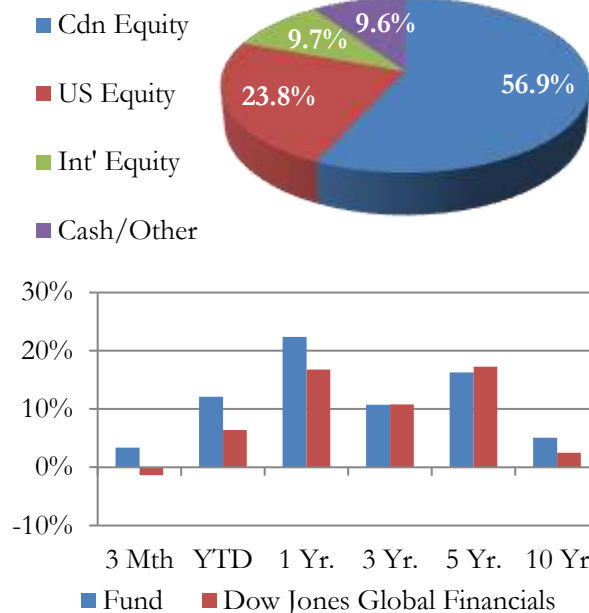
Performance, particularly over the long term has been excellent, outpacing the index over a three, five and ten-year period. Volatility has been roughly in line with the broader market, and it has tended to modestly outperform in falling markets.

On balance, this is an excellent core equity holding for most investors. Over the long term, I would expect it to continue to do what it has done in the past – above average returns with less volatility.

Dynamic Financial Services Fund

Fund Company	Dynamic Funds
Fund Type	Financial Services Equity
Rating	A
Style	Large Cap Blend
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Fair
Manager	Yassen Dimitrov since July 2010
MER	2.52%
Fund Code	DYN 201 – Front End Units DYN 7112 – Low Load Units
Minimum Investment	\$500

Asset Mix



ANALYSIS: Financial services is a key sector of the Canadian equity markets, and our banks are some of the strongest in the world. The Dynamic Financial Services Fund builds on Canada's strength, and improves on it, by finding the best financial services companies around the world.

Manager Yassen Dimitrov uses a high turnover, growth at a reasonable price approach that looks for financial services companies that have excellent management teams, a credible business strategy, a competitive advantage, and a proven track record.

He seeks out companies that are trading at the lower end of their valuation range, and will sell them as they approach the higher end of the range. This is a very active Fund that has shown extremely high levels of portfolio turnover. In 2016, turnover was more than 500%, and for the past five years it has averaged more than 200% per year. This level of trading has added

approximately 35 basis points in cost because of the high level of turnover.

Even with the additional costs, the performance has been strong, and has matched its index, and outpaced many of its peers. For the five years ending August 31, it gained an annualized 16.3%, besting its peer group. Volatility has been well below the index and category average, and has done an excellent job of protecting capital in down markets. For the past five years, it has experienced on average approximately 20% of the downside of the index.

Part of this strong downside protection comes from the manager's willingness to hold cash tactically, and to use index hedges when valuations become extended.

Apart from the narrow focus, another drawback to it is its high MER, which comes in at 2.52%. Still, for those looking for more diversified financial services exposure, this is a great fund to consider.