
Top Funds Report

Scare headlines don't faze markets

Equities gain, but Canadian bonds lower on BoC hike. Momentum risks remain.

September is usually an “interesting” month, and this year proved to be no different. Plenty of scare headlines occupied pretty much every available media channel with plenty of grist of the anxiety mill: nuclear testing and missile firing by North Korea; destructive earthquakes; devastating hurricanes; and news of a data breach at Equifax, a major credit reporting agency, which is reportedly still undergoing cyberattacks.

The world's equity markets, however, were mostly unfazed by all the excitement. The S&P/TSX Composite Index gained 2.8% in September, month over month, buoyed by strength in the energy and financial sectors. The S&P 500 Composite Index advanced 1.9% in U.S. dollar terms, and the MSCI EAFE Index rallied by 2.2%.

The Bank of Canada again hiked its target overnight lending rate by 25 basis points in early September, to 1%. While inflation remained contained below the Bank's target 2% rate, it argued that “growth is becoming more broadly-based and self-sustaining,” and that it's now time to start withdrawing “some of the considerable monetary stimulus in place.” The move has now completely erased the Bank's emergency rate cuts made a couple years ago after the precipitous drop in the global price of crude oil.

As a result, domestic bond yields moved higher, and Canadian bonds sold off. The FTSE/TMX Canadian Universe Bond Index lost 1.3% on the month. Bonds at the long-term end of the spectrum were the hardest hit, with the long bond index falling 2.6%, while short-term bonds were off by 0.46%.

Beyond the decline in bond prices, another consequence of the rate hike was a modest increase in the Canadian dollar, which hurt returns for any foreign investments that were unhedged. The loonie

gained on the greenback because the BoC's rate hike narrowed the interest rate differential between Canada and the U.S., causing greater demand for Canadian dollars. Translated to equity market performance, the S&P 500 gained 2.06% in U.S. dollar terms, with stronger loonie over the month, the index was up only 1.81% in Canadian dollar terms.

There's no clear consensus on whether the Bank of Canada will hike rates again this year. BoC Governor Stephen Poloz has noted that the Bank will proceed cautiously going forward, saying that “there remains some excess capacity in Canada's labour market,” and adding that wage and price pressures remain subdued.

South of the border, however, the consensus expectation is the U.S. Federal Reserve will move rates higher at its December meeting. It has already increased its target federal funds rate twice this year, to a current 1.25%, and has started to unwind its balance sheet.

Looking ahead, October is often seen as the cruelest month for investors, with many of the largest market drops occurring in the month. While this may be true in some instances, there is nothing on the horizon now that indicates a selloff is likely. Sure, equity valuations remain on the higher end of historic ranges, but growth rates remain positive, and interest rates remain low by historic standards.

The biggest risk to the markets at the moment is the potential for a geopolitical shock, such as a nuclear missile strike from the ever-unpredictable North Korea or another “black swan” type of event.

In this environment, my investment outlook remains the same. I continue to favour equities over fixed income. In the equity sleeve, I remain neutral for the most part, but I am starting to slightly favour

Canadian over U.S. equities, as expectations seem to be swinging towards a narrowing of the performance gap between the two countries that we have experienced so far this year. Assuming no collapse in the price of oil, I expect this to be a likely scenario.

I continue to favour mutual funds and exchange-traded funds (ETFs) that invest in well-managed, high-quality companies trading at attractive valuation levels. This positioning has hurt my portfolios over the past year, but at some point, momentum-driven markets must return to focusing on fundamentals for the long term.

Within the fixed-income space, I expect we'll likely see one more rate hikes both in Canada and the U.S. To that end, I continue to favour investment-grade corporate bonds and lower duration positioning.

My current outlook is shown in the accompanying table:

		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	

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feedback@paterson-associates.ca

Funds of Note

This month, I highlight funds from Fidelity, IA Clarington, and Dynamic...

Fidelity Event Driven Opportunities Fund (FID 2798 – Front End Units, FID 2790 - Low Load Units) – Managed by Fidelity's Arvind Navaratnam, the fund has something of a unique mandate: It aims to invest in companies that are undergoing some sort of a corporate action. Examples include companies coming out of bankruptcy protection, mergers, and spinoffs.

The theory behind this strategy is that in many cases, because of the potential uncertainty, the markets will tend to avoid companies in such situations, putting downward pressure on the share prices. This can result in short-term profit potential for those willing to step in and "buy low." It is, in fact, a strategy used by many hedge funds.

The fund provides a way for investors to participate in these types of situations within a diversified, actively-managed portfolio. It is classified as a Small/Mid-Cap U.S. Equity fund, but its mandate allows for

investment in companies of all sizes, and the manager may invest wherever the opportunities are.

The portfolio typically consists of between 40 and 50 names. At present the top holdings are somewhat concentrated, with Madison Square Garden making up 9.1% of the portfolio as of the end of August. Mr. Navaratnam picked up the company at an attractive valuation after it was spun out from the company's TV and broadcast assets a few years ago. Another top holding, at 7.8% of the fund, is media giant Twenty-First Century Fox Inc., which was spun out from Rupert Murdoch's News Corporation. Armored-car firm Brink's Co. is another key holding, as the fund looks to benefit from an activist shareholder.

Performance history, while relatively short, looks promising. In just under the three years since inception (the fund debuted in November 2014), it has delivered a compounded average annual rate of return of 14.3% to the end of September, compared with 12.8% for the

Russell 2000. Volatility has been slightly higher than the index.

The fund's strategy has the potential to deliver strong returns over the long-term. But it carries an above-average level of risk, and the potential for some bigger losses. Still, if you have the stomach for a possibly bumpy ride, it can be an interesting piece of a well-diversified portfolio.

IA Clarington U.S. Dividend Growth Fund (CCM 202 – Front End Units, CCM 1502 – Low Load Units) – This U.S. Equity fund has been managed by Pierre Trottier since early 2013. With his unique way of looking at the U.S. market, he does basic due diligence, researching companies with good balance sheets and the ability to consistently grow both their cash flow and dividends. But the twist here is that he also looks for companies that are potential takeover targets. In most takeovers, there is a reasonable premium offered, which has the potential to increase returns.

His stock selection process has a value bias to it, which helps to explain some of the fund's recent underperformance. However, over the long term, it has the potential to deliver stronger returns with slightly less volatility.

In addition to the fundamentally-driven, bottom-up stock selection process, Trottier also uses two additional components.

First is that the fund's currency exposure is actively hedged, which means he will look to opportunistically manage the currency, not only to protect capital but also to enhance returns.

Second, he may use a covered call strategy, which can help increase the overall income generated by the fund, with the added potential for mitigating downside volatility. At the end of June, Trottier did not have any covered calls in place – he believes the strategy is not profitable in a rising market environment because many of the good stocks are called away, thereby reducing upside.

Performance has been somewhat disappointing on a relative basis. For the three years ending September 30, the fund gained an annualized 10.7%, while the S&P 500 gained 15.1% in Canadian dollar terms. There are two factors that may have caused this

underperformance. The first is the value bias, and the second is the currency hedging strategy. Despite recent strength, the Canadian dollar has lost ground against the greenback, meaning any hedged currency exposure would detract from absolute returns.

Looking ahead, this is a fund that has a lot of potential. The focus on dividend growers, the enhanced income strategy, and the attractive portfolio valuation levels provide a strong foundation for growth. However, performance will all depend on the execution of the strategy. In most cases, investors looking to the U.S. market tend to be better rewarded through a passive index exposure.

IA Clarington Global Opportunities Fund (CCM 340 – Front End Units, CCM 935 – Low Load Units) – This Global/Small/Mid-Cap Equity fund is sub-advised by Radin Capital Partners, led by manager Brad Radin, who first made a name for himself managing the Templeton Global Smaller Companies Fund from April 2009 to February 2011. During that time, he posted extremely impressive results, posting positive returns in 10 of 11 years. After leaving Templeton, Mr. Radin set up his own shop, and started managing this IA Clarington offering.

This is a go-anywhere fund that scours the globe looking for mispriced stocks of companies of any size. Radin searches for stocks where the market has overreacted and sold off, allowing him to step in and pick up a quality company at an attractive price.

To find these companies, he and his team use a fundamentally-driven, bottom-up investment process that starts with a screen of the investment universe, looking at valuation, balance sheet strength, returns, and profitability. Once an investment candidate is found, Radin undertakes a detailed review, looking to understand the business, the management, and the outlook.

The fund typically holds between 30 and 60 names, and the country and sector mix will be the result of the security selection process, and not an index-tracking mandate. At the end of August, Radin held 45 names in the portfolio, with the top 10 making up just under a third of total assets. He remains true to the all-cap focus, with roughly 40% in large caps, a quarter in

large caps, and the balance in small- and micro-cap names.

Radin has a large overweight to consumer cyclicals and financials, which combined make up more than half the portfolio. He is significantly underweight tech and real estate.

The portfolio's valuation is very attractive, trading at levels well below the benchmark and peer group. However, performance has been middle of the pack, with a 5-year average annual compounded rate of return of 13.7%, while the MSCI World Small Cap Index has returned 18.9% in Canadian dollar terms. Volatility has been in line with the index and peer group.

Much of the underperformance can be attributed to the value focus of the fund, with value and quality names lagging recently in favour of growth and higher beta names, which tend to outperform in momentum-driven markets.

Looking ahead, the portfolio's valuation levels combined with the favourable growth outlook put this fund on track to outperform down the road. Given the solid investment process run by a management team with a history of top performance, this fund is a solid offering for those looking for all-cap global equity exposure.

Dynamic iShares Active Global Financial Services ETF (TSX: DXF) – Last month, I highlighted the Dynamic Financial Services Fund, and a few days later, Dynamic, in partnership with BlackRock, launched this ETF.

It's managed by the same team as the Dynamic Financial Services Fund, led by Yessen Dimitrov, using the same basic investment process. The manager looks for high-quality financial firms with strong earnings growth potential, trading at attractive valuations. A key difference between the mutual fund and the ETF, however, is the amount of Canadian content. The mutual fund is currently holding approximately 60% Canadian content. But as of the end of September, the ETF had a mere 5% invested in Canadian financials.

In addition to a more global mandate, the ETF also has a wider investment universe. This ETF can also invest in financial technology companies such as those

involved in payment processing, back office type companies, and credit agencies.

Having been trading for only a few days (the ETF debuted on Sept. 29), it is far too early to recommend it. But with its global focus, it may well become a great complement to a Canadian-focused portfolio. At the very least, this is an interesting ETF to keep an eye on for future consideration.

Cecilia Mo takes leave of Absence – 1832 Asset Management, the outfit behind Dynamic Funds, announced on Sept. 19 that Dynamic Portfolio Manager Cecilia Mo would be taking a leave of absence from the firm for personal reasons. The firm gave no indication on when or if Ms. Mo may return.

Ms. Mo was the lead manager on several offerings, including Dynamic Value Fund of Canada, Dynamic Canadian Value Class, and Dynamic Value Balanced. Dynamic's Don Simpson and Eric Mencke have assumed management duties for these funds.

Ms. Mo was also lead manager for a couple of U.S. funds, Dynamic U.S. Dividend Advantage, and Dynamic U.S. Monthly Income Fund. Dynamic's Eric Benner, Tom Dicker, and Leanne Caravaggio have taken the helm on those funds.

Performance of the Dynamic funds under Ms. Mo has been disappointing. For example, the Dynamic Value Fund of Canada posted a 3-year average annual compounded rate of return of 0.8% to the end of September. In comparison, the S&P/TSX Composite has returned 4.5%.

Ms. Mo's style was very much a research-driven, bottom-up approach that sought out stocks trading below what she believed them to be worth. In practice, her portfolios tended to run a bit more to the growth side, with valuation levels well above the broader market and index.

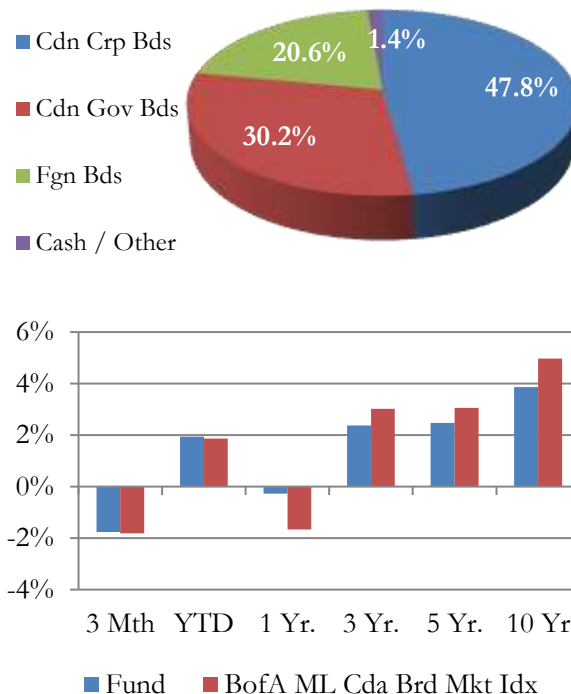
With the new managers at the helm, I would expect to see some changes around the edges, but not a dramatic shift in the portfolios. Don Simpson has over 20 years of experience in the business and made a name for himself on the Canadian equity team at Trimark. I expect to see comparable results moving forward.

If there is a fund that you would like reviewed, please email it to me at feedback@paterson-associates.ca

Franklin Bissett Core Plus Bond Fund

Fund Company	Franklin Templeton Investments
Fund Type	Canadian Fixed Income
Rating	D
Style	Top Down Macro Bottom up security selection
Risk Level	Low
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Thomas O’Gorman since Jul 10 Darcy Briggs since May 2015
MER	1.49%
Fund Code	TML 200 – Front End Units TML 515 – Low Load Units
Minimum Investment	\$500

Asset Mix



ANALYSIS: Over the past few years, Franklin Bissett has quietly grown out its fixed-income team, and the results are now starting to show. This was one of the strongest-performing bonds funds in 2016, gaining 3.3%, placing it in the first quartile for performance and outpacing its peers.

For the past year (to September 30), the fund was down 1.7%, while the broader Canadian market was down nearly 3%.

The fund’s goal is to provide strong risk-adjusted returns and a steady income stream over a full market cycle. To do this, the management team, headed by Tom O’Gorman, uses a process of top-down macro analysis and bottom-up sector and security analysis.

The team’s top down analysis looks at global economic trends, interest rate outlooks, growth and inflation expectations, central bank policies, and sector fundamentals. Using the macro view, the analysis helps the team determine the most attractive areas of the fixed-income universe, taking into consideration

duration positioning, yield curve positioning, sector, country, and currency allocations.

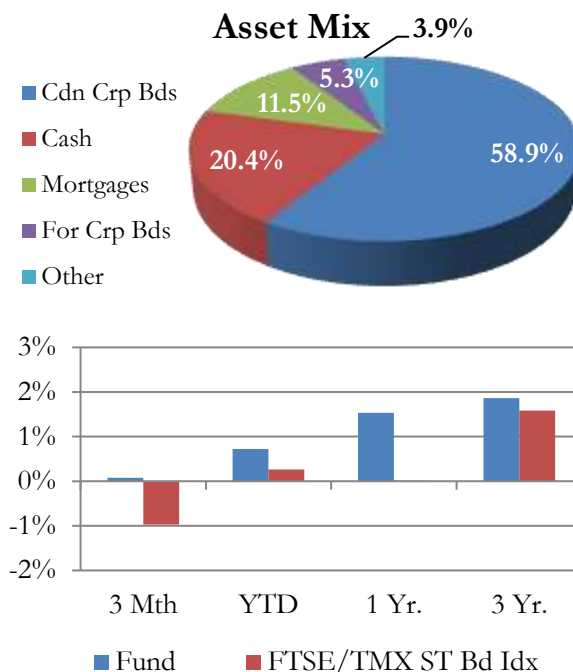
The more granular bottom-up security analysis looks at individual issues, weighing relative value, duration, company financials, as well as fundamentals, management, and liquidity

The fund aims to deliver returns in excess of between 50 and 150 basis points over the benchmark, with a Canadian-focused mandate that allows the managers to invest across the Canadian fixed-income universe. Up to 25% of the portfolio can be held in high-yield issues. While the fund has a primarily Canadian focus, it can still invest up to 30% outside of Canada, of which 10% of currency exposure can be unhedged.

The portfolio is allocated 52% to corporate bonds, 37% to government issues, 5% to bank loans, and 6% to municipal bonds. Given the flexibility of the fund’s mandate, its active management style, and its well-diversified portfolio, this fund has the potential to outperform in a volatile bond market.

Lysander-Canso Short Term & Floating Rate

Fund Company	Lysander Funds Ltd.
Fund Type	Cdn Short Term Fixed Income
Rating	B
Style	Bottom up Credit Analysis
Risk Level	Low
Load Status	Front End
RRSP/RRIF Suitability	Good
Manager	John Carswell since Sept 2013
MER	1.31%
Fund Code	LYZ 805A – Front End Units
Minimum Investment	\$5,000



ANALYSIS: In the bond space, there are few shops that are as well respected as Canso Investment Counsel, the managers of Lysander-Canso Short Term & Floating Rate Fund. Manager John Carswell aims for high current income and some long-term capital appreciation with a fundamentally-driven credit analysis process.

Carswell can invest not only in traditional short-term bonds, but also in floating-rate securities and convertible bonds. The fund has a go-anywhere mandate, but as of the end of July, more than 90% of the portfolio was invested in Canada.

The fund also has flexibility around credit quality, and can invest up to 40% in non-investment grade issuers. And at the end of September, nearly 10% was in fact allocated to non-investment grade debt.

Canso's 28-member investment team gives it the bench strength for an in-depth fundamental review to understand a company's cash flow picture to assess creditworthiness, and covenants, to understand their rights should things go south. An internal credit rating system and maximum loss score sets up a worst-case scenario.

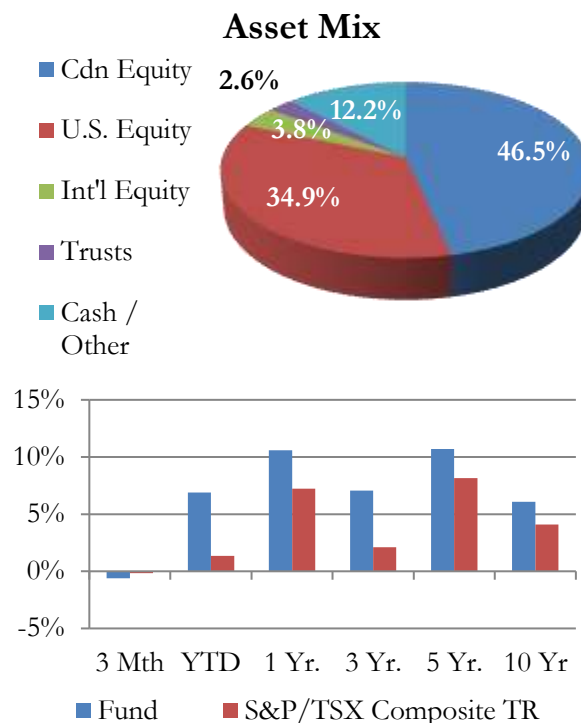
The managers are active in their approach, and will manage credit quality based on the risks of the market. The result is a concentrated portfolio, with the fund holding just north of 60 securities. The top 10 holdings make up roughly half of the portfolio. In the expectation of higher yields, the fund is defensively positioned, with half of the portfolio invested in floating-rate notes.

This positioning has benefitted the fund. In September, the FTSE/TMX Short Term Bond Index fell by nearly 0.5%, the fund was down only 0.1%. For the quarter, the index was down 0.5%, while the fund gained 0.1%. Longer-term numbers are also strong on a relative basis, with a 3-year average annual compounded rate of return of 1.8% to the end of September, compared with 1.4% for the index.

Looking ahead, given the bench-strength of the management team and the active investment process they use, I would expect this fund to be able to outpace most of its peers on both an absolute and risk-adjusted basis. However, given its focus on corporate debt over government issues, it may be a touch more volatile than its peers over short-term periods.

Dynamic Dividend Fund

Fund Company	Dynamic Funds
Fund Type	Cdn Dividend & Equity Income
Rating	A
Style	Large Cap Blend
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Excellent
Manager	Jason Gibbs since March 2007 Oscar Belaiche since July 2000
MER	1.60%
Fund Code	DYN 048 – Front End Units DYN 7007 – Low Load Units
Minimum Investment	\$500



ANALYSIS: Managed by the Dynamic team of Oscar Belaiche (who has a 17-year history with the fund) and Jason Gibbs, the fund aims for a stable monthly income stream with the potential for some capital growth.

It currently pays a monthly distribution of \$0.018 per unit (an annualized yield of about 1.5%), generated from a concentrated portfolio of what the managers believe to be best-in-class companies that pay a sustainable dividend and have the potential for growth.

They call their process “quality at a reasonable price,” which is a fundamentally-driven, bottom-up approach that focuses on identifying low-volatility firms with strong balance sheets, dominant industry positions, invested management, and a history of steadily growing free cash-flow and increasing shareholder yield.

The fund’s mandate allows for investment in common shares as well as preferred equity and trusts. It may also invest outside of Canada, and at the end of August the fund’s portfolio was allocated 33% to U.S. securities.

The portfolio is concentrated, yet still sufficiently diversified, recently listing 48 names, with the top 10

making up just over 28% of the allocation. With its focus on yield, top-sector exposures are what you’d expect, and the fund currently has allocated 18% to financials, 11% to industrials, 8% to utilities, and 7% to telecom. Underlying dividend yield of this portfolio is currently listed at 2.9%, which indicates that the distribution is expected to be fairly sustainable.

Performance has been strong, with the 5-year average annual compounded rate of return at 10.4% (as of Sept. 30), compared with 8.1% for the S&P/TSX Composite.

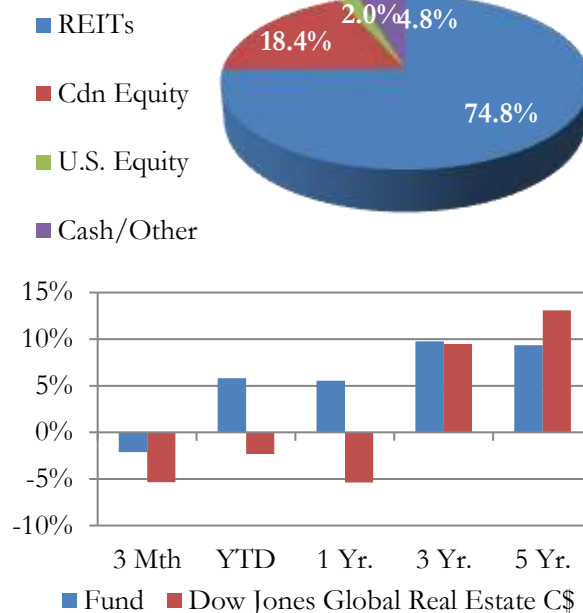
Even more impressive, the fund’s volatility has been well below both the index and the Canadian Dividend & Income Equity peer group. It has also done an excellent job of preserving capital in down markets, experiencing roughly 40% of the losses of the broader market, on average. Conversely, the fund has also done a pretty decent job at keeping pace in a rising market; however, I would expect it to lag in a sharply rising market.

Given the management team, the focus on quality, and the lower-than-average cost, I see this as a great core Canadian equity holding for most investors.

First Asset REIT Income Fund

Fund Company	First Asset Investment Mgmt
Fund Type	Real Estate Equity
Rating	A
Style	Mid Cap Blend
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Fair
Manager	Lee Goldman since June 2010
MER	2.67%
Fund Code	FAF 5803 – Front End Units FAF 5801 – Low Load Units
Minimum Investment	\$500

Asset Mix



ANALYSIS: Under the leadership of manager Lee Goldman of CI's First Asset subsidiary, the fund has quietly delivered the strongest risk-adjusted returns of any real estate equity fund in Canada.

It invests in a mix of REITs and real estate operating companies, as well as in companies that are involved in real estate-related services. The fund's focus is on Canada, but it can also invest up to 30% in foreign securities. At the end of August, it held 33 names, with the vast majority of those holdings in Canada.

Goldman and his team follow a disciplined value-focused investment process, looking for securities that are trading below what they are believed to be worth. As a result, valuation metrics of the portfolio are well below both the index and peer group.

With about only \$35 million in assets, the fund can invest in smaller names and can quickly reposition to invest opportunistically. Most of the fund is allocated to mid- and small-cap companies, with only 4% currently allocated to large-cap names.

The strategy has delivered some decent performance, with a 5-year average annual compounded rate of

return of 9.2% (to Sept. 30), which is right in the middle of the Real Estate Equity category. However, the shorter-term numbers have been much better, with the fund delivering an annualized 10.6% over 3 years, handily outpacing the competition. Year-to-date to Sept. 30 the fund has returned a solid 5.95%.

Most impressive is the fact that with a 3-year average standard deviation of 7.73%, the volatility of the fund has been substantially lower than its peer group. But this has been a bit of a double-edged sword. On one hand, the risk-adjusted numbers are excellent, and the downside protection has been stellar. On the other hand, performance is likely to lag the group when markets are rallying, as they did in 2014 and 2015.

Looking ahead, the fund remains focused on REITs with quality assets that have the potential to add value through development or intensification, that have exposure to high growth markets, and that have low payout and leverage ratios. The portfolio's largest exposure is to the multi-family sector, which is often considered to be the least risky part of the market. All things considered, this is a very solid REIT offering.