

Top Funds Report

Markets soar to rarefied heights

Investors revel in a sweet spot as volatility remains low and momentum rules the day.

The much-feared fall selloff just didn't happen this year, as November logged another positive month for equity markets, with all the major indices finishing higher. The trend continued well into December with record highs set weekly, if not daily.

The S&P/TSX Composite gained 0.5% in November, while the S&P 500 Composite advanced 3.1% and the MSCI EAFE Index rose 1.1%.

In Toronto, both energy and materials finished the month lower, while the financial sector posted a very modest 0.4% rise. Energy issues declined despite a 5.6% rise in WTI crude oil.

In fact, year to date, the S&P/TSX has gained 5.4%, despite about an 11% drop in the energy sector, which at the end of November claimed a near-20% weight in the index. This indicates that the gains in the index are widespread, supported by all sectors but with energy being positive on a year-to-date basis.

The outlook for Canada remains strong, but there are two big risks to that: 1) the high levels of consumer debt; 2) potential troubles from a breakdown in the NAFTA negotiations with the U.S. This partially accounts for why the Bank of Canada is likely to remain on the sidelines for the next few months, keeping interest rates steady.

Against that backdrop, Canadian bond yields eased, with the benchmark Government of Canada 10-year bond slipping to 1.89% from 1.95%. It was a positive month for Canadian bonds, with the FTSE/TMX Canada Universe Bond Index climbing 0.8% on the month. Long bonds rallied even higher, gaining 1.8% in November.

In the U.S., markets rallied later in the month after both the House and the Senate passed tax reform

bills, which investors took as positives for corporate profit growth.

Globally, profit growth remains strong, which is expected to continue supporting stock prices.

Barring anything from left field, I don't expect to see markets move significantly in either direction as we head into the last couple weeks of the year. As usual, trading volumes are expected to lighten substantially over the holidays.

In this environment, I continue to favour mutual funds and ETFs that invest in well-managed, high-quality companies that are trading at attractive valuation levels. This value-tilt has weighed on my portfolio performance over the past year, but the market must eventually return to focusing on fundamentals for the long term.

In fixed-income, I favour investment-grade corporate bonds, and lower-duration positioning.

My investment outlook is shown below:

		Underweight	Neutral	Overweight
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 look at funds from PH&N, Fidelity, Steadyhand, plus a Horizons pot offering...

PH&N Monthly Income Fund (RBF 6660 – Front end Units, RBF 4660 – Low Load Units)

MER: 1.92%
Assets (\$mil): \$69.12
Fundata Rank (1Yr): 443/655
Std Dev (3Yr): 5.30%

As the name suggests, the focus of this Canadian Balanced fund is to provide a relatively high monthly income. The Advisor series units pay a monthly distribution of \$0.0405, which works out to an annualized yield of slightly more than 5% at current prices.

Manager Scott Lysakowski is responsible for the equity sleeve, while fixed income is managed by the PH&N fixed income team. The neutral asset mix of the fund is 50% equities and 50% fixed income, although either sleeve can be moved as high as 60%.

The equity part of the portfolio is overweight financials and real estate, and is carrying a market weight to telecom, energy, industrials, and consumer names. It is significantly underweight materials, which is not surprising given the focus on yield.

Fixed income consists mostly of investment-grade issues, but can hold some high yield. At the end of October, less than 10% was invested in high-yield bonds. Duration is listed at 7.3 years, which is slightly below the 7.5 years of the index.

The dividend yield of the equity sleeve is approximately 2.8%, while the yield to maturity of the bond sleeve is listed at 2.6%, which puts the total yield of the fund well below the payout. This means the managers must rely on capital gains or return of capital to finance the distribution to investors. In fact, in 2016 and 2017, a little more than half of the distribution was return of capital. If this trend continues, the distribution level may need to be cut to prevent significant erosion in the NAV.

Performance has largely lagged the index and the peer group. The managers have been actively trading the fund hoping to take advantage of opportunities.

Portfolio turnover has averaged around 200% over the past five years.

Over the past five years, volatility has been slightly below the index and peer group, but in the past couple years, this has increased and has been running at levels above both the index and peer group.

Looking ahead, with volatility in both equities and bonds expected to be on the rise, I believe there are other funds available that can do a better job at preserving capital and managing risk.

Fidelity Canadian Large Cap Fund (FID 231 – Front End Units, FID 031 – Low Load Units)

MER: 2.28%
Assets (\$mil): \$1,792.02
Fundata Rank (1Yr): 515/524
Std Dev (3Yr): 5.76%

A reader asked for my thoughts on this fund given its lackluster results recently. To understand the recent performance, we need to revisit the fund's investment process. Manager Daniel Dupont uses a bottom-up, value-focused approach, with a very defensive philosophy. Capital preservation is the first and foremost objective of the fund.

Dupont looks to build a portfolio of high-quality companies that are trading at very attractive discounts to what he believes they are worth. While valuation is important, so too is quality, with management being key. He looks for management teams that have a strong consistent track record of effective execution.

The portfolio is concentrated, typically holding between 35 and 50 names. At the end of September, the fund held roughly 40 stocks. About half the fund was weighted to Canadian equities, and 24% to foreign equities. About 15% was dedicated to short-term bonds as a cash substitute, with the balance in cash. The sector mix is a by-product of the stock selection process.

The long-term performance numbers, particularly the risk-adjusted returns, are stellar. The defense-first focus of the manager has resulted in volatility numbers that are well below the index and peer group, and excellent

downside protection. For example, over the past five years, the fund has experienced less than 10% of the downside of the broader market.

Recently, the fund has struggled because the market has generally been rewarding higher growth, higher beta, and in many cases, lesser-quality companies at the expense of higher-quality, value-focused names. Another headwind for the fund has been its high cash balance, which has dragged overall gains when markets have rallied.

Despite its recent underperformance, I still believe in this fund. It is managed using a very disciplined process, and has a focus on protecting capital. I am comfortable in foregoing some upside for protection of my capital during periods of market turbulence.

Market volatility is currently at its lowest level in more than 40 years, and periods of low volatility are always followed by periods of high volatility. While low-volatility periods can last for many quarters or even years, the fact is they do come to an end. It is for that eventuality that I favour this fund.

Steadyhand Global Equity Fund (SIF 140 – Front End Units)

MER: 1.78%

Assets (\$mil): \$85.8

Fundata Rank (1Yr): 232/862

Std Dev (3Yr): 12.34%

I must admit I'm a fan of what Vancouver-based Steadyhand is doing. A typical Steadyhand fund has low turnover, is concentrated, unconstrained, and looks nothing like its benchmark. For the most part, the strategy has worked well, with most Steadyhand funds outpacing their peers since inception.

However, the Global Equity offering has struggled. Managed by Sandy Nairn and his team at Edinburgh Partners in Scotland, the fund takes an almost contrarian, value-focused approach and buys companies the manager believes to be attractively priced.

It is this focus on valuation that has seemingly hurt the fund, as it has carried significantly less U.S. equity than the benchmark. For example, the MSCI World Index is nearly 60% in the U.S., while this fund has approximately 10%. With U.S. equities leading the

rally in recent years, this has created a significant headwind.

In fact, if you were to compare this fund with a group of International Equity funds that carry no U.S. equity, its rating improves dramatically, and it would be the fourth-ranked International Equity fund in my universe. Instead it has invested heavily in the Japan, the U.K., and Europe.

Performance in absolute terms has been decent, with a 5-year average annual compounded rate of return of 14.6% ending November 30, while the MSCI World was higher by more than 18%.

A drawback to this concentrated style has been volatility that is well above the index and peer group. It has also done a less-than-stellar job at protecting capital in down markets.

Still, the outlook for the fund is encouraging. Valuations remain well below the index and peer group, and the forward-looking growth estimates appear strong. Although I really want to like this fund, other global and international equity funds that are managed using a similar style in my opinion offer a more compelling risk-adjusted return outlook.

Mawer New Canada Fund (MAW 107 – No Load Units)

For the longest time, this Canadian small-cap offering was one of the best around, typically delivering above-average returns for investors, on both an absolute and risk-adjusted basis.

Until 2016, the lead manager was Martin Ferguson. When he stepped aside, co-manager Jeff Mo took over. Mr. Mo had worked closely with Mr. Ferguson since joining Mawer in 2008, and had been co-manager since July 2012.

The fund has posted excellent results, with an a 5-year average annual compounded rate of return of 16.1% to the end of November, while the BMO Small Cap Index has returned a more modest 5.8%.

Even more impressive is that volatility has been well below both the benchmarks and peer group. The managers have done an excellent job protecting capital in down markets, participating in only a fraction of the downside movement of the market.

However, since Mr. Ferguson stepped aside, results have not been as impressive, with the fund returning roughly 20% since December 2015, modestly trailing its peers. Is it a result of the management change?

First, 23 months is far too short a time to make an accurate assessment of the performance. Second, other Mawer equity funds have also struggled relative to their peers over the past two years. And third, Mr. Mo is well versed in Mawer's bottom-up investment process, seeking a combination of strong, well-managed, wealth-creating businesses that are trading at attractive prices.

The process is very research driven, and the managers' assumptions are constantly stress tested to ensure they are reasonable.

We have experienced some market environments where the quality-focused companies that Mawer invests in have been left behind by the market, while higher beta, lower-quality names have rallied. There have also been some stock-specific issues that have hurt, including the Home Capital debacle in the spring and a few energy holdings that have struggled.

Putting their recent performance in context, I don't believe that the departure of Mr. Ferguson is the reason for lagging performance. It appears to be more a function of the investment style currently being slightly out of favour. Although the fund remains closed to new and existing investors, I will continue to monitor it for the benefit of current unitholders over the next few quarters to see if things rebound or if there is any further erosion.

Horizons Marijuana Life Sciences Index ETF (TSX: HMMJ)

MER: 0.75% (plus applicable sales tax)

Assets (\$mil): \$338 million

Fundata Rank (1Yr): N/A

Std Dev (3Yr): N/A

With the July 1, 2018, legalization of recreational marijuana fast approaching, investor interest in cannabis producers as an investment is very strong. But apart from investing in individual companies involved in the cannabis industry, there aren't many other ways for investors to get exposure.

The Horizons ETF, launched on April 4, 2017, was the first to invest in cannabis-related companies, and

remains one of the only ways to access a diversified portfolio of "pot stocks."

The fund tracks the performance of the North American Medical Marijuana Index, a cap-weighted index. To be considered for inclusion, a company must be involved in the production of cannabis, the research and development of cannabinoids, equipment providers, and companies involved in leasing property to growers. The maximum weight of any one name is capped at 10%, and the index is rebalanced quarterly.

There is little doubt that the potential for growth is very high in the space, as the industry is in its infancy and governments in Canada and some U.S. states continue to legalize the drug. Some estimates expect that annual, regulated pot sales in North America will top more than \$20 billion by 2021. But strong growth potential doesn't necessarily make a good investment.

Today, there are many small players in the industry, with more joining in every day. Some are well-managed, with well-thought-out business plans, but most are undercapitalized and have inexperienced management with poor business plans.

Furthermore, valuation levels are off the charts, based on any normalized fundamental metric. For example, the largest holding in the Horizons fund, Canopy Growth, has no earnings, but is trading at more than 50 times sales, and more than 5 times its book value. Yes, there is growth, but that level of valuation increases the risks substantially in an evolving industry.

There is no doubt that money is to be made in the sector, but one is cautioned to proceed with caution.

In such an evolving industry, I don't believe an ETF that selects and weights stocks based on market capitalization is necessarily the best way to access the sector. One of the flaws of a market-cap index is that it tends to overweight the most overvalued names, which in this sector significantly increases the risks.

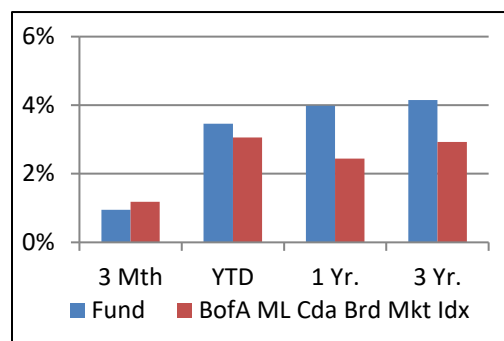
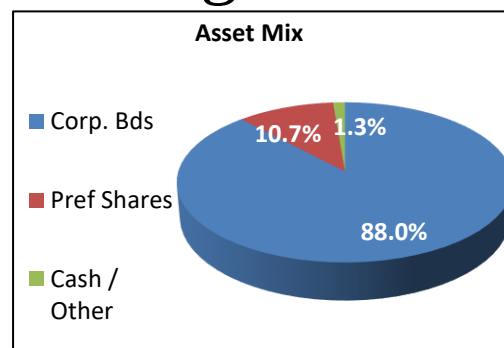
Instead, investors who want diversified exposure to the sector may be wise to hold off until other, more actively-managed options, become available.

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

feedback@paterson-associates.ca

Leith Wheeler Corporate Advantage Fund

Fund Company	Leith Wheeler Investment Cnsl
Fund Type	Canadian Fixed Income
Rating	A
Style	Top-down Macro Bottom-up security selection
Risk Level	Low
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Jim Gilliland since May 2014 Druv Mallick since May 2014
MER	0.79% No Load/0.53% Fee Based
Fund Code	LWF 021 – No Load Units LWF 032 – Fee Based Units
Minimum Investment	\$25K No Load / \$5K Fee Based



ANALYSIS: Vancouver-based Leith Wheeler uses the slogan “Quiet Money,” which is pretty apt, given they are not exactly a household name. The employee-owned firm focuses on one thing: managing money for investors.

The Corporate Advantage Fund is an actively-managed Canadian-focused bond fund that invests mainly in investment-grade corporate bonds. Managers can be very flexible in their approach and have many tools at their disposal. The fund can invest up to 20% in non-investment-grade bonds and up to 30% in preferred shares, which provides additional yield. It can also invest in convertible bonds, bank loans, and mortgages. And the managers can also use derivatives to hedge against interest rate and credit risk.

The investment process starts with a top-down analysis that sets the economic and interest rate outlook. This helps the managers establish targets for duration, sector, and credit quality factors. Security selection is bottom-up and uses a fundamental credit analysis that looks for credits trading at reasonable levels, offering attractive yields for the risk.

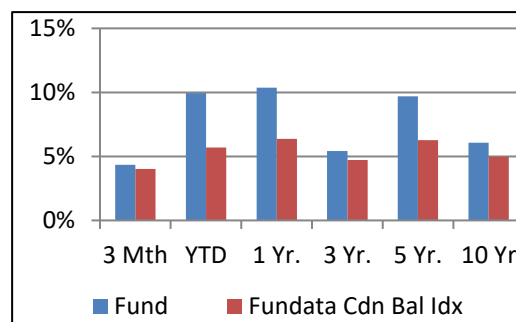
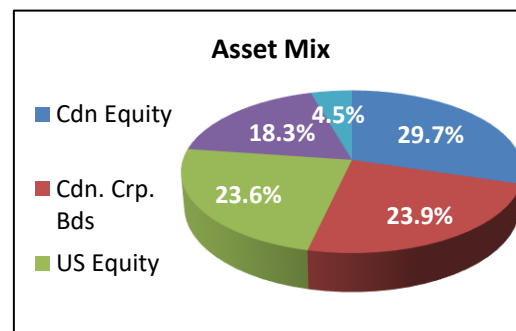
In positioning the portfolio, the managers are careful not to take on too much risk for the conditions. At the end of October, for example, the fund was about 75% invested in corporate bonds, 11% in preferred shares, 10% in Leith Wheeler Multi Credit Fund, and the balance in cash. Credit quality was high, averaging BBB, and the duration was 4.3 years, well below the 7.4 years of the benchmark

The process has paid off, with the fund gaining 4.2% in the past 12 months, doubling the category average, and handily outpacing the benchmark. Volatility has been well below the index and peer group. The fund pays a variable monthly distribution, which over the past year has yielded investors approximately 4%.

With its defense-first approach, the fund has lagged in rising markets, but has done an excellent job protecting capital in falling markets. As we head into a potentially tricky bond market, the depth of the team, combined with the focus on capital preservation, disciplined process, and the availability to use some non-core strategies, gives this fund the potential to continue delivering above-average returns for investors, on both an absolute and risk-adjusted basis.

Manulife Monthly High Income Fund

Fund Company	Manulife Investments
Fund Type	Canadian Neutral Balanced
Rating	A
Style	Large Cap Growth
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Excellent
Manager	Alan Wicks since Sept 1997 Duncan Anderson since Sept 97
MER	2.01%
Fund Code	MMF 583 – Front End Units MMF 783 – Low Load Units
Minimum Investment	\$500



ANALYSIS: Co-managed by Alan Wicks and Jonathan Popper, this fund has long been a favourite of mine, but had been closed to investors since August 2015. However, Manulife plans to reopen it to new investors in January, as management believes they can effectively implement their process at the current \$9.4 billion in assets under management (AUM).

For the equity space, the managers use a bottom-up, fundamentally-driven process that seeks out businesses of any size with high returns on invested capital. Each investment candidate is scored on a number of fundamental factors.

A deeper due diligence review then includes meetings with management and generating an estimate of fair value. Buy and sell prices are also determined, and position sizes are actively managed based on real-time valuation levels. Surprisingly, turnover levels have averaged a modest 70% for the past three years.

The fixed-income sleeve is managed using a combination top-down economic review and bottom-up credit analysis. The fund aims to generate returns by focusing on sector allocation, credit quality, and individual credit selection. Managers aim to mitigate

risk with active management of the portfolio's yield curve and duration exposure.

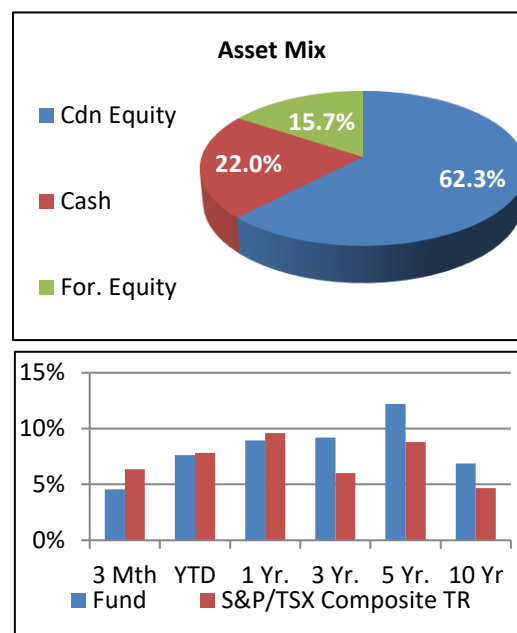
At the end of November, roughly 28% of the portfolio was in bonds, 15% in cash, 25% in Canadian equity, and 30% in U.S. names.

Performance has been excellent, with the fund delivering an impressive 5-year average annual compounded rate of return of 9.7% to Nov. 30, handily beating both its index and peer group. Shorter-term, the fund is ahead 9.9% year to date, making it one of the strongest performers in the category. Volatility numbers have also been lower than the index and peers, and the managers have done an excellent job protecting capital in down markets. Still, the way the portfolio is built, there will be periods when it lags, which is what happened in 2016, when it trailed the index and peer group.

This is a strong balanced offering, and remains one of my favourites. While the managers have sufficient runway to implement their strategy with the current AUM, I will continue to monitor the fund closely for any erosion in the risk-reward profile, particularly if inflows are robust.

CI Cambridge Canadian Dividend Fund

Fund Company	CI Investments
Fund Type	Cdn Dividend & Income Equity
Rating	A
Style	Mid Cap Growth
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Stephen Groff since July 2015
MER	2.42%
Fund Code	CIG 11112 – Front End Units CIG 11362 – Low Load Units
Minimum Investment	\$500



ANALYSIS: Manager Stephen Groff looks at total return instead of just dividends, searching for quality companies that pay a fair dividend and offer compounding returns.

The portfolio is somewhat concentrated, typically holding less than 40 names. Given the total-return focus, the fund tends to invest in much smaller companies than many other dividend offerings, which tend to focus on big blue-chip dividend payers like the banks and pipelines. The average market cap of the category is in the \$35 billion range. This fund, however, skews much smaller, with an average market cap of just over \$11 billion.

The sector mix, which is the result of the stock selection process, is also significantly different, being underweight in financials, telecoms, and utilities, and dramatically overweight in REITs, consumer names, and industrials. At the end of June, the fund held no Canadian banks.

The portfolio also has more of a growth bent to it, with the managers looking for what they believe are value-creating businesses with identifiable competitive advantages that will allow the companies to generate free cash flow, which they can reinvest or pay out to shareholders in the form of dividends. Valuation is a concern, but less so than with many other dividend funds.

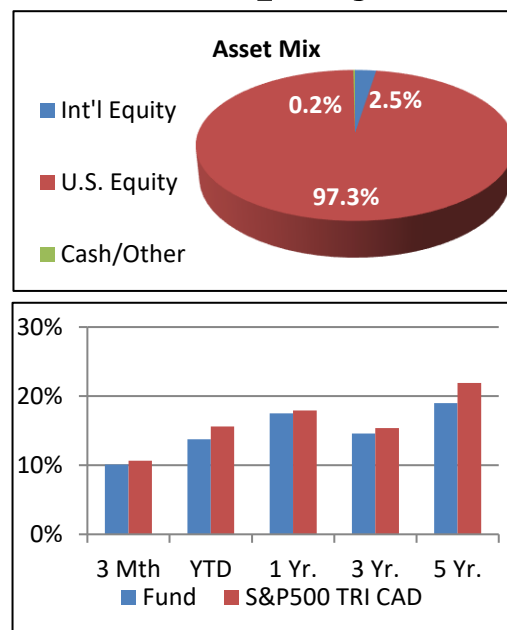
The manager is very tactical with cash, letting it rise if suitable opportunities are unavailable. At the end of October, the fund held roughly 25% in cash. Managers are also very active, more so in volatile markets, using selloffs to pick up attractive names at great prices.

The fund lags its peers in performance this year, but has been very strong over the past three years, delivering an average annual compounded rate of return of 9.6% to Nov. 30, handily outpacing its peers. Volatility has been well below both the index and peer group. The managers note that currently, the overall risk appetite remains high, making it difficult to find attractive opportunities, so they remain defensively positioned.

Because the fund pays a modest monthly distribution of \$0.03 (a 1.5% annualized yield), I wouldn't use it as a meaningful source of income. However, it is an excellent dividend-focused fund for the long term. But because it is so different from the benchmark, performance may also be significantly different, both to the upside and downside. Given this proviso and its more mid-cap focus, I'd be reluctant to use the fund as a core holding. But it could be a great risk-diversifier if used in a well-diversified portfolio.

RBC QUBE Low Volatility U.S. Equity

Fund Company	RBC Global Asset Management
Fund Type	U.S. Equity
Rating	C
Style	Large Cap Blend
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Bill Tilford since November 2012
MER	1.94%
Fund Code	RBF 718 – Front End Units RBF 018 – Low Load Units
Minimum Investment	\$500



ANALYSIS: About a year ago, low-volatility funds were all the rage, attracting significant inflows and generating above-average returns for investors. Fast forward a bit, and returns have moderated, but the funds continue to live up to the promise of lower volatility and better capital protection in down markets. Launched in November 2012, and managed by a team headed up by Bill Tilford, this is RBC's U.S. Equity low-volatility offering, complementing its low-volatility Global and Canadian Equity lineup.

The manager uses a very disciplined, rules-based quantitative investment process that aims to minimize the fluctuations of the portfolio while still providing strong returns. The process starts by rating and ranking each stock on a variety of fundamental criteria that are both forward- and backward-looking. The team then reviews a number of stability measures, which are also scored.

A risk forecast is generated for each stock, which is then used as an input in the manager's portfolio optimization model. The portfolio is optimized twice – once using a more traditional approach and the second time using more predictive factors. The final step is a more fundamental review that is completed by the team.

The result is a large-cap-focused portfolio, holding around 110 names. Given the emphasis on low volatility, it is not surprising to see it significantly overweight in defensive sectors like utilities, consumer staples, and telecoms.

A drawback to this strategy is that investors have bid up the value of these sectors significantly, resulting in a portfolio that is bit more richly valued than the broader market. That will make it tough, although not impossible, to repeat the recent performance in absolute terms.

The fund will lag in rising markets, but is expected to outperform in falling markets. To date, it has. For example, on Aug. 24, 2015, the market fell 3.7%, while the fund was off 3.1%. On Sept. 1, the market was again off by 3.7%, yet the fund slipped only 2%.

And that highlights the appeal of this fund – not to outperform the market, but rather to earn decent returns, with less risk and lower volatility.

I believe that this fund can continue to do that, given the investment process used by the team. It can be a great way for more conservative investors to access core U.S. equities with a bit less risk. Just don't expect to see double-digit returns from here on out.