Top Funds Report

Review and outlook for 2018

Scorecard on last year's outlook, plus a look at what's in store for the next 12 months

Last year around this same time, in my annual outlook commentary, I said that the biggest threat to the markets was valuation. Back then, the S&P 500 was trading at 21.3 times earnings and 17.6 times forward earnings. I noted also the 10-year average was more in the range of 14 times earnings. I even went so far as to say, "…lofty equity returns appear unlikely at current levels, meaning more subdued returns can be expected on a go-forward basis." As the famous quote by physicist Niels Bohr goes, "Prediction is difficult, especially about the future." Turns out I was wrong on this one.

Last year turned out to be an excellent year for investors. The S&P 500 gained 21.8% in U.S. dollar terms, the MSCI EAFE Index rose by 25.6%, and the S&P/TSX Composite rose by a more modest 9.1%. So what happened? (Not that I'm complaining, you understand.)

In fact, synchronized global growth happened, pushing global GDP growth rates and markets higher. U.S. markets got an extra boost late in the year following the passage of the Trump Administration's tax reform bill and attendant tax cuts. This provided renewed optimism for continued growth in corporate profits.

In the first half of the year, it was largely the so-called FANG stocks (Facebook, Amazon, Netflix, and Google) that drove markets higher. These propelled other higher-beta, tech-focused names to new heights, while more quality-focused, value-type names were held back. But that all changed in the latter part of the year, when markets again focused on fundamentals.

In Canada, energy issues weighed on market performance, as the sector fell by 10.6% despite a nearly 18% gain in the price of crude oil. Part of that loss was currency related, as the Canadian dollar rose sharply against the greenback. The other part related to growing investor skepticism over the sustainability of the rally in oil prices.

One prediction that that I did get right was my decision to favour equities over fixed income. Bonds were positive in the year, but modestly so, with the FTSE/TMX Universe Bond Index gaining 2.5% in 2017.

Now looking ahead to 2018, it looks a lot like the latter part of 2017, with equity markets rallying even higher.

The consensus expects both the Bank of Canada and the U.S. Federal Reserve to increase their benchmark interest rates throughout the year. The Fed is expected to move three or four times. After last Wednesday's 25 basis-point rate hike, the Bank of Canada could move again this year, but this is up in the air given the uncertainty caused by the potential fallout from a weakened NAFTA and the expected slowdown resulting from sharp increases from minimum wages in four provinces.

(*Continued on Page 2*)

		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	

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At the risk of sounding like a broken record, later in the year, I would expect to see some volatility return to the equity markets, with valuation again being the biggest risk. At the end of December, the S&P 500 was trading at valuations even higher than at the end of 2016, at 23 times historic earnings and 21 times forward earnings.

As I said last year, "…there is little room for continued multiple expansion. At some point we will have to see things begin to normalize. This doesn't necessarily mean a correction is imminent, but the longer this bull runs, the higher the probability a correction will happen."

In the interim, I remain defensive in my allocations, and I continue to focus on higher-quality, actively-managed funds that have the potential to withstand a drawdown better than the broader markets.

My investment outlook is shown in the table on Page 1.

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

Funds of Note

This month, I look at funds from Fiera, and some of the best and worst performers from 2017…

Fiera Capital Equity Growth Fund (SIC 303 – Front End Units, SIC 303L – Low Load Units, SIC 003 – No Load Units)

MER: 2.41% for Advisor Units, 1.52% Low Load Units
Assets ($mil): $376.04
Fundata Rank (1Yr): 129/148
Std Dev (3Yr): 10.75%

You may never have heard of Montreal-based money manager Fiera Capital. Yet this highly-respected, low-key shop manages more than $123 billion across institutional, high net worth, and retail fund mandates, with separately managed accounts, pooled funds, mutual funds, and alternative investment offerings. Like other institutionally-focused shops, they do a lot of things right, and I have found solid Fiera funds in the fixed income, preferred share, and global equity space.

This fund is their small and mid-cap offering, and I became familiar with it a couple of years ago when I was setting up portfolios for an asset management program I oversee. The fund has delivered excellent long-term numbers, but has hit a rough patch in the past year or so. In 2016, the A-Class units were down 2.2%, while the BMO Small Cap Index gained 5.3%, and the S&P/TSX Completion Index rose 7%. This has been a source of frustration for advisors who have invested their clients' assets in the program.

While it is frustrating, I don't think it's time to hit the panic button. A big reason for the underperformance comes down to the investment process. The manager is looking to build a portfolio of high-quality small-cap companies that have sustainable competitive advantages and strong return on equity and assets. They also look for companies that are trading at a discount to what their internal analysis shows them to be worth.

Unfortunately, this is an investment style that was out of favour for most of last year. The markets were generally not rewarding "quality" companies, but were focused instead on riskier, higher-beta names in hot sectors like tech, cannabis, and now blockchain. The companies that were driving most of the market gains are not the types of companies you would expect to see in a "quality-focused" portfolio. However, if we look at the final quarter of 2017, quality companies returned to favour, and the market rewarded fundamentals. Not coincidentally, the performance of this fund also dramatically improved, advancing 8.0% in the fourth quarter, besting both the category and index.

Looking at its positioning, the fund is overweight consumer names and industrials, market weight in energy, real estate and tech, and is underweight financials and utilities. Valuation numbers look in line with the market, but the quality metrics (ROE and ROA) look better. Furthermore, the growth outlook for the underlying portfolio is positive. The market cap is significantly smaller than either the peer group or the benchmark, which tends to create larger dislocations in valuation over certain time periods. This can work for or against the fund, depending on the time period.

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Taking a step back, the longer-term numbers are very respectable, with the fund posting a 5-year average annual compounded rate of return (or "annualized rate of return," for short) of 9.2% to Dec. 31, which handily outpaced its peers and the benchmark. Volatility over the long term has been in line with the category and index. The managers have also done a very solid job protecting capital over the long term. For the past five years, the downside capture ratio is 66%, meaning that the fund participated in far less of the market selloff than the index.

Michael Chan, the portfolio manager, has been running the fund since 2008, which has ensured consistency in the implementation of the investment process.

So yes, it's been a frustrating year or so with this fund, but I still believe it is a good fund for a few reasons, namely consistent management, disciplined investment process, and quality-focused portfolio.

While I am always looking for alternatives and ways to improve my portfolios, at the moment I'm more inclined to believe the recent underperformance is more a function of the investment style being out of favour rather than an erosion or breakdown in the quality of management. I continue to follow the fund closely.

2017 – The Best and Worst

Now that 2017 is in the books, I thought it might be fun to take a look at the best- and worst-performing funds of the year.

The best-performing fund was one of my favourites, the **Dynamic Power Global Growth Class**, managed by Noah Blackstein. The fund, highlighted in our November 2017 issue, gained more than 51% in 2017. Blackstein runs a very concentrated portfolio that looks for companies from around the world that he believes to have the best growth prospects, strong earnings momentum, and a history of upside earnings surprises. Performance over the long-term has been stellar, gaining an annualized 20.5% over the past five years to Dec. 31, handily outpacing the index and its peers. Be warned, though, that this is a volatile fund and has the potential to sell off hard when markets turn. This is in no way a core holding for most investors. However, if you can stomach the risk, it can be a nice addition to your portfolio to help enhance returns.

Turning to the worst-performing fund in the year, with the struggles faced in the energy patch, it's not surprising to see an energy fund as the biggest laggard. The **Sprott Energy Fund**, managed by Eric Nuttall, lost nearly 35% in 2017, while the broader Canadian energy market was down 10.6%. Contributing to this underperformance is the concentrated, small-cap, value focused nature of the portfolio. No matter the sector, value-focused names lagged, and the concentrated portfolio offered no place for the manager to hide. While not my favourite energy fund, this is still a much stronger offering than the 2017 numbers suggest.

Next, let's take a look at the broader asset classes

Fixed Income

Manulife Preferred Income Class

Preferred shares had a solid year, as the S&P/TSX Preferred Index advanced 13.6%. With a gain of 16.3% in 2017, this fund outpaced the index and was the best-performing fixed income fund. The fund invests in a diversified portfolio Canadian-traded preferred shares and had a great year. But it tends to be more volatile than other preferred share funds. This is a decent fund, but I prefer the Natixis offering given its more favourable risk-reward profile.

Brandes Corporate Focus Bond Fund (Unhedged)

This fund invests in a portfolio of between 60 and 150 U.S. corporate bonds that the managers believe are trading below what they are worth. The manager has the flexibility to invest in investment-grade bonds and up to 40% in high-yield bonds. For the year, the fund lost 3.7%, but note that this was all a result of exchange rate risk, as the firming of the Canadian dollar against the greenback later in 2017 weighed on the fund's performance. The fully hedged version of the fund rose by 2.9%. Despite the 2017 loss, this is a solid fund for those looking for U.S. bond exposure. I'd suggest looking at the hedged version, as the currency fluctuation can add substantial risk to the unhedged fund.

Canadian Equity

The best performing Canadian equity fund was the **Manulife Canadian Focused Fund**. For a more detailed overview of the Fund, please see Page 6. Another very strong performer is also worth looking at.

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Fidelity Special Situations Fund

The fund gained 21% in 2017, more than doubling the S&P/TSX Composite Index. Much of this outperformance can be attributed to the active, opportunistic approach used by manager Mark Schmehl. In a recent *Financial Post* article, he said, "I focus on the stuff in the tails: really cheap, broken, horrible stories that nobody wants to buy again, and stocks that everybody is excited about but their valuation is so high they can't bring themselves to buy them." Last year was perfect for that type of approach. However, such strong performance is not likely to be repeated in an environment where investors are rewarding fundamentals. So this fund remains a decent pick for investors with high risk tolerance who can be comfortable with higher volatility.

Sprott Small Cap Equity Fund

This was the worst-performing Canadian Equity fund, posting a loss of 12% in 2017. Over the past three years to Dec. 31, it delivered an annualized return of only 2.3%. Managed by Sprott's Eric Nuttall, the fund holds a very concentrated portfolio of small and micro-cap growth companies. This is one of the more volatile small-cap funds, with the top 10 holdings making up more than 60% of the portfolio. Names in the energy and materials sectors hurt performance in the first half of the year, while the second half was stronger, with the fund advancing more than 13% in the six months to Dec. 31. Despite the manager's high-conviction approach, I'm uncomfortable with the volatility of the fund, and I have other small/mid-cap funds I prefer.

U.S. Equity

TD Nasdaq Index Fund

The tech-heavy Nasdaq Composite was the best performing U.S. index in 2017, and this low-cost fund is designed to track its performance. Top holdings include all the large-cap tech stocks (Facebook, Apple, Alphabet, Amazon.com, Microsoft) that led the way higher in 2017. Given current valuation levels, I wouldn't expect a repeat this year. In addition, with the Nasdaq's tech weighting, the fund has the potential to be highly volatile.

RBC U.S. Mid-Cap Value Equity Fund

This fund takes a value-focused approach to investing in U.S. mid-cap stocks. However, because value names struggled through 2017, particularly in the first half of the year, the fund posted a loss of 5.1% in the year. Portfolio valuation numbers currently look very attractive relative to the benchmark and peer group. While short-term performance is not indicative of the quality of the fund, I do believe there are better options available in the U.S. small/mid-cap space.

Foreign Equity

Desjardins Overseas Equity Growth Fund

This fund has largely flown under my radar. It posted a very strong 34% gain in 2017, nearly doubling the return of the MSCI EAFE Index in Canadian dollar terms. It is managed using a very disciplined, bottom-up fundamental investment process that looks for the most competitive, innovative, and efficient growth companies. The managers' approach is patient, and focused on the long term, looking out several years rather than just the next quarter. At Dec. 31, performance numbers across all periods were in the upper quartile; however, the growth approach has resulted in above-average volatility. It is the higher volatility that causes me to pause on this fund. Instead, I continue to favour other international offerings that have better overall risk-adjusted numbers.

Portland Value Fund

This very concentrated global equity fund is managed by industry pioneer Michael Lee-Chin and Dragos Berbecel. At the end of Nov. 2017, it had only 12 positions, with the top holding, Nomad Foods, representing nearly 13% of the fund's portfolio. The investment approach is value focused, and the managers look for undervalued companies and potential activist opportunities. Launched in April 2015, the fund has not seen much success, stumbling more than 12% in 2015, and not really recovering after that. Since inception, the fund has produced an annualized loss of 7.4%. That's reflected in assets under management, which come in at only $620,000. Combine that with a relatively high MER of 2.82%, and despite its managers' pedigree, I don't see a lot of reasons to look any further at this fund.

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

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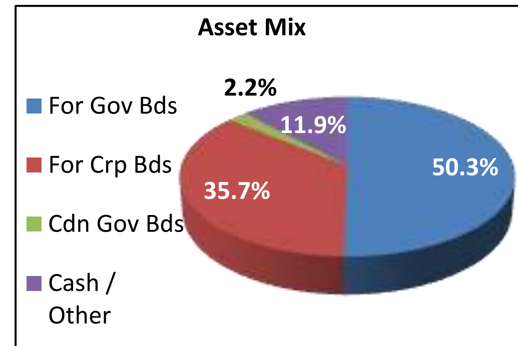
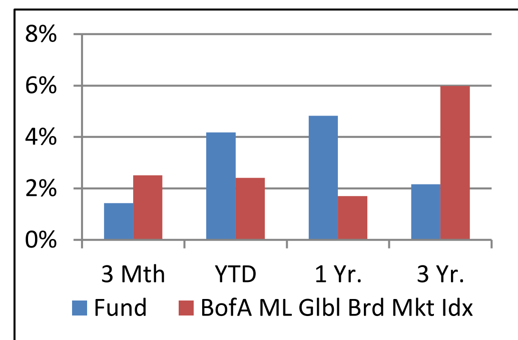
NEI Global Total Return Bond Fund

Fund Company	NEI Investments
Fund Type	Global Fixed Income
Rating	A
Style	Top-down macro Bottom-up security selection
Risk Level	Low
Load Status	Optional
RRSP/RRIF Suitability	Good
Managers	Laurent Crosnier since Apr 2014 Myles Bradshaw since May 2015
MER	2.13%
Fund Code	NWT 194 – Front-end units NWT 894 – Low-load units
Minimum Investment	$500





ANALYSIS: Launched in September 2013, the fund is sub-advised by Paris-based Amundi Asset Management. It focuses primarily on investment-grade bonds around the world, in both developed and emerging markets, with the goal of balancing returns with potential risk.

Risk-management tools include duration management, country and yield curve positioning, sovereign bonds, and credit allocations, as the fund blends top-down macro analysis with bottom-up security selection, also incorporating socially responsible investing criteria.

Their top-down macro analysis takes a directional and relative value view on government and corporate bond issues, helping the managers zero in on the best opportunities and create a model portfolio. The bottom-up security selection process looks for bonds or derivatives that will provide what they believe to be the most effective exposure based on their model.

As of Nov. 30, about 54% of the portfolio was weighted to government bonds, with corporates at 38% (including about 12% in high-yield issues). At Nov. 30, about 60% of the portfolio was invested in Europe and 15% in the U.S., making this a truly global option.

Currency exposure is determined by the model, but at the end of November, substantially all the currency was hedged back to Canadian dollars. Duration remains well below the index, and was posted as 4.1 years at the end of November.

Over the past three years to Dec. 31, the fund posted a modest average annual compounded rate of return of 2.7%, as weaker performance in 2015 and 2016 acted as headwinds. Last year, however, saw an improvement, with the fund gaining 5.3% in 2017.

The fund's volatility profile is well below the broader markets and peer group, and it has done an excellent job protecting capital in down markets. For the three years ending Dec. 31, it participated in less than 10% of the downside of the Bloomberg Barclays Global Aggregate Index.

This fund is shaping up to be a lower-volatility way to play global bonds. It provides exposure across a wide range of geographic sectors and credit qualities. While not my favourite fund at the moment, it is one certainly worth keeping an eye on.

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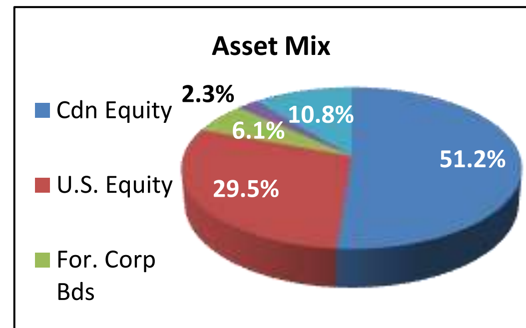
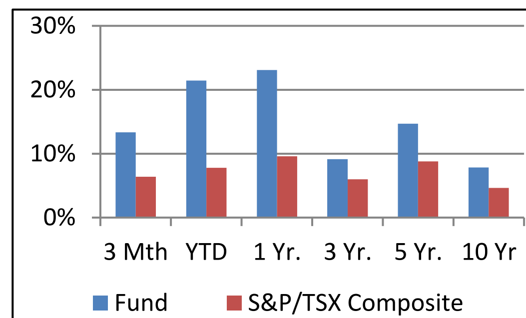
Manulife Canadian Focused Fund

Fund Company	Manulife Investments
Fund Type	Canadian Focused Equity
Rating	A
Style	Mid Cap Growth
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Excellent
Manager	Duncan Anderson since July 2012 Alan Wicks since July 2012
MER	2.29%
Fund Code	MMF 4589 – Front-end units MMF 4748 – Low-load units
Minimum Investment	$500





ANALYSIS: The fund is managed by the same team, using a nearly identical process as one of my favorites, the Manulife Dividend Income Fund. The managers use a unique multi-step approach that looks to fully understand the value of a business.

With an all-cap mandate, at Nov. 30, the fund was 53% invested in Canadian equity, 36% in U.S. equity, 2% in international equities, and the balance in cash and other assets.

The managers' process analyzes the quality and risks of a potential investment by scoring each company on several factors, including stability and level of earnings power, managerial skill and ownership, and financial leverage. This generates the inputs for an estimate of fair value, which in turn helps to determine buy and sell prices. A deeper due diligence review is conducted on the most attractive opportunities, including meetings with management.

The portfolio is built as if the managers were putting together a conglomerate company. They strive to ensure there is significant diversification across business risk and return drivers. Each company has a role to play in the portfolio.

The managers are also very active in managing position sizes, and will buy and sell based on the difference between the stock price and their estimate of its real worth.

The portfolio consists of roughly 60 names, with the top 10 making up about 45% of assets. It is overweight consumer, technology, and healthcare, and significantly underweight energy, materials, and financials, giving it a much different profile than the typical Canadian equity fund.

Performance both over both the long and short term has been excellent. In 2017, the fund delivered a 26.5% return, and boasts a 5-year average annual compounded rate of return of 15%.

Because the portfolio is more concentrated, differing considerably from the index, the fund has been more volatile. But even with the higher volatility, it has done a great job protecting capital in down markets.

Although I still lean towards its sister Manulife Dividend Income Fund, this one is a good option and can be a great core holding for investors with an above-average risk tolerance.

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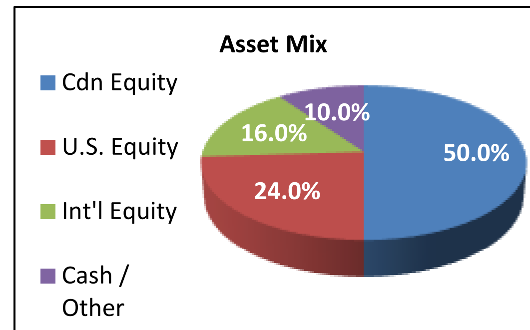
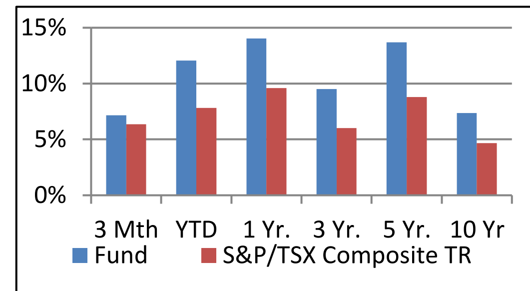
Steadyhand Equity Fund

Fund Company	Steadyhand Investment Funds
Fund Type	Canadian Focused Equity
Rating	A
Style	Large Cap Growth
Risk Level	Medium
Load Status	No Load
RRSP/RRIF Suitability	Excellent
Manager	Gordon O'Reilly since Feb. 2007
MER	1.42%
Fund Code	SIF 140 – No-load units
Minimum Investment	$10,000





ANALYSIS: It's been said that to beat the index, you can't be the index. This is the overriding philosophy of Vancouver-based Steadyhand, with their "un-dexing" approach to investing. And as a result, Steadyhand funds tend to be concentrated, with offerings that look nothing like their benchmarks. The Steadyhand Equity Fund is their North American equity offering, and is managed by Gord O'Reilly of Toronto based CGOV Asset Management.

The portfolio consists of only 25 holdings, constituting the firm's "best ideas." This approach, for which CGOV is known, creates a unique "competition for capital" within the portfolio. Before a new idea is included in the portfolio, an existing holding must be sold to make room. This forces the managers to remain objective on the portfolio holdings at all times.

The managers first screen the investment universe on liquidity and quality factors, and then drill down using different criteria, including management quality, fundamentals, and valuation.

Valuation is key, and to be considered, a stock must be trading well below what the managers believe it to be worth, providing investors with a strong margin of safety. The result is a portfolio made up of high-quality companies that have sustainable business models, a growing and sustainable dividend yield, and excellent management teams with a history of generating strong levels of free cash flow.

While the portfolio is built on a bottom-up basis, there are controls in place to ensure proper diversification. For example, the fund must be invested in at least eight of the Global Industry Classification Standard (GICS) sectors, and the maximum weight in any sector is capped at 30%.

Performance has been excellent over both the long and short terms. Its 5-year average annual compounded rate of return to Dec. 31 is 13.2%, outpacing both the index and peer group. Volatility has been below average, and the fund has done an excellent job protecting capital in down markets.

As with other Steadyhand funds, the costs are rock bottom, with an MER of 1.42%. One drawback is that the concentrated, differentiated portfolio could see periods where performance differs dramatically from the index or peer group.

Still, the Steadyhand Equity Fund is an excellent fund that could be a solid core equity holding for most investors.

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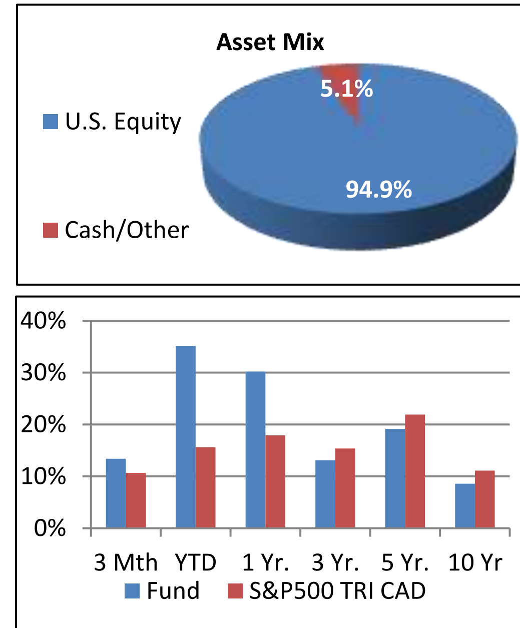
Dynamic Power American Growth Class

Fund Company	Dynamic Funds
Fund Type	U.S. Equity
Rating	D
Style	Mid Cap Growth
Risk Level	High
Load Status	Optional
RRSP/RRIF Suitability	Poor
Manager	Noah Blackstein since Mar. 2002
MER	2.43%
Fund Code	DYN 004 – Front-end units DYN 604 – Low-load units
Minimum Investment	$500



ANALYSIS: This fund is managed using a process similar to its sister Dynamic Power Global Growth Class, with the key difference being its focus on U.S. equities. The fund holds a concentrated portfolio of 20 to 30 U.S., companies that veteran manager Noah Blackstein believes to have the best growth prospects, strongest earnings momentum, and a history of upside earnings surprises.

The portfolio has a high degree of sector concentration, with nearly 60% in technology and another 26% in healthcare. The balance is split between consumer discretionary and financial services.

Make no mistake, this is a high-growth portfolio. Valuation levels are extreme when compared with the broader U.S. equity market. The fund's price/earnings ratio recently was recently shown at more than 65 times earnings, compared with a P/E just shy of 20 for the S&P 500. The price-to-book value ratio is at more than 13 compared with a P/B of 3 for the index.

Valuations are undeniably high, but then so too is earnings growth. The underlying portfolio has been able to grow earnings at a pace that is more than double that of the broader equity markets.

The manager is very active, with the fund posting a 5-year average portfolio turnover of 300%. This has added approximately 27 basis points to the total cost of owning the fund, at an MER of 2.43%.

In return, though, performance numbers have been stellar, particularly in the short-term. The fund grew 32.4% in 2017, more than doubling the 13.8% rise in the S&P 500 in Canadian dollar terms. Longer-term numbers are still above average, but more in line with the peer group.

Like its global counterpart, this fund wins big, but also loses big, boasting one of the larger upside capture ratios as well as one of the biggest downside capture ratios. This is a volatile fund, with a standard deviation more than 50% higher than the benchmark. This volatility has hurt the fund's risk-adjusted returns, as it trails both the index and peer group.

I like this fund for the long-term, but am not sure it is appropriate now, given its overall valuation levels and concentrated portfolio. However, it would be a solid pick after a market selloff and would be expected to outperform its peer group and the broader equity market.

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