

Top Funds Report

Volatility returns to markets

Normal-course market correction brings valuation levels back down to earth

Markets came bursting out of the gate in early January, making it look a lot like “2017, the sequel.” U.S. and global markets rallied higher, with the S&P 500 gaining 5.7% in U.S. dollar terms, and the MSCI EAFE Index rising 5.0%. Emerging Markets were also very strong, with the MSCI Emerging Markets Index rising by 8.3%, and China gaining 12.5%. Closer to home, the S&P/TSX Composite bucked the global trend and sold off modestly, falling 1.4% on weaker energy. Investors were generally feeling pretty good. Then came Groundhog Day.

Like Wiarton Willie emerging from his groundhog hole to see his shadow, on Feb. 2 volatility started creeping out of its year-long hibernation. It must have rested up over the weekend, because it came back and hit us with a vengeance on Monday, Feb. 5, with markets selling off hard. The S&P 500 lost more than 4%, the Dow was down 4.6%, Nasdaq was off 3.8%, and the TSX lost just under 2%.

Over the next couple days, the markets licked their wounds, clawing back some of the losses, only to see volatility rear its ugly head again on Feb. 8, with a near repeat of Monday’s losses. Markets again sold off by roughly 4%.

For some investors, fear has begun to set in, and they worry we could instead be in for “2008, the sequel.”

I certainly don’t want to downplay the severity of the correction we have seen, but I certainly don’t see this as anything even close to a financial crisis. (Yes, there have been rumblings about potential issues created by the unwinding of volatility derivative products, but the size of those trades is not anywhere near the scope of sub-prime mortgages a decade ago.)

First of all, the global economy is positive and continues to grow, and the economies are creating jobs. Corporate earnings for the most part are

positive, and despite an upward move in labour costs in the latest U.S. jobs report, inflation remains mostly well contained. The yield curve is steepening, which is as it should be.

Interest rates are moving upward, but they are still very low by historical standards. Even if we do see the three or four hikes that are expected from North American central banks this year, we are still on the low end of history.

The only real concern with the markets has been valuations. With interest rates higher, valuations need to be adjusted to reflect the new reality of higher rates. What markets have been doing this month is really nothing more than a normal-course market correction that will bring valuation levels back to more realistic numbers.

How low could the indexes fall? That’s hard to say, and I won’t even try to guess, but I expect it will be much less severe than the 2008 selloff. At the time of writing, the S&P 500 has even staged something of a rally since hitting a low on Feb. 9. That’s not to say there won’t be another dip or two as more normal trading patterns emerge.

		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	

In the meantime, my investment outlook remains consistent. I am still modestly overweight equities over fixed income, but I expect that if we do see continued upward pressure on yields, I will move to

a more neutral positioning. 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 Steadyhand, O'Shaughnessy, and funds on my Recommended List...

Steadyhand Global Equity Fund (SIF 140 – No-Load Units)

MER: 1.78%

Assets (\$mil): \$90.8

Fundata Rank (1Yr): 238/871

Std Dev (3Yr): 11.67%

On Jan. 17, Franklin Resources Inc., the parent company of Franklin Templeton Funds announced that it had agreed to buy Edinburgh Partners, the manager of the Steadyhand Global Equity Fund. The transaction is expected to close in the first half of the year.

Under the terms of the deal, Dr. Sandy Nairn will become chairman of Templeton Global Equity Group and remain investment partner and CEO of Edinburgh Partners.

Interestingly, Dr. Nairn worked at Franklin Templeton for more than a decade before starting Edinburgh Partners, and worked alongside Sir John Templeton. Looking at the investment styles and philosophies of Edinburgh and the classic Templeton approach, there certainly appears to be a strong fit. However, it is too early to understand what effect, if any, this deal will have on the Steadyhand Global Equity Fund.

For the time being it's business as usual, and the fund will continue to be managed in the same disciplined fashion as it has been in the past. The managers will continue to take an almost contrarian, value-focused approach and buy companies they believe to be attractively priced.

If you hold the fund and it is consistent with your investment objectives and risk tolerance, there is no reason to make any changes for now. However, if you were considering a new investment in the Fund, you might consider holding off until the uncertainty about

the fund's management is cleared up. Once the dust settles, we will all be in a much better position to assess the situation and outlook.

Change in Leadership at O'Shaughnessy Funds

On Jan. 24, it was announced that Jim O'Shaughnessy was stepping aside as CEO of O'Shaughnessy Asset Management. Patrick O'Shaughnessy, Jim's son will step into the role. Jim remains with the firm as Chairman and Chief Investment Officer.

In the role of CEO, Patrick will oversee the day-to-day business of the firm and will direct the firm's initiatives in the areas of research, portfolio management, investor education, and client relationships.

Given the systematic focus of the investment process it is not expected this change will have any impact on the investment management of the O'Shaughnessy funds.

The investment process continues to screen the stock universe on factors that have historically been found in stocks that outperform. These include valuation, market cap, momentum, and return on invested capital, which includes dividends, share buybacks, and debt repayments.

Stocks are scored on these factors and then ranked from most attractive to least attractive, with the portfolios being made up of the most attractive.

Of the RBC O'Shaughnessy offerings, the RBC U.S. Value Fund remains my favourite, but I am also a fan of the RBC O'Shaughnessy Canadian Equity Fund.

I believe in the disciplined systematic process for the long-term, but there may be periods where it lags the broader markets.

iShares eliminating Advisor Class Units on their ETFs

On Feb. 1, it was announced that BlackRock Canada would be eliminating the Advisor class of its ETFs in early April. This series paid advisors a trailer fee, much like the A class mutual funds that carry embedded dealer compensation.

These trailer fees were typically in the 0.5% per year range. All the ETFs that have these embedded trailers were derived from the old Claymore ETFs that BlackRock acquired when it bought Claymore back in 2012.

To be honest, I never really understood the need for an advisor series ETF, as most ETFs would be used in a fee-based account. Turns out I wasn't the only one who didn't see a need for these ETFs, as the advisor series represented less than 1% of BlackRock Canada's total assets under management.

Holders of these ETFs will automatically be reclassified into the common units of the affected ETFs, each of which carries an MER that is significantly lower than the advisor series. And this is definitely a good thing for investors!

Mackenzie Ivy Foreign Equity Fund (MFC 081 – Front-End Units, MFC 7107 – Low-Load Units)

MER: 2.50%

Assets (\$mil): \$1,995.52

Fundata Rank (1Yr): 841/871

Std Dev (3Yr): 8.63%

The fourth quarter was another tough one for this global equity offering. Net asset value rose by 2.8%, trailing the MSCI World, which gained 6.2%. The fund's high cash balance was again a key reason for this underperformance. At the end of December, the fund held more than 25% in cash, which would translate very roughly to approximately 1.34% in potential performance given up during the fourth quarter.

Another reason for the underperformance was poor stock selection in the consumer discretionary sector. Clothing retailer H&M struggled in the quarter and over the year, as many retailers faced headwinds. Bankruptcies of other traditional retailers (Sears, Toys

R Us) combined with the continued rapid growth of Amazon hurt most retailers and dragged down H&M. Fund management believes that H&M is uniquely positioned, and their investment thesis on the company remains intact. In addition, an underweight allocation to technology also hurt the fund.

Managers remain very defensive, with heavy emphasis on consumer names, industrials, and healthcare.

The key reason I like this fund is for its defensive nature. With markets becoming more volatile, I expect this fund will really start to shine. In the first three trading sessions in February, it held up relatively well, falling 2.4%, while the MSCI World Index lost nearly 4%.

Further, as we see volatility increase, I expect the manager will start to put some of the cash to work as quality companies become more attractively valued. I am monitoring it closely.

Trimark U.S. Companies Fund (AIM 1743 – Front-End Units, AIM 1745 – Low-Load Units)

MER: 2.79%

Assets (\$mil): \$623.65

Fundata Rank (1Yr): 30/699

Std Dev (3Yr): 13.22%

This Trimark offering had a really solid fourth quarter, gaining 9.7%, handily outpacing the benchmark and peer group. In comparison, the S&P 500 gained 7.2%.

While manager Jim Young uses a similar approach to other Trimark funds in managing this one, he tends to have more of a growth tilt. At the end of December, he was overweight technology, industrials, and healthcare, and underweight real estate, telcos, and utilities.

As part of his investment process, Young looks for companies that have distinct proprietary advantages, invest significantly to obtain a competitive advantage, and demonstrate consistently strong management and industry leadership.

The portfolio is concentrated, holding just over 40 names, with the top 10 making up 40% of the fund's holdings. Top holdings include PNC Financial

Services, biotech firm Celgene Corp, and semiconductor maker Analog Devices.

At the end of December, the manager believed the market was fairly valued relative to interest rates and inexpensive compared with bonds. Within the fund specifically, valuations are rich, but in line with the broader market.

Performance has generally been above average, and for the 12 months ending Jan. 31, the fund gained 28%, outpacing both the index and peer group. Volatility has also been well above average, which makes it much less attractive on a risk-adjusted basis.

My concern with this fund is that when the markets begin focusing on fundamentals, it will trail because of its emphasis on growth names. If you have held this fund for some time, you may now want to consider taking some profits off the table. I continue to monitor it closely.

RBC O'Shaughnessy U.S. Value Fund (RBF 766 – Front-End Units, RBF 130 – Low-Load Units)

MER: 1.49%

Assets (\$mil): \$25.96

Fundata Rank (1Yr): 37/699

Std Dev (3Yr): 13.08%

This fund had a really solid fourth quarter gaining 8.4%, handily outpacing the benchmark and peer group. It is managed using a very systematic approach that scores the U.S. stock universe on several factors including valuation, market cap, momentum, and return on invested capital, which includes dividends, share buybacks, and debt repayments.

The result of this process is a portfolio that is much different than the S&P 500. According to RBC, the Active Share, which measures the similarity of a fund with the benchmark, was 89%. The higher the Active Share, the more different the holdings of the fund are from the benchmark, making this a very distinct U.S. equity offering. In the fourth quarter, it was the yield and value factors that were the strongest contributors to the overall return.

Any currency exposure is fully hedged, which was a modest drag in the fourth quarter, but a big driver of returns over the year, adding more than 800 basis points of return in 2017. This helped boost relative returns, as most of the peer group tends to run with unhedged currency exposure.

This fund remains an interesting U.S. equity pick for the long-term.

BMO Asian Growth & Income Fund (GGF 620 – Front-End Units, GGF 942 – Low-Load Units)

MER: 2.83%

Assets (\$mil): \$38.56

Fundata Rank (1Yr): 44/44

Std Dev (3Yr): 9.62%

Despite a respectable gain of 5.5% in the fourth quarter the fund trailed its index and peer group, mostly a result of the fund's more conservative positioning. Unlike its peers, which are typically all equity plays, this fund will also hold convertible bonds and preferred shares.

At the end of January, it held approximately 85% in equities, 9% in convertibles, and 3% in preferred shares. The fund's holdings in Hong Kong and China were strong contributors over the quarter, with big gains coming from AIA Group, a pan-Asian life insurance company that saw strong growth in new business. Continued liberalization in the China market is expected to see it expand further in the country.

Looking ahead, the managers expect the current synchronized global growth cycle will continue into 2018. Valuations in Asian markets are attractive compared with the U.S. providing significant room for growth. While the outlook is favourable, there are risks on the horizon. Central bank tightening, China, and increased trade barriers could all create potential headwinds.

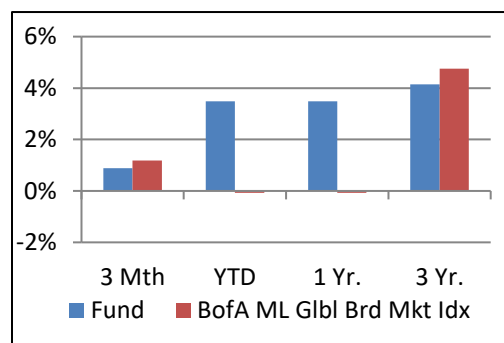
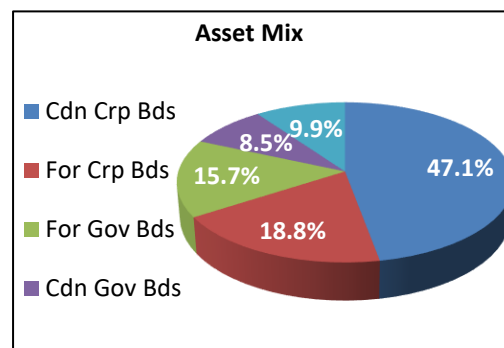
However, with volatility on the upswing, the more conservative positioning of this fund makes it an excellent way to access Asian markets.

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

feedback@paterson-associates.ca

CI Investment Grade Bond Fund

Fund Company	CI 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
Manager	Paul Sandhu since Dec. 2014
MER	1.68%
Fund Code	CIG 2185 – Front-End Units CIG 1185 – Low-Load Units
Minimum Investment	\$500



ANALYSIS: The investing environment is getting considerably more challenging, as interest rates are likely to be moving higher in Canada and the U.S., and likely around the globe. Passive, low-cost, index-like bond investments have done well over the past few years, but now it will be the time for truly active bond strategies to shine. And this CI bond fund offering is one such strategy.

Managed by Paul Sandhu of Marret Asset Management, this is a global bond fund that affords the managers a lot of flexibility. With its global mandate, the fund can invest in Canadian, U.S., and European corporate bonds.

Mr. Sandhu builds a core portfolio using a combination of top-down macro analysis combined with fundamental, bottom-up security selection. Once the portfolio is set, he then uses an overlay strategy to tactically hedge three key risks: interest rate risk; credit risk; and currency risk.

To hedge interest rate risk, the Mr. Sandhu can tactically short government bonds and interest rate futures, while credit risk is hedged through the use of credit default indexes.

In addition, he will actively trade the portfolio, looking to take advantage of short-term opportunities.

At the end of December, the fund held 47% of assets in Canadian corporate bonds, 19% in foreign credit, 16% in foreign government bonds, 9% in Canadian government bonds, and the remainder in cash.

Performance has been very strong. The 3-year average annual compounded rate of return ending Jan. 31 was 3.0% compared with the FTSE/TMX Canada Universe Bond Index return of 2.3%.

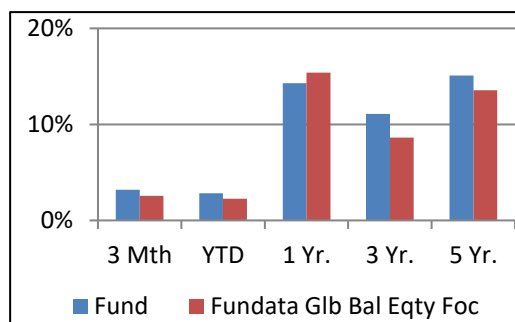
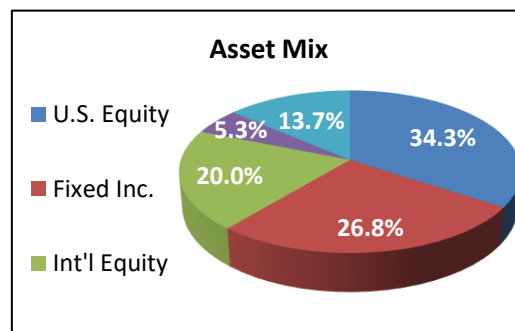
Volatility has been well below the index and the peer group, resulting in above-average risk adjusted returns.

With credit spreads tight around the world, and interest rates likely to become volatile, you need a bond fund that is actively managed. The CI Investment Grade Bond Fund is certainly one worth taking a look at.

If you prefer an ETF structure, a substantially similar mandate is available in the First Asset Investment Grade Bond ETF (TSX: FIG).

EdgePoint Global Growth & Income

Fund Company	EdgePoint Wealth Management
Fund Type	Global Equity Balanced
Rating	A
Style	Bottom-Up / Mid-Cap Growth
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	EdgePoint Management Team
MER	2.01% - Front-End Units 2.27% - Low-Load Units
Fund Code	EDG 180 – Front-End Units EDG 380 – Low-Load Units
Minimum Investment	\$15,000



ANALYSIS: EdgePoint is the little Toronto-based money manager that could. Its four Funddata FundGrade A+ Awards in 2017 prove the point. This fund is one of the A+ Award winners and is EdgePoint's global balanced offering, investing in companies anywhere in the world. With a fair bit of flexibility in asset mix, the portfolio was weighted 59% to equity and 41% to fixed income at the end of December.

The management team takes a patient, long-term approach to investing, allowing them to build concentrated portfolios of companies they have really kicked the tires on, developing what they call a "proprietary insight." The managers look for well-run companies with strong competitive positions, defensible barriers to entry, and solid long-term growth prospects. They use a fundamentally-driven, bottom-up investment process that looks for high-quality, undervalued businesses.

Because they are not traditional value investors, EdgePoint's view of the value of a business may differ from the market consensus. They are not afraid to pay up for what they believe is a quality company with excellent long-term prospects. That's mainly why the

portfolio's valuation metrics appear to be higher than the index, but this can be offset by the higher expected growth rates.

Not surprisingly, this strategy results in a portfolio that is significantly different than its benchmark or peer group. From a sector perspective, the fund is meaningfully overweight industrials and underweight financials, telecom, energy, and utilities.

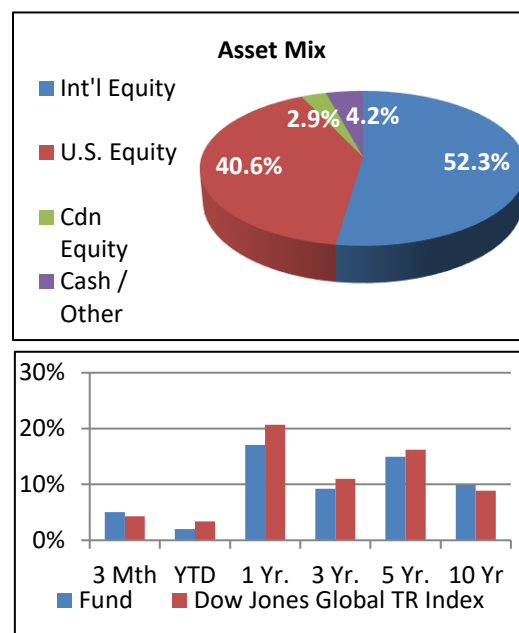
On the fixed income side, managers can invest in both investment-grade and high-yield issues. At the end of December, the average credit quality was listed by Morningstar as BBB.

The managers' patient approach is also reflected in the portfolio turnover numbers, which are very low, averaging less than 50% per year. Performance has been excellent with the fund delivering a 5-year average annual compounded rate of return of 15.1% to Jan. 31, and a one-year gain of 14.3%. Volatility numbers have been higher than the index and peer group, but the excess return has more than offset this.

This is a great core holding that has the potential to continue to deliver solid risk-adjusted returns for investors.

Trimark Global Endeavour Fund

Fund Company	Invesco Canada Ltd.
Fund Type	Global Equity
Rating	D
Style	Mid Cap Blend
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Excellent
Manager	Jeff Hyrich since August 2002 Erin Greenfield since Jan. 2008
MER	2.58%
Fund Code	AIM 1593 – Front-End Units AIM 1595 – Low-Load Units
Minimum Investment	\$500



ANALYSIS: Managed by the team of Jeff Hyrich and Erin Greenfield, this concentrated, all-cap offering has been one of my favourites for some time. The managers aim for a concentrated portfolio of between 25 and 40 companies of any size that are typically leaders in their industry.

They focus on what they determine to be attractively valued companies with strong management teams that have a proven history of generating strong free cash flows, sustainable competitive advantages, and solid long-term growth prospects.

The process is very much bottom up with the sector mix and geographic exposure being the result of the stock selection process. At the end of January, roughly half the portfolio was in U.S. equities, with the balance spread across Europe and Asia.

As for sector exposure, the portfolio is tilted towards consumer discretionary names, with overweighting in industrials and healthcare.

Both long- and short-term performance has been excellent. For the 12 months ending Jan. 31, the fund gained more than 17%, and its 5-year average annual compounded rate of return came in at nearly 15%.

Volatility has been roughly in line with the broader market, but the managers have done a reasonable job protecting capital in down markets. For the past three and five years, the fund has participated in about 88% of the market's drawdowns.

In the fourth quarter, the managers sold Fugro N.V., a long-term energy holding, and with the proceeds added to a recent acquisition in the health care sector as well as to current holdings in the consumer discretionary sector.

The fund is somewhat defensively and, as the managers believe any increase in volatility can bring about opportunities to pick up quality names trading at attractive prices.

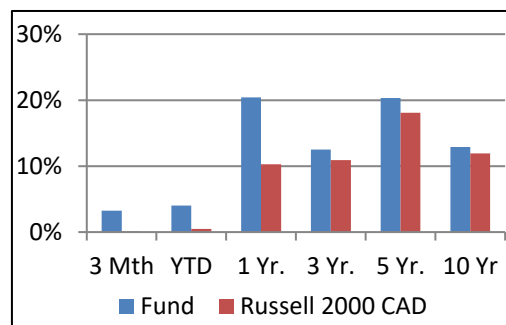
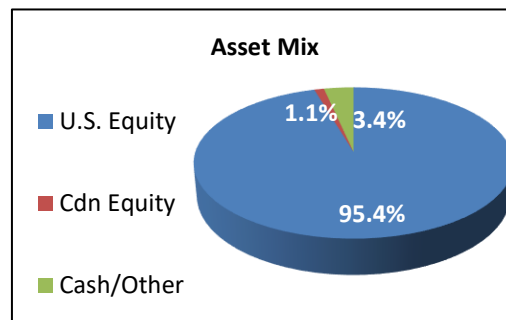
Overall market valuations remain rich, but the managers have still been able to find a few quality opportunities. That pool is expected to deepen somewhat with the return of market volatility and more traditional trading patterns.

They remain patient and will stick to their disciplined investment process, being careful not to overpay for growth.

All in all, this remains an excellent all-cap global offering.

TD U.S. Mid-Cap Growth Fund

Fund Company	TD Asset Management
Fund Type	U.S. Small Mid Cap Equity
Rating	B
Style	Mid Cap Growth
Risk Level	High
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Brian Berghuis since Jan. 1994 John Wakeman since July 2006
MER	2.55%
Fund Code	TDB 312 – Front-End Units TDB 372 – Low-Load Units
Minimum Investment	\$500



ANALYSIS: Managed by T. Rowe Price, the TD U.S. Mid-Cap Growth Fund has been one of the strongest performers in its category over the past few years. For the 5 years ending Jan. 31, the fund delivered an average annual compounded rate of return of 20.3%, outpacing both the peer group and the Russell 2000, which returned an average annual 18.1% over the same period. Shorter term numbers are also solid, with the fund producing a 1-year gain of 20.4%.

More impressive however is that the managers produced these results with a level of volatility that is well below the index and the peer group. For the past five years, the fund's volatility has been roughly 60% of the index. The managers have also done a great job protecting capital, participating in roughly 65% of the downside of the market.

To achieve these numbers, the managers look for high-quality companies that have the potential to grow earnings or cash flow at a rate of at least 12% per year. They look for solid business models that offer competitive advantages, such as a differentiated product or a franchise brand. Such companies quite often will generate higher margins and higher returns on invested capital. While this is a growth-focused fund, the

managers try to make sure they don't overpay for that growth.

The portfolio is well diversified, consisting of between 120 and 140 names, with the top 10 making up less than 20% of the fund's assets.

Valuations, however, are rich, with valuation ratios well above the broader market. But this is somewhat offset by the growth rates, which are substantially higher than the index. Taken all together, this is a portfolio that has the potential to post above-average numbers in rising markets. But in volatile markets, it also has the potential to sell off more than the index.

While the managers have done a great job historically in protecting capital, the higher-than-normal valuation levels may make that a bigger challenge down the road. Still, this is an excellent fund, and if you hold it, and it is in line with your investment objectives and risk tolerance, there is no reason to sell it. You may want to take some profits and get some money off the table.

At current levels, I'd be reluctant to take on a new position in the fund. If we do see a selloff, it may be a good time to start a new position.