

Top Funds Report

Markets rally from February bust

But risks remain against a backdrop of rising interest rates and the threat of a trade war...

February saw the return of volatility, sending markets on a wild ride, with swings that were reminiscent of 2008. The S&P/TSX Composite Index peaked in early January, and largely held its own until the last week of the month, when the freefall started and really picked up steam through early February. Peak to trough, the S&P/TSX Composite fell more than 8.1%.

But then, from the February 9 low, the index managed to claw back nearly 3% of the losses to end the month down only 3% from its peak. It was a similar story south of the border, where the S&P 500 Composite Index fell more than 10% peak to trough, but then managed to gain back nearly 5% in February to close out the month lower by only 3.7% in U.S. dollar terms.

There are many theories as to why the markets sold off, including the usual suspects: elevated market valuations; increasing bond yields; booming job creation and worries about rising inflation; and the unwinding of complicated financial instruments that are linked to market volatility.

Unfortunately, we'll never really know what caused markets to sell off, and truthfully, it really doesn't matter. Each of the purported triggers for a selloff is a valid reason in its own right, and the reality is that with bond yields moving higher, the markets need to adjust valuation levels. Market valuations have been well above normal for some time, and some level of correction or adjustment is needed.

But I certainly don't see this correction as the beginning of another 2008 bear market, or the bursting of the tech bubble in the late 1990s, or anything else that calamitous. Far from it. The global economy continues to show mostly positive signs, inflation remains reasonably well contained, and corporate profitability remains strong. I see this as a normal market correction that has resulted in a modest repricing of risk.

That was the case until March 1, when U.S. President Donald Trump announced he was imposing tariffs on steel and aluminum as a matter of national security. Understandably, this angered many of America's largest trading partners, namely Canada, Mexico, and the European Union, and threats of retaliation and trade war surfaced almost immediately. Canada and Mexico were subsequently exempted, at least temporarily while NAFTA talks are underway, from the tariffs, which are seen largely as being aimed at China.

However, this still has the potential to escalate into a significant trade war, with nations going tit for tat with the U.S. in retaliation for this boneheaded move by President Trump. Hopefully, calmer heads will prevail, and deals can be worked out separately without disastrous repercussions.

With so much uncertainty on the table, nobody can say with any certainty where things will progress from here. As for investors, the best course of action is to remain calm and level-headed, determine the asset mix that is

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Dave Paterson's Investment Outlook – March 2018				
		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	

most appropriate for your investment objectives and risk tolerance, and find high-quality, well-managed investments to round out your portfolio.

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 current asset weighting 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 ETFs from Vanguard, PowerShares, & iShares, and mutual funds from Fidelity...

Vanguard Aggregate Bond ETF (TSX: VAB)

The race to the (fee) bottom continues, with Vanguard announcing on Feb. 13 that it is reducing the management fee for VAB to 0.08% from 0.12%. This should see the all-in MER for the ETF drop to approximately 9 basis points. And that would make Vanguard the lowest-cost bond ETF, beating both **iShares Core Canadian Universe Bond (TSX: XBB)** and **BMO Aggregate Bond ETF (TSX: ZAG)** by 1 basis point on the management fee.

With interest rates poised to move higher, investors may want to consider the iShares XBB offering because of its higher exposure to corporate bonds, which are expected to hold up better in a rising yield environment. Investors are expected to favour corporate bonds for the additional yield they can generate, which results in a lower level of interest rate sensitivity.

At the end of January, XBB held nearly 30% in corporate bonds, compared with approximately 22% for VAB. Based on its positioning, I would expect XBB to slightly outperform VAB in a flat or rising yield environment. However, VAB would be expected to outperform in a falling yield environment.

Fidelity Event Driven Opportunities Fund (FID 2798 – Front-End Units, FID 2789 – Low-Load Units)

This is one of those funds that is hard to categorize. It's classified as a U.S. small/mid-cap fund, but that may not always be the best place for it. It has a unique mandate that looks to take advantage of corporate events that can help unlock shareholder value, including spinoffs, mergers, index additions or deletions, and 13-D filings.

A 13-D filing provides notification that a person or group has taken an interest of more than 5% in any class of a company's shares. These types of events can provide outsized profits if you're able to identify them early. This is because in some cases, there may be forced buying or selling, which can create share price movements.

In some cases, the companies may be under-followed by the analyst community, which can create an inefficiency that allows the manager to benefit as the broader market begins to recognize the potential impact of the event. These types of opportunities don't adhere to any set schedule – they can play out very rapidly or take a long time to develop. And this means that the fund's managers must be very nimble indeed.

Performance of the fund has been solid, with a 3-year average annual compounded rate of return of 12.8%, ending Jan. 31. In comparison, the Russell 2000 rose by 10.9% in the same period. The fund has also held up very well during the recent volatility, gaining 0.7% in February, handily outpacing the index and peer group.

However, the fund can be more volatile than the broader market, as recently confirmed by its 3-year average standard deviation of 14.5% (as of Feb. 28), which is higher than both the index and peer group. Still, the fund has done a solid job protecting capital in falling markets, participating in roughly three quarters of the market declines.

While not for everyone, the fund can be an interesting addition to a portfolio for those with an above-average risk tolerance, an appetite for growth, and a long-term time horizon. I would definitely not consider this a core holding, but rather a piece of an otherwise well-diversified portfolio.

PowerShares Senior Loan Index ETF – CAD hedged (TSX: BKL.F)

In the three months ending Jan. 31, the PowerShares Senior Loan Index ETF – CAD hedged gained 0.96%. But traditional fixed-income investments struggled as the FTSE/TMX Canadian Universe Bond Index lost 0.43%. The disparate returns are a result of the nature of the underlying investments, which for BKL.F are senior secured, floating-rate bank loans.

Bank loans pay a coupon rate that is reset based on a benchmark interest rate, usually the 3-month LIBOR. Because the coupon payments move in tandem with interest rates, floating rate notes can be an excellent investment in a rising yield environment with little duration risk and very high yields. The weighted average yield to maturity of BKL.F was recently posted at 5.1%.

However, there are some drawbacks, including credit risk, risk of default, and a potential lack of liquidity. However, these risks are somewhat mitigated by the fact that senior secured loans often rank at the top of the capital stack, meaning they will be paid out first in the event of insolvency. In addition, because the ETF invests in the largest and most liquid loans, the liquidity risk is much less than for individual loans or active funds or ETFs that invest in off-benchmark issues.

While short-term performance has been improving, the longer-term return numbers have been less than exciting, with the fund posting a 5-year average annual compounded rate of return of 2.45% at Feb. 28. That's a result of the low and falling-yield environment of recent years. But now with upward pressure on yields and overall higher levels of volatility, floating rate products have become significantly more attractive than many traditional fixed income investments.

Bottom line, for investors looking for a way to reduce their interest rate exposure, but comfortable taking on some additional credit risk, this is an ETF worth considering.

PH&N Balanced Fund (RBF 1350 – No-Load Units, RBF 6350 – Front-End Units, RBF 4350 – Low-Load Units)

The fund is managed like a fund of funds that invests in other mutual and pooled funds offered by RBC. At the end of February, approximately 36% was invested in

bonds, 30% in Canadian equities, 16% in U.S. equities, 15% in international equities, and the balance in cash

Performance has been very strong, with a 5-year average annual compounded rate of return of 7.4% to the end of February, outpacing most of its peers. It has also been a relatively consistent performer and has posted above-average results in every calendar year, except for 2011. The fund has been a touch more volatile than the benchmark and peer group, but even with the higher volatility, it has delivered above-average risk-adjusted returns

The fixed-income sleeve is invested predominantly in the very solid **PH&N Bond Fund**. But because it looks a lot like the index, it is likely to be a drag in a rising yield environment.

The PH&N Balanced Fund has also been helped by the growth tilt of the equity sleeve, which has an overweight allocation to financial services, technology, and energy-focused names. Valuations look rich by all measures, but this is partially offset by the higher forecasted growth outlook. If we see a meaningful correction or a market shift back towards fundamentals, the fund has the potential to see a sharp drawdown.

With an MER of 0.88%, the do-it-yourself D units are more attractive than the full-freight advisor-sold units, which carry an MER of 2.02%.

Historic performance has been strong, but I am less confident this can be sustained, and I expect to see higher levels of volatility with lower return levels.

iShares Core S&P 500 Index ETF (CAD Hedged) (TSX: XSP)

The S&P 500 Composite Index continues to be a tough bogey to beat, again posting the strongest results in the period, modestly outpacing both the more broadly diversified, cap-weighted **Vanguard U.S. Total Market (TSX: VUS)** and the fundamentally-built **iShares U.S. Fundamental index (TSX: CLU)**.

A higher weighting in technology, healthcare, and financials, combined with less exposure to small and mid-cap names helped to drive the outperformance. A drawback to this positioning is that the valuation level of the portfolio is modestly higher than the other two ETFs, which may create a headwind for future performance.

The foreign currency exposure of XSP is fully hedged, which has helped its recent performance compared with other unhedged U.S. equity funds and ETFs.

Because it's likely the U.S. Federal Reserve will move interest rates more quickly than the Bank of Canada, the U.S. dollar would be expected to continue to increase in value against the loonie.

If that scenario plays out, investors may be better off investing in XUS, which provides the same investment exposure, except that the currency exposure remains unhedged.

With a rock-bottom MER of 0.11%, this continues to be the U.S. equity ETF to beat.

iShares MSCI World Index ETF (TSX: XWD)

During the period, this was the strongest international/global equity ETF on our ETF Focus List, with a gain of 3.7%. The next strongest performer was the **iShares International Fundamental Index ETF (TSX: CIE)**, which earned 2.3%.

The main reason for the outperformance of XWD compared with the other ETFs on the list is its nearly 60% allocation to U.S. equities, while the others have little, if any exposure to the U.S. During the period, the U.S. was one of the strongest equity performers.

Returns were muted because of the ETF's unhedged currency exposure. If the currency had been fully hedged, it may have resulted in an additional 500 basis points or so in additional performance. However, had the Canadian dollar gained ground on the greenback, this ETF would have outpaced one that had fully hedged currency exposure.

I'd consider XWD for less sophisticated investors looking for a "one ticket" global equity ETF. Others are better off using a pure U.S. equity ETF (like XSP or XUS), combined with a pure EAFE ETF (such as ZEA or ZDM). This combination will provide a very similar investment exposure at a lower cost.

For example, XWD carries an MER of 0.47%. If we were to take 60% of XUS and 40% of ZEA, the combined MER, not including any transaction costs, would be approximately 16 basis points. Over time, this lower fee hurdle will increase the potential return.

Vanguard FTSE Emerging Markets All Cap ETF (TSX: VEE)

Emerging markets continued to outperform developed markets during the three months ending Jan. 31, with China leading the way higher. From a sector standpoint, technology was a leader, as were the commodity sectors, driven by higher crude oil and metals pricing.

Sustained improvement in global economic growth continues in Europe and Asia, with China seeing recovery in profitability, as the focus there shifts towards improving the quality and sustainability of growth. Elsewhere, economic reform is taking hold in India, and inflation in Brazil is on a downward trajectory.

Adding to this, valuation levels of emerging markets are well below their more developed peers. For example, the P/E ratio of VEE is listed at 15.3, while the **iShares Core S&P 500 ETF (TSX: XSP)** is carrying a P/E ratio north of 21. Factor in a better-than-average growth outlook, and the emerging markets story gets even more compelling.

There are risks, of course, as the recent U.S. tariff announcements could create a significant headwind for emerging markets that rely heavily on exports.

Within the EM space, VEE remains my top pick for low-cost, passive exposure. It offers a broader exposure than the iShares and BMO offerings, with just under a quarter of the portfolio invested in small- and mid-cap stocks, compared with 8% for BMO and iShares. Over the long-term, this broader exposure would be expected to deliver modestly higher levels of return.

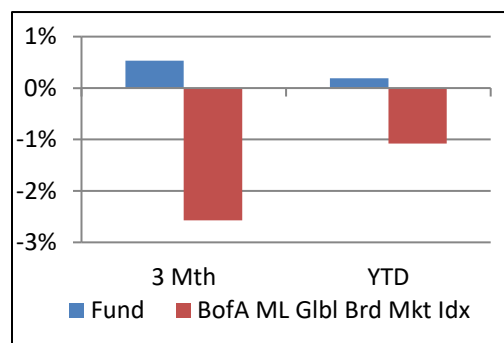
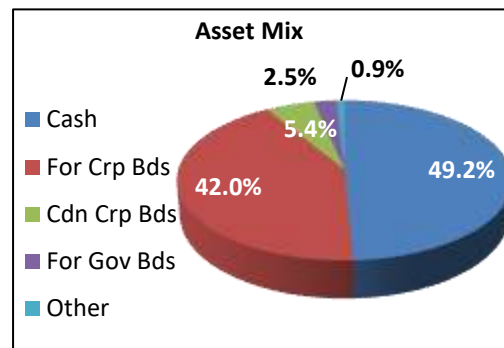
I prefer an actively-managed portfolio in the EM space, because nimble managers can better exploit inefficiencies in emerging markets. Among the active funds, my top pick is the **Trimark Emerging Markets Fund**, which is a concentrated portfolio of EM names. I also like **Brandes Emerging Markets**, which is a more diversified, deep-value portfolio. Both would be strong picks for the long-term when compared with a more passive strategy.

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

feedback@paterson-associates.ca

FA Enhanced Short Duration Bond ETF

Fund Company	First Asset Investment Management
Fund Type	Global Fixed Income
Rating	TBD
Style	Top-down Macro Bottom-up security selection
Risk Level	Low
Load Status	N/A
RRSP/RRIF Suitability	Good
Manager	Barry Allan since Sept. 2017 Paul Sandhu since Sept 2017
MER	0.60% Management Fee
Trading symbol	TSX: FSB
Minimum Investment	N/A



ANALYSIS: This interesting and innovative ETF aims to outperform traditional short-term fixed income investments while keeping volatility very well contained, regardless of the interest rate or credit environment. It invests primarily in a mix of investment-grade corporate and high-yield bonds with maturities of two years or less. It also has the ability to shift into government bonds to protect against recession. It has a go-anywhere mandate but tends to focus on U.S. and Canadian issues.

The investment process starts with top-down macro analysis that helps managers Paul Sandhu (corporate) and Barry Allan (high yield) identify where we are in the credit cycle, which then helps them determine the most attractive positioning from a credit quality, sector, and duration perspective. The security selection process focuses on a company's ability to generate cash flow to make its interest payments and repay principal.

What makes this ETF particularly interesting is its use of government bond futures, which can be used to hedge out interest rate risk. The managers actively manage both the interest rate and the credit risk exposure. Currently, they believe we are very late into the credit cycle and are therefore more defensively positioned.

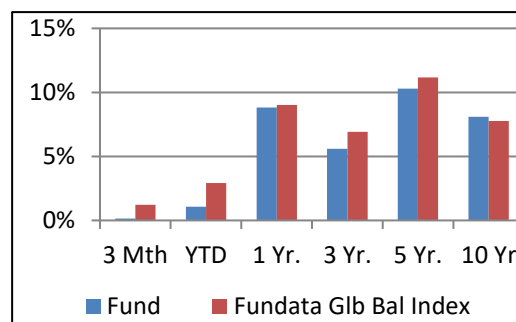
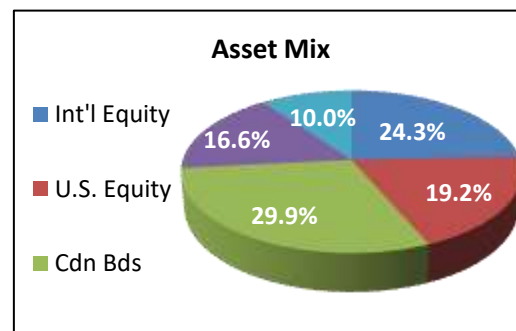
At the end of January, then, the duration of the fund was 0.49 years. In comparison, the **iShares Core Canadian Short-Term Bond Index ETF (TSX: XSB)** carries a duration of 2.7 years. The fund also offers a very attractive yield profile, with a yield to maturity of 3.15% compared with 2.2% for XSB.

The ETF was launched in September of last year, but the strategy is very similar to a pooled fund offering that was launched in late 2014. Consequently, there is not nearly enough history on which to base an analysis of the return stream of the ETF. However, from its inception in November 2014 to January 31, 2018, the pooled fund delivered an average annual compounded rate of return of about 4.5%, with an annualized volatility well below both the Canadian bond market and short-term bond indices.

The ETF is expected to trail the pooled fund slightly in total return, as the pooled fund can short bonds directly, which results in better hedging. Still, for those seeking an alternative to traditional short-term fixed-income funds or ETFs, this is certainly worth taking a look at.

Mawer Balanced Fund

Fund Company	Mawer Investment Management
Fund Type	Global Neutral Balanced
Rating	C
Style	Strategic
Risk Level	Low – Medium
Load Status	No Load
RRSP/RRIF Suitability	Excellent
Manager	Greg Peterson since June 2006
MER	0.94%
Fund Code	MAW 104 – No-Load Units
Minimum Investment	\$5,000



ANALYSIS: One of the best balanced funds in the market, Mawer Balanced is managed much like a fund of funds, investing in other Mawer mutual funds. After modest underperformance in 2016, it bounced back with a 10% gain in 2017, matching the benchmark and outpacing its peers.

Manager Greg Peterson adjusts the asset mix based on the risk-reward outlook, and is currently neutral, with 60% equity and 40% bonds. The fund does not have a tactical mandate, so any changes to this mix are very measured and gradual.

Through its holdings of other Mawer funds, the portfolio is diversified quite nicely, with exposure to most key asset classes, including domestic and foreign large- and small-cap stocks, as well as domestic and foreign fixed income. At the end of January, a third of the portfolio was invested in bonds, 16% in Canadian equity, 22% in U.S. equity, and 24% in international equity.

The equity portfolio holds what can best be described as quality companies, and the sector mix is somewhat similar to the benchmark, except for a modest overweight in financials and industrials, and an underweight in healthcare, utilities, and energy. The

equity sleeve remains well positioned for most market environments and will likely be the key driver of any potential outperformance.

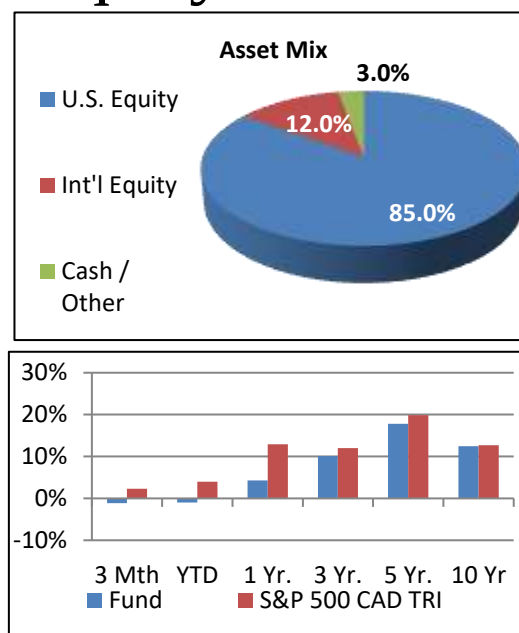
Fixed income is a bit of a weakness with this fund, with the majority of exposure to investment-grade Canadian bonds and a very modest exposure to global bonds. This positioning looks very much like the indices, resulting in a high level of interest sensitivity, which can dampen returns in a rising yield environment as is anticipated this year.

Overall performance for the fund has been excellent, with a 5-year average annual compounded rate of return of 10.3% to Jan. 31, outpacing the benchmark and peer group. And these returns have come with volatility lower than the benchmark and peer group, resulting in excellent risk-adjusted numbers.

My only real concern is the interest rate sensitivity of the fixed-income sleeve. Still, this remains one of the best choices for investors looking for a one-ticket solution. It offers a very disciplined management process and a rock-bottom MER of 0.94%. Even adding in 1% for dealer compensation, this fund is very reasonably priced compared with many of the available options.

Beutel Goodman American Equity Fund

Fund Company	Beutel Goodman & Company
Fund Type	U.S. Equity
Rating	C
Style	Large Cap Value
Risk Level	Medium
Load Status	No-Load/Fee-based
RRSP/RRIF Suitability	Excellent
Managers	Glenn Fortin since June 1997 Rui Cardoso since June 2013
MER	1.50% No-load, 1.10% Fee-based
Fund Code	BTG 774 – No-Load BTG 105 – Fee-Based
Minimum Investment	\$5,000



ANALYSIS: This has consistently been one of the best U.S. equity funds around. It is managed using a highly disciplined, bottom-up value approach that places emphasis on capital preservation, with a focus on delivering absolute returns and managing risks.

Lead managers Rui Cardoso and Glenn Fortin look for high quality, well-managed companies that have a history of generating stable cash flows and that have earned a level of return that is greater than the company's cost of capital.

Given the value bias, any company considered for inclusion in the portfolio must not only be undervalued but must also have the potential to grow its share price closer to its intrinsic value within a three-year period.

When evaluating a company, Beutel Goodman's managers pay attention to key fundamental metrics such as the price-to-earnings, price-to-cash flow, and price-to-book ratios in the context of not only the company's historical numbers, but also compared with the market and what the management believes to be the company's sustainable earnings growth rate.

The portfolio is concentrated, holding U.S.-based large-cap companies that are leaders in their field. As of Jan.

31, the fund held less than 30 stocks, with the top 10 making up nearly 60% the portfolio.

The managers are patient in implementing their process, with portfolio turnover averaging roughly 30% for the past five years. However, they are not afraid to use periods of heightened volatility as an opportunity to improve the quality of the portfolio. This happened in 2008 and again in the first half of 2012 when several new names were added to the portfolio.

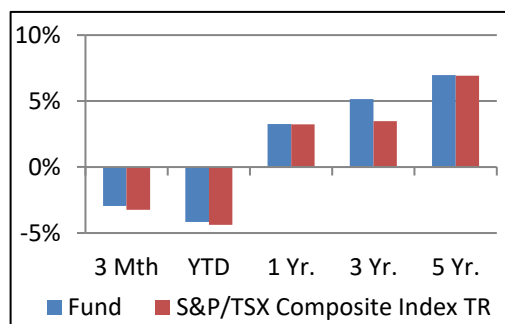
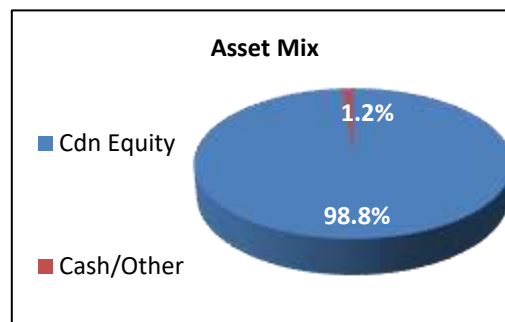
Performance, particularly over the long-term has been excellent with the fund delivering a 5-year average annual compounded rate of return of 19.4%, slightly trailing the S&P 500 but outpacing the category average.

The fund also has a history of decent downside protection, holding up well in 2008, for example, with a loss of less than half the index's 23% decline. It has a down capture ratio of 77% over the past three years. Volatility has been lower than the category average but was roughly in line with the broader market.

In most cases, I would suggest investors use a low-cost passive option for their U.S. equity exposure. However, this is one of the few actively managed U.S. equity funds worth taking a look at and remains one of my favourites.

PShares FTSE RAFI Cdn Fundamental ETF

Fund Company	Invesco Canada
Fund Type	Canadian Equity
Rating	D
Style	Large Cap Blend
Risk Level	Medium
Load Status	N/A
RRSP/RRIF Suitability	Good
Manager	PowerShares Canada
MER	0.51%
Trading symbol	TSX – PXC
Minimum Investment	N/A



ANALYSIS: In the past few months, we have seen a slight shift as fundamentals once again start to matter. As a result, the PowerShares FTSE RAFI Canadian Fundamental ETF had a decent showing for the three months ending Jan. 31, gaining 1.4% and outpacing the broader S&P/TSX Composite Index by nearly 100 basis points. Much of this outperformance is from its overweight in financials and underweight in industrials.

This difference in weightings comes from the way the portfolio is built. Instead of using market capitalization to select stocks, as is done in traditional indexing, fundamental ETFs use factors that are believed to better predict outperformance. These factors include sales, cash flow, book value, and dividends. The main criticism with a traditional market-cap-weighted index is the potential for overconcentration, as bigger companies take up a disproportionate weight in the portfolio. Fundamental indexing reduces that likelihood, at least at the stock level, as position sizes are determined by their fundamental attractiveness.

At the sector level, however, the risk of concentration is real as there are no set limits on sector weights within the ETF. This can result in levels of sector concentration that are as high as, or even greater than, what you would see with a traditional market-cap index. For example, at the

end of January, this ETF had nearly 65% invested in just two sectors – energy and financials. In comparison, the S&P/TSX Composite Index had approximately 50% in those two sectors.

Theoretically, fundamental indexing should result in a better built and more diversified portfolio than an index that is simply made up of the largest publicly traded companies in Canada.

From a performance standpoint, while the shorter-term numbers have lagged the broader markets, the longer-term numbers have outperformed the traditional cap-weighted index. However, volatility has also been higher than the broader markets, which has meant that on a risk-adjusted basis, PXC has lagged the **iShares Core S&P/TSX Cap Composite Index ETF (TSX: XIC)**. I suspect that much of this higher volatility is the byproduct of the larger exposure to energy.

Looking ahead, I still believe in the theory behind fundamental indexing, and believe that as the overall level of market volatility increases, a fundamentally constructed index is likely to outperform the traditional cap-weighted indices. Further, looking at the valuation levels and growth outlook, PXC is well positioned to deliver above-average growth over the long term.