D.A. PATERSON & ASSOCIATES INC. MAY 2018

Top Funds Report

Stocks positive but yield concerns loom

Rising inflation rates and geopolitical tensions could create headwinds

The stock market volatility that characterized trading in February and March continued through most of April. Geopolitical headlines dominated the news, with the growing prospect of a trade war between the U.S. and China, as well as rising tensions between the U.S. and Russia over Syria. Still, equities were mostly positive in the month as first-quarter earnings continued to show strength and global growth outweighed concerns over rising yields.

The S&P/TSX Composite gained 1.8% in the month on the back of a surge in energy stocks. The S&P/TSX Energy Index gained more than 12% as the price of crude oil rose sharply. U.S. stocks were modestly higher, as the S&P 500 Composite gained 0.4% in U.S. dollar terms, and the MSCI EAFE Index rose by nearly 2.4%.

With the price of oil rising and geopolitical tensions ratcheting higher, the U.S. dollar strengthened, eroding gains for portfolios with unhedged exposure. In Canadian dollar terms, the S&P 500 was lower by 0.2%, while the MSCI EAFE gained 1.8%.

Bond yields moved higher both in Canada and in the U.S as investors reacted to concerns that strong economic growth trends and rising inflation would cause the U.S. Federal Reserve and the Bank of Canada to hike rates more quickly than anticipated.

In the U.S., the yield on the benchmark U.S. 10-year Treasury bond briefly crossed the 3% threshold for the first time since early 2014. It ended April at 2.95%, 21 basis points higher for the month. In Canada, there was also upward pressure on yields, with the 10-year Government of Canada bond yield climbing 21 basis points to end April at 2.30%.

This bump in yields saw bond prices fall (bond prices move inversely with yields), as the FTSE/TMX Canada Bond Universe Index fell by 0.85% in April, with most of the damage occurring at the long end of the yield curve. Corporate bonds, with their higher yields and lower sensitivity to interest rates, outperformed government issues, falling around 0.5%, compared with a 1% drop in governments.

Global economic growth continues to be strong and is expected to remain positive for the rest of the year. In the U.S. particularly, corporate earnings growth is likely to be above trend, thanks to the Trump tax cuts, which will help boost consumer and business spending, and job growth

The key risk to the outlook is higher-than-expected inflation, which would cause yields to rise more than expected, pushing down bonds and creating a headwind for equities. Another risk would be sudden spikes in geopolitical tensions, caused by the unpredictability of Mr. Trump.

In this environment, I am making one modest change, moving my allocation of real return bonds from underweight to neutral on inflation worries.

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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I am keeping my allocation to fixed income underweight with a modest overweight to equities. I expect volatility to remain higher than it has been in the past couple of years, but barring something out of left field, I expect volatile, but modestly rangebound, markets to persist. 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, funds from IA Clarington, Manulife, RBC, and Mackenzie's new hedge fund strategy…

IA Clarington Global Growth and Income Fund (CCM 1220 – Front-End Units, CCM 1222 – Low-Load Units)

IA Clarington announced that starting on June 1, PineBridge Investments would take over the management duties of this fund, replacing Radin Capital Partners. Under Radin, the fund was a balanced fund with an equity focus.

The equities were managed using Brad Radin's fundamentally-driven, bottom-up, value-focused approach. He invested in a mix of mid- and large-cap companies around the world. The fixed-income sleeve was tilted to the high-yield side of the spectrum and was predominantly in U.S. issues.

Unfortunately, the value bias of the fund has hurt its relative performance over the past few years, as the higher flying, higher beta names have been driving most of the market gains. Under the new management team, the fund will take on a more multi-asset approach that will strive to be more adaptive to market conditions.

PineBridge is an Asian-based global asset manager with offices in 17 countries around the world. The firm has more than $85 billion in assets under management and employs more than 200 investment professionals. In addition to the new management team, the fund will be renamed starting June 1 as the **IA Clarington Global Multi-Asset Fund**.

PineBridge's process uses a mix of top-down asset allocation combined with fundamental, bottom-up security selection. They employ an absolute-return framework that targets a rate of return set at the consumer price index plus five percentage points over a rolling five-year period.

Their top-down allocation process uses a mix of both long- and short-term outlooks in setting the asset mix. The managers look at their five-year view on the various asset classes and overlay that with their 9- to 18-month outlook. This then allows them to optimize the mix for the best risk-reward tradeoff. Once that mix is set, they can use their fundamental security selection process to implement the portfolio

The managers have a significant amount of flexibility around the asset mix. Equities and fixed income will typically range between 20% and 80%, while cash can range between 0% and 45%. There is also an alternative sleeve that can be as high as 25%.

I expect this to be a positive development for the fund, resulting in better risk-adjusted returns, and a less volatile return stream.

While PineBridge's approach has been implemented in other strategies around the world, I will still want to see a few quarters of real track record to better assess how the strategy works for this Clarington offering in the Canadian market. I will continue to monitor the fund.

Manulife Global Infrastructure Fund (MMF 4569 – Front-End Units, MMF 4769 – Low Load Units)

The fund is managed by Brookfield Investment Management, one of the preeminent players in the global infrastructure space, which is why I have liked this fund as a way to access infrastructure. However, it has failed to keep pace with its peers, with an overweight exposure to pipelines and utilities taking most of the blame. Pipelines have struggled for the past few years, selling off hard in the aftermath of the oil price collapse in 2015 and 2016. The sector has faced headwinds again recently as the regulatory environment

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Another headwind for the fund is its overweight exposure to sectors that have a high degree of sensitivity to interest rates, such as utilities and telecoms. With interest rates on the rise, these sectors are often viewed as bond proxies and are impacted by movements in rates. Combined, it has almost been a perfect storm for the fund. While I am actively looking at potential alternatives, I am not yet prepared to make a change. Watch this space for updates.

RBC Global Precious Metals Fund (RBF 468 – No Load Units, RBF 774 – Front-End Units, RBF 178 – Low-Load Units)

Frankly, I've never been much of a gold bug. To date, I have not yet used precious metals funds or bullion in any of my managed portfolios. I've found that adding precious metals funds brings more volatility to the portfolio over the long term than they add in incremental return. In other words, while there may be a theoretical benefit to including gold in a portfolio, the longer-term performance numbers tend not to support the theory.

My view is essentially that gold may be a better trade than it is an investment. So is now a good time to hold precious metals? I can't say for certain, but with inflation worries starting to appear, and geopolitical uncertainty remaining elevated, there may be a case to be made for the gold trade.

This RBC offering, run by Chris Beer and Brahm Spilfogel, has been one of the better funds in the precious metals category. It invests in companies located anywhere in the world that are involved in the exploration, mining, and production of gold and other precious metals. Nearly 80% of the fund's holdings are in Canadian companies, including some of the better-known players, like Agnico Eagle, Newmont Mining, and Kinross.

The portfolio is very diversified, yet concentrated, holding more than 100 names, while the top 10 make up more than 56% of the fund. Holdings tend to be weighted to small- and mid-sized companies, and the fund has more exposure to small and microcap stocks than the index.

Performance has been volatile, with a standard deviation that is more than two times that of the broader equity market. However, it has been less volatile than the S&P/TSX Global Gold Index and its peer group. This has resulted in a risk-adjusted return that is better than the index or peer group over three- and five-year periods. Year to date, however, the fund has struggled, largely on weakness from Alamos Gold, Detour Gold, and Belo Sun Mining.

Looking ahead, the managers note that the second quarter is historically a tough one for gold, but given the environment, there may be rallies on stumbles from central banks and from political uncertainty. The fund is likely to benefit as it now focuses more on higher-quality companies with strong assets, good cost controls, and excellent management.

While I would be reluctant buy into a precious metals fund as a longer-term investment, this is one certainly worth considering as a short-term trade-type holding if precious metals fit within your investment objectives and risk tolerance.

RBC Managed Payout Solution (RBF 581 – No Load Units, RBF 754 – Front-End Units, RBF 121 – Low-Load Units)

This fund of funds aims for a high level of monthly income with the potential for modest capital growth. It invests in a basket of mutual funds offered by RBC. At the end of April, the portfolio had a decided fixed-income tilt, with nearly 60% in bonds, 25% in Canadian equity, 13% in U.S. equity, and the rest a mix of international equity and cash.

The fund targets an annualized payout of 5%, which works out to a monthly distribution of $0.0375 per unit each month, a very lofty goal in today's low-rate environment. The bond sleeve is heavily weighted to investment grade issues, resulting in a yield to maturity well below the target.

Within the equity sleeve, the dividend yield is listed at just shy of 3%, which is well below the target yield. The yield on the Canadian bond market is around 2.75%, while the dividend yield on the Canadian equity market is approximately 2.6%. Therefore, in order to achieve its target yield, the fund will have to either generate a reasonably high level of capital gains or provide distributions through a return of capital.

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Over the past five years, the fund has generated an annualized return of 3.4% for the period ending April 30. This means that a substantial portion of the distribution has been in the form of return of capital. For 2017, more than 60% of the distribution came from return of capital, and in 2016 it was more than two thirds.

Given the current environment, I would expect that the return of the fund will continue to fall short of the yield target. The managers could reach for yield by investing in high-yield fixed income or higher-yielding equities, but to do so would result in higher risks. The underlying funds are all of reasonable quality, but I don't see them generating the required return, either from yield or capital gain.

Against that backdrop, unless you are comfortable with a significant amount of return of capital, you may be better off looking at alternatives. For example, could create your own portfolio out of high-quality, high-yielding ETFs or mutual funds, and then withdraw funds as necessary to supplement your cash flow needs. This strategy puts you in control of the total return potential, the expected risk, the composition of the distribution for tax purposes, and the timing of any incurred capital gains or losses. While not a "one ticket" solution like the RBC fund, I believe the build-it-yourself approach to be a better option for most investors.

Mackenzie Multi-Strategy Absolute Return Fund

This summer, the Canadian Securities Administrators (CSA) will be proposing rule changes that make true alternative strategy funds available to retail investors. The proposals will create a new category of mutual funds to be called Liquid Alternatives. These funds will allow managers to use strategies previously available only in hedge funds, including the use of short selling, derivatives, and leverage. While the rules are changing, they will be somewhat watered down compared with true hedge funds. Still, it will allow managers a great deal more flexibility.

For example, if the proposals are passed, a fund may borrow up to 50% of its net asset value, it could use short selling for up to 50% of the NAV, and it could invest up to 20% in one security. These limits are significantly higher than what is allowed under the current framework.

Mackenzie Investments has jumped out ahead of the curve and received exemptions from the regulator that would allow it to launch a new fund that would be considered a mutual fund under the new rules. The **Mackenzie Multi Strategy Absolute Return Fund**, announced on May 2, will invest in several hedge fund strategies, including an absolute return bond sleeve, a global macro sleeve, and a long/short equity component. As it's still early days yet, very little is known about the actual make-up of the fund or how assets will be allocated.

In theory, these types of funds can be an excellent addition to a more traditional portfolio made up of stocks and bonds. They typically offer low volatility and are uncorrelated to the traditional asset classes, which can allow for higher returns and less overall risk when used in a portfolio.

In practice, the results for many of the currently available funds that are classified as Alternative Strategy have been largely disappointing. Most are very expensive and have not really performed as advertised.

However, I am optimistic that these new types of Liquid Alternative mutual funds can do a better job than the previous iterations. I am eagerly awaiting more details on the Mackenzie offering, and I am also closely monitoring the market to see what some of their competitors will come up with.

I have spoken with a number of hedge fund managers, and a few have said that they are interested in taking their existing strategies and offering them as mutual funds under the new rules. Others say they are running strategies that are very capacity constrained, and so will likely maintain the status quo.

In any event, this announcement is a very positive step in the right direction, and if these new funds are implemented reasonably well, there could be some real benefits for investors in portfolio construction.

Stay tuned!

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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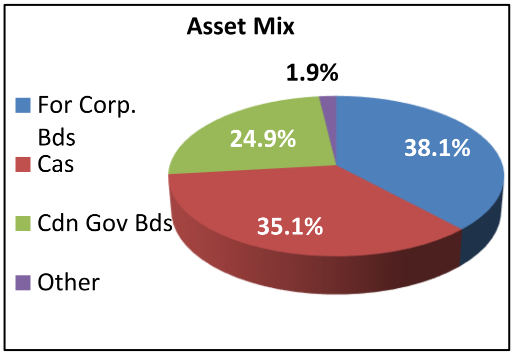
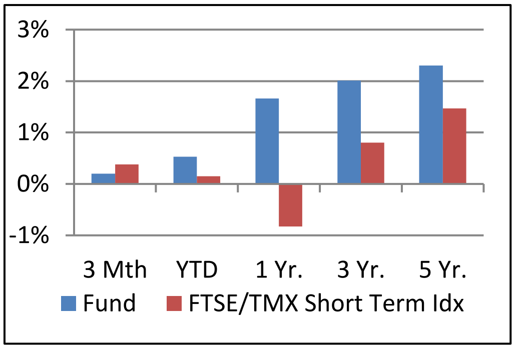
Norrep Short Term Income Fund

Fund Company	Norrep Investments
Fund Type	Miscellaneous
Rating	B
Style	Bottom-up Credit Analysis
Risk Level	Low – Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Managers	Bill Holy Owen Morgan
MER	1.25% - Class/1.77% A Class
Fund Code	NRP 1100 – Fee-Based Units NRP 1101 – Front-End Units
Minimum Investment	$5,000





ANALYSIS: With continuing upward pressure on interest rates, short-term bond funds are expected to come under even more pressure. But this Norrep fund, managed by Bill Holy and Owen Morgan, is an option for those seeking a higher yield and who are comfortable taking on a bit more risk.

The fund invests in a diversified portfolio of short-term high-yield bonds, senior bank loans, and investment-grade bonds. The underlying yield of the portfolio is listed at 4.5%, which is well above the 2.4% offered by the index.

But overall risk is also higher because the fund is taking on more credit risk. It is also more volatile than other short-term bond funds, with a standard deviation nearly double that of most of its peers. The fund is consequently susceptible to larger swings. For example, between mid-2015 and early 2016, when crude oil sold off sharply, the fund fell more than 5%, but then rebounded strongly, ending 2016 up more than 5%.

The target mix is roughly 50% short-term high-yield bonds, and 50% senior loans, a mix that dramatically reduces interest rate sensitivity. At the end of April, the fund's duration was listed at 1.5 years, compared with 2.7 years for the index.

Credit risk is an issue, however, bank loans sit very high in a company's capital structure, helping mitigate that risk. To protect against default in the high-yield, the managers do a significant amount of credit analysis to fully understand a company's overall debt situation.

Returns have been modest in absolute terms, but the fund has consistently been near the top of the Short-Term Bond category. Its 3-year average annual compounded rate of return ending April 30 was 2.0% for the advisor units, well above the category average of 0.5%

The fund pays a monthly distribution that is adjusted based on the yield outlook. Distributions are currently $0.03 monthly, for an annualized yield of 4%. MER is a relatively steep 1.77%, but the costs have thus far been more than offset by the higher return.

The fund isn't for everyone and is not a core holding. But those comfortable taking on a bit more risk can earn a higher return and shorten the duration of their fixed-income sleeve by adding an appropriate allocation of this fund to their well-diversified portfolio.

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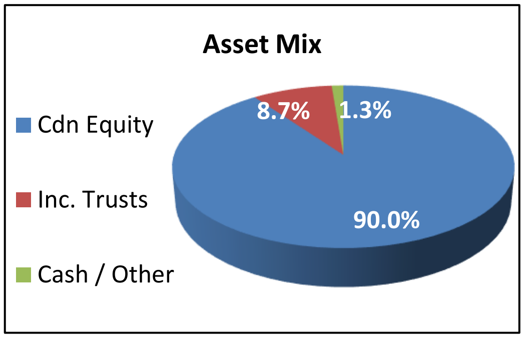
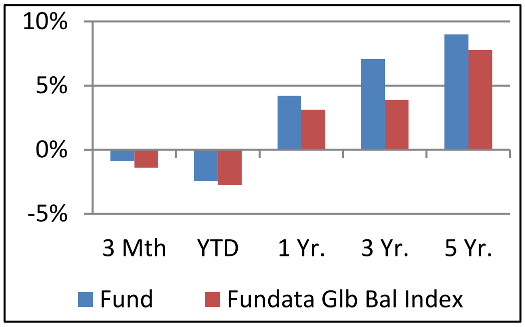
Leith Wheeler Canadian Dividend Fund

Fund Company	Leith Wheeler Invest. Counsel
Fund Type	Cdn Dividend & Equity Income
Rating	B
Style	Large-Cap Value
Risk Level	Blend
Load Status	Fee-Based DIY
RRSP/RRIF Suitability	Excellent
Managers	Leith Wheeler Equity Team since December 2012
MER	1.03% F Class/1.50% DIY Class
Fund Code	LWF 031 – Fee-Based Units LWF 019 – DIY Units
Minimum Investment	$5,000 F Class/$25,000 DIY





ANALYSIS: Over time, dividends have consistently been responsible for a significant portion of the equity market's overall return. Studies have shown that this has ranged between 65% and nearly 80% of the return, depending on the market and period reviewed. This fund invests in high-quality companies that can grow dividends through higher prices or organic growth.

The fund's managers look for companies with quality management, stable earnings, and a business model they are comfortable with. The portfolio is built on a bottom-up basis, and potential investment candidates are put through a fundamental, value-focused process that emphasizes return on equity, free cash flow, and earnings growth. The managers take a longer-term outlook, estimating how the business is likely to evolve over the next three to five years.

While dividend yield is important, the managers focus more on the total return potential of a stock, rather than the absolute yield. The result is a concentrated portfolio of around 30 names. The portfolio looks somewhat similar to other dividend funds, yet with enough unique characteristics to markedly differentiate it from its peers. It has a significant overweight to financial services, which make up roughly 45% of the fund. It also carries a higher weight in utilities and industrials. Where it differs is in its big underweight in telecom and energy stocks.

Performance has been excellent, with the do-it-yourself Series B units posting a 5-year average annual compounded rate of return of 9.0% ending April 30, compared with 7.8% for the S&P/TSX Composite Index.

One potential drawback is that the fund has higher average 3-year standard deviation than the index and peer group. Still, even with the higher volatility, it has delivered solid risk-adjusted returns, outperforming in both up markets and down markets.

The fund is well positioned, with a valuation level well below the index and a yield that is higher. Component holdings have all delivered earnings growth superior to both the index and the peer group.

Costs are very reasonable, with an MER of 1.50% for the DIY units, and 1.03% for the fee-based units. These metrics, combined with the disciplined management approach, lead me to conclude that the fund will continue to deliver excellent risk-adjusted returns.

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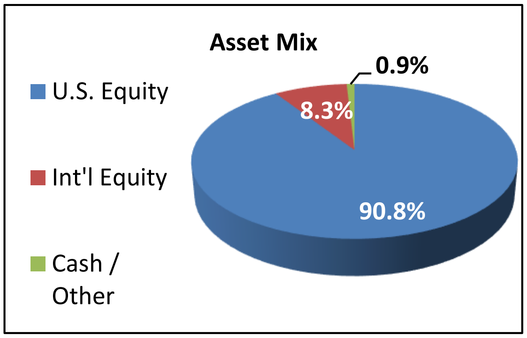
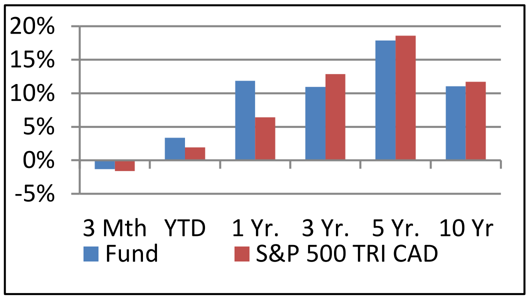
Trimark U.S. Companies Fund

Fund Company	Invesco Canada
Fund Type	U.S. Equity
Rating	D
Style	Large-Cap Growth
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Jim Young since October 1999
MER	2.76%
Fund Code	AIM 1743 – Front-End Units AIM 1745 – Low-Load Units
Minimum Investment	$500





ANALYSIS: The fund jumped out to a strong start in the first quarter of 2018, thanks to a strong contribution from its healthcare and technology holdings. It gained 5.1%, outpacing both the index and the peer group. Longer-term numbers are also strong, with a 10-year average annual compounded rate of return of 11.1% to April 30, besting its category, but slightly lagging the S&P 500.

In a recent commentary, the manager noted that on the whole, he views the market as fairly valued, particularly when compared with interest rates. However, he concedes that certain pockets of the market have become overvalued, as investors chase returns in the late stages of a somewhat frothy market. In response, he has been trimming some of the more richly valued names in the portfolio, including Starbucks and Estee Lauder.

Further, he sees room for a rotation into more modestly valued companies, which are expected to help mitigate some of the risk in the portfolio and also set the stage for the next upturn. Making such a shift would be expected to help lower the overall volatility of the portfolio, help bring the overall valuation numbers of the fund more in line with longer-term averages.

Like other Trimark branded funds, the fund invests in a portfolio of attractively priced U.S. companies that have distinct proprietary advantages, strong management, industry leadership, and a history of strong capital allocation policies. One key difference is that this process is undertaken under more of a growth lens. In addition, the manager pays particular attention to companies that have a proven ability to profit from technological advances, and that have invested significantly to obtain their competitive advantages.

The manager's process is fairly patient, with a level of portfolio turnover that has averaged around 36% per year. This indicates that the implied holding period for each stock in the fund is nearly three years.

The portfolio remains rather concentrated, with just north of 40 names and an overweight in technology, healthcare, and industrials. Unlike most of the other Trimark-branded funds, this one is nearly fully invested, with cash of less than 1%.

A drawback to the fund is its cost. It carries an MER of 2.77%, which while on the way down in recent years, remains well above the category average.

The fund remains ***under review***, as I am watching to see how the manager repositions the portfolio over the next quarter or two.

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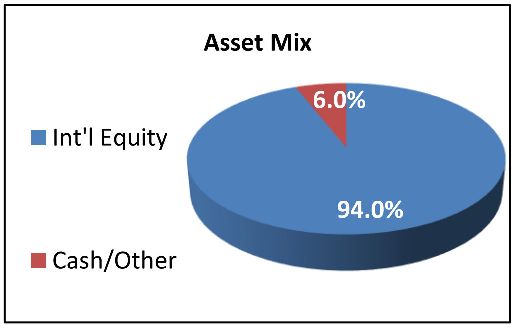
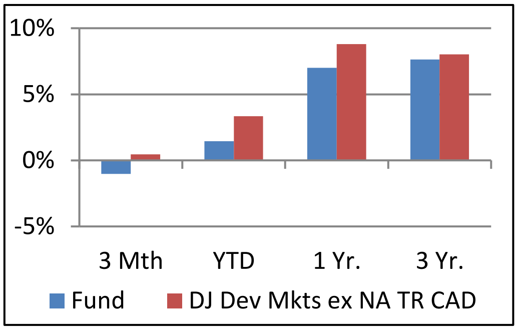
Manulife World Investment Fund

Fund Company	Manulife Investments
Fund Type	International Equity
Rating	C
Style	Large Cap Blend
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Excellent
Managers	David Ragan since August 2013 Jim Hall since August 2013
MER	2.55%
Fund Code	MMF 4536 – Front-End Units MMF 4736 – Low-Load Units
Minimum Investment	$500





ANALYSIS: For advisors, this is an excellent international equity fund. In fact, it is the highly-regarded **Mawer International Equity Fund** in a Manulife wrapper. The full-freight Manulife advisor units have an MER of 2.55%, which includes full dealer compensation. However, for those using fee-based accounts, the F class version carries an MER of 1.2%, which is below the 1.40% charged by Mawer directly. Certainly, some investors will be turned off by the higher cost, and I get that. But I still believe that this is a case of "you get what you pay for."

One of the higher-rated international equity funds, its 3-year average annual compounded rate of return to April 30 was 7.6%, outpacing its peers and matching the index. The fund has struggled a bit year-to-date, gaining 1.5%, while the MSCI EAFE rose 3.3%. Volatility has been below the index and peer group, resulting in above average risk-adjusted returns.

Much of its recent underperformance is the result of the quality focus inherent in Mawer portfolios. In the broader market, the higher-beta names have recently been outpacing value names, but this is not sustainable. This fund is thus very well positioned to rise when the market again rewards strong fundamentals.

The managers use a highly disciplined investment process, looking for wealth-creating companies that are trading at discounts to their estimate of intrinsic value, and that generate high returns on equity. Mawer's research process is one of the best in the business and includes a rigorous scenario analysis to get a stronger understanding of a company's true worth under a range of situations.

The result is a portfolio that is made up of between 50 and 60 names, with the top 10 making up 30% of the fund. Sector and country weights are largely the result of the stock selection process. At the end of April, the portfolio had nearly 60% invested in Europe, a third in Asia, with the balance in the Americas. More than 80% is invested in developed markets, with the rest in emerging markets.

This fund remains a top pick for investors looking for a disciplined, well-managed portfolio with a focus on non-north American stocks. If you are a do-it-yourself investor, you're better off buying through Mawer direct, but for advisors, the Manulife wrapping is the best way.

Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the simplified prospectus before investing. Mutual funds are not guaranteed and are not covered by the Canada Deposit Insurance Corporation or by any other government deposit insurer. There can be no assurances that the fund will be able to maintain its net asset value per security at a constant amount or that the full amount of your investment in the fund will be returned to you. Fund values change frequently and past performance may not be repeated. The foregoing is for general information purposes only and is the opinion of the writer. No guarantee of performance is made or implied. This information is not intended to provide specific personalized advice including, without limitation, investment, financial, legal, accounting or tax advice