

Top Funds Report

Tensions bubble under dog days of summer

Surface calm masks growing threats from trade wars, central bank tightening...

Tensions remained high in June as the world remained teetering on the brink of an all-out trade war, instigated by U.S. President Donald Trump. Investors remained unsettled through June, resulting in another month of choppy market performance.

The S&P 500 Composite Index started the month strong, rising more than 3%, only to give most of the gain back in the second half of the month, and ending June only modestly higher, with a marginal 0.6% advance in U.S. dollar terms.

It was a similar story with international markets, with the MSCI EAFE Index posting modest gains in the first half of June, only to sell off in the latter half to end the month down 1.2% in U.S. dollar terms. With the U.S. making good on its threats to implement massive tariffs a wide number of Chinese imports to the U.S., Asian markets were hit particularly hard.

Fortunately, for Canadian investors, the U.S. dollar continued its ascent, improving performance for investors with unhedged currency exposure. The S&P 500 was up 2% when the currency impact is considered.

Here at home, the S&P/TSX Composite rose 1.7% in June propelled by strength in the energy and healthcare sectors, as cannabis stocks moved higher on news that the Senate had approved the marijuana legalization bill.

Bonds posted modest gains in June, and the Bank of Canada raised its benchmark overnight rate by 25 basis points, to 1.50%, in its July 11 announcement. Looking ahead, the direction of rates remains up in the air given the uncertainty caused by the continuing trade battles and the potential for a slowing economy.

We are now in the “dog days” of summer and are not expecting much in the way of market activity. Many

traders are on vacation, and volumes tend to be much lighter than normal. Consequently, barring anything unexpected, markets are likely to be rangebound for the next month or two, setting the table for what could prove to be a very interesting fall. In this environment, I am making two changes to my investment outlook.

First, I am lowering my exposure to high yield from neutral to underweight. With spreads on high-yield credit now approaching historic lows, I don't believe investors are being adequately compensated for the higher default risk. If we see an economic slowdown, defaults are expected to rise and returns to suffer.

Second, with a full-blown trade war underway, emerging markets have already felt some pain, with more expected. As a result, I am reducing my allocation to EM equities to underweight from neutral.

		Underweight	Neutral	Overweight
Cash			X	
Bonds		X		
	Government		X	
	Corporate		X	
	High Yield	X		
	Global Bonds		X	
	Real Ret. Bonds		X	
Equities				X
	Canada		X	
	U.S.		X	
	International		X	
	Emerging Markets	X		

Please send your comments to:
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ESG investing with Foresters

Foresters was using ESG screens way before they become popular.

In recent years, investor interest in “value based” investing has been on the rise. Today, this investment strategy takes many forms with environmental, social, and governance (ESG) investing leading the way.

While ESG investing has been a bit of a niche strategy historically, it has been gaining more traction in the mainstream, as ESG screening has evolved to finding any well-managed companies that have very strong governance frameworks and that have the potential to be good investments. The view now is that the companies with sound ESG policies have the potential to add alpha over the long-term.

As ESG filtering moves more into the mainstream, we find many companies you would not think of as being proponents of ESG investing have in fact been practicing it for many years.

One such company is Foresters Asset Management, an asset manager with more than \$10 billion in retail, institutional, and asset liability matching investments in Canada, and nearly \$44 billion worldwide. In Canada, Foresters bought Aegon Capital Management about a year ago, picking up six imaxx branded mutual funds

I recently had a chance to sit down with Suzanne Pennington, Chief Investment Officer of Foresters, to discuss the firm and how ESG plays a key role in the investment selection process across the firm’s mandates.

Since taking over Aegon, Foresters has made some additions to the equity team, both in terms of personnel and refining the investment process. They are focusing their efforts in the areas of the investment landscape where they have the highest probability of adding value.

The fixed-income and equity teams together review the full capital structure of a potential investment, helping them to find the best investments. The process used is a disciplined, holistic, fundamental approach that blends a mix of quantitative and qualitative analysis to better understand the risk and reward profile of the company and its business, as well as its industry as a whole.

One of the more interesting things the team undertakes is an “old school” SWOT analysis (strength, weakness, opportunities, threats), which highlights the factors likely to lead to success or failure of the company. The managers also do in-depth financial modeling that focuses on the fundamental value of the company, rather than focusing on the share price. Further, they calculate the potential upside and downside for each investment opportunity

In addition to the traditional investment valuation considerations, ESG has always played a role in how Foresters manages money, with ESG being implemented in four key ways:

- 1. Product exclusions** – avoiding in companies that have significant exposure to tobacco, gambling, pornography, or weapons.
- 2. ESG ranking** – how each investment prospect stacks up compared with its global peers based on its ESG rating as scored by Sustainalytics or internally.
- 3. Controversy rating** – how historic and potential controversies that could impact a company or industry.
- 4. Positive change** – whether a company can help enact positive change through corporate engagement.

Historically, the imaxx fixed-income funds have consistently delivered above-average returns over the long-term. Equity offerings have been less consistent, but Foresters believes its changes to the team and the investment process will lead to better longer-term numbers. I will continue to watch these funds in the coming quarters.

Along with NEI, Meritas, OceanRock, and Guardian Capital, Foresters is another option for those looking for ESG investing options.

ESG investing has evolved over the past few years to take a broader view of the world. Today, ESG investors no longer have to settle for second-best in the search for good performance. Instead, I believe that you will be able to both invest according to your conscience and generate solid returns.

Funds of Note

This month, I look at ETFs from Invesco, active mutual funds from Vanguard, and changes at Sentry...

Invesco S&P 500 Equal Weight Index ETF (TSX: EQL (CAD), EQL.U (USD), EQL.F (CAD-hedged))

This is a new ETF being launched by Invesco that provides equal weight exposure to the S&P 500 Composite Index. It is also the first ETF launched under the Invesco banner, as the firm undergoes a rebranding that will see the PowerShares and Trimark brands disappear over the next few months.

Traditional market indices are built using a company's total market capitalization as the main determinant in how much of the stock is in the index. The larger the company, the bigger the weight in the index. While this is the most common methodology, it is not without its flaws, one of the bigger of which is that the use of market cap can result in overvalued companies making up a disproportionate weight in the index.

Another critique, which is especially familiar to Canadian investors, is that using market cap can result in significant concentration in the index, making it less diversified than it appears. Historically, this has been a Canadian problem, but in the past year, with the emergence of the FAANG (Facebook, Apple, Amazon, Netflix, Google) stocks, it has also begun to show in the U.S. For example, on May 31, the five FAANG stocks represented more than 12% of the S&P 500. In fact, according to Invesco, the performance of these five stocks accounted for nearly a quarter of the overall returns of the index.

That is fine when all is going well. However, if the fortunes of these companies turn, investors may be hit with a larger drawdown, and overall more portfolio volatility. The problem is not a new one, and over the years, financial engineers have tested a variety of alternative weighting methodologies that are commonly referred to as "smart beta."

Of all the smart beta methodologies, equal weighting is by far the simplest, at least from a theoretical perspective. You simply buy an equal weight of each stock in the portfolio and rebalance occasionally. For the S&P 500, you buy 0.2% for each of the 500 companies in the index.

This strategy can result in some benefits, namely higher levels of diversification, as there is a wider exposure to market sectors. This equal weighting would prevent the kind of concentration in sectors we experienced during the dot-com bubble 20 years ago.

The theory is sound, but how does it play out in the real world?

In the case of two U.S. traded ETFs, the SPDR S&P 500 ETF (SPY) and the U.S. traded version of this ETF (RSP), the short-term results have favoured the traditional cap-weighted index, while the longer-term numbers favour the equal weighted ETF.

For the year ending May 31, SPY was up by 14.4%, compared with 12.0% for RSP. For the past five years, SPY gained 12.9% compared with 11.9% for RSP. Looking out 10 years, RSP outperforms with an average annual compounded rate of return of 9.8% compared with 9.1% for SPY. This makes sense given the higher exposure to the higher-flying tech names that have driven much of the index's gain over the past few quarters.

Somewhat surprisingly, the volatility of RSP has been higher than the traditional cap-weighted SPY, resulting in a more favourable risk-adjusted return for the more traditionally constructed ETF.

Looking into the portfolio, RSP is underweight technology, telecoms, and healthcare, and overweight industrials, real estate, and utilities. From a valuation standpoint, the two ETFs are pretty close, although RSP is slightly more attractive, which makes sense given its positioning.

Costs are slightly higher for the newly launched Canadian EQL, which carries a management fee of 0.25%, compared with 0.10% for the cap-weighted indices that track the S&P 500. Still, EQL is an interesting ETF, and I believe it can deliver a return stream that is roughly in line with the traditional market-cap indices. It also has the potential to outperform, particularly if we start to see the FAANG stocks hit some turbulence.

On balance, given the overall efficiency of the U.S. equity markets, and the S&P 500 specifically, combined with the marginally higher costs, I am not sure you will be meaningfully better off with this ETF than you would be with a traditional cap-weighted ETF on a risk adjusted basis. However, for markets that are more concentrated and less efficient, this equal weight strategy may be more beneficial to investors over the long-term.

Vanguard launches actively managed mutual funds

On June 25, Vanguard Investments, one of the pioneers of low-cost indexing, launched a suite of actively managed mutual funds in Canada. Globally, Vanguard manages more than \$6.4 trillion in assets, but surprisingly, \$1.6 trillion, or nearly 30% of these assets, are invested in actively managed strategies.

The new funds are the **Vanguard Global Balanced Fund**, **Vanguard Global Dividend Fund**, **Vanguard International Growth Fund**, and the **Vanguard Windsor U.S. Value Fund**, and are available only through financial advisors in fee-based accounts. (Vanguard does not pay any form of dealer compensation anywhere they operate.)

The funds are largely managed by external sub-advisors including Wellington Management, Schroders, and Baillie Gifford. Performance looks interesting, but what really catches my attention is the innovative fee schedule used.

For each fund, there is a maximum management fee that may be charged, which is capped at 0.50% per year. In practice, the actual management fee is variable and is based on the previous 36 months of performance. The stronger the relative performance, the higher the management fee, and conversely, the worse the relative performance, the lower the management fee.

Coming out of the gate, the management fees on the funds will range from a low of 0.34% for the Vanguard Global Dividend Fund, and a high of 0.40% for the Vanguard International Growth Fund. This type of structure provides incentive for the managers to deliver strong returns for investors by aligning their pay structure with performance.

However, unlike a pure performance fee that is available with many hedge fund products, the difference in compensation isn't so dramatic that the

managers are incentivized to take on a lot of extra risk to earn a substantially higher fee. Overall, this strikes a nice balance for both investors and fund managers. I really think that this approach could be a step towards a meaningful reduction in the fees charged for active management in general.

As far as the funds themselves go, they seem solid, and I will watch them closely in the coming months.

Sentry Global REIT Fund (NCE 705 – Front End Units, NCE 205 – Low Load Units)

Effective June 1, the management duties for the Sentry Global REIT Fund were handed over to the team of Lee Goldman and Kate MacDonald, who are also responsible for managing the highly regarded **First Asset REIT Income Fund and REIT**. They replace Michael Missaghie who left CI to pursue other interests. It is highly likely the two funds will remain as two separate offerings.

Mr. Goldman and his team have posted very strong numbers with the First Asset fund, using a disciplined value-focused investment process, looking for securities that are trading below what they are believed to be worth.

The First Asset funds will continue to be primarily Canadian-focused, with some modest exposure to U.S. holdings. Sentry will continue to be more global in scope. How this will affect the funds remains to be seen.

The global mandate is considerably broader than the funds Goldman and Macdonald have managed in the past, and it may take some time to get up to speed on the broader global real estate market. However, they can now rely more on the full Signature team, which has more than 50 investment professionals managing more than \$50 billion in assets. This can help to broaden the coverage very quickly.

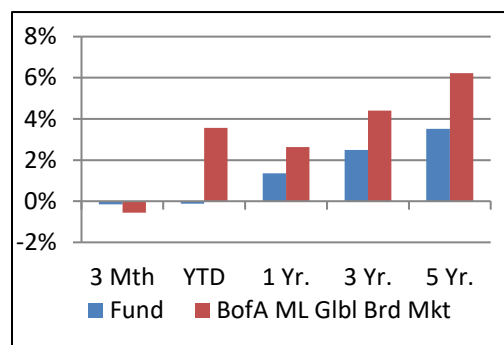
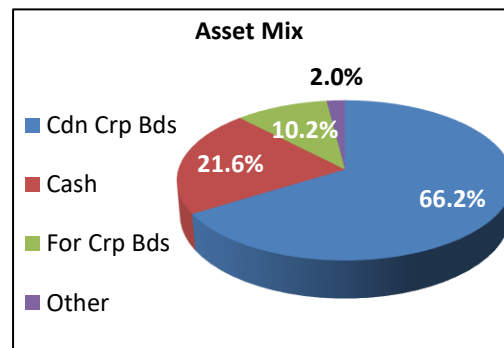
The other concern is that with a broader global mandate to be responsible for, the amount of time the managers spend on the First Asset funds may be reduced. I will continue to watch both funds over the next few quarters for any erosion in the risk-reward metrics.

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

feedback@paterson-associates.ca

NinePoint Diversified Bond Fund

Fund Company	NinePoint Partners LLP
Fund Type	Global Fixed Income
Rating	C
Style	Top-down/bottom-up
Risk Level	Low-Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Mark Wisniewski, Chris Cockeram
MER	2.10%
Fund Code	SPR 018 – Front-End Fund Units SPR 200 – Front-End Class Units
Minimum Investment	\$1,000



ANALYSIS: This is a diversified North American-focused bond fund with a flexible mandate allowing the manager to invest across the capital structure. The fund takes an absolute return approach and aims for a 4% to 6% return, net of fees over a rolling three-year period, regardless of interest rates

The fund's management team is headed by fixed-income veteran Mark Wisniewski. Their disciplined investment process blends top-down macro views, thematic tactical trades, and bottom-up security selection. Management tools at their disposal include the ability to alter interest-rate sensitivity, currency exposure, security mix, and credit quality to either capture potential upside or to reduce or manage risk.

Given the current credit environment, the manager is more defensively positioned. Duration is 2.5 years, compared to roughly 7.5 years for the broader Canadian bond market. Yield to maturity is also significantly higher than the benchmark.

The fund is heavily weighted toward corporate bonds, with nearly 64% in credit and 18% in high yield, which is more defensive than it was a few months ago, when it

had greater exposure to high yield issues. Given the current market, the managers don't expect to dramatically change that positioning but will continue to improve credit quality where possible. They are also exploring ways to participate in the upside of any potential flight-to-safety trade in government bonds while avoiding the downside associated with the lower yield and higher duration.

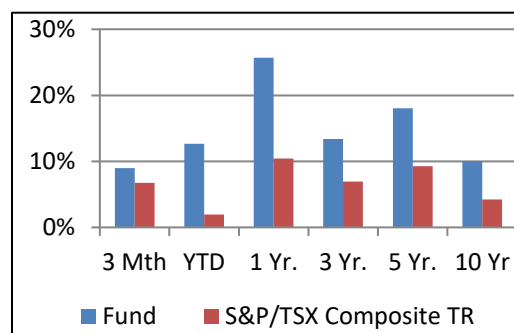
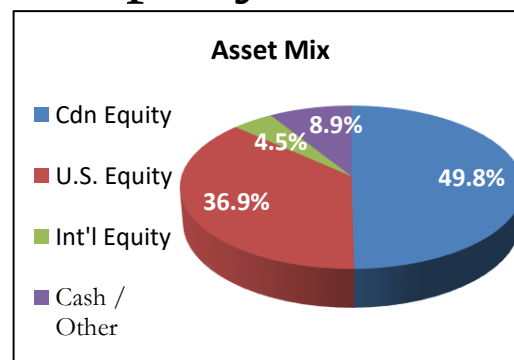
Fund performance has outpaced its peers and benchmark since Mr. Wisniewski took the reins a year or so ago. With its defensive positioning, I'd expect it to lag in a bond rally but outperform in volatile periods.

Another interesting feature of this fund is it is available in a corporate class structure, which makes it more tax friendly for non-registered investors.

The biggest concern I have is the fund's cost. Its 2.10% MER is well above the category average. I'm not sure I would use this fund as my only fixed-income exposure, but I do see it as possibly playing a role in a well-diversified portfolio. I would expect it to help reduce overall volatility while helping improve returns over the long-term.

Fidelity Canadian Growth Company Fund

Fund Company	Fidelity Investments Canada
Fund Type	Canadian Focused Equity
Rating	A
Style	Large-Cap Growth
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Excellent
Managers	Mark Schmehl since March 2011
MER	2.27% - Front-End Units 2.47% - Low-Load Units
Fund Code	FID 265 – Front-End Units FID 065 – Low-Load Units
Minimum Investment	\$500



ANALYSIS: Growth stocks have been on a tear for the past few quarters, and apart from a couple of blips along the way, have shown no signs of slowing down yet. But they will eventually, as valuations continue to become more stretched. One of the stronger performers in the Canadian Focused Equity category has been this Fidelity offering, managed by Mark Schmehl since early 2011.

Schmehl uses a slightly unconventional approach, looking for companies that are undergoing some sort of fundamental change he believes will be a catalyst to unlock share price appreciation and ideally deliver above-average growth over the next 12 to 18 months.

The fund can invest in companies of any size but tends to favour the mid- to large-cap space and can invest up to 49% of assets outside Canada.

The process is bottom-up, meaning the sector mix is the byproduct of stock selection. Schmehl is not overly concerned with traditional valuation metrics. Instead, he's more likely to play the momentum, allowing his winners to run, regardless of the valuation.

He is also a very active manager, with portfolio turnover that could charitably be described as "robust." For the

past five years, turnover has averaged more than 240% per year. At the end of May, the fund had 54% in Canadian equity and 45% in foreign equities, with tech the largest sector, comprising nearly 28% of assets. What is somewhat surprising is that energy is the next largest sector at 23%, up from just 5% at the end of March.

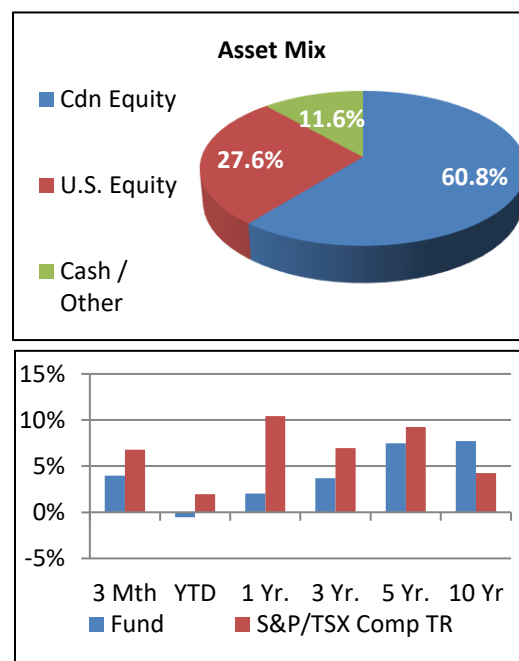
The fund has delivered top-quartile performance every year since Schmehl took the helm, except for 2016 when he was in the second quartile. For the past five years, he has generated an average annual compounded rate of return of more than 18%, well above the index and peer group.

The tradeoff is that the fund's volatility well above the index and peer group. But Schmehl has also done an excellent job protecting capital, participating in less than 20% of the downside of the market.

Despite the excellent track record, I'm concerned that the fund may struggle when we see market leadership rotate to value. For that reason, I'm reluctant to use this as a core holding, favouring it instead as part of a well-diversified portfolio. I see this pairing fund up nicely with a more value-focused offering such as **Fidelity Canadian Large Cap**.

Sentry Canadian Income Fund

Fund Company	Sentry Investments
Fund Type	Canadian Focused Equity
Rating	A
Style	Large-Cap Blend
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Michael Simpson since Apr 2002 Aubrey Hearn since June 2008
MER	2.33% (Front-End Units)
Fund Code	NCE 717 – Front-End Units NCE 217 – Low-Load Units
Minimum Investment	\$500



ANALYSIS: While this fund has been a solid performer for a long time, in the past couple of years it has trailed the Canadian market significantly. Its 2-year average annual compounded rate of return to May 31 was 3.4%, while the S&P/TSX Composite delivered 10%. While it's easy to point to the large market cap of the holdings for the underperformance, I believe there is another reason.

The fund really started to underperform in 2016 and 2017 and has been focused on larger companies for at least the past five years, if not longer, meaning moving up cap is not the main reason for its recent underperformance. Rather, I believe the underperformance is more a function of the investment process, which has focused on higher-yielding equity securities.

Managers Michael Simpson and Aubrey Hearn look for well-managed, high-yielding equity names that have the ability to deliver strong and growing cash flows.

The portfolio will typically hold around 60 names and tends to look much different than its benchmark. It can invest up to 49% of the fund in the U.S., and it can also hold preferreds, corporate bonds, and low-risk options to help boost the internal yield.

While not a value fund *per se*, valuation plays a key role in the stock selection process, and this eye on valuation

has resulted in the fund's maintaining an underweight position in Canadian banks, which has dampened performance in the short run.

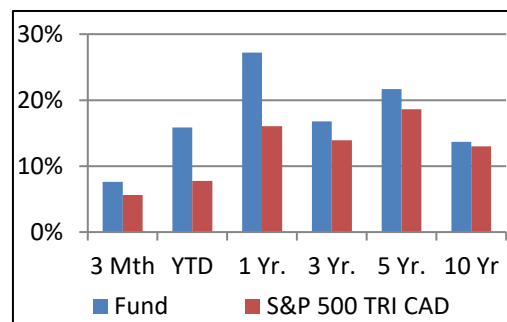
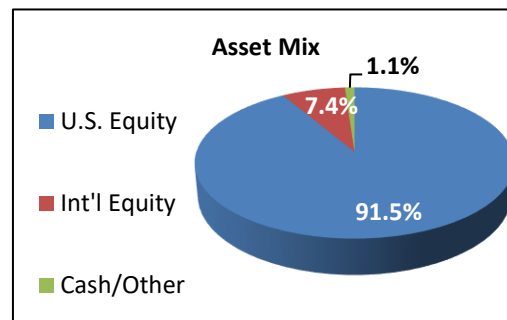
Unlike other Canadian-focused dividend strategies, this fund does not have a bank in the top 10 holdings, mainly because the managers feel the sector is vulnerable to an overheated housing market and excessive consumer debt. A quick back-of-the-envelope calculation shows that banks made up less than 3% of the portfolio at May 31 compared with nearly one quarter of the S&P/TSX Index.

The managers' steadfast refusal to chase hot trends and momentum plays has hurt the fund over the past couple of years. But as we head into a more volatile period, I believe the market will again rewards those companies that are producing strong levels of cash flow, have low levels of operating leverage, and are well managed.

The biggest drawback to the fund is its cost, with an MER of 2.33%, which is in the upper end of the category. However, the managers continue to focus on the fundamentals, and that discipline has been very successful for them over the long-term. The fund remains a very strong pick for the long term and I believe it can be a core holding in most portfolios. It also generates an attractive distribution yield.

TD U.S. Blue Chip Fund

Fund Company	TD Asset Management
Fund Type	U.S. Equity
Rating	D
Style	Large-Cap Growth
Risk Level	Medium to High
Load Status	No-Load/Optional
RRSP/RRIF Suitability	Good
Manager	Larry Puglia since October 1996
MER	2.41%
Fund Code	TDB 977 – No-Load Units TDB 310 – Front-End Units
Minimum Investment	\$500



ANALYSIS: With growth stocks continuing to be the market favourites, it's not surprising to see this growth-tilted U.S. equity fund posting above-average returns. For the first half, it has risen by 15.9%, handily outpacing the S&P 500, which is up 7.8%. Longer-term numbers are even more impressive, with a 5-year average annual compounded rate of return of nearly 22% to May 31, compared with 13.4% for the index.

The portfolio is diversified yet focused. It holds just over 100 names, while the top 10 make up 46% of the portfolio. It's exposure to the FAANG stocks has certainly helped propel returns. At the end of June, its top holding, Amazon.com, alone represented more than 10% the portfolio. In fact, tech is the largest sector exposure at 34%, followed by consumer services at 21%, and financials at 15%.

Manager Larry Puglia uses a bottom-up, fundamental investment process that looks for companies with have a history of generating free cash flow and a management team that has demonstrated ability for strong capital allocation. He looks for companies that can grow their cash flow even after covering necessary capital expenditures. Also, like other growth-focused managers, he likes companies that can compound earnings through self-sustained growth.

Puglia is also incredibly patient, with portfolio turnover averaging about 40% for the past five years compared with the 100% for other growth managers. He has reportedly held U.S. tech and health sciences firm Danaher for more than 24 years.

Granted, valuations within the fund are extremely high, with the weighted average P/E listed at more than 25 times earnings, compared with 17 for the index. Other valuation metrics are similarly high. However, forward-looking growth rates are also higher, making the valuation levels a bit more palatable. Given the growth tilt, the fund is more volatile than the index or peer group.

Over the long-term, this is an excellent growth-focused U.S. equity offering, and I see no reason for that to change. However, I do have some concerns about the extremely high levels of valuation. While I expect the fund to run hotter than the market, it is now well ahead of the broader market, and a correction or period of below-average returns is to be expected. Unfortunately, we don't know when that will occur. In the interim, further gains are possible.

If you have held this for a while, you will definitely want to take some profits and reduce your exposure.