

Top Funds Report

Markets stay calm in dog days of summer

But global trade and currency storm clouds are gathering on the horizon

On balance, July offered up a solid start to the third quarter. Global economic growth numbers continue to point to continued expansion despite the potential fallout from a trade war instigated by U.S. President Donald Trump.

Offsetting the trade tensions that have been dominating the business news in the past few months were second-quarter corporate earnings, particularly in the U.S., which were stronger than the consensus had expected, thanks largely to the tax cuts introduced by President Trump back in December.

Investors took some solace from the fact that the U.S. may be willing to pull back a bit on the trade front, after the U.S. and Europe agreed to a cease fire on tariffs while a new trade deal is negotiated. There were also signs that the U.S. may be willing to reopen NAFTA negotiations.

However, the U.S. continued to play hardball with China, as another round of tariffs are set to kick in in August. China has implemented another round of retaliatory tariffs.

While the trade situation may not appear to be as dire as it was a few months ago, it is still far from being resolved.

In this environment, equity markets were mostly higher in the month. U.S. stocks led the way with the S&P 500 Composite Index gaining 3.7% to July 31. European markets were also higher, with the main Europe index rising by 3.2%. Closer to home, the S&P/TSX Composite Index gained 1.2% on the month, with financials and industrials leading the way.

The U.S. dollar lost some ground, ending the month at \$1.3017, down from \$1.3168 in June.

In fixed income, upward pressure on yields pushed bond prices lower. The FTSE/TMX Canada Universe Bond Index ticked down 0.2% in July. Corporate bonds outpaced government bonds, as a lighter new issue calendar helped bring dealer inventories down and move supply and demand closer to equilibrium.

As we move through August, I don't expect much unusual activity while markets remain largely rangebound. Many investors and traders are on vacation in August, and market volumes tend to be lighter than normal as a consequence.

But given all that's on the horizon, including fresh currency turmoil among emerging market countries, originating with Turkey's economic troubles, I expect it to be a very eventful fall.

In this environment, I am not making any changes to my investment outlook.

	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:
feedback@paterson-associates.ca

Reducing taxes in fixed income

Tax-efficient bond funds from Horizons, Natixis, Dynamic, CI, and Canoe...

I am rarely one to let the tail wag the dog when it comes to taxes, but with yields on fixed income funds likely to be muted in the near to medium term, reducing potential taxes will become increasingly important for non-registered investors. This is because any distributions from fixed-income funds or exchange-traded funds (ETFs) are likely to be considered regular income, which is taxed at the investor's highest marginal tax rate. So anything you can do to reduce the amount of taxable income paid will go a long way to improving your total return.

Unfortunately, there are not as many ways to reduce taxable income in corporate accounts as there used to be. I thought it might be timely to take a look at a few of the options available for investors.

Horizons Canadian Select Universe Bond ETF (TSX: HBB) – Offered by Horizons ETFs, this fund is designed to track the Canadian bond market as represented by the Solactive Canadian Select Universe Bond Index. What makes this fund unique is that it uses a total-return swap structure, which means there are no taxable distributions being generated by the fund. This means that the fund's return will be treated as a capital gain rather than as interest income.

The ETF carries a management fee of 9 basis points, plus a SWAP fee that will not exceed 0.15%.

On a before-tax performance basis, the fund has trailed its peers. However, taking into account the lack of taxable distributions generated, it tends to outperform on an after-tax basis. For example, for the year ending July 31, HBB earned a return of 1.46%, while the iShares Core Canadian Universe Bond Index (TSX: XBB) gained 1.75%. However, XBB paid \$0.89 per unit in distributions, which would be taxed as ordinary income at the highest marginal rate. Assuming a 50% tax rate, the net return for the investor would be approximately 0.3%, compared with 1.46% for HBB.

The Horizons offering thus is clearly a very effective way to reduce taxes and enhance return for ETF investors.

Natixis Canadian Bond Fund – This Natixis fund offers a unique structure that allows investors to select the type of income they would like to receive: capital gains; dividends; or return of capital.

Within this structure, there are a few different fixed-income options, but the most attractive in my view is the Natixis Canadian Bond Fund managed by Toronto-based J. Zechner Associates. It invests in a diversified portfolio of predominantly Canadian bonds. At the end of June, it held roughly 40% in corporate bonds, half in governments, and the balance in cash. Performance has been middle of the pack, but when you factor in the ability to choose the type of income you are able to receive, the after-tax performance becomes considerably more attractive.

Dynamic Advantage Bond Class (DYN 1800 – Front End Units, DYN 1801 – Low-Load Units) – This defensively managed bond fund has been one of my favourites for many years. Recent performance has lagged somewhat, given the defensive positioning of the fund. But because it is offered in a corporate class structure, net return to investors in taxable accounts is improved.

CI Investments – There are a couple of CI corporate class offerings that may be worth looking at in non-registered accounts: **Signature Canadian Bond Class** and **CI Signature Corporate Bond Class**.

Managed by the Signature team at CI, these funds offer more tax-favourable exposure to Canadian bonds and high-yield fixed income.

CI Signature Corporate Bond Class has done better on both an absolute and relative basis than the **Signature Canadian Bond Class**. However, both funds have done better than many of their peers when the impact of taxation is taken into account. *(Continued on next page)*

Canoe Funds – Canoe also has a couple of funds worth taking a look at in the corporate class structure. **Canoe Global Income** is a go-anywhere global bond fund. It's not the type of fund that will shoot the lights out, but it is expected to deliver steady, stable results over time, resulting in better risk-adjusted returns than its peers. Factor in the more favourable tax treatment and you have a fund definitely worth looking into for non-registered accounts.

Canoe Bond Advantage is another corporate class bond fund worth investigating in more depth. So far this year, returns have trailed, but the longer-term numbers have been above average. Again, factor in the more favourable tax treatment and the fund becomes even more attractive.

Canoe Strategic High Yield Class is a high yield offering that provides exposure to a diversified basket of global non-investment grade bonds. It's managed by AEGON Investment Management. It wouldn't be my pick in the space on a before-tax basis, but it is a solid offering after taxes.

While not a complete list of corporate class offerings, these funds should help you reduce the amount of taxes paid in your non-registered investments, at least when it comes to your fixed-income allocation. If there are any funds I've missed, and I'm sure there are, please feel free to reach out, and I'll review them for you.

Funds of Note

This month, global funds from Mackenzie and Manulife, plus a laddered bond fund from Invesco...

Mackenzie Ivy Foreign Equity Fund (MFC 081 – Front Units, MFC 7107 – Low-Load Units) – This has historically been one of the best global equity funds around. It is a concentrated portfolio of high-quality, multi-national companies that the manager believes are trading at a level below what they are truly worth. However, in the past few quarters, the fund has really struggled, delivering performance that has disappointed, with returns trailing not only its benchmark but also its peer group.

One of the larger contributors to the fund's underperformance is the high cash balance in the portfolio. The manager has noted that market valuations are high, and he believes there is trouble on the horizon on a number of fronts. For most of last year, the fund carried a cash allocation of around 30%. Only in the past quarter, in the wake of higher levels of volatility, has the manager put some of that cash to work, bringing the cash balance down to roughly a 25% weighting. This has created a significant headwind for fund performance, particularly in rising markets.

Another factor that has dragged on returns has been the fund's underweight in technology stocks. Given the manager's focus on quality and valuation, he has been significantly underweight tech names. However, it has been the mega-cap tech names, specifically the FAANG stocks (Facebook, Amazon, Apple, Netflix,

and Google), that have been responsible for a big chunk of recent market gains. With no exposure to these high-flying tech stocks, the fund has trailed much of its global equity brethren.

Yet another significant issue affecting performance has been security-specific issues within the consumer discretionary holdings. The biggest detractor in the sector has been clothing brand H&M, which has struggled in the midst of worries over the retail sector and a marketing gaffe or two. The stock has consequently been punished by investors. But the managers believe the company has a business model that is resilient and poised for growth in this challenging retail environment. That, combined with the very attractive share price, set the table for what the manager believes will be a solid rebound in the stock.

Other stocks that have weighed on returns include Samsonite, which was hit by a short seller's report, and Hyundai Motors, which sold off in the face of the potential trade tariffs.

So, where do we go from here? Historically, this has been one of the best funds in volatile market environments. It has exhibited less volatility than the index or peer group and has protected the downside significantly better. I see no reason based on the manager's investment process or portfolio positioning

that it will be any different this time around. I also expect that as the market again rewards fundamentals and valuation over growth, the fund will see improved performance.

However, the one area that continues to be a source of concern for me is the high cash balance. I would like to see a continuation of the recent trend where the manager uses periods of market weakness to effectively deploy cash, picking up attractive names with good prospects at compelling valuations. I am not asking him to fully invest the proceeds immediately, but to take a more measured approach. If there is a marked increase in cash without a significant erosion in market or economic fundamentals, the fund's standing on our Top Funds Recommended List will need to be reviewed.

For the long-term, this can be a great core holding for investors. Unfortunately, it has recently undergone a "perfect storm," which has hurt performance and dampened returns. I will continue to watch it closely. Regardless, those looking for more upside and growth potential would be wise to find an alternative to this offering. But for those looking for a very risk-managed, conservative global offering, this is one that may be worth considering.

Manulife Global Infrastructure Fund (MMF 4569 – Front Units, MMF 4769 – Low-Load Units) – The fund posted a strong quarter on the back of an overweight allocation to energy stocks, with a nice pop coming from Enbridge. Enbridge rose by more than 17% on news it would be simplifying its corporate structure, with a massive consolidation and restructuring of its assets. The markets reacted very favourably to this announcement. The fund managers added to their holdings after this announcement, noting evidence of strong execution of Enbridge's strategy. The managers remain optimistic on energy infrastructure, believing that volume growth will be strong. Further, they believe that current valuation levels are compelling, particularly if growth picks up.

Many utility companies have seen their share prices fall sharply in the face of rising interest rates. This has created an excellent opportunity for the managers to pick up some high-quality names at very attractive prices. They continue to favour companies with an emphasis on low cost renewable power generation.

Geographically, the team is finding attractive opportunities in Europe and Latin America in the transportation sector, but geopolitical factors are causing them to remain cautious and defensive.

Interest rates, particularly in the U.S., are likely to continue to move higher. This is expected to weigh on many areas of the infrastructure sector and to create strong buying opportunities for the fund.

I continue to watch this fund closely. The pedigree of the management team is keeping the fund on the Recommended List, but I continue to be frustrated by the performance relative to the peer group and the index. The fund remains UNDER REVIEW.

Invesco 1-5 Year Laddered Corporate Bond Index ETF Fund (AIM 53203 – Front Units, AIM 53207 – Fee-Based Units) – This has always been an interesting fund to me. It has a somewhat unique approach to investing in short-term investment-grade corporate bonds that carry a credit rating of BBB or higher. It has five equally-weighted maturity buckets with staggered maturities between one and five years. Each maturity bucket will hold 10 equally-weighted bonds of roughly the same maturity.

The index is rebalanced annually in June, with those bonds with a maturity level falling out of the fund, while a new tranche of five-year bonds is added. The fund recently underwent its annual rebalancing. As a result, the duration has increased to 3.3 years from 2.6 years, and the yield has increased to 2.9% from 2.7%. Given the laddered approach to the fund, the duration will gradually fall between now and the next rebalance in June.

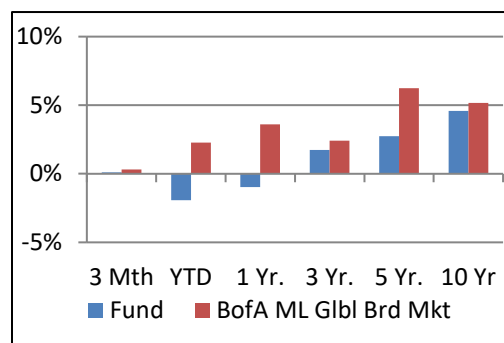
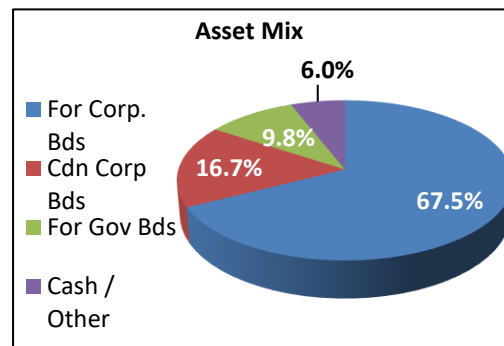
While the fund has trailed some of its actively-managed peers in the shorter term, its lower cost is expected to allow it to outperform over the longer term. The fund may also trail in periods of extreme equity market volatility as investors move to the safe haven of governments and shun corporate issues. Still, the fund remains a very solid pick for those looking for exposure to short-term corporate bonds.

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

feedback@paterson-associates.ca

RBC Global Bond Fund

Fund Company	RBC Global Asset Management
Fund Type	Global Fixed Income
Rating	B
Style	Top-down/Bottom-up
Risk Level	Low
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Dagmara Fijalkowski Soo Boo Cheah
MER	1.61%
Fund Code	RBF 765 – Front-End Fund Units RBF 117 – Low-Load Units
Minimum Investment	\$500



ANALYSIS: North American interest rates will likely continue climbing. The U.S. Federal Reserve is expected to raise rates in September and again in December. In Canada, given the uncertainty over NAFTA negotiations, the outlook for rates is much cloudier, and will depend on the overall strength of the economy and the outlook for inflation. Globally, other countries remain in an easing or stable rate environment.

Given this wide discrepancy in the outlook for rates, this RBC offering with its go-anywhere mandate can be helpful in generating returns. It invests in a well-diversified portfolio of fixed-income securities issued by governments and corporations around the world.

While the focus is on investment-grade bonds, the fund can also invest in high yield. At the end of July, it had a 90% weight to government bonds, with only about 5% in high yield issues, and the rest in cash.

The fund is very diversified geographically and looks much different than its peers. Less than 25% is invested in the U.S., compared with more than 40% for the peer group. The next largest weights are Japan, Spain, and

Italy, each of which are overweight compared with the peer group.

Credit quality remains very high, with more than 86% in investment-grade issues with average credit quality rating of AA. The balance is non-investment grade or unrated.

Performance has trailed the peer group largely because of the fund's overweight exposure to government bonds, which have trailed corporates. However, government bonds will provide a better buffer against volatility in equity market selloffs.

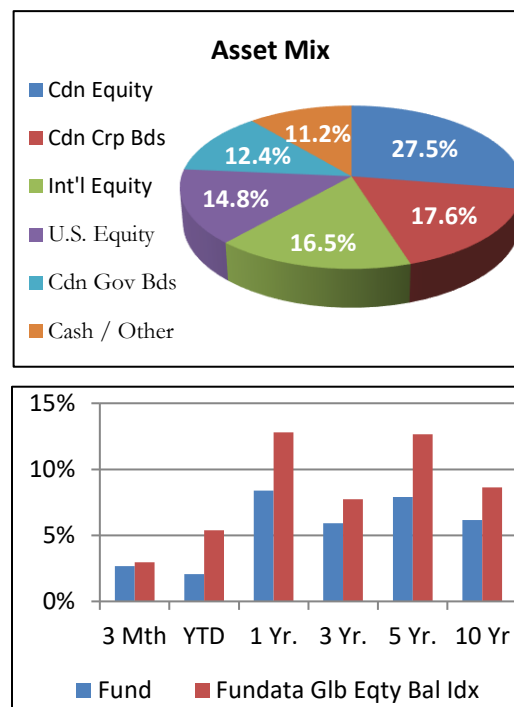
The fund has a modest duration, at around 7.5 years, with a yield to maturity of approximately 2.7%.

The fund's current tilt towards "peripheral" European countries could expose it to larger swings if we see a repeat of the government crisis that occurred in Italy back in May.

The fund has a reasonable MER of 1.57% for advisor-sold units, and 0.89% for the do-it-yourself units. All things considered, this remains a solid pick for those looking for a more defensive global bond fund.

Leith Wheeler Balanced Fund

Fund Company	Leith Wheeler Investment Cnsl
Fund Type	Global Equity Balanced
Rating	B
Style	Large-Cap Value
Risk Level	Medium
Load Status	Fee-Based/No-Load
RRSP/RRIF Suitability	Excellent
Managers	LW Management Team
MER	0.95% - Fee-Based Units 1.16% - DIY Units
Fund Code	LWF 029 – Fee-Based Units LWF 036 – DIY Units
Minimum Investment	\$5K (Fee-based)/\$25K (DIY)



ANALYSIS: I'm not usually a fan of balanced funds, as I believe that investors can often do better building their own diversified portfolio of high-quality mutual funds and ETFs. However, for those who want a one-ticket solution, this is one to look at.

The fund has a target asset mix of 60% equities, 35% bonds, and the rest in cash. The managers have some flexibility around these numbers and can take the equity weight as high as 75% or as low as 45%. At the end of June, it held 57% in equity, 35% in bonds, and the rest in cash.

Equities are managed over a three- to five-year horizon and chosen using a fundamental, bottom-up security selection process, with a focus on return on equity, free cash flow, and earnings growth. Stocks must be trading at attractive levels, and the managers are not afraid to step in after the value has fallen, which helps improve the overall margin of safety.

For Canadian and U.S. large-cap holdings, the fund invests directly in individual securities. For international exposure, it invests in units of the Leith Wheeler International Equity Plus Fund, managed by Edinburgh Partners. At the end of June, valuation

numbers were better than both the index and the category, also offering a more attractive earnings outlook.

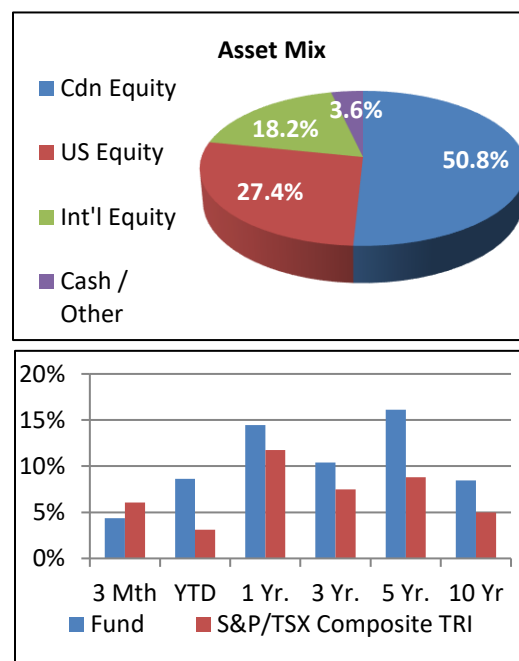
On the fixed-income side, the focus is on providing a buffer to the potential volatility of equity markets. The emphasis is on investment-grade bonds, with an overweight to corporate bonds. Any non-investment grade exposure is obtained through holdings of the Leith Wheeler Multi Credit Fund.

Over the longer-term, the 10-year average annual compounded rate of return of 6.2%, which is above the peer group average. Shorter term, the fund has trailed, largely because of its more value-focused approach. With its focus on quality and valuation, volatility is below both the index and category, resulting in compelling risk-adjusted numbers. I expect we will see relative performance improve as the market leadership shifts from growth to value.

With an MER of 0.95% for fee-based units, and 1.16% for do-it-yourself units, costs are low. While I would still suggest that most investors build their own portfolios, this is an excellent balanced fund option for the long term.

Mackenzie Canadian Growth Fund

Fund Company	Mackenzie Investments
Fund Type	Canadian Focused Equity
Rating	A
Style	Large-Cap Growth
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Dina DeGeer since August 1995 David Arpin since January 2013
MER	2.46%
Fund Code	MFC 650 – Front-End Units MFC 7028 – Low-Load Units
Minimum Investment	\$500



ANALYSIS: Despite disappointing performance in July, the fund has recently been on fire! Year-to-date, it is up more than 8.6%, outpacing its peers, and besting the 3.1% rise in the S&P/TSX Composite.

The management team, led by Dina DeGeer, manage a concentrated portfolio of 30 to 35 businesses of any size. They look for well-managed niche players with unique competitive advantages, a history of strong free cash flow generation, and that are growing faster than the economy and their competition. The team creates a valuation model based on free cash flow to help determine the estimated fair value for the company. A potential investment must be trading at a minimum of 10% below their estimate of fair value to ensure they don't overpay for future growth.

Although the portfolio is concentrated, it is well-diversified, with exposure to most market sectors. With its growth tilt, valuation levels are well above the broader market. It is overweight current growth sectors such as industrials, healthcare, and consumer names, with no exposure to real estate or utilities, and a significant underweight in energy, materials, and financials.

The managers are reasonably active, with a portfolio turnover that has averaged around 70% over the past five

years. They can invest up to 49% in foreign stocks and are currently more than 45% invested abroad.

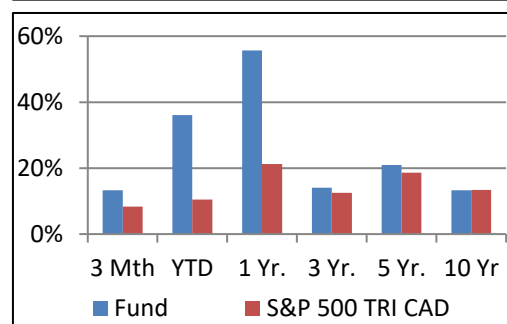
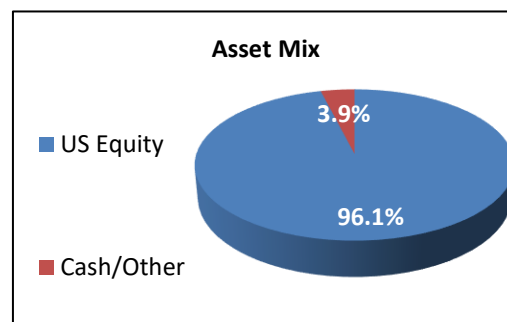
The forward-looking growth rate looks very positive, which makes the valuation levels more reasonable. Given the growth tilt, the fund has been more volatile than the index or peer group. However, the absolute level of outperformance has more than offset this, resulting in better risk-adjusted returns.

The fund has had an excellent run since the 2008 financial crisis, with an average annual compounded rate of return of 8.5%, driven by the fund's focus on growth sectors. As market leadership returns more towards the quality- and value-focused names, I would expect performance to moderate somewhat. I don't envision a severe correction, but rather a period of underperformance relative to more value-type funds.

Bottom line, if you have held this fund for any length of time, you will likely want to take some profits and rebalance your holdings back to your target mix. Despite my expectation of more moderate performance ahead, this fund remains an excellent growth-focused offering for the long-term and can be a nice addition to a diversified portfolio.

Dynamic Power American Growth Fund

Fund Company	Dynamic Funds
Fund Type	U.S. Equity
Rating	C
Style	Large-Cap Growth
Risk Level	High
Load Status	Optional
RRSP/RRIF Suitability	Fair
Manager	Noah Blackstein since July 1998
MER	2.43%
Fund Code	DYN 004 – Front-End Units DYN 604 – Low-Load Units
Minimum Investment	\$500



ANALYSIS: This is an aggressive, actively-managed, concentrated, high-growth equity fund, very much like the **Dynamic Power Global Growth Fund**, which has been on my Recommended List for many years. The key difference is this offering invests only in U.S. companies.

The fund manager is very growth-focused, looking for companies that have the best growth prospects, strong earnings momentum, and a history of upside earnings surprises.

The managers also seem to downplay valuation numbers, as evidenced by the fund's price-earnings ratio at over 55, more than three times the broader market. The price-to-book is listed at over 12, more than four times the market. However, the underlying growth rates of the stocks in the portfolio are also substantially higher than the broader market, putting a different, more favourable, light on the simple raw valuation numbers.

With just 23 holdings, the fund is very concentrated. The top 10 names make up more than 50% of the fund. The fund is also concentrated in just two sectors: technology, which makes up nearly two thirds of the portfolio; and healthcare, which makes up nearly one quarter. The rest is invested in consumer names.

This is a very volatile fund, with standard deviation significantly higher than the S&P 500. The manager is extremely active, with portfolio turnover that has averaged more than 281% (or an average four-month holding period for a stock).

One drawback is that the active style can generate significant capital gains, which can attract a significant tax bite. To help offset this, the fund is also available in a corporate class version.

Another potential drawback is higher trading costs, which for the past five years have averaged 0.27% annually. Returns have more than offset any additional trading costs, and as long as the fund is making money, trading costs will be a non-issue. But that could change if returns moderate or if the fund starts losing money, a strong possibility if market leadership returns to more quality- and value-focused names.

Because of this, I would not suggest that this fund be used as a core holding, nor would I suggest it for anyone who does not have a high tolerance for risk. But for those looking to juice up their portfolios and are comfortable with some volatility, this is a great U.S. equity fund to consider.