
Top Funds Report

Rising bond yields impact stock markets

Increasing equity market volatility now top of mind for investors.

After a nice summer break, traders got back to work in September. Markets were largely mixed, with global equities rising in local currency terms, Canadian equities mostly lower, and bonds falling in the face of rising bond yields.

In fact, the yield on the benchmark 10-year U.S. Treasury bond moved from 2.86% to end the month at 3.05%. It has continued to climb so far in October. It was a similar story in Canada, with the 10-year Government of Canada bond rising 20 basis points, to close at a yield of 2.42% on September 30.

This bump in yields, which was felt across the yield curve, pulled bond prices lower. The benchmark FTSE/TMX Canada Universe Bond Index fell nearly 1%, with corporate bonds outpacing government issues.

In the stock markets, international equities led the way higher thanks to a strong showing in Japan. The MSCI EAFE Index gained 0.9%, while the S&P 500 Composite Index rose by 0.6% on the month. Closer to home, the S&P/TSX Composite Index lost nearly 0.9% in September, with weakness in energy, materials, and consumer discretionary stocks.

Healthcare issues, led by weed stocks, continued to rally higher with pot legalization becoming effective in Canada on Oct. 17. U.S. investors have also taken note of the cannabis sector, with many of the high-flying names, such as Canopy and Tilray, moving even higher.

Perhaps the biggest relief was the last-minute announcement that a trade deal had been reached between Canada, the U.S., and Mexico. (I elaborate on this in the article on the next page.) While the so-called U.S.-Mexico-Canada Agreement (promptly dubbed USMCA by U.S. President Donald Trump) is really the old NAFTA with a couple of tweaks, it

removes the cloud of uncertainty that had continue to weigh on Canadian markets.

With this overhang now gone, I expect we'll see Canadian markets begin to close the valuation gap with the U.S. And this also paves the way for the Bank of Canada to continue moving its key target overnight bank rate higher. It last increased its rate in July, with a 25-basis-point hike to 1.50% but left it unchanged at its September meeting.

In the U.S., economic numbers continue to show the country on sound footing with strong consumer confidence and increasing factory activity.

China continues to remain resilient, even in the face of further tariffs levied by President Trump. However, signs are emerging that factory production is slowing, with China's central government becoming concerned enough that it announced a program to support economic growth and the economy as needed.

With the global economy moving along at a reasonable pace, the biggest near-term threat to the markets is rising interest rates. As the U.S. 10-year bond yield continues to move ever higher, investors have begun to reexamine their equity holdings, and a modest repricing has begun. Most of the pain has so far been felt in the mega-cap tech-related names (i.e., the FAANG stocks, consisting of Facebook, Apple, Amazon, Netflix, and Google-parent Alphabet).

I expect that we will see further upticks in volatility, along with the strong possibility of continuing near-term equity losses. In this environment, then, I continue to favour high-quality equities that are trading at reasonable valuation levels. I still slightly favour the U.S. over Canada, but that may begin to change in the coming weeks as we monitor the pace of economic activity. *(Continued on Page 2.)*

Within fixed income, I continue to favour lower-duration and less interest rate sensitivity. The U.S. Federal Reserve is widely expected to move its federal funds rate, currently sitting at target range of 2.0%-2.25%, once more this year, and the Bank of Canada likely to move twice.

In this environment, I am not making any changes to my investment outlook. My current investment outlook and recommended asset weightings are shown in the table at the right.

Please send your comments to:
feedback@paterson-associates.ca

		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		

Trade truce reached

USMCA not too different from NAFTA, with no clear-cut victory for anyone...

Taking it right down to the wire, Canada and the U.S. announced they had agreed to terms to bring Canada into a the previously negotiated trade pact between the U.S. and Mexico. Despite a lot of hoopla and a new name, United States-Mexico-Canada Agreement (USMCA), the deal really isn't substantially different from the old North American Free Trade Agreement (NAFTA). Still, there are some important changes to note.

Perhaps the biggest change, at least in terms of media attention, is Canada's opening up limited access to our dairy market. Under the terms of the new deal, Canada has increased the amount of U.S. milk, cheese, and other dairy products that can come into the country duty free. Canada has also agreed to end the pricing regime that kept milk proteins artificially low. Digging deeper, however, the quota represents a very modest 3.6% of the Canadian dairy market. According to BofA Merrill Lynch Global Research, this amounts to a very modest \$70 million, or 0.0003% of U.S. GDP. Canadian dairy farmers are not pleased, but all things considered, the impact will likely be very minimal.

A more meaningful change was made to the automotive industry. Under the new deal, at least 75% of a vehicle must be manufactured in North America to be allowed to move across the borders duty free. This is up from 62.5% under the original NAFTA. Another change is that at least 40% to 45% of car and truck parts must be made by workers making at least \$16 per hour. The goal of this clause is to have more production moved to Canada and the U.S. However, it's too early to tell whether that will be the result, as some experts reckon that more production will be moved to Japan and Korea, where the total production costs may be lower than they would be by complying with the terms of the new agreement.

A victory for Canada was that two of the key dispute mechanisms of the old NAFTA remain in the new deal. These clauses lay out the rules by which trade disputes between nations are settled. According to reports, the absence of such a mechanism would have been a deal breaker for the Canadian team. There were also changes to digital copyright rules, along with the addition of stronger intellectual property protections for biotech and financial services.

What was not addressed was the elephant in the room: the hefty U.S. tariffs currently being levied on steel and aluminum.

While all sides are claiming victory, the quick analysis shows this isn't really a great deal for anyone. It's also not a bad deal either. The largest benefit of the agreement is that it removes the uncertainty around trade that has been

a headwind on Canadian markets for the past several months. With this impediment now gone, it is very likely that the Bank of Canada will raise its benchmark target overnight rate at its Oct. 24 meeting, with another bump higher expected in early December.

Some observers expect this to be a source of strength for the Canadian dollar. I am less certain of this, because it appears as if the U.S. will continue to move its rates higher at a much quicker pace than Canada. Still, I expect we will see a stronger bid under the Canadian dollar, which will help to preserve its value, and possibly even contribute to some modest appreciation. However, if we see any significant volatility, I would expect the U.S. dollar to appreciate substantially on the flight-to-safety trade.

The outlook for Canadian equities is marginally positive. Some analysts believe that we should start to see the valuation gap between U.S. and Canadian equities start to close, with autos, industrials, and some retail being the main benefactors.

The USMCA does not dramatically alter my investment outlook. I have been modestly positive on Canadian equities and remain so. I continue to favour the U.S. in the near term, but I will be looking to reduce U.S. exposure and add to Canadian, European, and Asian names as growth starts to wane in the U.S.

The larger near-term threat to equities has been the sharp increase in the yield on the 10-Year U.S. Treasury note, which has shot up well past the key 3% level. With bond yields rising sharply, we are likely to see some repricing for equities, as investors weigh the higher returns now available from “risk-free” U.S. government bond investments.

Even with this scenario in play, I continue to favour equities over fixed income in the near term, given the strong economic and corporate fundamentals. However, I continue to monitor the data closely, and I’ll keep you posted of any shift in my views as the data change.

Funds of Note

This month, fund news from IA Clarington & Mackenzie, Fiera & CGOV, and Ninepoint’s pot fund...

IA Clarington Conservative Canadian Equity Fund (CCM 1300 – Front-End Units, CCM 1200 – Low-Load Units) – This is one of Canada’s oldest mutual funds with roots dating back to 1950. The fund has a focus on large-cap companies that have the potential to increase their dividends. The investment approach is a combination of top-down macro analysis combined with bottom-up fundamental security selection.

I had been a fan of this fund a few years ago when its defensive-first approach had a very strong appeal in a potentially volatile market environment. However, an overweight allocation to energy, particularly pipelines, saw the fund pay a very high price, with sharp losses during the crude oil selloff in 2015. Following that, there was a manager change, with Terry Thib taking the reins from the team at Leon Fraser.

Under Mr. Thib’s leadership, the fund had a strong 2016, but again found itself struggling as the quality, value, and yield-focused strategies trailed the higher-

beta growth strategies. It was recently announced that Mr. Thib was leaving the firm, handing the fund off to co-managers Michael Formuziewich and Peter Prattas.

Mr. Formuziewich has been part of the management team of the fund since 2009 and was promoted to portfolio manager in 2016. Mr. Prattas joined IA Clarington last year, after nearly 15 years spent as a sell-side analyst. As both managers have worked on the mandate previously, this is likely to result in a strong level of continuity of process and implementation.

However, this is their first time managing a fund on their own which may lead to some bumps along the way. I view this change as neutral in the near term and will continue to follow the fund closely.

CGOV acquired by Fiera Capital – The pace of consolidation in the investment industry continues to pick up steam. Back in May, for instance, Fiera Capital acquired Toronto-based CGOV Asset Management, for

combined assets under management of about \$130 billion. CGOV is a Toronto-based manager that runs very concentrated portfolios that look nothing like the index. The number of stocks in a portfolio is capped at 25. Their investment process blends quantitative and qualitative analysis with a focus on management, the business, and the valuation levels.

CGOV is active in the high net worth and institutional space, runs several SMA mandates, and sub-advises on funds for Steadyhand and Quadrus. No significant changes to the investment team or process are expected. Further, management expects this to be a beneficial move as they now have access to the wider Fiera platform and the additional resources it offers.

I expect this to be a neutral to modestly positive change for the firm in the near term.

Mackenzie Investments cuts management fees on 14 ETFs and 7 mutual funds – The race to the bottom for mutual fund and ETF fees, while not as far along as it is south of the border, is gathering momentum here in Canada. Earlier this month, Mackenzie Financial announced it is cutting management fees on several of its ETFs and mutual funds.

The fee cuts for ETFs range from 5 to 15 basis points and include the actively managed **Mackenzie Floating Rate Income ETF (TSX: MFT)**, **Mackenzie Unconstrained Bond ETF (TSX: MUB)**, and **Mackenzie Ivy Global Equity ETF (TSX: MIVG)**. There were also fee cuts to their TOBAM-offered Maximum Diversification ETF family.

On the mutual fund side, the management fee was cut by 5 basis points on seven of Mackenzie's fixed-income funds for the fee-based series. These included **Mackenzie Canadian Bond Fund**, **Mackenzie Investment Grade Floating Rate Fund**, and **Mackenzie Global Tactical Investment Grade Bond Fund**.

It is always a positive sign when we see fund companies step up to the plate and reduce fees. While fees are not the only factor one should consider when evaluating an actively-managed fund or ETF, costs do play a role in return, and lower fees are better than higher fees when looking at comparable investment products.

NinePoint Alternative Health Fund (NPP 5420 – Front-End Units) – With a one-year return of more

than 107%, this has been the best-performing mutual fund by a significant margin, with the next best, the highly growth-focused **Dynamic Power American Growth Fund** generating a 66% gain, which is still fantastic in anyone's book.

Lead managers Charles Taerk and Doug Waterson of Faircourt Asset Management look for companies involved in the alternative health sectors, including pharmaceuticals, vitamins and supplements, health and wellness providers, weight loss, and cannabis.

With such strong performance, it's not surprising to see that 9 of the top 10 holdings are companies involved in the cannabis sector. At the end of August 53% of the fund's assets were in the cannabis sector, 20% in pharmaceuticals and health technology, 9% in supplements and nutraceuticals, 12% in cash, with the rest in other wellness companies.

The fund's portfolio is fairly concentrated, at between 25 and 35 names. Geographically, about half the fund is invested in Canada, which is consistent with the focus on the cannabis sector.

As impressive as the one-year performance number is, it trails the **Horizons Marijuana Life Sciences ETF (TSX: HMMJ)**, which has delivered more than 171% for the year ended Sept. 30. Year-to-date however, the more diversified Ninepoint offering has outperformed, gaining 43%, outpacing the 33% rise in HMMJ.

Make no mistake about it, this is a fund that will see significant volatility. With the narrow focus and exposure to companies that are involved in very early stages of an emerging industry, the risks are high.

When compared with the ETF, I like the fund's active management approach and its greater diversification that HMMJ. While that may see the fund trail in a rising weed market, the broader diversification is likely to see a modestly lower volatility profile, which may help over the long term.

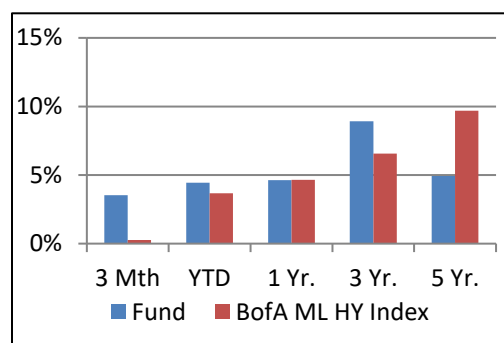
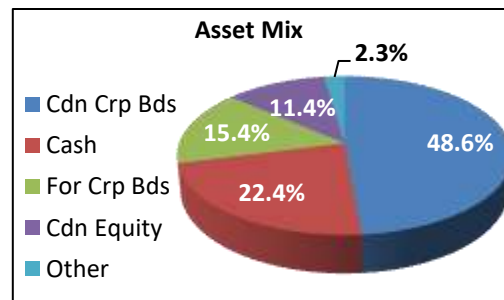
The fund is *not* a core offering and should only be used as a potential return enhancer by those with high risk-tolerance levels.

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

feedback@paterson-associates.ca

First Asset Canadian Convertible Bond

Fund Company	First Asset Investment Mgmt
Fund Type	High Yield Fixed Income
Rating	C
Style	Fundamental Credit Analysis
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Fair
Manager	Lee Goldman since November 09
MER	2.47%
Fund Code	FAF 5703 – Front-End Units FAF 5701 – Low-Load Units
Minimum Investment	\$500



ANALYSIS: Convertible bonds are a very interesting asset class with characteristics of both bonds and stocks, depending on whether the company's share price is above the bond's conversion price (behaves like a stock) or below (behaves like a bond). Convertibles are considered "high yield" because they do not sit as high on the capital structure of a firm as traditional bonds. For investors, there are only a few options available to access the convertible bond market, including a handful of mutual funds and a couple of ETFs. This fund is one of the more attractive mutual fund options.

It invests primarily in Canadian convertible bonds but may invest up to 30% in non-Canadian issues. First Asset portfolio manager Lee Goldman looks for bonds issued by companies that have strong balance sheets that he believes can withstand an economic downturn.

The fund is well diversified, holding more than 50 names, with the top 10 making up roughly 35% of assets. Real estate and REITs make up the largest sector exposure, at roughly a quarter of the fund, while financials and industrials comprise about 30% of the fund combined.

Portfolio turnover has been very modest, averaging approximately 20% per year. However, the manager may

use periods of volatility as an opportunity to improve performance, as occurred in 2017, when portfolio turnover was more than 50%.

The fund has recently outperformed other convertible bond funds as well as the broader high-yield peer group. Its 5-year average annual compounded rate of return to Sept. 30 came in at 4.9%, trailing the index, but beating its peers. For the past 12 months, it has substantially outpaced the peer group, gaining 4.6%.

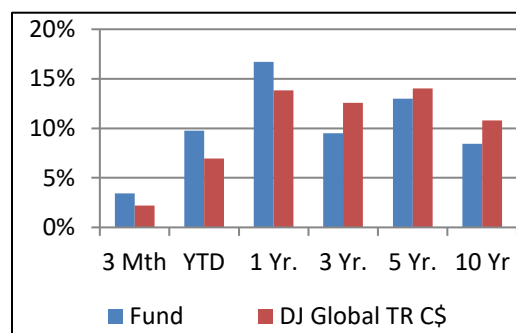
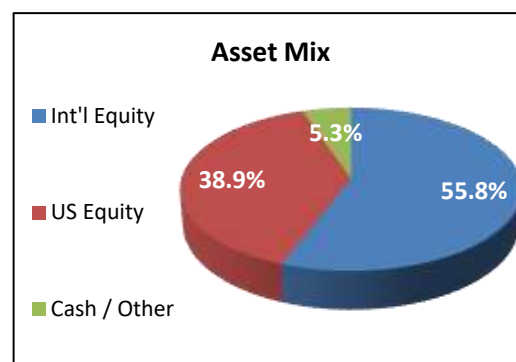
Volatility has been slightly higher than the broader high yield market, but the downside protection has been significantly better. It has shown positive correlation to Canadian equities, but negative to the broader Canadian bond market.

I would expect this fund to perform much like a conservative dividend fund but with better downside protection. The fund is not suitable for everyone and can be tricky to use in a portfolio, given its hybrid nature.

I see this fund playing a role similar to a high-yield bond fund in a portfolio, offering higher yields than traditional fixed income, less interest rate sensitivity, and higher overall upside potential.

Dynamic Blue Chip Equity Fund

Fund Company	Dynamic Funds
Fund Type	Global Equity
Rating	D
Style	Large-Cap Growth
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Managers	Dana Love since December 2015 Vishal Patel since December '15
MER	2.43%
Fund Code	DYN 204 – Front-End Units DYN 214 – Low-Load Units
Minimum Investment	\$500



ANALYSIS: Veteran manager Dana Love and his team invest in a concentrated portfolio of “best in class” companies located around the world. The investment process is very much a bottom-up approach that first looks to find well-managed businesses that can generate sustainable free cash flow, have high barriers to entry, and are trading below what the manager believes it to be worth.

The resulting portfolio has a growth tilt, with valuation levels that are higher than the index and the peer group. However, the earnings growth and cash flow generation tend to run higher, helping to justify this higher valuation.

The fund holds 35 names, with the top 10 making up more than 40% of the portfolio. While the fund has a large-cap focus, the manager will invest in small- and medium-sized companies where the opportunities are present. It does not have any geographic constraints and can invest anywhere. At the end of August, the fund held 56% in foreign equities, 42% in U.S. equities, and the rest in cash.

Despite its “Blue Chip” moniker, not all the holdings are exactly household names. While some name

brands are instantly recognizable, such as Microsoft, Union Pacific, and Ross Stores, the fund also holds many lesser-known companies, such as Cognizant Technology Solutions, Fresenius SE & Co., and United Overseas Bank.

The manager takes a longer-term view, with very modest levels of portfolio turnover. The fund is overweight financials, consumer names, tech, and industrials, and underweight energy, materials, real estate, and communication.

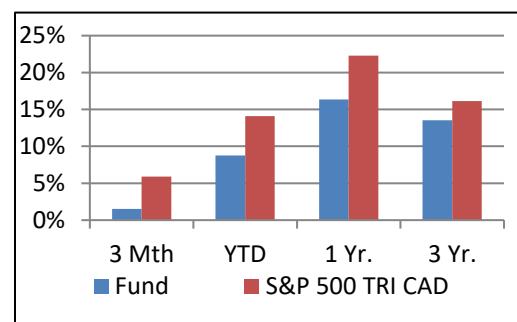
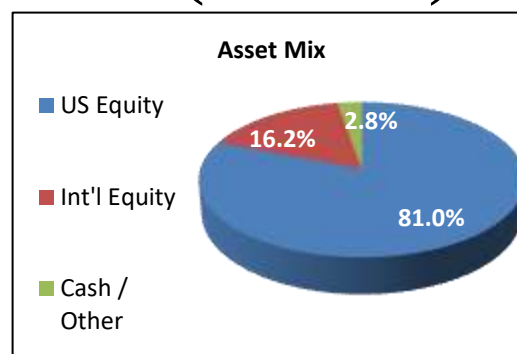
Short-term performance outpaced the peer group in 2017 and is on pace to do so again this year. In the past three years to Sept. 30, it has finished in the middle of the pack with an average annual compounded rate of return of 9.5%. Volatility has been slightly less than average.

Most of the fund’s recent gains can be attributed to its higher exposure to growth names, and I expect to see performance moderate slightly as more value-focused names regain market leadership with the fund producing solid risk-adjusted returns for investors.

This can be a core global equity offering.

Capital Group U.S. Equity Fund (Canada)

Fund Company	Capital International Asset Mgmt
Fund Type	U.S. Equity
Rating	D
Style	Large-Cap Blend
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Christopher Buchbinder Barry Crosthwaite Mark Hickey
MER	2.03%
Fund Code	CIF 847 – Front-End Units CIF 867 – Low-Load Units
Minimum Investment	\$500



ANALYSIS: This fund has a modest four-year track record here in Canada, but it is modelled on Capital International's oldest portfolio, the **Investment Company of America**, which was launched in 1933. The fund is managed with a multi-manager approach, whereby the portfolio is divided into different sleeves that are managed independently by managers of different backgrounds and styles. A portion of portfolio is also made up of top picks from the firm's own analyst teams.

Because each sub-advisor uses their own unique, research-driven approach to stock selection, the result is a portfolio that tends to be somewhat style agnostic.

The firm's Portfolio Coordinating Group is responsible for monitoring the portfolio in real time and sets the weight between the managers and analysts within the fund, based on their outlook of the investing environment.

The portfolio is often quite different from its benchmark. For example, at the end of June, it was overweight energy and healthcare and underweight in financials, industrials, and technology. It holds 57 names, with the top 10 making up 41% of the fund. Valuation metrics currently look more attractive than the S&P 500.

The compensation structure for the portfolio is unique. Incentive bonuses are paid to the managers based on their rolling one-, three-, five-, and eight-year performance numbers, with more emphasis being placed on the longer-term numbers.

Performance has been above average, with lower levels of portfolio volatility, resulting in better risk-adjusted performance. Moreover, the fund has done an excellent job protecting capital in down markets, delivering less than 60% of the downside of the index over the past three years.

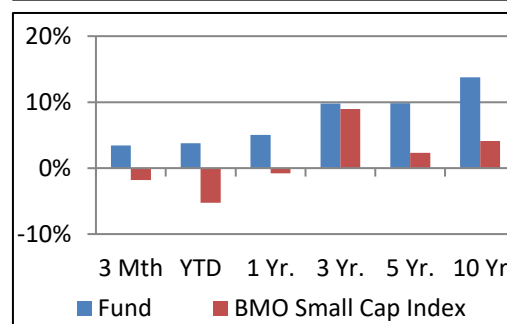
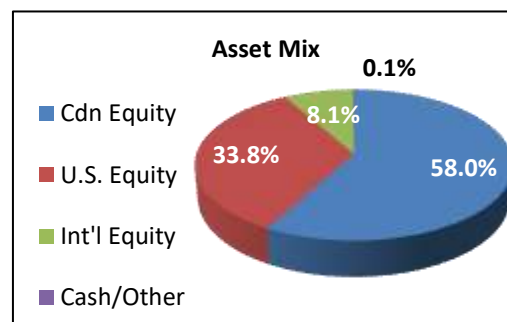
Costs are very reasonable, with an MER of 2.03% for the front-end units and 2.20% for the low-load units, both of which are below the category average. The lower fee hurdle will help in this category where outperformance is often very difficult.

Given the emphasis on risk management, I wouldn't expect this fund to shoot the lights out, but I would expect it to deliver index-like or better returns with volatility levels that are slightly better than the broader market.

All these factors add up to a compelling reason to consider this fund a core U.S. equity holding.

Sentry Small/Mid Cap Income Fund

Fund Company	CI Investments
Fund Type	Cdn Foc. Small/Mid Cap Equity
Rating	A
Style	Mid-Cap Blend
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Aubrey Hearn since June 2008 Michael Simpson since July 2005
MER	2.45%
Fund Code	CIG 50221 – Front-End Units CIG 53221 – Low-Load Units
Minimum Investment	\$500



ANALYSIS: Even with more than \$1.8 billion in assets under management, this small-cap offering is one of the better funds available. Led by Sentry portfolio manager Aubrey Hearn, it continues to deliver above-average risk-adjusted returns for investors.

Mr. Hearn uses a bottom-up security selection process that looks for small- and mid-cap companies in Canada and the U.S. that have a history of delivering high return on capital, low leverage, rising free cash flow, low earnings volatility, strong management teams, high barriers to entry, sustainable competitive advantages, and the ability to consistently grow their dividends over time. Valuation is also a consideration in the process, as the manager doesn't want to overpay for an investment.

With about 60 names, the portfolio is well diversified. The top 10 holdings comprise about a third of the fund.

The sector mix is very much the result of the stock selection process. The portfolio often looks dramatically different than its benchmark and its peer group. The fund currently has overweight positions in consumer cyclicals, industrials, communications, and tech. It is underweight materials and energy.

Somewhat surprising for a fund with an income mandate, it is underweight real estate and utilities, which

are staples of more traditional income offerings. It is also nearly 40% invested outside of Canada. Valuation levels are higher than the benchmark, but this is offset by a very healthy earnings growth outlook.

Relative absolute performance has trailed slightly in the shorter term, with the fund placing in middle of the pack over the past three years to Sept. 30. However, volatility has been well below the peer group, resulting in much stronger risk-adjusted numbers. In addition, the fund's performance in down markets has been excellent, participating in just a third of the market drops over the past three years.

Given the focus on capital preservation and downside protection, I continue to believe in this fund, and see it as one of the stronger small/mid-cap offerings available. It has a solid management team, with recent additions deepening bench strength, and uses a disciplined, sound, and repeatable investment process.

In the short term, we may see higher levels of volatility, but the fund should remain less volatile than its peers. Longer term, I expect the fund to continue generating above-average returns with below-average levels of volatility.

I continue to follow it closely.