

Top Funds Report

Why October is the “cruellest month”

Bond yields are climbing, earnings may be peaking, and traders are getting ornery

As T.S. Eliot famously wrote in his poem *The Waste Land*, “April is the cruellest month....” I disagree. I will just come right out and say it: October is. I hate October. Rolling through the summer months, all is good in the world, and then Labour Day hits. I start to get a bit nervous as traders come back to work, and then it seems almost like clockwork, as they start to get ornery a few weeks after the break. And when traders get ornery, they sell stocks. And sometimes, they sell a lot of stock in a very short time.

Luckily this time around, they weren’t in too bad a mood, as stocks sold off as they usually do, but nowhere near the levels they have in some Octobers past.

Now to be fair, markets don’t sell off every October. In fact, they tend to rise more often than they fall in, but it seems that if something bad is going to happen, it happens in October.

This time around we saw equity markets sell off, with European and Asian markets suffering most. The MSCI EAFE Index ended the month nearly 8% lower after being down nearly 10% in the month.

In the U.S., the bellwether S&P 500 Composite Index was down 6.8%. However, small and mid-cap stocks, along with tech names, were hit even harder, with the tech-heavy NASDAQ Composite Index dropping 8.7% and the small-cap Russell 2000 Index losing nearly 11% in the month.

Closer to home, the S&P/TSX Composite fell 6.3%, with energy and cannabis names leading the way down.

Historically, when stocks sell off, bonds rally. That didn’t happen this time around as rising bond yields put pressure on bond prices. For the month, the FTSE/TMX Canada Universe Bond Index fell by 0.8%, with long-term bonds taking most of the pain.

According to some experts, it was this rise in bond yields that was a key reason for the equity market selloff. With yields rising here and, in the U.S., traders are in the process of “repricing risk” for their holdings. Now that the benchmark U.S. 10-year Treasury Note yields well north of 3%, the premium required to hold risk assets has been moving higher.

There are also other headwinds slowing markets, including the ongoing trade skirmish between the U.S. and China, rising worries over consumer, business, and government debt levels in the face of rising bond yields, and concerns that the robust earnings growth we’ve seen in the past few quarters has peaked.

Given those headline risks, combined with market valuation levels, I expect that we will see higher levels of market volatility heading into the end of the year. In this environment, 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.

		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	
	Emerg Markets	X		

For fixed income, I continue to favour lower-duration, higher quality issues. I am also watching the credit markets for signs of erosion, as historically, the credit markets have been a leading indicator for the equity markets.

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 on page 1.

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

The birth of Liquid Alts

New mutual fund category comes with a lot of provisos and cautions...

After years of consultation with investors, regulators, and advisors, the Canadian Security Administrators (the national association of security regulators) is set to launch a new category of mutual funds in January – and they’re calling it Liquid Alternatives. These new funds are expected to become widely available on January 3, 2019.

A few companies like Mackenzie, Dynamic, and CI have jumped the gun and applied for and received exemptive relief, but those products are offered only by IIROC advisors. In January, the Liquid Alternative funds will be available to both IIROC advisors and MFDA advisors (mutual fund only) who have obtained the necessary accreditation.

A good way to look at the new Liquid Alternatives category is to think of it as “hedge fund lite.” The funds are allowed to use some of the strategies used by hedge funds but have very strict limits on how the portfolio is to be managed, including such things as limits on short selling, the use of leverage, and the use of private or illiquid investments.

For example, a fund may use leverage, but would be capped at three times net assets. A hedge fund, on the other hand, has no such regulatory restrictions in place. The new funds may also use short selling, but are limited to 50% of the NAV. The difference is that unlike the short selling that is allowed for traditional mutual funds, no cash cover is required.

The funds may also take more concentrated positions, and can invest up to 20% in one issue, compared with the current cap of 10%. And Liquid Alternative funds may also invest up to 10% in illiquid assets.

Funds may also be paid performance fees on positive performance. In theory, this is a great move for investors. By including an any fund that has a positive expected return and low or negative correlation to the other portfolio holdings will actually reduce risk and enhance return over the long term. *In theory.*

The challenge will come in the execution of these new funds. These funds are using strategies that until now have been off limits for most mutual fund managers. A great example is short selling. On the surface, this looks to be a “no brainer.” A fundamental manager finds a stock that is overvalued and shorts it. Unfortunately, it’s much more complicated than that, and there are a lot more moving parts to the practice of shorting.

First, the manager needs to “borrow” the stock that they will be able to sell into the market place. That is not always an easy task. Second, there is often a cost to borrow a stock. In some cases, the borrow will be cheap, and in other cases, it will be prohibitively expensive. The manager must weigh the cost of the borrow against the potential upside to determine whether it is worth it.

Typically a near-term catalyst is also required to be successful in shorting, and that may not be something a manager who has a history of running traditional long-only funds will be quickly able to identify.

There are potentially a lot of moving parts to these new funds, and it is imperative that the managers have a proven track record of running alternative strategy money. In other words, you can’t simply flip a switch and watch a

great mutual fund manager become a great hedge fund manager. It may happen in a few cases, but more often than not, the results will be disappointing.

The due diligence and “know your product” obligations are significantly higher with Liquid Alternative funds, which is why there are higher professional requirements needed before an advisor can offer these funds to clients. Anyone offering these funds really needs to understand what they are, how they work, and fully understand the risks.

These funds also have the potential to be more expensive than traditional funds, particularly if there is a performance fee included. That’s fine if the manager has the potential to consistently add value over time, but if not, you’re stuck holding a very expensive, sub-par mutual fund.

Taking a very quick look at some of the Liquid Alt funds that have been brought to market so far, there hasn’t been much that has caught my eye. In my opinion, the best so far have been the systematic long/short funds brought to market by hedge fund manager Edgehill Partners. It will be very interesting to see how the new product launches begin to unfold in the New Year.

If the rollout of these new funds goes well, it will be a win for all parties involved. Investors will have another very strong tool to help them build better portfolios designed to withstand all market conditions. My fear, however, is that the products launched will be watered down versions of hedge funds or expensive levered long mutual funds and will be mis-marketed to investors with unrealistic claims of what these funds can do. Several years from now, we may look back at the Liquid Alt funds and see that this has been one giant failure. I am challenging the advisors and fund providers to prove me wrong.

Funds of Note

This month, a review of funds from Fidelity, CI, Manulife & BMO...

Fidelity Canadian Large Cap Fund (FID 231 – Front End Units, FID 031 – Low Load Units) – Manager Dan Dupont has been concerned about market valuations for several quarters, resulting in the fund’s very defensive positioning. Unfortunately for investors, this has led to some serious underperformance. However, in September and October, market volatility increased as worries over the pace of economic growth, the effect of higher interest rates, and the headwinds caused by tariffs began to cloud equity valuations, and we’ve seen a correction in many equity markets as a result. Over this period, this fund has outperformed significantly, thanks to its previous positioning, which now looks like a prescient move by the manager.

In the recent volatility, Mr. Dupont has been putting some of his cash to work but continues to focus on protecting capital. The fund is overweight the defensive sectors, including telecoms and consumer staples. Unlike most of his peers in the Canadian equity space, he has no exposure to Canadian banks and a 10% weight in gold. This can serve as a nice haven if we see an extreme bout of volatility. Even with the recent

repricing in the equity markets, Mr. Dupont sees many reasons for caution, given his view that we are very late in both the economic and credit cycles, that high levels of consumer debt will begin to weigh on sentiment and spending, and that housing prices remain stretched. In this type of environment, he believes a defense-first positioning is warranted.

While the fund may have trailed its peers in the recent runup driven mostly by growth stocks, I firmly believe that this is one of the better funds to hold for the long-term. I expect that if the recent market volatility continues, investors will be rewarded with continued above-average returns, strong downside protection, and a much smoother ride.

CI Signature Select Canadian Fund (CIG 677 – Front End Units, CIG 1777 – Low Load Units) – This core Canadian equity fund was flat on the quarter, outpacing the broader market but trailing the peer group. A strong showing from several of its technology holdings, including Shopify and Alibaba, were offset by weakness from its energy holdings. It is very well

diversified, holding more than 100 names, with the top 10 making up a third of the portfolio. More than half the fund is in Canadian equities, 23% in U.S. equities, and 18% in international equities, and the balance in cash. The largest sector weights are financial services, energy, and technology. Still, the valuation levels of the portfolio are very attractive when compared with the broader market and the peer group.

This positioning is expected to be a positive as the market leadership turns from growth stocks to higher-quality, more value-focused companies. The manager remains bullish on all risk assets, but on equities specifically. Even with interest rates moving higher, overall financial conditions remain rather simulative based on historic levels, making a strong case for gains in stocks.

Fidelity Small Cap America Fund (FID 261 – Front End Units, FID 061 – Low Load Units) – Despite some weakness over the past couple of years, the fund has regained its mojo, and was posting above-average returns, modestly outpacing the peer group, at Sept. 30. However, in October, it outpaced the peer group by more than 550 basis points, as the defensive positioning and focus on quality has seen its holdings fall significantly less than the peer group and market.

Looking at the environment, Manager Steve MacMillan believes a cautious positioning is warranted and has been adding exposure to the more defensive sectors including utilities, consumer staples, real estate, and cash. At the end of September, the fund held nearly 10% in cash. The portfolio remains concentrated, holding roughly 50 names with the top 10 making up slightly more than half of the fund.

In the small-cap space, this remains one of my favourites.

Manulife World Investment Fund (MMF 4336 – Front End Units, MMF 4236 – Low Load Units) – Managed by David Ragan of Calgary-based Mawer Investments this high-quality fund mirrors the highly respected Mawer International Equity Fund. The manager uses a fundamentally-driven, bottom-up investment process that looks to find well-managed, wealth-creating companies that are trading at discount to what the managers believe it to be worth.

Essentially, they look for companies that have both a history of, and the potential to continue generating, a

high return on invested capital. They are looking for companies anywhere in the world outside of Canada and the U.S.

While aware of the macro environment, the manager focuses his efforts on bottom-up security selection. In the current environment, he notes that valuations are high, and as a result, he remains cautious. He concedes that if there were a significant correction, all stocks are likely to be sold off heavily. However, with the fund's focus on quality, I expect that it is likely to hold on better than most of its peers, with the potential to bounce back more quickly.

Despite higher-than-average costs, this is an excellent international equity fund, given its longer-term performance, focus on risk management, and volatility profile. And if you are using it in a fee-based account, you can access it in an F-class version more cheaply than you can buy it from Mawer directly.

BMO Monthly High Income II Fund (GGF 619 – Front End Units, GGF 941 – Low Load Units) – Managed by the team of Kevin Hall and Michelle Robitaille, this Canadian dividend fund has the goal of providing a high and consistent level of monthly income, with a very modest level of volatility. It has done just that, paying a monthly distribution of \$0.06 per unit, which equates to an annualized yield of just shy of 5.8%.

With the absence of high-flying growth names in its portfolio, the fund has struggled in the past year or two. Instead, it has a portfolio of high-yielding mid- and large-sized companies across a wide range of industries, with largest sector weights in the highest-yielding names, including financials, energy, real estate, and utilities.

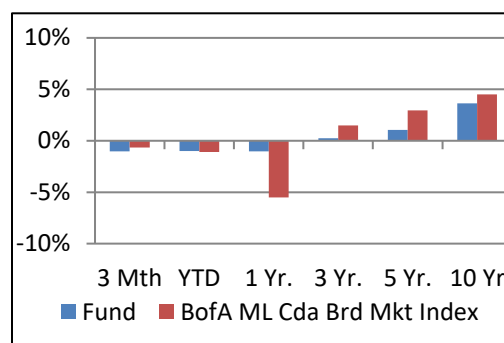
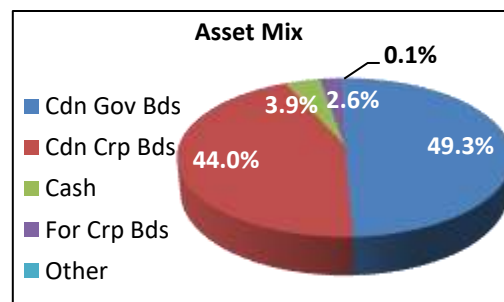
The portfolio currently offers a level of valuation that is more attractive than both the benchmark and peer group. As equity market volatility spikes, I would expect this fund to hold up better than the index and peer group. The portfolio positioning remains somewhat defensive, which is likely warranted as we head into a potentially volatile period.

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

feedback@paterson-associates.ca

Dynamic Advantage Bond Fund

Fund Company	Dynamic Funds
Fund Type	Canadian Fixed Income
Rating	C
Style	Top-down Macro
Risk Level	Low to Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Michael McHugh since July 2006 Domenic Bellissimo since Mar '12
MER	1.43%
Fund Code	DYN 258 – Front-End Units DYN 538 – Low-Load Units
Minimum Investment	\$500



ANALYSIS: The managers of this core bond offering from Dynamic Funds have been defensively positioned for several quarters, and now that yields are finally moving higher in a meaningful way, the fund is being rewarded with above-average performance.

Dynamic's veteran fixed-income managers Michael McHugh, who has over 12 years' experience on this fund, and Domenic Bellissimo, with a six-year tenure on the fund, are very active in implementing their strategy.

The fund has a flexible mandate and can invest across the various fixed-income sectors, including government bonds, corporate bonds, real return, and high yield bonds. McHugh and Bellissimo are very active in managing the interest rate and credit exposure of the fund.

At the end of September, the portfolio held just under 90% in Canadian bonds, 7% in the U.S., and the rest in the U.K. The asset mix looks very different from the FTSE/TMX Canada Universe Bond, with only 0.6% in Government of Canada bonds, compared with nearly 36% in the index.

The fund holds nearly 40% in Canadian corporate issues and 25% in provincial bonds. This positioning results in

a yield to maturity that is well above the benchmark, with a credit quality that is firmly investment grade.

The managers have some worries over inflation and have nearly a quarter of the portfolio invested in inflation-protected bonds. In the past few quarters, as bond yields have risen, they have been adding duration exposure to the portfolio. At the end of September, duration sat at 5.47 years, compared with 7.45 years for the broader market.

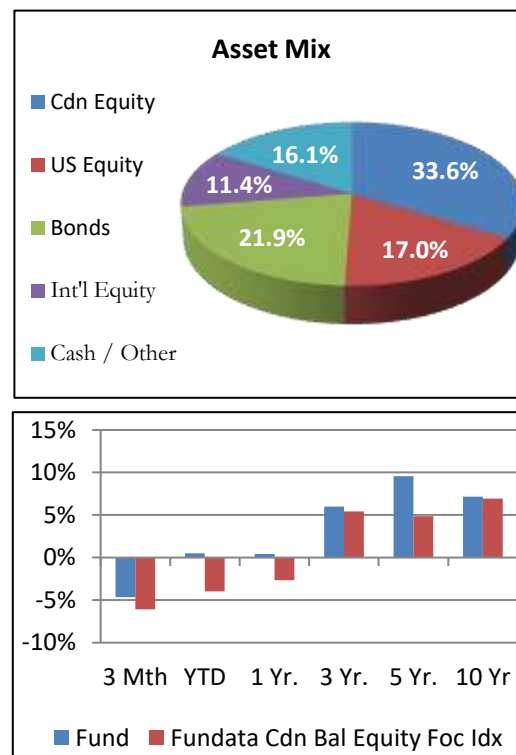
Looking ahead, it appears that interest rates are expected to push higher over the next few months as the pace of economic growth continues to be reasonably strong. But there are also worries that the central banks are behind the curve on inflation and may become even more hawkish over the next few quarters.

With the fund's lower-than-benchmark duration, higher-than-benchmark yield, and exposure to real return bonds, it is well positioned to benefit if the managers' expectations for the market play out.

I continue to like this fund for its defensive positioning, and I see it as a strong holding for more defensive investors.

Mackenzie Canadian Growth Balanced Fund

Fund Company	Mackenzie Investments
Fund Type	Canadian Equity Balanced
Rating	A
Style	Top-down/Bottom-up
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Managers	Dina DeGeer – since Nov 1996 David Arpin – since Nov 2012 Steve Locke – since January 2010 Alain Bergeron – since Aug 2014
MER	2.29%
Fund Code	MFC 724 – Front-End Units MFC 7034 – Low-Load Units
Minimum Investment	\$500



ANALYSIS: A couple years back, Mackenzie Investments made some changes to the way their balanced funds are managed. After the change, the top-level asset mix decisions were made by the Multi Asset Strategies Team, headed by Alain Bergeron. This change allowed the underlying portfolio managers to focus on what they do best – select securities.

For this top-rated balanced fund, the equity sleeve is managed by the team of Dina DeGeer and David Arpin who use a fundamentally-driven, bottom-up security selection process that looks to build a concentrated portfolio of 30 to 35 businesses. They look for well-managed niche players with unique competitive advantages, a history of strong free cash flow generation, and a growth rate that is faster than the economy and their peers. This has resulted in a growth-focused equity sleeve, which can be volatile.

The fixed-income sleeve is managed by a team headed by respected manager Steve Locke. They use a “core plus” approach that invests not only in Canadian investment-grade issuers, but also in high yield bonds, floating-rate loans, and other fixed-income instruments,

using a blend of top-down macro analysis and bottom-up credit analysis.

At the end of September, the bond sleeve was overweight corporate bonds, with a very high average credit quality. More than 80% of the bond holdings were rated investment grade, with the balance in higher yielding issues.

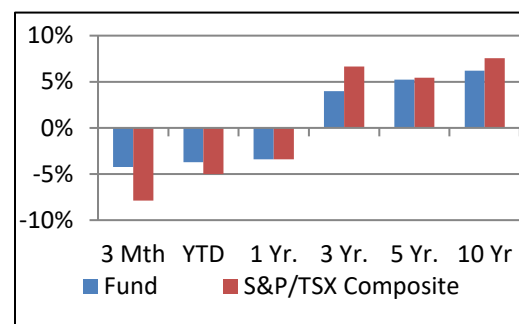
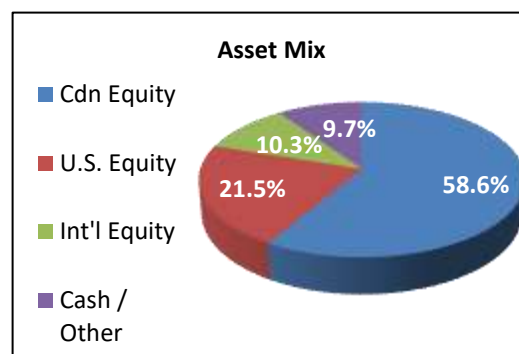
The asset mix for the overall portfolio is somewhat defensive at the moment, running approximately 62% in equity, 7% in cash, and 30% in bonds. The managers have some flexibility in setting the asset mix and can have between 60% and 90% of the fund invested in equities at any time.

Historically, this fund has produced excellent long-term performance, and I don't see that changing. In the near term, though, it may be susceptible to higher volatility and may see a modest underperformance.

More conservative investors may want to look elsewhere given the potential for higher volatility that comes from a higher equity weight.

Mackenzie Ivy Canadian Fund

Fund Company	Mackenzie Investments
Fund Type	Canadian Focused Equity
Rating	B
Style	Large-Cap Blend
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Paul Musson since January 2009 Graham Meagher since Oct 2015 James Morrison since April 2016
MER	2.46%
Fund Code	MFC 083 – Front-End Units MFC 7024 – Low-Load Units
Minimum Investment	\$500



ANALYSIS: Over the years, I have come to equate Mackenzie's Ivy brand with capital preservation and downside protection. As the bull market ages, we will likely see periods of higher-than-normal volatility and selloffs, much like we saw in October. In those types of environments, a focus on quality and downside protection become increasingly important, and the Mackenzie Ivy Canadian Fund is one of the stronger picks for that reason.

Historically, the fund has been significantly less volatile than the broader markets, with a standard deviation that is between 15% and 20% lower than the S&P/TSX Composite Index. It has also done an excellent job protecting capital, participating in only 50% to 60% of the market downside.

If there is a criticism, it is that the fund may be *too* conservatively positioned, which leaves a lot of potential return on the table. Over the past five years, it has delivered roughly 70% of the market upside.

The portfolio holds industry leaders in both Canadian and global companies, and is concentrated at between 35 and 40 names. The managers' investment process is fundamentally-driven, bottom-up that looks for well-

managed, high-quality companies trading below what the managers believe them to be worth. The process is very much benchmark agnostic and results in a portfolio that is much different than the index.

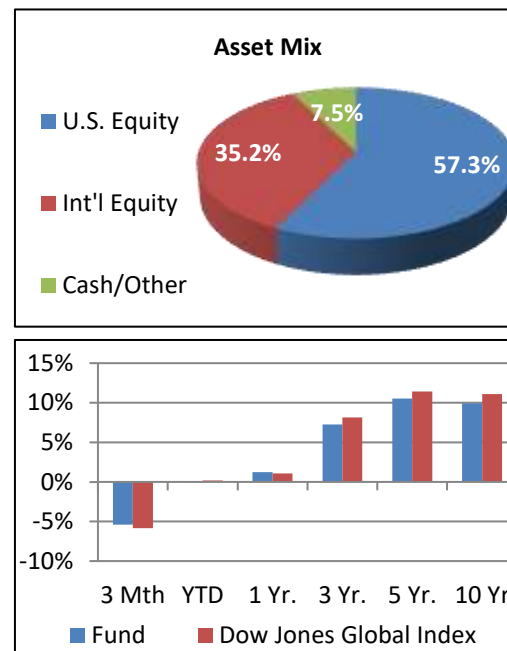
The portfolio is currently defensively positioned with overweight in consumer stocks, telecoms, and healthcare, and 8% cash. Not surprisingly, healthcare names include large multi-national companies like Johnson & Johnson, rather than start-ups involved in the cannabis sector. The fund has no exposure to materials, which is consistent with its focus on quality and cash flow. It's underweight in energy, industrials, and utilities.

Longer-term absolute performance numbers have been in the middle of the pack, but risk-adjusted returns are very strong. With recent volatility, relative performance has been excellent, as the defensive positioning has helped preserve value.

This is not a fund I would ever expect to "shoot the lights out." But if you're a bit more conservative and are looking for a relatively steady ride in a Canadian-focused equity fund, I believe this is definitely one to consider.

Invesco Global Companies Fund

Fund Company	Invesco Canada
Fund Type	Global Equity
Rating	D
Style	Large-Cap Blend
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Michael Hatcher since April 2011 Jeff Feng since April 2011
MER	1.71% SC Units/2.69% A units
Fund Code	AIM 1513 – Front-End Units AIM 1515 – Low-Load Units
Minimum Investment	\$500



ANALYSIS: This fund (formerly the Trimark Fund) has fallen off my radar over the past year or so, which is unfortunate, because it remains a very solid global equity pick. Managers Michael Hatcher and Jeff Feng use a disciplined, proven, fundamentally-driven, bottom-up investment process that seeks out industry leaders with strong barriers to entry, high levels of free cash flow, excellent management teams, and a history of generating high returns on invested capital.

While not a value fund *per se*, valuation plays a key role in building the portfolio. The managers model out the company and forecast what they believe it to be worth, based on their expected future cash flows. The stock must be trading at a level well below what the managers believe it to be worth before they buy.

The result of this process is a concentrated portfolio of between 30 and 50 names. At the end of September, it held 34 stocks, with the top 10 making up around 40% of the fund.

With an emphasis on quality, the fund's valuation metrics are in line with the broader market. This is because the managers are willing to "pay up" a bit for higher-quality companies if they believe there's potential for growth. According to the managers, the long-term

expected growth rate of the companies in the portfolio is 11% annualized.

The bottom-up process sees a portfolio that is markedly different than the index or peers. For example, at the end of September, it was significantly overweight industrials, consumer defensive, and technology stocks, while maintaining no exposure to materials, telecom, or utilities. It was also underweight financials, consumer cyclicals, and healthcare. Because the fund tends to run a concentrated portfolio, its volatility is slightly higher than the index and the peer group.

Performance has been very strong, with a 5-year average annual compounded rate of return of 10.5%, trailing the MSCI World Index, but finishing in the top quartile of the category.

In a recent commentary, the managers note that while global growth remains positive, there are still risks that need to be monitored, including the impact on individual holdings of trade wars, tightening of monetary conditions, and overall debt levels.

Looking ahead, with more volatility expected, the managers believe that more fundamental factors, such as earnings, cash flows, and return on capital, will drive stock prices, rather than momentum.