

Top Funds Report

Winds of change rattle markets

Equity volatility, flattening yield curve spook investors going into year-end...

Despite global equity markets ending November mostly higher, the volatility that has dogged markets since September was still very much in play. The S&P 500 Composite Index rose by more than 2% in November, but the intra-month swings were very pronounced. Peak to trough, the index fell more than 6.4% in the month. Investor sentiment turned very bullish in the last few days of the month as the U.S. and China appeared to have negotiated a temporary truce on trade, moving markets higher.

In Canada, the S&P/TSX Composite Index rose by 1.4% in November, with the more defensive sectors leading the way. Consumer staples were up nearly 7%, telecom rose by 6.6%, and utilities gained 5.6%.

The energy sector was the biggest headwind in the month, falling more than 10%, bringing the year-to-date loss to more than 21%. The drop in energy was the result of another sharp decline in the price of crude oil, which fell roughly 22% in November alone. OPEC has been negotiating production cuts that are hoped to help stem losses as inventories creep higher on lower demand expectations.

Other equity markets were mixed. The MSCI EAFE Index fell 0.1% on the month as worries over Brexit weighed on sentiment. European markets were lower by 0.9%. Asian markets were mostly higher, with China gaining more than 7% on trade.

Fixed-income markets were largely positive as yields drifted lower on the month. In Canada, the yield on the benchmark Government of Canada 10-year bond dropped to 2.27% by the end of November, down from 2.49%. The FTSE/TMX Universe Bond Index gained 1%, with government issues outperforming corporate bonds.

Corporate bonds were weighed down by a massive new bond issue by Loblaw's Cos. in the last couple days of

the month, which widened the yield spread between government and corporate bonds.

Another continuing worry is that the yield curve is flattening. Investors are concerned that the yield curve could invert, which has historically signaled a recession on the horizon. While we are dangerously close to an inversion, the 2-year to 10-year curve remains positive.

Heading into the end of the year, much uncertainty remains. Faced with unresolved trade tensions, political uncertainty over Brexit in Great Britain, rising bond yields, and some economic data indicating significant slowdowns, investors are becoming worried. This is likely to result in even more volatility and the potential for more selling pressure than buying pressure.

In this type of an environment, I continue to favour equities, although only slightly. For equities, I am favouring more defensive types of funds, including many of the low-volatility and dividend-focused funds.

Within fixed income, I continue to favour lower-duration, higher-quality issues. I also continue to watch the credit markets for signs of erosion. If we see continuing weakness as we saw in November, it may be time to become even more defensive.

		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		

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In this environment, I remain consistent with my investment outlook, as shown in the accompanying table.

Please send your comments to:
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Fund in Focus: Vertex Value Fund

Manager Matt Wood walks us through his value-focused, contrarian investment style...

Over the past few years, value investing has been a bit of a dirty word, as massive amounts of monetary stimulus, low bond yields, and an increasing risk appetite led investors towards more high-flying growth companies, leaving many higher-quality, reasonably-valued stocks behind.

Over the long-term, growth and value stocks are expected to generate comparable levels of return; however, there are often periods where the performance differential can be quite wide. The past few years has definitely been one of those periods, and in fact, the differential between growth and value hasn't been this wide since the tech bubble back in the late 1990s early 2000s.

If you subscribe to the theory that in investing, performance will often regress back to the mean, the significant outperformance of growth over value may be pointing to a substantial bump in value stocks once the market leadership shifts away from the higher beta growth stocks.

Over the past few months with worries over a slowing economy and increasing volatility, we have seen value stocks start to outperform, but time will tell whether this is a short-term blip or a more normalized trading pattern.

In the value investing segment in Canada, Matthew Wood of Vertex One Asset Management is one of better-known managers. Recently, I had the chance to speak with Mr. Wood about his investment process and views on investing.

Vancouver-based Vertex One was founded in 1997 and today has nearly \$1 billion in assets under management across seven traditional and alternative strategy funds. Mr. Wood is one of the founders of the firm and runs its value-focused portfolios.

Having managed value strategies at Vertex since 1998, Mr. Wood has a very well-defined investment process. His objective is to "buy inexpensive stocks and sell them before they become expensive."

To find these inexpensive stocks, Mr. Wood takes a contrarian approach and is looking for companies that are trading at levels well below what he believes them to be worth. In a perfect world, he is looking to find companies that are trading at roughly a quarter of their intrinsic value.

He scours the stock universe looking for companies that are trading at their 52-week lows. Once he finds one, he will do a quick fundamental review of the company to better understand its business and financial position. Any stock that does not generate positive earnings is immediately eliminated from consideration.

Next, he reviews the corporate balance sheet to gain an understanding of the balance sheet strength and financial leverage used. At this stage, he will often have a meeting or a call with the senior management of the company to understand their vision and strategy.

Assuming the stock has made it this far in his selection process, Mr. Wood next attempts to identify the catalyst he believes will help the company close the valuation gap. If such a catalyst is present, he will then begin acquiring the stock, usually stepping into the position in a more measured and gradual way.

Once he owns a stock, he monitors it continuously. As the valuation gap closes, he will often start writing out-of-the-money call options on the stock. This allows him to generate some additional income for the fund by collecting the option premiums. He allows the fund to exit the position as the stock is called away.

If a stock falls in value, assuming the investment thesis still holds, he is likely to add more, which lowers the average cost and increases the probability of a larger gain as the value increases.

It is this contrarian investment approach that takes the fund into some of the very unloved parts of the market. For example, at the end of October, the **Vertex Value Fund** was nearly 50% invested in energy with another 30% in materials. This can lead to periods of significant volatility and a return that looks much different than, and in some cases out of step with the broader market.

The fund can invest in companies of any size and will often skew very much towards small- and mid-cap names.

Looking at the underlying portfolio fundamentals, the fund is trading at a valuation level that is less than half the broader market, and yet the long-term earnings growth of the portfolio has been nearly 28% according to Morningstar.

While the future may look bright for this fund, it has travelled a rocky road in the recent past. In the three months ending Nov. 30, the fund lost more than a quarter of its value. Much of this is the result of its energy holdings, with companies like Blackbird Energy falling more than 40% and Surge Energy falling nearly 30% in the period. Combined, those two stocks account for more than 16% of the fund's portfolio.

Historically, any time the fund has posted a negative year, it has rebounded sharply the following year. For example, in 2011, it fell 9.4%, only to rebound 25% in 2012 and another 37% in 2013. In 2015 the fund fell 5.6% but then rebounded 33% in 2016.

There is no guarantee that such a return is coming in 2019, but given the valuation levels in the portfolio, if we see a rebound in the energy sector, this portfolio is well positioned to benefit.

Mr. Wood noted that he holds a significant portion of his personal investible net worth in the fund and has recently added to his holdings. Not only is he invested with his investors, he is doubling down and adding to his holdings.

But make no mistake about it. Vertex Value Fund is not a fund for the faint of heart. It has a level of volatility that is well above the index and peer group thanks to its more concentrated portfolio and small-cap focus.

But for those with a higher appetite for risk, looking for a fund with the potential to rebound sharply in the next several quarters, this long-standing offering may be worth a look.

Funds of Note

This month, Mawer stays independent, plus a look at funds from IA Clarington, NCM, and Sun Life...

Mawer to remain independent – Over the past couple of years we have seen a wave of consolidation in the investment management business, with many of the long-standing independents being snapped up by the big banks. Most recently Calgary-based Mawer Investments announced in November that it had hired Scotiabank to help it “obtain more information on the options available” as part of its strategic planning process. Reuters estimated it could be valued around \$2

billion. After completing the review in early December, the firm announced it is not for sale, and will remain independent. In my view, this is very welcome news.

Mawer has long been one of my top managers. They use a very rigorous, disciplined, fundamental investment style that looks to find well-managed, excellent companies with the ability to create shareholder wealth and that are trading at a level below what they believe it to be worth.

Mawer is consistently delivering above-average performance on both an absolute and risk-adjusted basis. By remaining independent, it can continue to focus on doing what it does best without worrying that a new ownership group would disrupt the unique culture the firm has developed in its more than 40 years of serving investors.

IA Clarington cutting fees on several funds – Fee compression in the mutual fund industry is continuing at a very brisk pace. Last month, IA Clarington announced that it is cutting its management fees and administration fees on 33 mutual funds. The net difference in MERs ranges from one basis point to 50 basis points.

The biggest cuts are seen in some of its foreign equity funds. The **IA Clarington U.S. Dividend Fund** will see the MER slashed by 50 basis points for the Series T6 units, and 49 basis points for the Series A units. The **IA Clarington Global Value Fund** will see its MER fall by 44 basis points. Somewhat surprisingly, one of the bigger cuts is happening with the **IA Clarington Bond Fund**, which will see its MER fall by an estimated 45 basis points.

With the increased pressure pushing costs lower, investors continue to be the winners.

NCM Energy Plus Class (NRP 701 – Front-End Units, NRP 702 – Low-Load Units) – It's been a rough autumn for energy companies with the price of oil plummeting by more than 22% in November alone. West Texas Intermediate crude oil closed at \$50.93 on November 30, down from more than \$65 on October 31. Canadian crude oil has been in a free fall since May, with Western Canadian Select crude oil falling more than 70%! So it's not surprising to see energy funds sell off sharply.

One of hardest hit is the **NCM Energy Plus Class**, managed by Calgary-based veteran manager Mark Heim. In November, it was down more than 16%, and is down more than 32% year-to-date. The longer-term numbers aren't much better, with the fund posting an average annual negative compounded rate of return of 16% over the past five years. In comparison, the S&P/TSX Energy Index is down an annual 8.6% over the same period.

The fund has an all-cap mandate and invests in a concentrated portfolio of Canadian energy producers

and exploration companies. It skews towards smaller-cap names with about 60% in small- and mid-cap companies at the end of October. The balance was in bigger companies. The top 10 holdings make up nearly three quarters of the fund's portfolio. So it's not surprising to see the fund's volatility run well above the index and the peer group.

With oil poised to rebound, this and other energy-focused funds may experience a bounce back. Still, I would be hesitant to invest in this or any energy fund, given the dependence on the underlying commodity. Furthermore, most Canadian equity funds will typically have a meaningful allocation to energy, making it less important to add a standalone allocation.

Sun Life Excel India Fund (SUNL 100 – Front-End Units, SUNL 300 – Low-Load Units) – China has long been the darling of those looking to invest developing markets. India, on the other hand, has largely been ignored. But India has outperformed China by a reasonable margin. For the past 10 years, the MSCI India Index has risen by nearly 12% annualized, while the MSCI China A Index has returned less than half of that. Year to date, India is down more than 7%, while China's stock market has plunged 30%.

India's success can be attributed to its young, well-educated population, a diverse economy, and strong growth rates. And the country continues to modernize.

With only a handful of India funds available, Sun Life Excel offers the largest and most established fund. Performance has been strong, with a 10-year average annual compounded rate of return of 12.1% to Nov. 30, and a 5-year annualized return of 17%. Year-to-date, the fund is down 8.3%, dragged lower as trade worries and a rising U.S. dollar continue to weigh on many emerging economies.

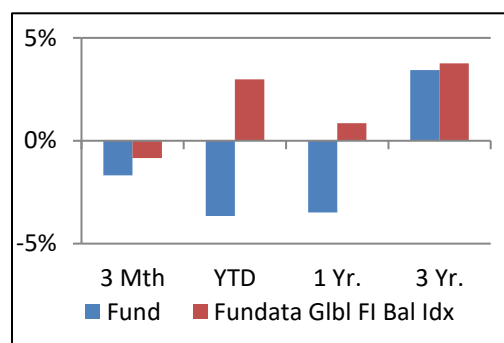
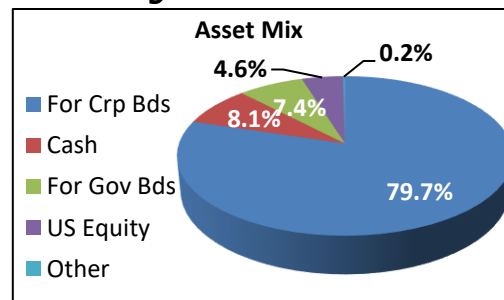
The fund is well diversified with financial, energy, and technology holdings making up 56% of the portfolio. While the fund cut its management fee in January, at roughly 2.7%, it's still pricey. It's volatile too, with a standard deviation significantly higher than Canadian or U.S. equities. Despite the higher risk though, this is still the best choice for direct exposure to India.

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

feedback@paterson-associates.ca

Loomis Sayles Strategic Monthly Income

Fund Company	Natixis Investment Managers
Fund Type	Global Fixed Income Balanced
Rating	A
Style	Bottom-up
Risk Level	Low to Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Dan Fuss since September 2015 Matt Egan since Sept 2015
MER	2.14%
Fund Code	NXG 6201 – Front-End Units NXG 6208 – Fee-Based Units
Minimum Investment	\$5,000



ANALYSIS: This bond-focused balanced fund takes a go-anywhere approach. The experienced management team is led by Dan Fuss, and while the fund focuses mainly on bonds, can invest up to 20% in dividend-paying common stocks. Right now, it's using that mandate sparingly, with only 4.7% equity holdings at the end of October, 71% in corporate bonds, 11.5% in U.S. Treasuries, and the balance in convertibles, asset-backed securities, and cash. In recent months, the managers have taken a more defensive positioning, increasing exposure to cash and short-term U.S. Treasuries.

The managers use a mix of bottom-up credit analysis, quantitative risk analysis, and an opportunistic trading style, reflected in the fund's equity exposure. The equities are weighted to tech companies including Apple, Oracle, and Microsoft, which were key contributors in the first three quarters of the year.

With a 75% weighting to corporate bonds, the bulk of the credit exposure is investment grade, but about a quarter of the portfolio invested in higher-yielding, non-investment-grade securities. Maximum individual position sizes are capped at 5%, but in practice tend to be significantly lower. The fund is well diversified, with

more than 300 individual names. The top 10 comprise just over 11% of the portfolio.

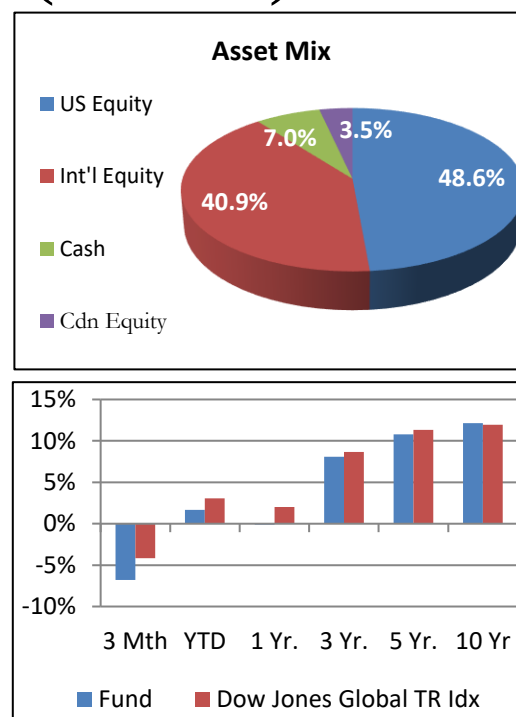
Launched in 2015, the fund has a relatively short track record in Canada. However, it is substantially similar to a U.S.-offered fund that was launched in 1999. Year-to-date it has struggled, trailing both the index and the peer group, but the numbers since inception are much stronger. It outperformed in 2016 and 2017 and posted a 3-year average annual compounded rate of return of 3.4% to November 30, besting the index and its peers.

Volatility has been well below average and capital protection in falling market environments has been excellent, resulting in strong risk-adjusted returns. Costs are a touch on the high side, with an MER of 2.14%. Despite this, it's still slightly below the category average.

Fixed income markets are likely to remain challenging, so funds like this one, with a well-seasoned management team, using an active investment style that often looks nothing like its benchmark would be worth looking at. It is not a core bond holding, given the go-anywhere mandate. However, I see it as a nice addition to a more core-focused bond allocation, to enhance returns and reduce overall portfolio variability.

Capital Group Global Equity (Canada) Fund

Fund Company	Capital International Asset Mgmt
Fund Type	Global Equity
Rating	D
Style	Large-Cap Blend
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Managers	Carl Kawaja since November '02 Dina Perry since November 2002 Leo Hee since December 2016
MER	2.19%
Fund Code	CIF 843 – Front-End Units CIF 863 – DSC Units
Minimum Investment	\$500



ANALYSIS: Launched in 1931, the low-key Capital Group has been around for a long time, today managing \$1.7 trillion globally. It uses a multi-manager approach, sourcing different managers with distinct styles, overseen by the firm's Portfolio Coordinating Group.

Capital Group also uses a performance-based compensation scheme placing great emphasis on the longer-term performance, reducing the incentive for managers to take unnecessary risks for short-term gains.

This approach has served investors well. The fund's 10-year average annual compounded rate of return is 12.2% to November 30, which is roughly in line with the MSCI World Index, but handily outpacing the peer group. And the fund has posted above-average returns every year the past 10 calendar years.

At the end of October, it had a growth tilt, with an overweight in technology and consumer discretionary names, and an underweight to telecom, utilities, and real estate. Valuation numbers are a bit rich relative to the benchmark, but this is offset by higher growth rates, both on a historic and forward-looking basis.

The portfolio is very well diversified, with more than 230 positions and the top 10 making up 14% of the portfolio. Portfolio turnover is modest, averaging around 30% annually, which reinforces the fund's long-term outlook and approach.

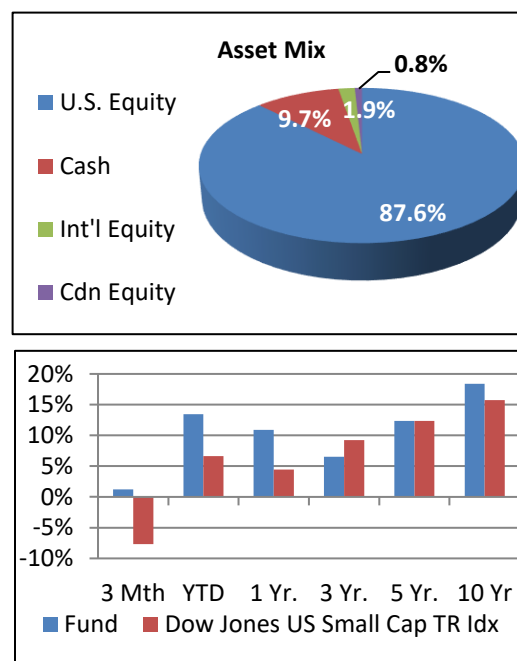
About half the fund is invested in U.S. stocks, 13% in Europe, and 6% in the U.K. The fund can also invest in emerging markets, and at the end of October it held approximately 11% in developing economies. With the growth tilt and EM exposure, volatility has been slightly above average. The fund has also felt a lot of the market downside.

Looking ahead, the growth tilt may be a near-term headwind as the market leadership moves towards more value type names. However, given the long tenure of the management team combined with the consistency of the process, I expect that the longer-term numbers will continue to be above average.

This can be an excellent core global equity holding for most investors with a long-term time horizon. However, those worried about short-term mark-to-market losses in periods of uncertainty may want to look at alternatives that provide better downside protection.

Fidelity Small Cap America Fund

Fund Company	Fidelity Investments Canada
Fund Type	U.S. Small Mid Cap Equity
Rating	A
Style	Mid-Cap Blend
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Steve MacMillan since May 2011
MER	2.27%
Fund Code	FID 261 – Front end Units FID 861 – Low Load Units
Minimum Investment	\$500



ANALYSIS: While the fund has undergone a rough patch over the past couple of years, it's on the comeback trail. The relative slump in performance was really a result of the market's rewarding growth-type companies over higher quality, more reasonably valued names.

With market leadership again returning to fundamentals, the relative performance of this fund has also turned the corner. As U.S. small caps sold off, the fund outperformed nicely, gaining 1.2% while the Russell 2000 fell by more than 9.9%. In October, the index fell by more than 8%, while the fund dipped a more modest 2.4%.

This relative outperformance is directly related to the investment process used by lead manager Steve MacMillan. It's a fundamentally-driven, bottom-up approach that looks to find high-quality stocks with lower-volatility business models that are trading at a level below what he believes them to be worth.

He looks for proven management teams in niche businesses and sustainable competitive advantages that allow for solid growth opportunities and the ability to earn more than their cost of capital. Strong balance sheets and high levels of free cash flow also figure into the equation.

The portfolio is somewhat concentrated, with between 35 and 45 names. Sector mix is largely the result of the security selection approach. Currently, the portfolio is defensively positioned as the manager believes we are at a point in the economic cycle where caution is warranted. The fund is overweight the more defensive sectors, such as utilities, consumer staples, and real estate.

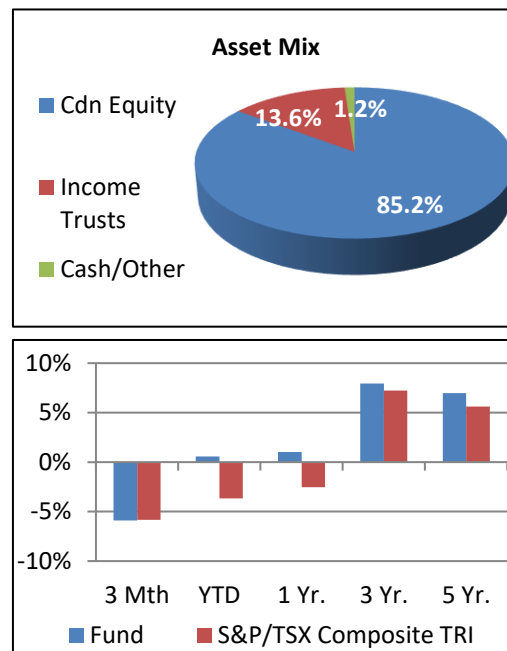
While valuation is a part of the security selection process, this is not a value fund. Valuation levels aren't cheap, but the manager is willing to pay up for quality companies.

Volatility is significantly lower than the index and peer group, which has resulted in a risk-adjusted return that is well above average. The fund has done an excellent job of protecting capital in down markets, delivering roughly 60% of the market's downside over the past three and five years.

As a result of its success, assets under management have grown to more than \$2.5 billion, which may make it increasingly difficult for the manager to continue to outperform. Still, this remains one of my top picks in the U.S. small-cap equity space, and I expect it to continue to deliver above-average risk-adjusted returns over the long term.

Horizons Active Canadian Dividend ETF

Fund Company	Horizons ETF Management
Fund Type	Cdn Dividend & Income Equity
Rating	A
Style	Mid-Cap Blend
Risk Level	Medium
Load Status	N/A
RRSP/RRIF Suitability	Good
Manager	Sri Iyer since February 2010 Fiona Wilson since February 2010 Adam Cilio since February 2010
MER	0.79%
Fund Code	TSX: HAL
Minimum Investment	N/A



ANALYSIS: With volatility returning to the market, funds and ETFs with a focus on valuation, quality, and better-than-average fundamentals outperformed in the period, while higher-beta investments trailed.

This dividend focused strategy uses a systematic approach that scours the Canadian dividend universe looking for stocks that are reasonably valued, with growing and sustainable dividends, offering the potential for strong capital growth. The focus is not only on the dividend yield of a stock, but also the growth potential and its sustainability.

The investment process evaluates more than 30 different quantitative and qualitative factors covering valuation, yield, growth, quality, size, volatility, and price momentum. Some of the underlying metrics include earnings yield, dividend yield, dividend and earnings growth, return on equity, earnings and sales growth stability, beta, and standard deviation. The managers measure these monthly, looking for companies that are undergoing an increase in the rate of change in these factors.

The result is a portfolio that holds approximately 50 names, with the top 10 making up less than a third of the fund. The sector mix is the result of the stock selection

process, and at the end of October was overweight in the more defensive utilities, real estate and telecom sectors. It was also overweight energy, which has been a headwind given the recent drop in crude oil prices. Interestingly for a dividend-focused fund, the exposure to financials is roughly half that of the index and peer group. The dividend yield is sharply higher than the index and peers.

Despite a rough October, the longer-term prospects for the fund remain strong. The focus on fundamental quality would be expected to allow it to outperform the cap-weighted indices in a more volatile market environment. Furthermore, it has demonstrated the ability to protect capital better in a down market. For the five years ending October 31, the fund participated in 75% of the downside of the market.

It was recently announced that starting December 1, the management fee on HAL would be reduced to 0.55% from 0.70%, a very meaningful reduction in cost. This will certainly have a positive effect on the future performance of the fund, and this, combined with the disciplined and repeatable investment process, reinforces its place as one of the most attractive dividend ETFs available.