

Top Funds Report

October not so scary after all

U.S. stock indices gain, as Fed cuts rates but signals a pause...

For me, October tends to be the scariest month of the year. Not only is there Halloween, but typically, if there is going to be a major market selloff, it seems to be that it happens in the month of October. Fortunately, this time around, it was more treats than tricks for investors with most markets ending in positive territory.

The S&P 500 gained 2.2% in U.S. dollar terms, and the MSCI EAFE Index gained 3.6%. Notably, Canadian equities bucked the trend, ending the month down 0.9% on weakness in the energy sector.

In the U.S., markets got off to a bit of a rough start after a weaker-than-expected ISM manufacturing report sent many investors to the exits. This report had many fearing the worst – that an economic slowdown was here. However, sentiment turned positive as trade talks between China and the U.S. resumed.

Throughout the month, it was a tug of war between good news and bad news, but in the end, good won out over the bad. We saw corporate earnings come in stronger than expected, only to see that rally knee-capped by weaker-than-expected retail sales.

Globally, we saw markets rally higher on improving sentiment around trade and some positive baby steps on the Brexit debacle. Asian stocks were the biggest benefactors with the MSCI AC Far East Index, gaining 4.7% in U.S. dollar terms. European shares, as measured by the MSCI Europe Index rallied higher by 3.2%, while the main emerging markets index was also higher by 4.2%

Despite widespread expectations that the U.S. Federal Reserve was going to cut rates, bond yields, particularly in Canada, moved higher in the month. The yield on the Canada 10-year bond moved from 1.37% at the end of

September, peaking at 1.62% on Oct. 28, and then promptly falling to end the month at 1.42%.

In this environment, corporate bonds outpaced government issues. Short-term bonds held up much better than longer-term bonds. And international and high-yield bonds did well compared with Canadian issues

As expected, the Fed did cut rates at its Oct. 30 meeting. Comments from Federal Reserve Board Chairman Jerome Powell suggested that there were no immediate plans to cut rates further, and any future cuts would be more dependent on data. According to Bloomberg, as of Nov. 8, there was a 7% chance the Fed would cut rates before the end of the year. Looking out even further, the markets are not projecting any further cuts until September.

Meanwhile, the Bank of Canada held rates steady and is expected to keep rates on hold until the middle of next year.

I have been defensively positioned throughout this year, and that has been a headwind. Still, looking at the risks,

		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		

I continue to believe a more defensive position is warranted. Consequently, I continue to focus on quality, both in equity and fixed income.

For equities, I continue to favour North America. For fixed income, I'm still focused on North American investment-grade and government bonds. I am

underweight high-yield issues.

My investment outlook remains consistent as shown in the accompanying matrix.

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

Funds of Note

This month we look at some of the funds on my Mutual Fund Focus List...

NinePoint Diversified Bond Fund (NPP 018 – Front-End Units, NPP 318 – Low-Load Units)

Managed by a team headed by veteran manager Mark Wisniewski, this is an actively-managed, diversified North American-focused bond fund with a flexible mandate allowing the manager to invest across the capital structure. The fund takes an absolute return approach and aims for a 4% to 6% return, net of fees over a rolling three-year period, regardless of interest rates. It is managed using a disciplined investment process blending top-down macro views, thematic tactical trades, and bottom-up security selection. Management has a range of tools at their disposal, including the ability to alter interest-rate sensitivity, currency exposure, security mix, and credit quality to either capture potential upside or to reduce or manage risk.

Performance over the long-term has been decent, with an average annual compounded rate of return of 2.9% over the past three years, and 3.1% over the past five years ending Sept. 30. The three-year number is well above average, while the five-year return is in line with the average. However, when we factor in the risk level of the fund relative to other global bond funds, the risk-adjusted numbers are excellent. For example, according to Morningstar, the annualized five-year standard deviation of the fund was 2.7% compared with 4.9% for the global fixed-income category. This results in a Sharpe Ratio that is significantly higher, 0.84 for the fund versus 0.54 for the category. Furthermore, the fund has negative down capture ratio, meaning that it has historically been positive when the broader global bond market is negative. This makes it an excellent diversifier when used in a portfolio.

In a recent commentary, the managers noted that with the deterioration in economic data, they are expecting that markets are likely to remain volatile. In this environment, they have positioned the portfolio somewhat defensively, with a larger exposure to higher-quality corporate bonds, and a lower duration with their corporate bonds.

As of Sept. 30, the fund held 28% in government bonds, 61% in investment-grade corporate bonds, and a very modest 7% in high-yield issues. Approximately 86% of the portfolio is invested in North America, with the balance roughly split between France and Germany. The managers have moved the overall portfolio duration to 6.5 years from 5.4 years in June. This may result in gains if rates move lower.

Despite the modest absolute return numbers, the defensive positioning of the portfolio combined with the experienced management team and active investment process keeps this as one of my top bond fund picks for most investors.

Sentry Small/Mid Cap Income Fund (CIG 50221 – Front-End Units, CIG 53221 – Low-Load Units)

In September, it was announced that long-serving manager Michael Simpson had left Sentry. No reasons for his departure were provided. While Mr. Simpson had been a named manager of the fund, most of the day-to-day management duties were the responsibility of Aubrey Hearn, who remains as lead manager. Mr. Hearn is being joined by Jack Hall, with Sentry since 2012, who is now co-manager.

Capital Group U.S. Equity Fund (CIF 847 – Front-End Units, CIF 827 – Fee-Based Units)

Last time around, I noted some concern around the recent performance of this Capital Group offering. With a gain of 0.67%, it again trailed the S&P 500, which gained 2.9% in Canadian dollar terms. It also trailed the category average of 1.9%, resulting in another fourth-quartile return.

There were a few reasons for the underperformance. The fund had significant overweight in energy, which lost nearly 10% in the quarter. Facebook, one of its largest holdings, lost 6.5%, while the index gained nearly 3%. The fund also missed out on potential gains by not having any exposure to AT&T, which rallied sharply in the quarter. An overweight to materials stocks was another detractor with the sector losing 7%. And the average cash balance of 7.5% was a headwind in the rising market.

Earlier in the summer, it was announced that some additional portfolio managers were being added to the portfolio. As a result, it is expected the number of holdings will triple, moving to about 180 from approximately 60. This move is expected to increase the diversification of the fund and provide a more balanced sector mix. Given this change, I will monitor the fund for another quarter, but I am at the point where I need to see an improvement in the risk-reward metrics soon.

Manulife U.S. Equity Fund (MMF 4504 – Front-End Units, MMF 4704 – Low-Load Units)

Mawer Investments, the management team at the helm of this offering, continues to be one of the better managers around, consistently delivering above-average returns on both an absolute and risk-adjusted basis.

Over the quarter, the fund gained 4.2%, bringing the year-to-date number up to 19.5%, outperforming both the category and index. The fund's financial, technology, and consumer names were the biggest contributors to the outperformance, while materials and healthcare muted gains. Alphabet, Verisk Analytics, and Procter & Gamble helped boost returns.

Looking ahead, the managers remain defensive. There is a lot of "noise" affecting the markets, including the ongoing trade war, central banks, elevated debt levels, Brexit, and slowing economic growth. The managers continue to focus on high-quality companies with strong recurring revenue streams. They believe these companies are well positioned to benefit from the low interest-rate environment and are likely to hold up better if we see a meaningful slowdown in the economic environment.

Fidelity NorthStar Fund (FID 253 – Front-End Units, FID 853 – Low-Load Units)

Managed by the team of Joel Tillinghast and Dan Dupont, this value-focused global all-cap offering has certainly struggled so far this year. Year-to-date the fund is down 1.4% to the end of September, while

the MSCI World Small Cap Index is up more than 13% in Canadian dollar terms. The main reason for this underperformance is the fund's value focus, with value stocks dramatically trailing growth stocks. While we did see a quick rotation from growth into value in September, the trend has not sustained, and growth names are again outperforming. That won't always be the case, and when we do see a sharp uptick in volatility, this fund will be expected to outperform. The fund tends to do a strong job of protecting investor capital in down markets, participating in roughly 60% of the market downside over the past five years.

Unfortunately, with the value focus, the upside participation of the fund has significantly trailed its peers. To help address this, it was announced on Oct. 24 that Kyle Weaver would be added to the fund as a manager, in addition to Tillinghast and Dupont, starting November 1. Mr. Weaver has not yet run any mandates for Canadian investors but has been active in some U.S. offerings. Under the new structure, Joel Tillinghast will have roughly half the fund with the balance split evenly between Dan Dupont and Kyle Weaver.

Mr. Weaver uses a more growth-focused approach, which would be expected to be rather complementary to the current management team. The U.S. exposure in the fund is likely to increase, as this is the area where Kyle has extensive experience.

I will be watching this change closely to see if it results in any further erosion in the risk-reward profile of the fund.

Invesco Emerging Markets Fund (AIM 2143 – Front-End Units, AIM 2145 – Low-Load Units)

With macro headlines dominating investor sentiment, emerging market equities fell by nearly 3% in the third quarter. In this environment, the Invesco Emerging Markets Fund rose by 2.8% for the Series A units. Helping drive this outperformance was the fund's overweight in China. While this may seem counterintuitive given the uncertainty created by the ongoing trade war with the U.S., the fund's China holdings are in more domestic and consumption-focused businesses, which tend to be less affected.

The managers have been finding more opportunities in small- and mid-cap stocks in the past few months. According to a recent commentary published by the managers, the reason is that small and mid-cap names have largely been overlooked by investors, as most of the fund flows have been going into large cap-focused ETFs.

Looking ahead, the managers note that global growth is slowing but don't see a recession as imminent. This combined with continued uncertainty is likely to result in higher levels of market volatility. Furthermore, they believe that given the uptick in volatility, broad diversification is recommended.

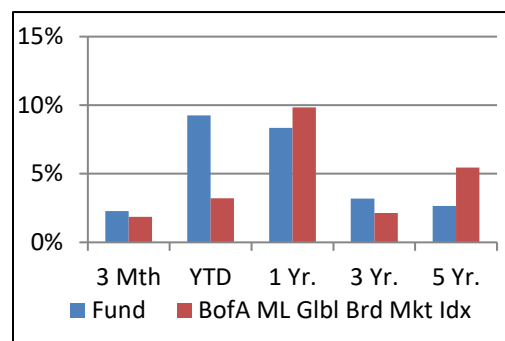
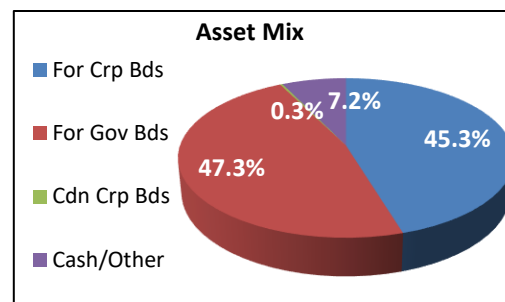
While the macro headwinds can create havoc in the investment markets, the investment managers use a fundamentally-driven, bottom-up investment process to try to find high-quality, well-managed companies with sustainable competitive advantages that can do well in most environments. The portfolio is unconstrained and can invest in companies of any size. At the end of September, half of the fund was invested in small- and mid-cap names.

Given the investment team and disciplined investment process, this remains my top pick for emerging markets.

If there is a fund that you would like reviewed, please email a request to me at: feedback@paterson-associates.ca

NEI Global Total Return Bond Fund

Fund Company	NEI Investments
Fund Type	Global Fixed Income
Rating	B
Style	Top-down Macro/Bottom-up Security Selection
Risk Level	Low
Load Status	Optional
RRSP/RRIF Suitability	Fair
Manager	Laurent Crosnier since Apr 2014 Myles Bradshaw since May 2015
MER	1.85%
Fund Code	NWT 194 – Front-End Units NWT 395 – Low-Load Units
Minimum Investment	\$500



ANALYSIS: While it has been a challenging time for bond markets, global bonds can still offer very attractive diversification benefits to Canadian investors, helping reduce the overall portfolio risk. This offering from NEI is one of the more appealing options in the category, delivering respectable returns, with a risk level well below the category average.

Managed by Paris-based Amundi Asset Management, the fund uses a risk-based portfolio construction process that blends top-down macro analysis of bond markets and single-country currency outlooks around the world with bottom-up security selection. This helps determine the most appropriate portfolio, taking into account the interest rate exposure, term structure, and credit quality.

The bottom-up security selection process finds the most appropriate bonds for the portfolio, which are also subject to a socially responsible screening.

The fund has posted a solid 9.3% year-to-date to the end of October, handily outpacing the Bloomberg Barclays Global Aggregate Index and the global fixed income

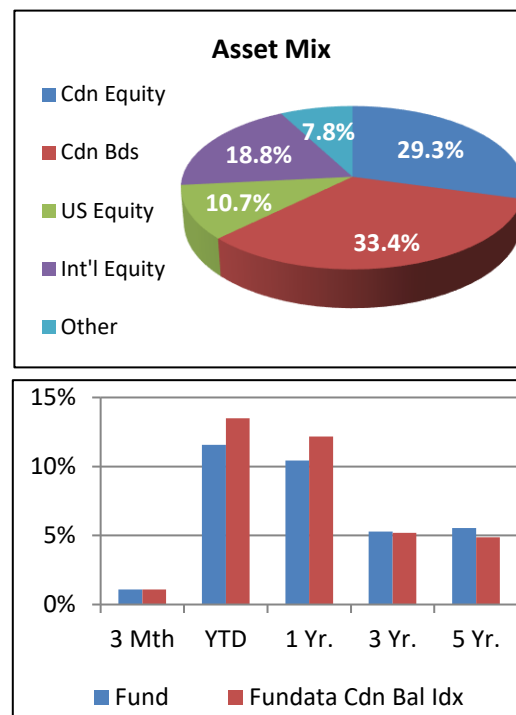
peer group. Longer-term, the fund has slightly trailed the index but has outpaced the peer group on a 3-year basis, with a compounded average annual return of 3.2% to Oct. 31. Over the past five years, it's trailed both the index and peer group.

For me, the fund's risk profile makes it worth considering. Volatility has been roughly in line with the index but has been significantly lower than the category average, making it very appealing on a risk-adjusted basis. Even better, it has excelled in protecting investor capital in down markets, participating in less than 10% of the market's downside over the past three years, according to Morningstar data. Over the past five years, it has roughly 50% downside capture, all the while delivering about 65% of the upside.

Costs are reasonable, with an MER of 1.85% for the full-freight Series A units, which carry some embedded advisor compensation. While I would be very hesitant to use this as a core bond holding, it can be a nice diversifier if used as a portion of a bond allocation in an otherwise well-diversified portfolio.

PH&N Balanced Fund

Fund Company	RBC Global Asset Management
Fund Type	Canadian Neutral Balanced
Rating	B
Style	Top down Macro Fund of Funds
Risk Level	Low to Medium
Load Status	Optional
RRSP/RRIF Suitability	Fair
Managers	Sarah Riopelle since April 2015
MER	1.97%
Fund Code	RBF 6350 – Front End Units RBF 4350 – Low Load Units
Minimum Investment	\$500



ANALYSIS: This fund-of-funds offering from RBC has a target asset mix of 38% Canadian bonds, 30% Canadian equities, 26% foreign equities, 4% emerging market equities, and 2% in cash. Manager Sarah Riopelle has some flexibility in setting the asset mix and will use a top-down macro analysis to understand the broader economic and market environment and determine the most appropriate asset mix for the outlook.

At the end of September, the fund was underweight fixed income, with roughly 35% in bonds, mostly through the highly regarded PH&N Bond Fund. A small 4.6% portion was dedicated to foreign bonds through the RBC Global Bond Fund. With the manager's negative outlook for bond yields, the fund is overweight equities, holding just shy of 20% in Canadian stocks, with 42% in foreign equities.

Longer-term performance has been solid with the Advisor Series delivering 3-year and 5-year average annual compounded rates of returns of 5.3% and 5.6% respectively, to Oct. 31, outperforming both the peer group and the benchmark.

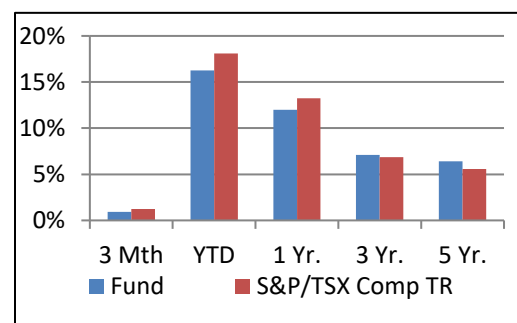
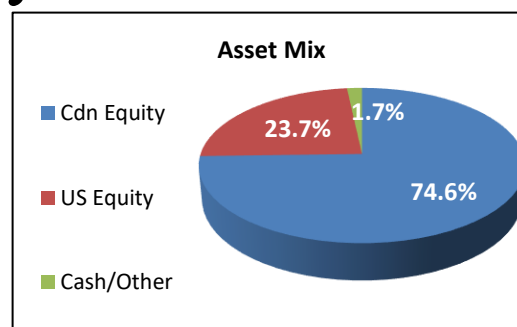
The fund's equity growth tilt has helped boost returns over the past couple of years, but valuation levels look a bit rich compared with the index and peer group, which may be a headwind in coming quarters. However, the fund's active-management style can help mitigate the risk.

The fund's volatility level may be a concern, exceeding both the benchmark and the category average over the past three and five years. Still, it has done an excellent job generating returns in rising markets, posting up-capture ratios well above 100%, outpacing the benchmark when markets rally higher. However, it has participated in more of the downside, performing worse than the benchmark when markets fall.

Costs are reasonable with an MER of 1.97% for the advisor-sold units. Overall, if you remain positive on the outlook for the markets and want to invest with RBC, this may be a great fund to consider. If you are worried that we may see market weakness or volatility, you may want to find another, more conservatively positioned balanced offering.

TD Canadian Low Volatility Fund

Fund Company	TD Asset Management
Fund Type	Canadian Equity
Rating	A
Style	Rules Based – Volatility focus
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Excellent
Manager	Jean Masson since April 2014
MER	2.04%
Fund Code	TDB 2941 – Front-End Units TDB 2943 – Low-Load Units
Minimum Investment	\$500



ANALYSIS: With a phenomenon known as the low-volatility anomaly, lower-volatility stocks have historically outperformed those with higher volatility on a risk-adjusted basis over the long term. In a fund structure, you have an investment with the potential to deliver most of the equity market's upside with much lower downside participation. This fund, one of the first low-volatility offerings for retail investors, debuted in April 2014, and is managed Jean Masson and his team.

The managers look for Canadian equities that have exhibited the least amount of volatility over the past 36 months. They also consider valuation and blend quantitative analysis with the judgment of the management team in the portfolio process. In fact, the team will override the model in certain circumstances.

The portfolio is very well diversified with more than 160 names, and the top 10 making up less than 30% of the fund. Looking for the best risk-adjusted return, the managers rebalance frequently, while remaining mindful of trading costs. The fund is currently overweight real estate, communication services, and consumer staples. But rare for a Canadian equity fund, it is significantly underweight energy, financials, materials, and industrials.

With growing interest in low volatility investments over the past year, the fund has been trading at valuation levels slightly higher than the broader market. In the past couple of months, we have seen some rotation out of low-volatility sectors, which dampened short-term performance, with the fund trailing both the category and index significantly in September and October.

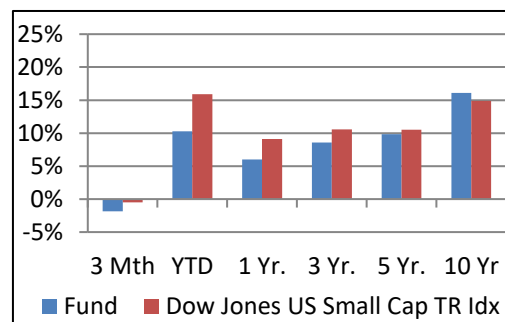
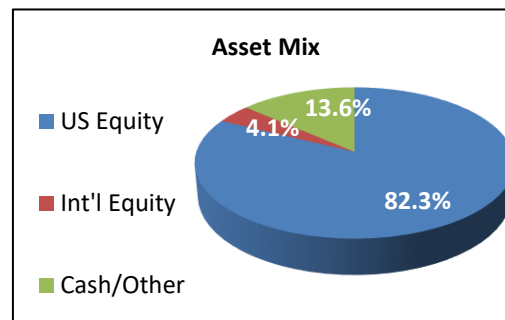
Longer-term returns have been very strong, however, particularly on a risk-adjusted basis, with a 5-year average annual compounded rate of return of 6.4%, outpacing the category and the index. Its 3-year annualized 7.1% return has beaten both index and peer group.

What's impressive is that true to its name, the fund has delivered returns with 5-year average volatility at just above 7%, well below the category's 12%, according to Morningstar data. Over the past five years, the fund has generated nearly 80% of the market upside while experiencing less than 60% of the downside.

I expect the near term may be a bit tough for low-volatility funds. However, if we experience a meaningful uptick in volatility or see the markets sell off sharply, I expect we will see these low-volatility funds hold up very well.

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: This fund had a solid 2018, where its defensive positioning handily outpaced the Russell 2000 and the U.S. small-cap peer group. But so far, 2019 hasn't been quite so kind, as the fund's 10.3% year-to-date return (to Oct. 31) has not kept pace. And a key reason for this comes back to the approach used by manager Steve MacMillan.

He uses a fundamentally driven, bottom-up approach seeking out quality stocks with lower-volatility business models that are trading at a level that is below what he believes them to be worth. He looks for proven management teams in niche businesses with sustainable competitive advantages that allow for solid growth opportunities and the ability to earn more than their cost of capital. Key factors include strong balance sheets and high levels of free cash flow.

The portfolio is somewhat concentrated, with between 35 and 45 names and the sector mix being largely the result of the security selection approach. While this approach has worked very well over the long term, there will be periods where it fails to keep pace, and most of 2019 has been one such period. Growth-type stocks have mostly driven market performance this year, and absent

such names, performance may lag, as has been the case for this fund.

In the later stages of the market cycle, it is important to be cautious and more defensive. And to be sure, this fund has a demonstrated history of protecting capital for investors, with a level of volatility well below both the index and the category average.

Furthermore, over the past three years, the fund has participated in less than 40% of the market declines, according to Morningstar data, and less than 55% over the past five years.

Mr. MacMillan has increased exposure to more defensive sectors, including utilities, consumer staples, and real estate. And indeed, these sectors are likely to outperform in volatile markets.

While the short-term has been frustrating, I believe that the fund's focus on quality and capital preservation will pay off for investors, as it has over the long term. I don't expect to see any sharp, short-term rebound. However, if you have patience and a long-term time horizon, in my opinion, this remains a very solid choice for those looking for U.S. small-cap exposure.