

Top Funds Report

Stock markets touch record highs

November gains driven multiple expansion, not earnings growth

November turned out to be a pretty strong month for investors, as equity markets around the world posted decent gains through the month. North American markets led the way higher with many broad stock market indices reaching fresh record highs.

Overall the S&P 500 Composite Index advanced 3.6% in November, bringing the year-to-date gain to more than 27%, in U.S. dollar terms. Markets seemed to shrug off the noise coming from the Trump impeachment proceedings, focusing instead on the positive trade news.

Toronto's S&P/TSX Composite Index likewise rose by 3.6% in November, gaining an impressive 22% year-to-date. Energy and consumer issues were the key drivers of performance for the S&P/TSX.

Buoyant market sentiment wasn't limited to North American markets. European and Asian indices also finished the month higher, as both the MSCI European Index and MSCI Asia Pacific Index rose by 1.5%. Emerging market gauges ended lower, though, bearing the brunt of the continuing trade dispute between the U.S. and China. The MSCI Emerging Markets Index fell 0.1% on the month and has trailed the developed markets in year-to-date performance so far this year.

Generally, the tone was positive for investor sentiment as growing tensions over protests in Hong Kong against China's heavy-handed attempts to suppress the democratic movement were more than offset by progress on the trade front.

A Dec. 13 announcement of an agreement on phase one of the U.S.-China trade pact helped propel U.S. stock indices to record highs in early December. That meant U.S. tariffs that were slated to take effect on Dec. 15 were called off, setting a strong foundation for a

broader trade deal. There has even been some talk of existing tariffs also being rolled back, which would go a long way to help reduce some of the uncertainty that continues to overhang the markets and economy.

In Europe, the Conservatives won a landslide victory in the Dec. 12 UK general election, giving Prime Minister Boris Johnson a strong mandate while removing entirely the uncertainty of a no-deal Brexit. In addition, recent economic data show that growth prospects in the region have improved and that the eurozone appears to have come through the worst of the downturn.

With U.S and Canadian policy rates hold in November, bonds were mixed. In Canada, long-term bonds outperformed short-term issues, and corporate bonds outperformed government bonds. Global bonds were modestly lower through the month.

Looking ahead, I remain positive, yet cautious, as many risks continue to overhang markets. Economic data this year have remained largely positive but have showed signs of weakening. Furthermore, most of the equity market gains in the past year have been driven by

	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		

increasing valuations and not from earnings growth. Earnings need to catch up to valuation levels, or we risk a market selloff and a sharp uptick in volatility.

In addition, there are many macro headwinds weighing on investor sentiment, including the seemingly interminable U.S./China trade war, Brexit, and Hong Kong. On the plus side, though, in the past couple of months we have seen a change in tone in trade talks with the announcement of a phase one deal, suggesting more progress in trade talks. If and when this happens, overall investor sentiment is expected to improve.

In this environment, I continue to favour higher-quality investments in both equities and fixed income. My investment outlook remains consistent as shown in the accompanying matrix.

While I realize this may result in some underperformance in a rising market, I am comfortable leaving some money on the table, knowing my portfolios are better positioned for market volatility.

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

Funds of Note

This month we look at some of the ETFs on my ETF Focus List...

iShares Diversified Monthly Income Fund (TSX: XTR) – This is a balanced ETF portfolio that invests in a mix of income-producing ETFs with the objective of providing investors with consistent monthly distributions and the potential for some long-term capital growth. At the end of November, it held slightly more than half in fixed income investments with the balance in equities. At more than a quarter of the fund, the largest holding is the **iShares CAD Hybrid Corporate Bond Index ETF**, which invests in Canadian high yield bonds. Next is the **iShares Floating Rate Index ETF** at nearly 20% of the portfolio. Combined, nearly half the fund is invested in non-investment-grade fixed income. This is great from a yield perspective but exposes the investor to a higher level of credit risk.

After a review of my ETF Focus List, I am removing this ETF from the list. When compared with the **BMO Monthly Income Fund ETF (TSX: ZMI)**, I believe ZMI is better positioned. It holds approximately 60% in income-producing equities with the balance in bonds, the majority of which are investment grade. Furthermore, my analysis shows ZMI is also more diversified, has slightly more favourable valuation levels, and has stronger forward-looking growth rates in the equity sleeve.

As I continue to rationalize the ETF Focus List, ZMI and XTR are very similar, and looking at the underlying composition of the two, I'd slightly favour ZMI in the current environment.

Invesco Senior Loan CAD Hedged ETF (TSX: BKL.F) – This is an ETF that provides passive exposure to the 100 largest and most liquid bank loans in the U.S. It remains a solid pick in the loan space, but I will be doing a more robust analysis of it in the coming quarters. I will be undertaking this review because IA Clarington has recently launched its well-managed, floating rate fund in an ETF structure.

The fund and new ETF are managed by a team headed up by Jeff Sujitno. Mr. Sujitno takes a very conservative, but active, approach to the loan market. He and his team use a very credit-focused analysis investment process that looks for issues from high-quality companies that can deliver strong free cash flow, sustain or grow revenues, and keep their balance sheets fundamentally sound. The portfolio is well-diversified, with between 100 and 125 loans, issued primarily in U.S. dollars, so all currency exposure is fully hedged.

From a performance standpoint, the **IA Clarington Floating Rate Income Fund** has delivered better absolute returns with less risk than the BKL.F ETF. It has also outperformed most of the other available floating-rate ETFs on an absolute and risk-adjusted basis, with the exception of the **Mackenzie Floating Rate Income ETF**. Despite the higher returns from Mackenzie, I favour the more conservative positioning of the IA Clarington offering, particularly if we start to see any cracks in the leveraged loan market.

While a change is not imminent, I will be watching the new ETF closely to see how it performs compared with the mutual fund version and the other available ETF options. In the interim, BKL.F remains my top pick in the floating rate note space for its well-diversified, reasonably priced exposure to the loan market.

iShares S&P/TSX Completion Index ETF (TSX: XMD) – When it comes to small- and mid-cap offerings in the Canadian equity ETF space, pickings are very slim, to say the least. At last count, there are only about half a dozen small- and mid-cap ETFs in the space, and quite frankly, this one is the best. It focuses on the members of the S&P/TSX Composite that are *not* in the S&P/TSX 60 Index.

Year to date, it's done well, gaining 18.3% to the end of October. Longer-term numbers are somewhat disappointing, with a 5-year average annual compounded rate of return of only 3.1%. At this point in the market cycle, I would likely avoid this dedicated small- and mid-cap exposure and focus instead on the broader S&P/TSX Composite that you can access through XIC. Furthermore, for small- and mid-cap exposure, I believe there are better options available in a mutual fund structure that offer a more compelling risk-reward profile. If you want small-cap exposure in the Canadian market through an ETF, this is the best option available right now, which is why it remains on the ETF Focus List.

iShares MSCI USA Minimum Volatility Index ETF (TSX: XMU) – Like TLV discussed above, this ETF provides exposure to a portfolio of low-volatility stocks. However, there are a couple of key differences between this and TLV. The first is that this provides exposure to U.S. equities. It holds about 200 individual positions.

Another differentiator is that this ETF is managed using a sector-neutral type approach, which means the underlying sector weights of the ETF will approximately match those of the index, while TLV is largely unconstrained. I like this approach for markets other than Canada because the Canadian equity market is heavily concentrated in financials, energy, and materials. Using a sector-neutral approach could result in more exposure to more volatility than running an unconstrained mandate. Greater inherent diversification in U.S. and global markets reduces that risk significantly, in my opinion. XMU also uses an optimization process that aims to construct a portfolio designed to deliver the least volatility overall.

It's a great pick for the long-term; however, like TLV and other low-volatility strategies, it has struggled to keep pace with the broader markets so far this year. To the end of November, it has gained 21.6%, while the S&P 500 is up 24.1%.

I expect that trend to continue for the balance of the year, as the underlying portfolio is trading at a valuation level above the market. However, if we see a market selloff or a bout of volatility, this ETF would be expected to hold up better than the other U.S. equity offerings on the list.

This remains my top pick for low volatility offerings for U.S. equities.

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

Beat the price increase!

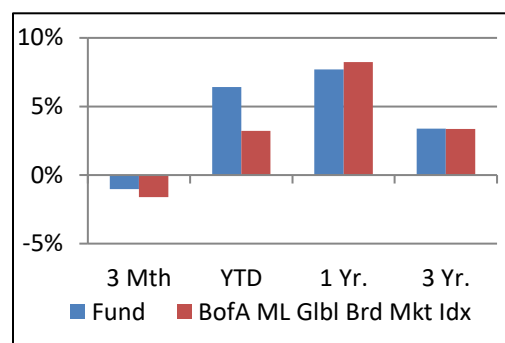
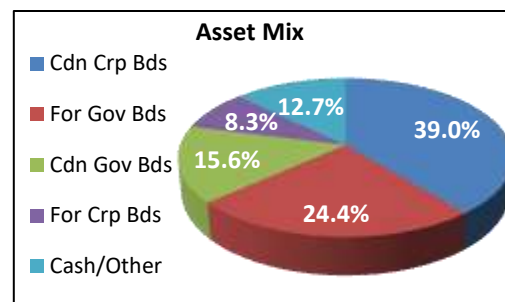
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CI Investment Grade Bond Fund

Fund Company	CI Investments
Fund Type	Global Fixed Income
Rating	A
Style	Top-down Macro/Bottom-up Security Selection
Risk Level	Low
Load Status	Optional
RRSP/RRIF Suitability	Fair
Manager	Paul Sandhu since Dec. 2014
MER	1.60%
Fund Code	CIG 2185 – Front-End Units CIG 1185 – Low-Load Units
Minimum Investment	\$500



ANALYSIS: As central bank bias turned dovish midway through the year, bond yields fell, and bonds have consequently had an excellent run. The FTSE/TMX Bond Index gained 7.25% year-to-date to Dec. 6, with corporate bonds outpacing governments. Such a rapid shift in sentiment highlights the benefit of active management for fixed-income portfolios. This fund is one of my favourite active mandates.

It's a global bond offering managed by Paul Sandhu and his team at Marret Asset Management that blends top-down macro analysis with fundamental, bottom-up security selection. The top-down analysis provides an overview of the global environment, which the team uses to determine the sectors they believe are best positioned to benefit from that outlook. The fundamental, bottom-up, credit analysis finds the best individual bonds for the fund.

Once the portfolio is set, Sandhu then uses an overlay strategy to tactically manage interest rate, credit, and currency risks. To managed interest rate risk, Sandhu can tactically short government bonds and interest rate futures, while credit risk is hedged through the use of

credit default indexes. In addition, he will actively trade the portfolio, looking to take advantage of short-term opportunities.

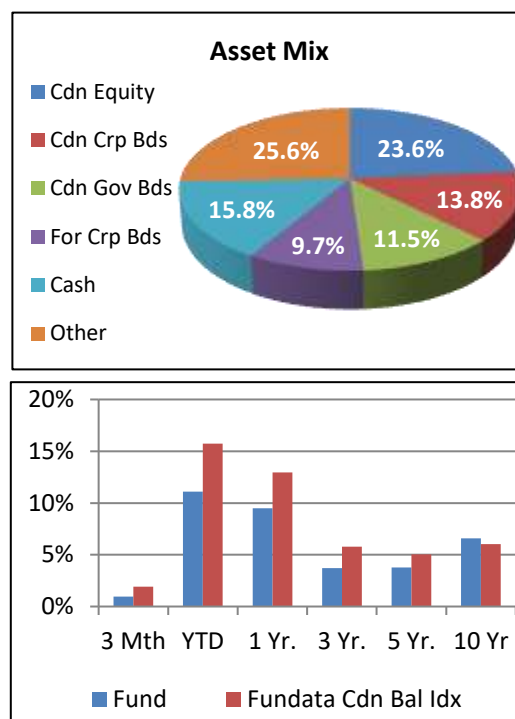
Despite its global reach, the fund is focused on North America, with nearly two-thirds invested in Canada, and the balance in the U.S. at Oct. 31 About half the fund is invested in corporate bonds, 40% in government issues, and about 14% in cash. The portfolio will typically hold between 50 and 75 issuers.

Performance has been roughly in line with the peer group, generating an 3-year average annual compounded rate of return of 3.3%. However, volatility has been significantly lower than the peer group, resulting in a risk-adjusted return that outpaces both the index and the peer group.

If volatility increases across all asset classes heading into 2020, as many expect, this CI offering with its high-quality active strategy and focus on risk management makes sense. If you prefer an ETF structure, a substantially similar mandate is available in the **First Asset Investment Grade Bond ETF (TSX: FIG)**.

Fidelity Monthly Income Fund

Fund Company	Fidelity Investments Canada
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	Good
Managers	Geoff Stein since Sep 2011 David Wolf since March 2014
MER	2.07% Front End/2.28% DSC
Fund Code	FID 269 – Front-End Units FID 869 – Low-Load Units
Minimum Investment	\$500



ANALYSIS: Focused primarily on Canada, this fund is structured very much like a fund of funds, investing in various underlying strategies managed by some of Fidelity's best managers.

Portfolio managers Geoff Stein and David Wolf, with the resources of Fidelity's Global Asset Allocation team, use a multi-input, multi-step investment process that blends top-down macro analysis, bottom-up research, market valuation, and investor sentiment to help shape their outlook, and position the portfolio accordingly.

The neutral asset mix of the portfolio is 50% equity and 50% fixed income. At the end of September, the fund was defensively positioned, holding around 9% in cash, 40% in equities, 47% in bonds, with the rest in a mix of gold and preferred shares. The fixed-income portion of the fund is overweight higher-yielding corporate bonds for the additional return potential and the diversification benefits. While inflation has been muted, the fund has some exposure to real assets, including gold and inflation-linked bonds.

The equity managers remain defensively positioned, expecting an uptick in market volatility, which they see as an opportunity for the fund.

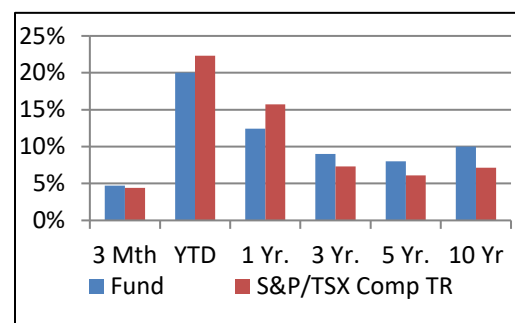
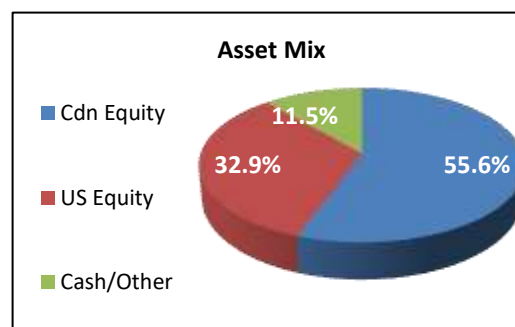
While the fund has gained more than 11% year-to-date to the end of November, it has lagged the index and the peer group owing to its defensive positioning. Still, over the past 10 years, the fund has delivered above-average returns in each calendar year except for 2016 and 2017.

Volatility has been well below average, with annualized 3-year standard deviation at 3.57%, significantly below the category average. It has also done a great job protecting capital in down markets, participating in less than 70% of the market downside over the past three and five years. One drawback is it yields a minimal 1.7%, making it less attractive for those who need cash flow.

The net result is a risk-adjusted return that is well above the category average, providing investors with a strong balance between risk and return. With its disciplined investment process, strong oversight, and a focus on risk management, this is a solid contender for those seeking a Canadian-focused balanced fund.

Dynamic Equity Income Fund

Fund Company	Dynamic Funds
Fund Type	Cdn Dividend & Equity Income
Rating	A
Style	Bottom-up quality
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Excellent
Manager	Oscar Belaiche since July 2001 Tom Dicker since January 2018
MER	2.15%
Fund Code	DYN 029 – Front-End Units DYN 7013 – Low-Load Units
Minimum Investment	\$500



ANALYSIS: As interest rates are likely to remain on the low side for some time, income from equity investments continues to be top of mind of many investors. With a focus on high-quality companies that pay a dividend and a stable monthly income stream, this fund has been a strong option for the past few years.

Manager Oscar Belaiche heads a team that uses an investment process they call “Quality at a Reasonable Price” (QUARP). It’s a blend of top-down macro analysis and bottom-up security selection. They look for companies that have best-in-class management teams, that are dominant in their industry, and that have a history of increasing cash flows and strong balance sheets. Once identified, these high-quality companies are subject to an in-depth valuation analysis to ensure the managers are not overpaying. They will then look at valuation through a few different lenses depending on the company, using a more private-equity-type of approach.

The fund is focused in Canada but can also invest in some U.S. names. At the end of October, it held 56% in Canada and a third in the U.S. The portfolio is somewhat defensively positioned, holding nearly 11% in cash.

From a sector perspective, it is overweight the more traditionally defensive sectors, including consumer staples, healthcare, and utilities. It is underweight financials, energy, and materials. And with its focus on income, the fund is slightly overweight REITs.

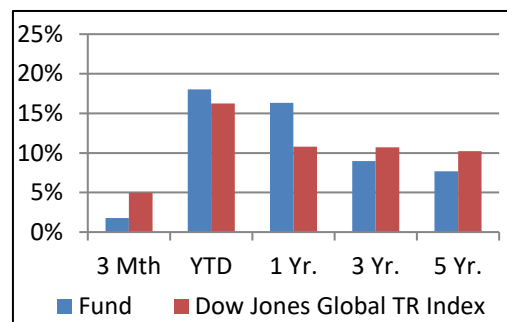
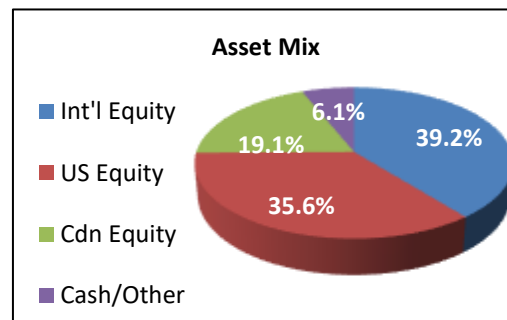
Performance has been solid, particularly over the long-term. The fund’s 3-year average annual compounded rate of return to the end of October is 9.0%, outpacing both the index and peer group. And over the past five years, it has delivered an annualized 10.0%, while the S&P/TSX Composite Index has returned 7.2%

The fund has also shown less overall volatility than the broader market or peer group and has done a good job of protecting capital in down markets, participating in about 60% of market declines over the past five years.

Costs are reasonable, with an MER of 2.15% for the Series A units that includes embedded dealer compensation. And the fund also pays a monthly distribution of \$0.07 per month, which works out to an annualized yield of approximately 3.76%, at the recent NAV. The fund checks all the right boxes and is well worth considering for diversified income portfolios.

Russell Global Infrastructure Pool

Fund Company	Russell Investments Canada
Fund Type	Infrastructure Equity
Rating	B
Style	Large-Cap Blend
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Greg Nott since January 2013
MER	2.31%
Fund Code	FRC 096 – Front-End Units FRC 068 – Low-Load Units
Minimum Investment	\$25,000



ANALYSIS: With central banks' showing a dovish bias for the foreseeable future, and the equity bull market running long in the tooth, many investors are looking to alternative asset classes as a way to help generate excess return and protect capital in down markets.

One of the more popular alternative asset classes is infrastructure, which involves investing in things like power generation, toll roads, telecom, railways, water, and airports. The case for infrastructure is strong, as governments increasingly call on private capital and companies to get large projects done.

With strong cash flows, infrastructure provides nice yields along with diversification benefits, because it tends to have low levels of correlation with other asset classes, including global equities and fixed income.

But the best way to realize these benefits is through "pure-play" infrastructure investment. In other words, through companies that own the road or the bridge, and not the companies that build them. There are now around 20 infrastructure mutual funds in Canada, and this offering from Russell is one of the more interesting options.

It invests only in companies actively involved in pure-play infrastructure, it is global in nature, and it is actively managed. Unlike some of its peers, it uses a multi-manager structure, using three different managers.

There are typically a couple of knocks against a multi-manager solution – high costs and too much diversification. But Russell does a good job on both fronts, with an MER of 2.31% for the front-end units, which carry a 1% trailer fee. And to mitigate the problem of overdiversification, Russell has selected three different managers (Australia-based Colonial First State, and U.S. managers Nuveen Asset Management and Cohen & Steers), each with a somewhat different style and approach, which has helped to dramatically reduce the duplication and overlap in the portfolio.

Returns have been solid with an a 5-year average annual compounded rate of return of 7.7%. However, volatility has been below the category average, resulting strong risk-adjusted returns.

For those looking for exposure to pure-play infrastructure in a mutual fund, this is one certainly worth considering.