Top Funds Report

Britain Votes to Leave EU

Market reaction swift and severe in days following. A month later, calmer heads prevail…

Unless you've been living in a cave, you've probably heard by now that residents in the UK voted to leave the European Union by a slim 51.9% to 48.1% margin. Market reaction was swift, with global equity markets, particularly those directly affected by the vote, selling off sharply. Traditional safe haven investments, namely gold and U.S. government bonds rallied.

After a couple days of sober reflection, markets realized that while this result was not ideal, or even likely to be a net positive to the global economy, it was far from the devastation that was being reflected by stock prices. Markets then turned the corner, rallying higher, with U.S. markets recently hitting all-time highs. On July 20, the S&P 500 closed at 2173, a record close.

Where we go from here is a much different story, with many unknowns. One, obviously is the Brexit process. With Theresa May stepping in to replace David Cameron as the UK Prime Minister, the divorce proceedings can now proceed in earnest. The first step is for Britain to figure out their needs, which will be followed by the negotiation process. Once the process is started, they will have two years to wrap it up. Until this is done, there will be much speculation as to what the new world will look like, resulting in significant volatility in the interim.

Another worry is the pace of economic growth coming out of China. Recent data suggests that growth, while still positive is expected to moderate considerably from its previously torrid pace. Given the overcapacity and massive debt, this will take some time to work out.

The U.S. Federal Reserve continues to weigh on investors. After a disappointing May jobs report and the initial reaction to Brexit, many traders were not expecting the Fed to move rates higher until early next year. In recent days, job numbers and other signs are pointing to continued strength in the overall economy, increasing the likelihood of a bump in rates this year.

Regardless, I will not be making any significant changes to my investment outlook. I still believe that equities are more attractive than bonds, and Canadian and U.S. equities are better positioned than foreign stocks.

My current investment outlook is:

	Under-weight	Neutral	Over-weight
Cash		**X**	
Bonds	**X**		
Government		X	
Corporate		X	
High Yield	X		
Global Bonds		X	
Real Ret. Bonds	X		
Equities			**X**
Canada		X	
U.S.		X	
International	X		
Emerging Markets	X		

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

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Funds of Note

This month, I take a look at funds from Steadyhand, RBC, Chou, and Mackenzie…

Steadyhand Income Fund (SIF 120) – On June 23, Steadyhand announced that they were reducing the quarterly distribution on the fund from $0.07 per unit to $0.045. The rationale for this cut was the current low yield environment has resulted in a lower level of interest and dividend income being generated by the fund. The managers do not want to have to reach for yield, taking on additional risk for the sake of a distribution. Nor did they want to pay out a dividend that is higher than the income earned, which has the potential to eat away at the fund's capital over time.

This change does nothing to alter my view of the fund. In fact, it reinforces my view of Steadyhand's management, highlighting their philosophy of putting investors needs first.

Further, while this fund in an "income" fund, I have never really viewed it that way. I see this more as a "bond like" fund that is expected to modestly outperform bonds because of its focus on corporate bonds, and its 25% exposure to quality high yielding common stocks and REITs. It has been one of the strongest funds in the fixed income balanced category.

Going forward, I would expect this fund to continue to deliver modest risk adjusted returns. It offers a well-diversified portfolio and carries an MER of 1.04%, which is well below its peers. The only drawback to the fund is it is not widely available through discount brokers or advisors, and it carries a $10,000 minimum investment.

Mackenzie U.S. Low Volatility Fund (MFC 4749 – Front End Units, MFC 4750 – DSC Units) – Low volatility funds have been rather popular with investors, and given the current market environment, I would expect that to continue. This offering from Mackenzie is one of the newer offerings in the U.S. equity space.

Launched in April 2014, the fund is managed by Robert Schoen and Adrian Chan of Putnam and it is substantially similar to a fund they run in the U.S. that was launched a year earlier.

There are a couple of interesting things that differentiate this fund from its peers. The first is it is managed using a sector neutral approach. Sectors must be kept +/-2% of the weights of the S&P 500. Other funds will look to invest in stocks that have the lowest volatility, irrespective of sectors. The result is a portfolio that looks a lot different than the others in the category. For example, it has a nearly 12% weight in technology, which has traditionally been one of the more volatile sectors. It also is significantly underweight utilities. This translates into a more attractively valued portfolio, with valuation measures that appear more favourable.

Another differentiator is the fund's currency exposure is 50% hedged, while many the other low vol options run unhedged.

A final difference is the Mackenzie offering will use an option strategy to help manage volatility. In the option strategy, the managers write covered calls on 50% of the portfolios holdings, and with the proceeds, purchase protective puts on the full value of the portfolio. This strategy will help to protect the downside, however, it will also erode the upside potential of the fund.

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While there are only a couple of years of data on the fund, it has lived up to the low volatility promise, and has been the least volatile of the U.S. equity low volatility mandates. But it has also been the worst performer, underperforming its peers by a significant margin. From inception to May 31, it has gained an annualized 6.2%, while the TD offering has gained an annualized 19.4% and the **RBC QUBE U.S. Low Volatility Fund** rose by an annualized 17.4%.

Looking ahead, I would expect this to outperform in down markets because of its put strategy and more favourable valuation profile. In rising markets, I would expect it to lag as more than half the portfolio is likely to be called away because of the call option strategy.

Because of this, I believe the tradeoff between the lower risk and lower return is too great for most investors. I will continue to watch this fund and see if there is any improvement.

Chou Associates Fund (CHO 100 – No Load Units) – This is a fund that has definitely struggled in the past year and a bit. In 2015, it lost nearly 7%, while the MSCI World Index was up nearly 19% in Canadian dollar terms. So far this year, it's down another 20% or so and the MSCI World is down about 5.5%. The longer term numbers are more positive.

There are a couple of reasons for this. The first would be the style. It is definitely a deep value fund. Mr. Chou likes to invest in companies that are very much out of favour with the rest of the market, and hold them until they come back. Often times, as is the case with a lot of deep value type managers, he can often be early in picking up one of these "distressed" companies, resulting in periods of short to medium term underperformance. I think that is a lot of what we are experiencing here.

Assuming there have been no substantial changes to the portfolio since March 31, there have been several names that have hurt him this year. The first would be Valeant. Mr. Chou added a position in Valeant in the first quarter (about 6.5% of the fund), and on a YTD basis, it's down 81%. That position alone would have cost him more than 5% in performance. Now whether or not we agree with his call to hold Valeant, these are the types of names that he invests in on a regular basis and has done rather well over the long term.

Other names that have really hurt him so far this year include Sears, Resolute Forest, and Citigroup. Combined, these three names contribute another nearly 5% in performance. So combined, those four names account for nearly half the YTD loss of the fund.

This highlights the other reason for the dislocation in performance – the highly concentrated portfolio. At the end of March, he held 17 equity names, three warrant positions, and two fixed income holdings. The top 10 holdings represented nearly two-thirds of the fund's assets, leaving very little room for error. Given the significant weights of many of the fund's holdings, any mistakes will hurt you. Obviously the flipside of that is a very strong showing by one or more of the names will have a very meaningful impact on the performance.

Perhaps not surprisingly, this concentration has led to a relatively high level of volatility. Over the past five years, the fund's volatility has been modestly higher than both the MSCI World Index and the MSCI World Small Mid Cap

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Index. This has also affected the other risk reward metrics, including the risk adjusted return and value added performance.

Looking at the portfolio's valuation metrics, it trades at significantly lower multiples than its benchmark and its peer group, while the forward looking growth metrics are a touch lower. Still, it looks reasonably decent on a forward looking basis, even with the lower growth rates.

Considering the above, while I believe this can be a solid fund over the long term, it is definitely not something that should be considered a core holding. Further, given the potential for returns that are significantly out of step with the index and the peer group, it is a fund that is really only suited for those that can stomach that. Another risk that I see is the high level of key person risk that is inherent in this fund. It is basically a one man show with Francis Chou at the helm. While there is a succession plan in place, if anything were to happen to Mr. Chou in the near term, the impact on the fund would be potentially devastating. The risk reward metrics have eroded substantially over the past few quarters, and while I expect they will rebound in time, I do believe that that there are more conservatively positioned global equity and global small and mid-cap equity funds that can deliver comparable returns over the long term, with less overall risk.

In the Global Equity space, some of my picks would include **Mawer Global Equity** (or the Manulife version…), or **Mackenzie Ivy Foreign Equity**. In the small / mid cap space, I'm liking **Brandes Global Small Cap**, **Fidelity Northstar**, or **Trimark Global Endeavour**.

Mackenzie Precious Metals Fund (MFC 142 – Front End Units, MFC 1192 – DSC Units) – With an impressive 102% rise in the first half of the year, this precious metals fund from Mackenzie was one of the strongest best performing funds in the country. Managed by the team of Benoit Gervais and Onno Rutten, it invests in companies involved in the exploration, refining and production of precious metals.

It invests in companies of any size, and at the end of June had about a third of the fund invested in large caps, 36% in mid-caps, and the balance in small cap names. Approximately a third of the fund was invested in non-Canadian companies.

While it can invest in firms involved in silver, platinum, and palladium, the focus is on gold companies, which make up 80% of the fund.

The managers use a somewhat unique approach to resource investing and focus a lot of attention on finding companies that have the ability to generate higher levels of sustainable free cash flow. They dig deep to gain an understanding of a company's true capital expenditure levels, which then allows them to more effectively forecast the free cash flow it can potentially generate. They also look for quality management that have a strong history of sound capital allocation.

Even with this unique approach, the majority of the fund's return will be driven by the price of gold and other precious metals. With negative interest rates becoming more prevalent, gold has rallied nicely in the past few quarters, propelling this, and other gold funds higher. I certainly don't expect these returns to be repeated in the second half of the year.

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

feedback@paterson-associates.ca**.**

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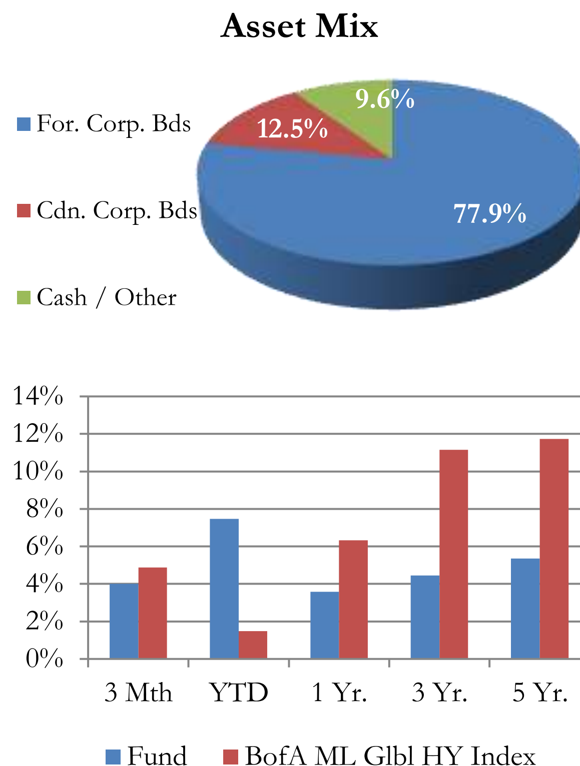
RBC Global High Yield Fund

Fund Company	RBC Global Asset Management
Fund Type	High Yield Fixed Income
Rating	C
Style	Credit Analysis
Risk Level	Low – Medium
Load Status	No Load / Optional
RRSP/RRIF Suitability	Good
Manager	Jane Lesslie since July 2003 Frank Gambino since July 2003
MER	1.74%
Fund Code	RBF 579 – No Load Units RBF 701 – Front End Units RBF 801 – DSC Units
Minimum Investment	$500



ANALYSIS: This fund has an interesting mandate with a target mix that is split between high yield bonds, and emerging market debt. At the end of May, managers Jane Lesslie and Frank Gambino were underweight emerging market bonds, which made up 43% of the portfolio, while 54% was invested in higher yielding issues.

From a credit quality perspective, approximately 27% of the fund was investment grade, while 70% was in non-investment grade. Even still, the focus was on high quality high yield names, with only 4% of the holdings rating less than a B.

The duration was 5.6 years, much lower than the duration of a more traditional investment grade portfolio. The yield to maturity was also significantly higher, coming in just shy of 6%.

With a year to date gain of 7.9%, this has been one of the stronger performing high yield funds in the country. But it has not been a one-off, as the longer term numbers also have been well above average. Except for 2013 and 2015, this fund has been above average in every year since 2006.

Volatility has been well contained, and hgas been less volatile than the index and in line with its peers. The downside protection offered has also been impressive, which is largely because of the significant exposure to emerging market bonds.

Management is active in employing their process and tends to be more active in volatile periods. Still, on balance, turnover has been modest, averaging just under 60% for the past five years.

While not my top pick in the high yield space, I like the diversified portfolio and active management approach used. I wouldn't use it as a core fixed income holding, but it could be a nice addition to an otherwise well diversified portfolio.

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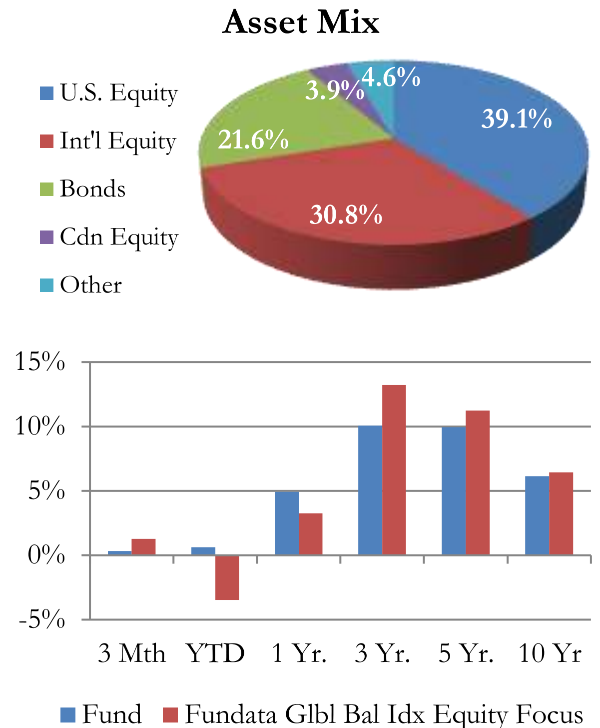
Mackenzie Ivy Global Balanced Fund

Fund Company	Mackenzie Investments
Fund Type	Global Equity Balanced
Rating	C
Style	Large Cap Blend
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Paul Musson since May 2001 Steve Locke since May 2013
MER	2.32%
Fund Code	MFC 086 – Front End Units MFC 616 – DSC Units
Minimum Investment	$500



ANALYSIS: Over the past few years, there have been some minor changes to this fund that have certainly helped improve on its stellar equity sleeve. The first such change was bringing Steve Locke and his fixed income team to take over the fixed income portion of the fund.

Using a core plus approach, the team has a lot of flexibility and can invest in a wide range of fixed income options, including high yield, floating rate notes, and real return bonds. Still, the bonds remain conservatively positioned, with the majority focused on investment grade bonds, with only a smaller exposure to higher yield issues.

The second change that has helped was to bring Alain Bergeron in to oversee the asset mix of the fund. Before he took over, it was left to the managers. Now, they can focus on what they do best, which is manage the investments and Mr. Bergeron will tweak the mix based on his outlook. The neutral asset mix for the fund is now set at 73% equity, and 23% bonds, but can range between 60% and 90% in equity. At the end of June, it was modestly overweight in equity.

Turning to the equity sleeve, it looks very similar to the highly regarded **Mackenzie Ivy Foreign Equity Fund**, with a very similar sector mix and comparable valuation metrics. There is also significant overlap between the holdings. It is concentrated, holding just 35 equity names

Performance has been strong across all time periods, handily outpacing its peers over the past three and five year periods. Like other Ivy branded products, volatility has been below average. Further, it offers excellent downside protection compared to its benchmark

I would expect that it is likely to lag in a rising market, but should outperform in a falling market

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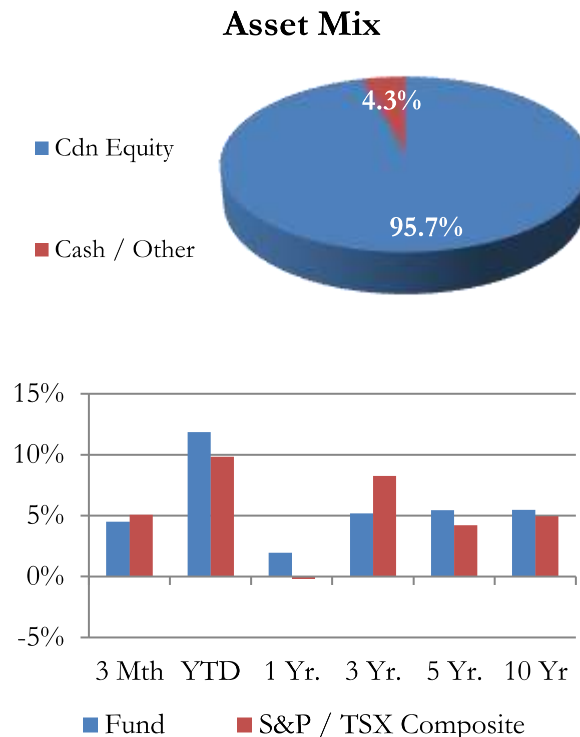
BMO Monthly High Income II Fund

Fund Company	BMO Investments
Fund Type	Cdn Dividend & Income Equity
Rating	A
Style	Large Cap Blend
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Kevin Hall since March 2012 Michelle Robitaille since Mar12
MER	2.14%
Fund Code	GGF 619 – Front End Units GGF 260 – DSC Units
Minimum Investment	$500



ANALYSIS: Dividends have been shown to be a key contributor to the long-term returns of equity funds, and this Canadian dividend fund is one of the stronger offerings out there. Managed by the team of Kevin Hall and Michelle Robitaille, it invests mainly in high yielding common equities and real estate investment trusts (REITs).

They look for potential investments in the higher yielding names of the S&P/TSX Composite Index. While dividends are a key factor they look for, they are careful not to sacrifice quality to chase yield. It holds around 40 names, with the top ten making up about a third of the fund.

It has significant exposure to higher yielding energy names, financials and REITs. Combined, these three sectors make up nearly 70% of the fund. Concentration is a potential concern with this fund, and in large part helps explain recent performance. With energy names under pressure in 2014 and 2015, so too was this fund. This year, with both energy and REITs showing strength, this offering has been one of the stronger performers on a year to date basis. Longer term, performance has been around average, however both volatility and downside participation have been lower than the peer group, resulting in better than average risk adjusted returns.

Looking ahead, stability in the energy market should continue to be a tailwind for this fund. I would expect that over the longer term, it should continue to deliver average or better returns with lower volatility. It can also be a great source of cash flow, paying a monthly distribution of $0.06 per unit, which is an annualized yield of 5%

Through a Worldsource advisor, you can access a lower cost version of this fund, the **Guardian Equity Income Fund (GCG 563)** which is virtually identical, but carries a lower MER.

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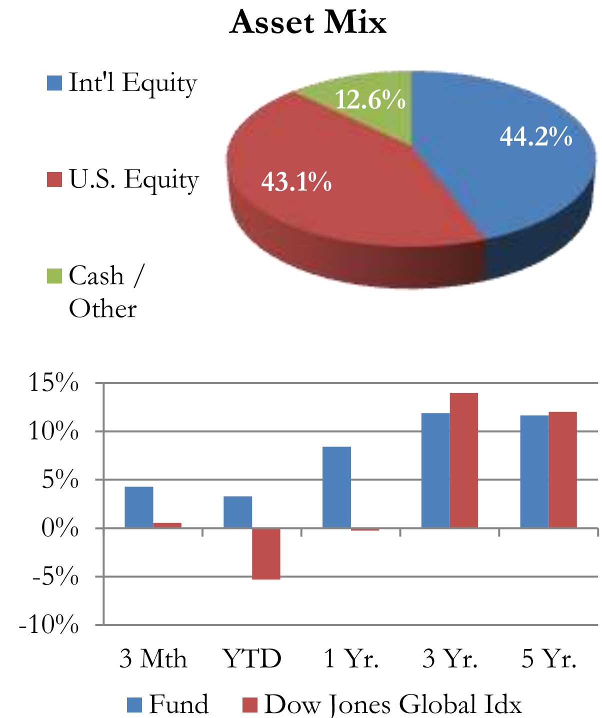
Trimark Global Dividend Class

Fund Company	Invesco Canada
Fund Type	Global Equity
Rating	C
Style	Large Cap Growth
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Michael Hatcher since Sept 13 Jeff Feng since October 2009
MER	2.62%
Fund Code	AIM 24913 – Front End Units AIM 24911 – DSC Units
Minimum Investment	$500



ANALYSIS: Managed by the team of Michael Hatcher and Jeff Feng, it invests in high quality, dividend paying companies around the world. It is managed using the Trimark philosophy that looks for well managed companies that are likely to deliver high returns on invested capital, and generate significant free cash flow. Given the dividend mandate, they also seek out a sustainable and growing stream of dividends.

The bottom up process results in a somewhat concentrated portfolio, typically holding around 40 names. Sector mix and country allocations are the byproduct of the stock selection process. Perhaps not surprisingly, the sector mix looks much different than its benchmark. At the end of June, it was overweight higher yielding sectors financials, industrials, and consumer defensives.

They are disciplined on valuation and are not afraid to let cash build when they are having trouble finding opportunities that fit their criteria. At the end of June, they held 9% in cash, which will help to provide a buffer against any market selloff. It will also act as a source of “dry powder”, allowing the managers to use periods of higher than normal volatility as a chance to step in and pick up high quality investments at attractive prices, improving the quality of the portfolio.

The focus on quality and valuation has paid off, with a year to date gain of 3.3%, one of the strongest performers in the global equity category. Longer term, numbers are also strong, with an annualized five year gain of 11.7%, finishing firmly in the top quartile. Volatility has been lower than both the benchmark and the peer group

This as a solid core global equity fund for the long term. I would expect some underperformance as the current high levels of valuation normalize, but would still expect strong downside protection compared to the index and peers, resulting from the quality focus and high cash balance.

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