Top Funds Report

Markets Take a Holiday in August

After a strong July, markets paused in August. Attention focused on Fed…

The dog days of summer were alive and well in August, with market activity rather subdued in the month. The S&P/TSX Composite Index gained 0.3%, as a rise in energy and financials was largely offset by a selloff in materials and real estate. The S&P 500 was also flat, gaining just over 0.1% in U.S. dollar terms, but with a slight drop in the Canadian dollar, it gained 0.75% in Canadian dollar terms. It was a similar story in global equities, with the MSCI EAFE Index gaining 0.7% in Canadian dollars, with most of that coming from the drop in the dollar.

It was a similar story in the fixed income markets, with the FTSE/TMX Canadian Bond Universe gaining 0.1%. Corporate bonds outpaced government issues, and long bonds outperformed short-term bonds. Most of the activity happened in the high yield markets, which showed some strength on the back of a modest rebound in the energy markets.

Looking ahead, most of the focus is now on the U.S. Federal Reserve, which is set to announce their interest rate decision on Wednesday (September 21). Most expect the Fed will hold rates steady this time around, with markets now looking for the Fed to move in December. Traders will no doubt parse every word from Fed Chair Janet Yellen's remarks, looking for clues.

Closer to home, Bank of Canada Governor Stephen Poloz signaled that any rate increase in Canada is likely on hold as the economy continues to struggle.

In this environment, I continue to favour equities over fixed income, as I believe there is more opportunity for growth from stocks than bonds. I don't expect it to be smooth sailing, as many stocks are priced for perfection, and September and October have historically been the most volatile. I don't expect this year to be different.

I have moved my weighting of emerging markets from underweight to neutral. The rationale was a recent report from the BlackRock Investment Institute, highlighting many tailwinds including an improving growth outlook, increasing investor demand, and attractive valuations. While not without its risks, the longer term outlook appears to once again favour emerging markets.

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 review the manager change at Steadyhand and highlight ETFs from my Focus List…

Steadyhand Small Cap Equity Fund (SIF 150 – No Load Units) – In mid-August, it was announced that Steadyhand was making a change to the management of its small cap fund. Taking the reins is Galibier Capital Management, a Toronto based, employee owned investment shop headed up by Joe Sirdevan. They replace Wutherich & Company, who have been managing the fund since its 2007 launch.

As with Wutherich, the portfolio will be concentrated, holding between 20 and 25 names. The investment process used is bottom up, and looks for well managed small and mid-cap companies that offer a sustainable competitive advantage, strong earnings history, a clean balance sheet, and good long-term growth prospects. Manager Joe Sirdevan describes their philosophy as "growth at a reasoned price", meaning they will not overpay for a company.

Individual position sizes will range between 3% and 7%, and will be based largely on relative valuation levels. Exposure to any sector is limited to 30%, providing a great deal of flexibility.

It is expected they will invest in more mid-cap names than with the previous team. They expect to focus on Canadian companies in the $3 billion market cap range, but may go up to $4 billion. In the U.S., they can invest in companies with up to $10 billion in market cap, but will invest in opportunities that meet their selection criteria.

While Mr. Sirdevan has been in the business for more than 20 years, the firm has only been around since 2012. As a result, there is not much meaningful track record on which to conduct a thorough quantitative review. That said, looking at the published performance of the firm's pooled fund products, it does look encouraging.

While all signs point to this being a positive for the fund, I will hold off making a judgement until I can see how the risk metrics show under the new management team. If you hold it, I don't see this as a reason to immediately sell. However, if you were looking to make a new purchase, you may want to hold on while the transition unfolds.

iShares Canadian Universe Bond ETF (TSX: XBB) – With sluggish economic growth, muted inflation expectations, and investor worries over Brexit, bond yields remain under pressure, pushing bond prices higher. The yield on the Government of Canada ten-year bond fell from 1.50% in April, to 1.03% in July, while long bonds saw yield drop from 2.06% to 1.69%.

As we look ahead, the rate environment is expected to be challenging. It appears the U.S. Federal Reserve is setting the stage for a rate hike in the fall or early in the new year, while Europe and Japan are now living with negative interest rates. This divergence is likely to result in higher volatility. Even if we see rates move higher in the U.S., the growth outlook for Canada remains somewhat muted. This should help to keep some level of support under bond prices.

In that environment, this ETF provides an excellent way to gain exposure to the broad Canadian bond market. The yield to maturity sits at approximately 1.74%, which is a good estimate of expected return if we see rates hold steady. However, with a duration of 7.7 years, it is fairly sensitive to rates, so if we see a move higher, this ETF will be under pressure. As we see the potential for stronger economic growth,

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we may want to take some measures to reduce the overall level of interest rate sensitivity, and look at some of the shorter term or more corporate focused ETFs available.

PowerShares S&P/TSX Composite Low Volatility ETF (TSX: TLV) – Low volatility funds and ETFs continue to generate strong interest with investors, and as we head into the most volatile period of the year, I would expect that trend to remain in place. What's not to love about low volatility funds? They have shown that they can deliver decent returns with better downside protection when markets get rough.

The main drawback to many of the low vol products is investors have bid valuations up significantly. For example, according to Morningstar, the **BMO Low Volatility Canadian Equity ETF (TSX: ZLB)** trades at a price to earnings ratio of 22.9 times, and the **iShares Edge MSCI Minimum Volatility Canada ETF (TSX: XMV)** trades at more than 19.5 times. The broader market trades at around 17 times earnings. At these extended valuation levels, generating above average returns will become increasingly difficult.

Turning to this ETF, TLV is more reasonably valued, trading at a P/E of around 15. The main reason is its sector positioning. Compared with other low vol ETFs, it has less exposure to the consumer defensive, technology, and utility sectors, all of which are trading at very elevated multiples. Further, it has about a third of the fund invested in real estate, which is trading at levels well below the broader market. The forward looking growth forecasts also look more favourable, making TLV the most attractively valued low vol Canadian ETF right now.

Given the more favourable valuation and growth outlook, I continue to favour TLV as my pick for the Canadian low vol space. That said, I continue to favour more actively managed investments, as I feel they are better suited for Canadian equity exposure at the moment.

PowerShares FTSE RAFI Canadian Fundamental ETF (TSX: PXC) – With a modest 4.17% gain for the three months ending July 31, this fundamentally weighted ETF lagged many of its peers. This was largely due to the significant exposure to energy and financials, two sectors that underperformed in the period. For the three months, financials gained approximately 1.25%, and energy rose by a little more than 1%. Combined, these two sectors make up nearly two-thirds of the portfolio, creating a modest headwind for the ETF.

Looking forward, the ability of this ETF to outperform will be dependent on two things. First will be the rebound in the energy market. While some stabilization has occurred, we would still need to see a further rebound in prices for there to be significant growth in the sector. Financials are also somewhat affected by energy, but also by interest rates and the housing market. If we see any signs of trouble, banks may be sold off by investors. Even with those potential headwinds, the forward looking earnings estimates look strong, particularly when compared to the other ETFs on the Focus List.

Even with the stronger growth estimates and more attractive valuation, I remain cautious in the short term, mainly because of the sector concentration. It is even more concentrated than the broader markets, which creates a greater risk over the short term. I continue to favour more

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actively managed investments for Canadian equity exposure in the current environment.

First Asset MSCI Europe Low Risk Weighted ETF (C$ Hedged) ETF (TSX: RWE) – In the months, and perhaps even years following the Brexit vote, many are expecting that volatility levels within the Eurozone to remain higher than normal. This ETF is a great way to gain exposure to the Eurozone, but in a more risk measured manner. To do this, it invests in the 100 least volatile stocks in the MSCI Europe Index, with the least volatile names getting the biggest weight in the index. Currency exposure is fully hedged, and it is rebalanced quarterly.

It is large cap focused, but it tends to skew a bit smaller than other Europe focused ETFs or the index. Sector mix is different, with an overweight to the traditional low vol sectors including consumer discretionary, industrial, real estate, and utilities. Still, valuations look to be more reasonable than other low vol ETFs, and more traditionally constructed indices.

Performance has been decent, but has lagged those ETFs that are focused on dividends or high quality stocks. Over the long term, I would expect this to deliver solid returns with below average volatility, and better downside protection. With an MER of 0.66% it is not cheap, but given the potential downside protection, I believe the higher cost may be worth it, particularly as we enter a period of potentially higher volatility. This is not for everyone, as I believe most investors can gain their European exposure through an EAFE or more global focused fund or ETF. But for those more risk averse investors looking for pure European exposure, this may be just the ticket.

Vanguard FTSE Emerging Markets All Cap ETF (TSX: VEE) – In a recent outlook piece, the BlackRock Investment Institute upgraded emerging market equities to overweight. Their rationale was that emerging market equities are well positioned to benefit from an increase in global growth expectations, and the lower for longer interest rate environment. Further, they note that investor appetite has been increasing, with significant inflows into emerging market mutual funds and ETFs since February. They also state that Asian investors have begun to rotate out of fixed income investments and are moving into equities, providing further support. From a valuation perspective, emerging markets are trading at a significant discount to developed markets from a forward earnings multiple perspective, and they expect that fundamentals could improve further, as companies focus on controlling expenses and improving profitability, rather than on increasing market share.

While the timing may be uncertain, and emerging market investing is not without risks, the medium to longer term outlook does look fairly compelling. While investors who have a more moderate risk tolerance may want to avoid the area, those with a healthy risk appetite may want to start looking at the region.

This Vanguard offering is my pick mainly for its lower cost. It tracks the FTSE Emerging Markets All Cap Index, which provides exposure to companies of all sizes in the emerging market countries.

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

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

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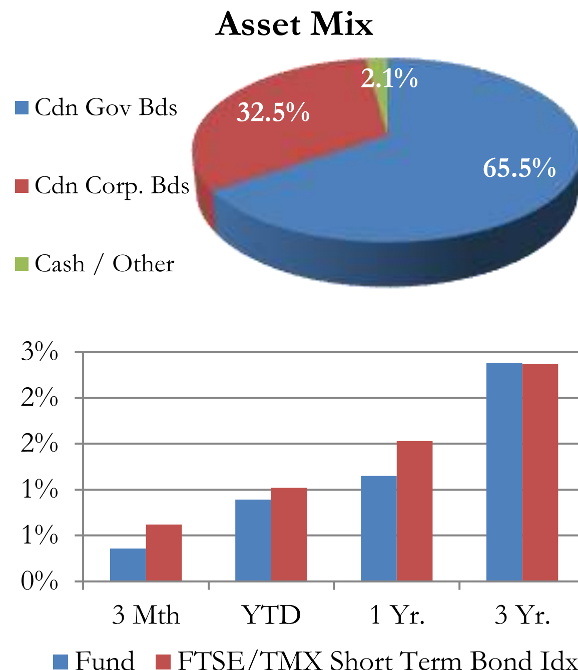
Vanguard Canadian Short Term Bond ETF

Fund Company	Vanguard Investments Canada
Fund Type	Cdn Short Term Fixed Income
Rating	N/A
Style	Passive, Cap Weighted
Risk Level	Low
Load Status	N/A
RRSP/RRIF Suitability	Excellent
Manager	Vanguard Investments Canada
MER	0.11%
Fund Code	TSX: VSB
Minimum Investment	N/A



ANALYSIS: This TSX traded ETF provides exposure to a portfolio of Canadian government and corporate bonds, that have a maturity that ranges be-tween one and five years. The index is weighted by market capitalization.

Credit quality is high, with more than 55% of the fund rated AAA, 25% rated AA, and the balance A or BBB. About 70% is in governments, with the balance in corporate bonds. Nearly 30% comes due within one to two years, with the rest pretty evenly spread across the other maturity buckets. This results in an average maturity of 2.9 years, and a duration of just 2.8 years. The average yield to maturity is a mere 1.1%.

This looks rather similar to the **iShares Canadian Short Term Bond Index (TSX: XSB)**, with similar asset mix, credit quality, and duration. However, Vanguard offers an MER that is 17 basis points lower than the 0.28% MER of XSB, making it a better choice for any new investment. The lower cost profile will provide it with a better chance at outperforming XSB over the long term, where a higher cost will drag returns.

As we enter the latter part of the year, the outlook for short term bonds remains muted, with Canadian short rates likely to remain lower for longer. That said, short term bonds can still be an excellent way to reduce overall volatility within a portfolio, as the shorter duration makes them less sensitive to interest rates, and less volatile than medium and long-term investment grade bonds, making them solid choice for very conservative investors.

Further, with the higher credit quality offered by this ETF, it is likely to benefit from periods of market volatility on a flight to safety trade if we see any periods of extreme uncertainty in the equity markets.

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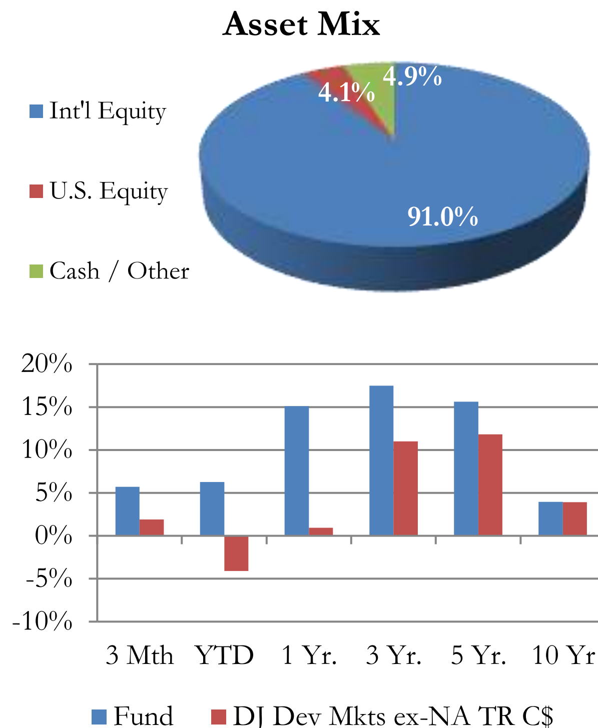
Trimark International Companies Fund

Fund Company	Invesco Canada Ltd.
Fund Type	International Equity
Rating	A
Style	Large Cap GARP
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Jeff Feng since October 2009 Matt Peden since 2013
MER	2.98%
Fund Code	AIM 1733 – Front End Units AIM 1731 – DSC Units
Minimum Investment	$500



ANALYSIS: Since taking the reins in late 2009, manager Jeff Feng has done a great job with this fund, posting above average returns in each year.

Like other Trimark branded equity funds, the managers like to view investing more as taking an ownership in a business, rather than trading stocks. They tend to focus more on the intrinsic value of a company, rather than its share price, leading to lower levels of portfolio turnover. The end result is a high conviction portfolio of quality companies with strong management, free cash flow generation, excellent organic growth. and sustainable competitive advantages.

Investing in non-U.S. based companies, they look to buy good companies trading at a discount to intrinsic value. However, if you look at the portfolio valuation metrics, you will see it is not cheap, trading at multiples that are slightly above the market. A reason for this disconnect is management is willing to pay a higher price for what they believe are high quality businesses. They will not sacrifice quality for price.

This approach has paid off handsomely. To the end of August, the fund has gained an annualized 15.6% for the past five years, outpacing its peers by a generous margin. The outperformance for the past year is even more impressive, gaining 15%, while the peer group was flat.

My biggest concern with this fund would be its cost, with an MER of just under 3%.

Given the investment process, I don't expect the absolute level of outperformance to be sustainable over the long-term, but I do believe it can deliver above average returns with average or better volatility over the long term. I see this as a solid pick for those looking for non-North American equity exposure.

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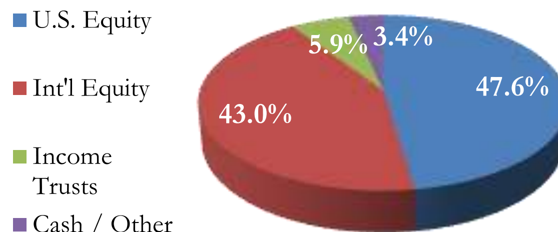
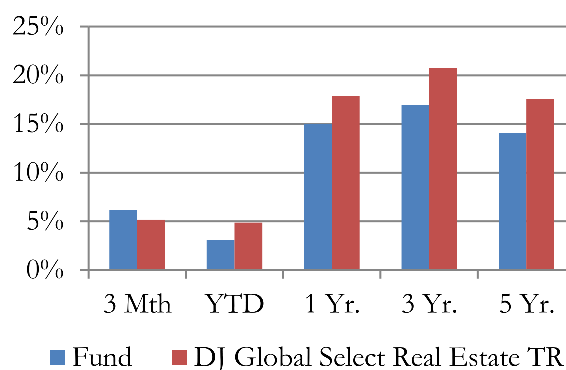
Renaissance Global Real Estate Fund

Fund Company	CIBC Asset Management
Fund Type	Real Estate Equity
Rating	A
Style	Mid Cap Blend
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Joseph Harvey since Oct 2010 Chip McKinley since Oct 2010
MER	2.63%
Fund Code	ATL 1255 – Front End Units ATL 1257 – DSC Units
Minimum Investment	$500





ANALYSIS: Modest economic growth, combined with relatively low interest rates are expected to help provide a level of support for real estate and REITs in the coming months.

This fund, managed by Cohen & Steers invests in a diversified portfolio of global REITs and other real estate securities. Cohen & Steers is one of the global leaders in real estate investing, with more than $52 billion in assets under management, the vast majority of which is invested in real estate. The firm is well staffed, with more than 250 employees, and an investment team that is made up more than 50 people.

The investment process used is best described as a relative value approach, where they seek out securities they believe are mispriced when compared to the underlying assets. To find these, the team uses a mix of top down macro analysis and bottom up security selection.

The top down view helps shape their outlook for the various geographic regions and the different market segments. The bottom up analysis involves a review of each company's management, balance sheet and property portfolio. To help assess this, they meet with each firm's management and conduct site visits for the property portfolio. This all helps shape the inputs for the firm's proprietary valuation model that is used to rank the selection universe.

It is a diversified portfolio, holding around 70 names of all sizes, although it tends to favour mid-cap names. The geographic mix is somewhat similar to its benchmark. Portfolio turnover is high, averaging more than 100% per year.

Given the investment team and reputation of Cohen & Steers, combined with the investment process used, this is a global real estate fund definitely worth taking a more detailed look at.

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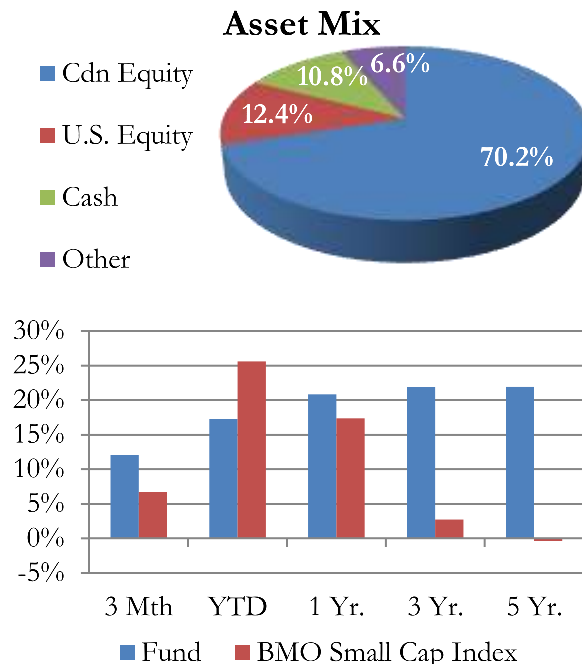
Pender Small Cap Opportunities Fund

Fund Company	Penderfund Capital Management
Fund Type	Cdn Focused Small/Mid Cap
Rating	A
Style	Small Cap Growth
Risk Level	Medium High
Load Status	Front End
RRSP/RRIF Suitability	Good
Manager	Dave Barr since June 2009
MER	2.50%
Fund Code	PGF 315 – Front End Units
Minimum Investment	$2,500



ANALYSIS: With a background in private equity, lead manager Dave Barr brings much of the same approach to the management of this, and other Pender Funds. The approach takes a long-term patient outlook and seeks to find high quality, predictable businesses, with strong management teams, that are trading at a price that is well below what they believe it to be worth.

They are thorough and look to fully understand the businesses in which they are investing. They will spend a great deal of time speaking with suppliers, customers, employees, and of course, senior management. Often times, because the fund focuses on small and microcap names with limited liquidity, they will identify an exit strategy, or catalyst that will enable them to realize the full value of the investment.

The portfolio is somewhat concentrated, holding in the ballpark of 20 to 40 names, with the top ten often making up more than 40% of the fund.

Given the bottom up approach, it looks much different than its benchmark or competition. It is significantly overweight in technology, industrials and healthcare, with little exposure to materials, financials, real estate or consumer defensives.

Performance has been excellent, finishing in the top quartile in every year except 2010 and 2013. It has handily outpaced its peers, posting an annualized five year gain of nearly 22%, while its peers returned a more modest 9.2% rise.

Risk management, specifically capital preservation has been a key tenet of the investment process. Over the past three and five years, this fund has a negative down capture ratio, meaning that it is often flat or positive when the broader small cap market is falling.

While I doubt the past return numbers are repeatable, I do expect this to provide above average returns with average levels of volatility. If you hold this fund, consider yourself lucky, as it is now closed to new investment.

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