Jan 10, 2017

Volume 22

Issue 1

ETF & MUTUAL FUND UPDATE

In This Issue:

Market Radar		
Markets	**TSX Composite**	**S&P 500**
P/E	17.56	20.81
Yield (%)	2.91	2.42
YTD Performance (%)	0.82	1.43
Top Performers	**ETF**	**Mutual Fund**
1-Month	CDN Natural Gas ETF	Aston Hill CDN Total Return
YTD	BMO Junior Gold ETF	AlphaNorth Resources
3-Year	BMO Low-vol US Equity	Dynamic Precious Metals

Market data as of January 9, 2017; top performers as of month-end.

Note: We are no longer including leveraged ETFs in top performers list

The Year That Was

By Ryan Modesto, CFA

What a year it has been! Upon taking over this publication who, nor we, would not have expected a Brexit, an incoming President Trump, US markets hitting record highs and Canadian markets rallying 18% as the year-end approaches. Not only was there a great deal of historic developments but the markets continued to rally regardless of how negative one thought a development would be. In our mind, this is a testament to the difficulty in timing the markets and the importance of staying invested in a balanced manner. Investors who went to cash before the election, even if they got the election result correct, likely got the market reaction wrong. The same goes for Brexit. Market moves such as in US financials were so quick that if investors did not have a bit of exposure across sectors, they likely found themselves chasing a sector after a lot of the gains (so far) had already been had.

This is the reason why ETFs and Mutual Funds are such an important part of a portfolio. The individual investor no longer needs to keep a constant eye on the markets and holdings to ensure they are generating appropriate gains. Holding a basket of funds can ensure the investor benefits when a sector or market comes into favour. Upon achieving easy and appropriate diversification, an investor can then look to active returns through mutual funds, tactical weightings across ETFs or security selection. While it was a treacherous year from a news flow perspective, it truly has never been a better time to be a Do-It-Yourself (DIY) investor. While it is a great time to be an investor, it is also getting more convoluted as a multitude of products flood markets, making a decision between products all the more difficult. This is a primary area we hope to continue to add value through: Cutting through the deluge of product and the marketing noise to highlight the funds that are worth your hard-earned dollars. In addition to fund specific commentary we also hope to continue to point to geographies, sectors and/or strategies that deserve investor attention or are showing promise and finally but probably most importantly, to educate our readers and make you a better, more confident investor. With that, let us look at some trends that formed in 2016 and some to look forward to in 2017.

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The Rise of the ETF

According to Lipper, for the week ended November 18th, Equity ETFs saw their largest weekly net inflows in history, with assets growing by $27 billion. Contrast this with mutual funds, which saw net outflows of $3.4 billion, adding to 36 straight weeks of net outflows in equity mutual funds. Increased reporting requirements on mutual funds through the CRM2 implementation in Canada also means that there will be enhanced fee disclosure on statements by the end of Q1 2017. These developments and trends will likely continue to push ETF inflows higher, drive new product introductions while potentially bringing mutual fund costs lower.

Benchmarking Gets Exposed

The year has not been kind to active managers with short-term and long-term performance lagging most passive benchmarks. While there could be multiple reasons for this, we think the big reason behind this is that of hugging holdings so close to the respective benchmark that after fees; underperformance is the only option in most cases. This issue was exposed with the decline in oil in the past with many managers tracking the TSX seeing large drawdowns because they were holding weights so close to an arbitrary Canadian benchmark that is dominated by energy, financials and materials. Any investor that believes in diversification knows that holding 57% of a portfolio in financials and energy sectors (68% when we add in materials) is not appropriate yet we see it in numerous funds that charge fees for active risk management. We think investors are talking with their money though and now that there are so many passive, low-cost options, higher cost fund managers will have no choice but to stop hugging benchmarks or lower their fees. Benchmarking performance to an index is important when evaluating how a manager has fared but it appears it has had unintended consequences of funds simply trying to match an index and squeak out a small gain on the year with minor tilts. We think and hope that 2017 will be a year where investors become less concerned with how the benchmark did and more concerned with how a fund performed relative to the amount of risk that was assumed.

Bond Bull Market Is Over

This will perhaps be the most difficult adjustment for many readers that have ridden the bond bull market over the last few decades. Those securities that promised safe, consistent returns (and still do in the scheme of things) may start to show losses on individual statements. Interest rates are rising and US policies may actually drive inflation, leading to more rate hikes than expected. While Canada is obviously not the US, interest rates do tend to follow our neighbours to the South. This means that there will likely be many pieces coming out of the woodwork suggesting that fixed income is useless and is a guaranteed loss. Put simply, do not listen to this talk. While arguments can be made for decreasing fixed income exposure, tossing the whole asset class to the side is dangerous and goes back to the issue of timing markets and flies in the face of the benefits of diversification. As long as there is a positive yield-to-maturity, fixed income should provide a positive return over time. Cash earns next to nothing while equity could continue its run or see a drawdown any given year. Fixed income at least provides a bit of a return while acting as a source of cash if a downturn does occur. To be clear, fixed income is hardly an area that excites us but this does not mean the whole asset class should be cast aside.

Given the series of events in 2016, trying to discuss what 2017 could hold seems pointless. Markets will go up and they will go down in the short-term. Keeping fees, taxes and costs as low as possible will continue to be a key, as will

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prudent saving strategies. What investors least expect or are not even considering as a risk will almost certainly happen and what the markets and media are already talking about is probably priced in to a large degree.

Finally, we just wanted to give a big thank-you to our readers and contributors both new and old. This letter would not exist without you. We have made some changes over the year and are now in a position where we hope to add even more value in the new year. We hope you had a great holiday season and have enjoyed the articles in 2016. We are happy to hear about any topics you would like covered in 2017 (but cannot promise all will be covered). We wish you all the best in 2017 and hope that it is a profitable year for you.

Mutual Fund Spotlight: Floating Rate Funds

By Michael Southern, CFA

Investors in the bond market have had to deal with two primary challenges over the last five years:

1) Searching for a better yield in a low rate environment
2) The eventual lift-off in near-zero interest rates, ending the 35-year bond bull market

Understanding this, many income investors have reached for yield further out on the credit risk spectrum and have kept duration shorter where possible. Combining these objectives with the fact the United States (U.S.) Federal Reserve (FED) has just raised interest rates by 25 basis points (bps) for the second time in a year, floating rate ("FR") notes are attracting a lot of attention.

Investment Options

Table 1 lists some of the more popular Canadian FR mutual funds. We have also listed iShares Canadian Short Term Bond (XSB) for comparison purposes, as the Exchange Traded Fund (ETF) can be viewed as a proxy for traditional, short-term bonds. Readers will likely notice the superior mutual fund yield vs. the traditional bond ETF, while at the same time benefitting from a drastically lower duration. Yields offered by FR notes typically fall somewhere between yields on investment-grade bonds and high-yield bonds.

Table 1: Comparison of Popular Canadian FR Mutual Funds

Ticker	Name	AUM ($M)	MER	Yield to Maturity	Duration
MFC4324	Mackenzie Floating Rate Income Fund	392	2.0%	7.3%	0.7
MMF4573	Manulife Floating Rate Income Fund	241	1.7%	N/A*	N/A
GGF626	BMO Floating Rate Income Fund	44	1.7%	N/A*	0.51
AIM1233	Invesco Floating Rate Income Fund	325	1.7%	3.5%	0.69
AGF4076	AGF Floating Rate Income Fund	271	1.8%	3.3%	0.40
XSB	**iShares Canadian Short-Term Bond**	**2,345**	**0.3%**	**1.4%**	**2.83**

FR mutual funds usually invest at least 70.0% to 80.0% of their investment holdings in FR bank loans. These securities are loans made to higher risk borrowers. The Manulife and AGF Funds show the highest FR bank loan allocation at +90.0% while the BMO product is the lowest at a 57.0% allocation.

In conjunction with FR bank loans, investors will also see these mutual funds holding high-yield corporate 'junk bonds'. When combined with the FR bank loan allocation, the two typically account for almost the entire bond portfolio. This risk should not be overlooked. For example, more than 90.0% of the BMO and AGF portfolio have a credit rating of less than 'BB'. Therefore, the higher yield and income earned by our sample mutual funds is compensation for credit risk.

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Taking a Look Under the Hood

FR mutual funds usually invest their capital primarily in FR bank loans. What is a FR bank loan? These are variable-rate loans made by banks to companies that are generally considered to have low credit quality. After banks facilitate the loan, they typically sell them to asset managers. The interest paid on FR bank loans adjusts periodically, usually every 30 - 90 days, based on changes in widely accepted reference rates, like LIBOR/CBOR, plus a pre-determined credit spread over the reference rate.

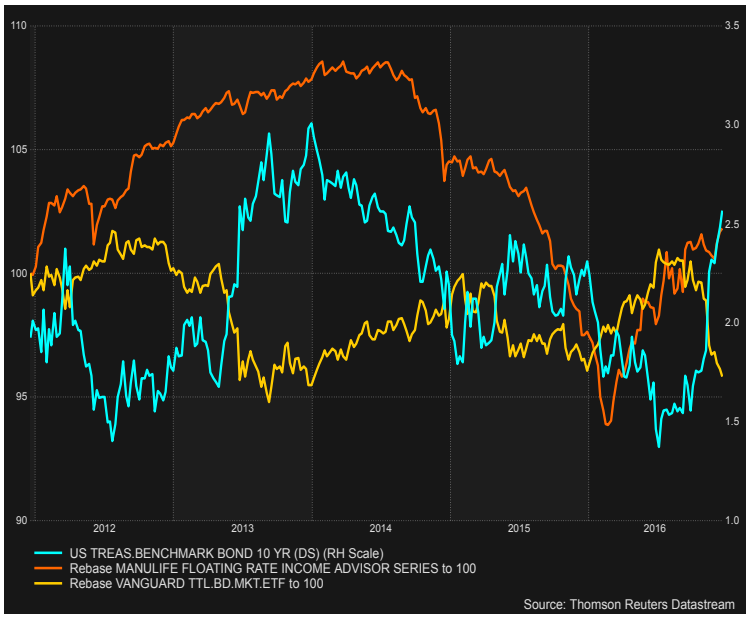
Protection Against Rising Interest Rates

Investors look to FR funds for the low duration. FR notes have a maturity date, similar to a traditional, fixed rate bond. However, because the coupon is tied to a reference rate and resets frequently, this has the effect of driving the duration on the note closer to zero. Table 1 shows all products offer a duration lower than one. This is significantly below XSB at 2.83, a proxy ETF for short-term, traditional bonds. A zero duration means the note will not lose value if interest rates rise. Instead, the FR note will almost immediately benefit by paying a higher coupon vs. the traditional, fixed rate bond that now offers an inferior rate in relative terms. This tends to lift the price of floating rate notes and makes them an attractive fixed income investment in the current environment where the U.S. FED has just raised interest rates, and is expected to do so at a more aggressive pace in 2017.

In addition to benefitting from an increase in the underlying reference rate, a diverse portfolio of FR loans should perform well when the economy is recovering and credit spreads are tightening. For example, year-to-date the Mackenzie, Manulife and AFG products from Table 1 are all up 9.0% while the BMO and Invesco funds are up 5.0%.

Meanwhile, XSB is down 1.5% and the broad Canadian bond market is down 2.0% (as represented by iShares Canadian Universe Bond Index ETF XBB). In Table 2 we highlight this relationship using the Manulife Fund. Other funds show similar profiles.

Table 2: Manulife FR Fund Performance



The blue line is the yield on a 10-year U.S. Treasury bond. This measure is often quoted as a proxy for expectations on both the direction of future interest rate increases and economic growth. We have seen higher volatility in the benchmark rate during 2016. With a December 2015 rate hike and a poor start to the year for equity markets, investors forecast the U.S. FED would delay further increases in interest rates. Here, the Manulife Fund followed yields lower. Over 2016, the U.S. economy strengthened and credit spreads tightened, culminating in a December 2016 rate hike. The Manulife Fund significantly benefitted from these developments. During December 2016, the fund is up 1.5% while the general bond markets have sold-off.

Is There a Catch

FR funds can outperform in a rising rate environment but if rates decline, or even just remain flat, the notes can underperform.

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In poor equity market conditions rates are likely to fall, as investors rush to safety and high credit quality bond portfolios outperform. For example, the BMO Fund lost more than 48% in 2008 as high-yield bonds cratered along with stocks and real estate. The Invesco Fund also took a 28% haircut that year. Clearly these funds are not a substitute for short-term investment-grade bonds or cash.

This brings us to our second pitfall, which is credit risk. Unfortunately, credit risk tends to show up at exactly the wrong time: when equities are getting hammered. FR funds are more stock-like in terms of their behaviour in that they can be more volatile than other bond types and are generally more correlated to equities. They also see drawdowns in weak credit markets, when investors flock to higher-quality debt instruments.

Consider that in 2008, when the S&P 500 lost 37.0%, the average bank loan fund in the U.S. lost 30.0% while the average high-yield bond fund lost 26.0%. By comparison, the Barclay's U.S. Aggregate Bond Index of investment-grade bonds gained 5.0% that year. Bank loan funds' volatility makes them a poor choice for fixed income investors in search of a more stable alternative to stocks.[1] Vanguard observed that for the period from February 1992 through June 2013, the correlation of returns on floating rate notes to both short-term and long-term Treasuries was -0.3. On the other hand, the correlation to high-yield corporate debt was 0.74 and 0.44 to the U.S. equity market. Said another way, floating rate notes are a lot like junk bonds and more similar to stocks than treasury bonds.[2]

Floating Rate ETFs: Middle of the Road?

In addition to mutual funds, investors can access the FR space via ETFs. However, ETF strategies can vary significantly from their mutual fund counterparts. Here we highlight iShares Floating Rate Index ETF (XFR) and Horizons Active Floating Rate Bond ETF (HFR). Unlike FR mutual funds, these ETFs do not make use of FR bank loans, resulting in a notably improved credit profile. This strategy divergence is reflected in the lower yield to maturities (YTM) for the ETFs.

Table 3: Comparison of FR ETFs

Ticker	Name	AUM ($M)	MER	Yield to Maturity	Duration
XFR	iShares Floating Rate ETF	225	0.2%	0.9%	0.21
HFR	Horizons Active Floating Rate Bond ETF	366	0.4%	1.9%	0.27
XSB	**iShares Canadian Short-Term Bond**	**2,345**	**0.3%**	**1.4%**	**2.83**

In our opinion, these ETF strategies are unique when compared to their mutual fund counterparts. For example, HFR is primarily an investment-grade corporate bond ETF, designed to keep pace with prevailing short-term corporate bond yields while stabilizing the market value of the ETF from the effects of interest rate fluctuations. We can see this stability profile in Table 4, which is even more pronounced for XFR, as the latter ETF holds mostly government securities. We would even view HFR as a decent place to park some cash that will be needed in the short-term, as you receive a better yield than a cash account/GIC, and your principal should be relatively stable. Of course, a fund with this exposure can lose money in a 2008-type crisis, but far from poor returns seen in high-yield products during black swan events. These high-quality bonds are not likely to see a significant decline in value when markets panic. Overall, XFR and HFR continue to provide protection against rising interest rates and do so with less volatility than their mutual fund peers.

[1] http://cawidgets.morningstar.ca/ArticleTemplate/ArticleGL.aspx?id=598675
[2] http://mutualfunds.com/news/2016/02/02/floating-rate-note-funds-too-good-to-be-true/

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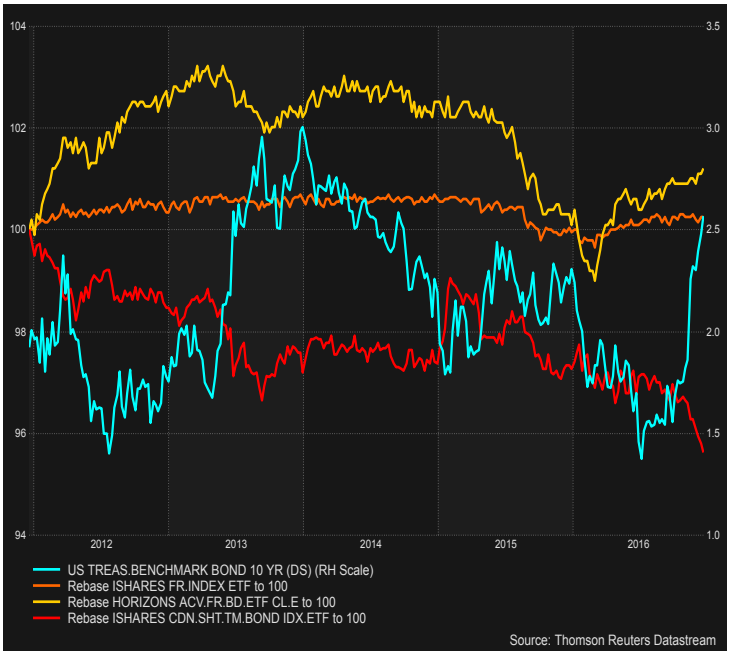
The catch here of course is that you sacrifice yield for credit quality.

Table 4: FR ETF Performance



Closing Thoughts

Every bond investor has spent the last few years worrying about rising interest rates; with the U.S. FED now increasing rates twice over the last year, FR funds are a viable hedge to this environment. While the yield offered on FR mutual funds is certainly attractive, do not be fooled into thinking you can have your low duration 'cake and eat it too'. FR mutual funds generally invest in the debt of low credit quality borrowers so they should be considered a riskier part of your portfolio. Like junk-bond funds, most securities held by bank loan funds are rated BB or lower and the companies that issue the bonds may be heavily leveraged, which raises the risk of default. You can improve the credit quality by using an ETF product; however, this of course comes at a reduced yield.

For long-term investors, a traditional bond allocation will provide more protection when equity markets take a tumble, and that is the most important role of fixed income in a portfolio. Look to FR mutual funds as a complement to your traditional fixed income portfolio, as a means to provide some extra income in a low-yield world, and as a diversifier in a rising rate environment.

Canadian MoneySaver Portfolio Update

By Michael Southern, CFA

We are quite pleased with the performance of the Canadian MoneySaver (CMS) model portfolio. Over 2016, the CMS portfolio is up 13.3% including cash distributions. On a price basis alone, the portfolio showed a 10.6% return versus our benchmark return of 9.2% over the same period. This resulted in our portfolio adding 1.4% of alpha over the benchmark.

There will be plenty of opportunities in both equity and bond markets during 2017. It may surprise our readers that we will be making limited changes to our positions. In our opinion, the CMS portfolio is well diversified by region and sector, and is properly positioned to both take advantage and avoid some of the trends we are seeing play out in markets 'today'. The one trade we have made as of December 31, 2016 is outlined below.

- Buy: 3.0% position in Vanguard Dividend Appreciation ETF (VIG)
- Sell: 3.0% positions in iShares S&P/TSX Canadian Dividend Aristocrats Index ETF (CDZ)

Both are of course dividend growth strategies but the trade will tilt the portfolio to positive tailwinds out of the U.S. and will better balance equity sector exposures.

Investment Objectives

The CMS portfolio allocation reflects a growth strategy and is appropriate for the higher risk equity investor. Our target allocations are as follows: equity (75.0%), fixed income (22.0%) and cash (3.0%). Our current allocations are all within 1.0%

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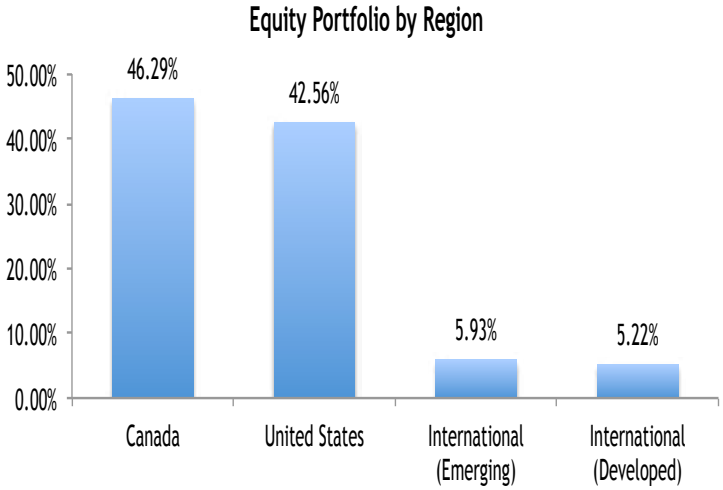
of the targets. Within the equity category, our regional targets are Canada (50.0%), U.S (40.0%) and international (10.0%).

From an asset class perspective, we remain comfortable with the higher equity allocation. While many investors are quick to point out valuation risk, investors are increasingly f ocused on the end of the 35-year bond bull market and the 'great rotation' out of fixed income and into stocks. The catalyst for this discussion has been the jump in the U.S. Treasury yields on the back of the most recent U.S. Fereal Reserve (FED) 25 basis point (bps) rate hike. Although the bond market has sold off with iShares Canadian Universe Bond Index ETF (XBB) down -4.1% over the last three months, our positions in iShares S&P/TSX Canadian Preferred Share Index ETF (CPD) and iShares U.S. High Yield Bond Index ETF (CAD-Hedged) (XHY) are up 4.0% and 0.5%, respectively. We like this higher risk fixed income balance against the more conservative XBB and iShares 1-5 Year Laddered Corporate Bond Index ETF (CBO) holdings, as both CPD/XHY can benefit from a rising rate environment in conjunction with improving economic growth. The yields are also very attractive. However, with a rough split between XBB/CBO and CPD/XHY, this is a higher risk fixed income portfolio already so we would not load up on these names beyond current levels.

Regional Exposure

Against the U.S. target allocation of 40.0%, we are slightly overweight (at the expense of Canada). While the U.S. market is likely the most expensive on a valuation basis, it also remains one of the most diverse and resilient economies. One risk we see facing global markets in 2017 is the OPEC deal. A non-cooperation issue or a meaningfully different agreement once the current deal expires in six months could be a source for higher volatility in commodity economies. In such an environment, we would expect to see capital rotate to safe-haven assets or economies, such as the U.S.

From a risk management perspective, we see the lower international equity allocation as a prudent move, especially when considering the combined effects of the higher risk international economies with the small-cap allocation via iShares Russell 2000 Growth ETF (IWO). Admittedly, we are seeing some positive momentum in international (developed) economies and valuations remain attractive across the group. However, there are simply too many prospective headwinds or unknowns to make us comfortable with a larger allocation. Growth remains elusive in Europe and the 'Brexit' deal continues to evolve with little insight into long-term impacts. With rising U.S. rates, we could see capital flow out of emerging economies in search of improved risk-adjusted returns. Our current regional allocations are as follows:



Sector Exposure

Going forward into 2017, we see opportunities tilting the portfolio to growth sectors and going underweight on defensive sectors. The latter traditionally include consumer staples, utilities and telecommunications. These sectors have done very well over 2016, particular utility stocks. However, we are seeing prices pull back over the last few months and valuations in all three are very high. For example, the consumer

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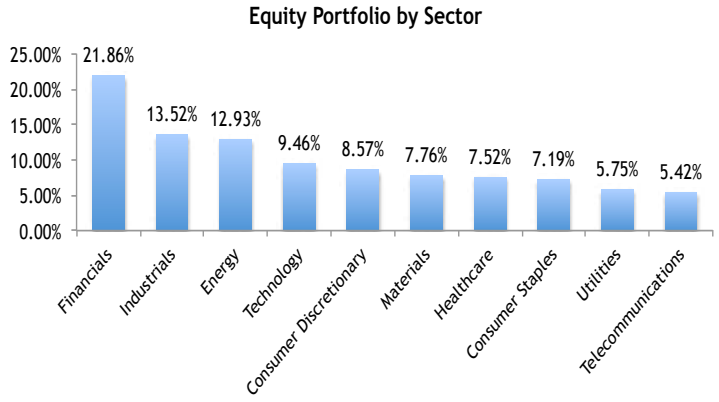
staples sector is trading at a forward Price/Earnings (P/E) fundamental of 20.1x and only yields 2.0%. With higher U.S. interest rates and expectations for a more aggressive FED approach in 2017, investors have started rotating capital out of dividend equities for better risk-adjusted yields elsewhere. These defensive sectors form the bottom three allocations for the CMS portfolio at an average weight of 6.1%. At this lower weight, we still see the portfolio as being fully diversified, as we often view 5.0% as a lower bound for lesser conviction sectors. Given that this is predominantly a growth portfolio, a lower allocation to defensive sectors continues to makes sense.



Of course, defensive sectors are not the only place where investors can find yield. Indeed, financial, industrial, energy and consumer discretionary sector equities can all offer attractive payouts. However, these sectors also benefit from increasing economic growth and investment. Such growth sectors represent the top allocations of the CMS portfolio with financials being the largest at 21.9%. We prefer to see no one sector account for more than 20.0% of the equity portfolio; however, the financial sector is traditionally driven higher by rising interest rates and economic growth. We have of course witnessed a run-up in financial sector ETFs over the last month and think this trend should continue into 2017. Most of the financial sector allocation is in Canada but the valuations are better domestically versus the U.S. The sector is trading at a forward P/E of 11.5x (only healthcare is cheaper) and yields 4.1%. With an improving price of oil and generally better oil landscape, we are 'ok' with the higher energy allocation. We are seeing some positive revisions to the sector with increasing production targets and capital expenditure (CAPEX) budgets.

Canadian MoneySaver MODEL ETF PORTFOLIO

ETF	Symbol	Category	Price	Units	Total	% of Portfolio
iShares 1-5 Year Laddered Corporate Bond	CBO	Fixed Income	18.93	506	9,578.58	7.6%
iShares DEX Universe Bond	XBB	Fixed Income	31.12	166	5,165.92	4.1%
iShares S&P/TSX Canadian Preferreds	CPD	Fixed Income	13.25	460	6,095.00	4.9%
iShares S&P/TSX Capped Composite	XIC	Equity: Canada	24.21	980	23,725.80	18.9%
iShares S&P/TSX Cdn. Div Aristocrats	CDZ	Equity: Canada Div.	26.65	562	14,977.30	11.9%
iShares U.S. High Yield Bond Index ETF	XHY	Fixed Income	19.87	350	6,954.50	5.5%
Vanguard FTSE Emerging Markets Index	VEE	Equity: Emerging	28.90	194	5,606.60	4.5%
Vanguard FTSE Developed Europe All Cap	VE	Equity: Interntional	25.36	194	4,919.84	3.9%
SPDR S&P 500	SPY	Equity: U.S.	223.53	33	9,884.50	7.9%
Vanguard Div. Appreciation Index	VIG	Equity: U.S. Div.	85.18	116	13,240.38	10.6%
iShares Russell 2000 Growth	IWO	Equity: U.S. Growth	153.94	69	14,233.29	11.3%
BMO Covered Call Utilities	ZWU	Equity: N.A. Div	13.83	437	6,043.71	4.8%
Cash	Cash	Cash			5,074.06	4.0%
Total Portfolio					**125,499.48**	

Exchange Rate	1.34	$ Gain/(Loss):	25,499.48
Inception value:	100,000.00	% Gain/(Loss):	25.50%
Inception date:	October 18, 2013	% Annualized:	7.34%

Prices are at market close on Dec 30, 2016.
Individual prices are in USD$. Portfolio values, $Gain/(Loss), % Gain/(Loss), % Annualized all reflect USD$ values are converted to CAD$

Current notes: as of Dec. 30, sold a 3.0% position in CDZ and bought a 3.0% position in VIG.

Other notes: Keep in mind all investors are different. This portfolio is designed as a guide in setting up your own personal portfolio. Unique considerations and adjustments need to be made to reflect your personal situation. Please perform your own due diligence before making investment decisions.