Top Funds Report

Solid first-quarter gains despite tremors

Yield curve inversion fears may have been overstated.

Stock markets rallied for a third consecutive month in March, to start the year with impressive first-quarter gains. Large-cap equities led the leaderboard in higher monthly gains. However, volatility also ticked higher in the month.

The S&P 500 Composite Index rose 1.9% in USD, or 3.4% in CAD. Toronto's S&P/TSX Composite gained 1.0% on the month, turning in a reasonable showing despite a 1.9% loss in the Energy index and a decline of 1.2% in Financials.

On the world stage, the MSCI EAFE Index gained 0.7% in USD (2.3% in CAD), while the MSCI Emerging Markets Index rose 0.9% in USD (2.3% in CAD).

Small-cap issues in general struggled as volatility ruled the month. The Russell 2000 Index dropped 2.1% in USD (down 0.7% in CAD) in the month, while the S&P/TSX Small Cap Index retreated 1.1%.

Bond markets, meanwhile, moved higher as yields tracked lower on aggressive central bank dovishness in the face of slowing economic growth data. In fact, bond futures indicate that there is only a very low probability that central banks will move rates higher in either Canada or the U.S.

March also witnessed the yield curve invert in both Canada and the U.S. The 30-day/10-year curve inverted, but the curve for the more widely followed 2-year/10-year terms remained more normal. Yield curve inversion has typically been a strong indicator of an imminent recession; however, there have also been many false signals.

An inversion is not usually a one-time event, but rather more of a process. We would need to see the curve remain inverted for a long period of time or see more inversions before we become too concerned

Economic data are still mostly positive, although there are signs of slower growth. The real test will be the next earnings season, which is currently underway. Earnings forecasts have been trimmed substantially, so if we see a lot of earnings misses, expect to see a lot of volatility to the downside. However, if we see many companies exceed their forecasts, more upside is possible.

Meanwhile, the global trade environment continues to be a headwind. The U.S. and China move haltingly towards a trade deal, but the sides are still considerably far apart. Many market participants have noted that the outcome remains somewhat asymmetric – if a deal does get done, they expect to see a short-term, but unsustainable bounce, as most of the "good news" has already been baked into stock prices. However, if a deal is not reached, they expect significant swings in volatility and potential selloff.

I continue to favour equities over bonds, although only slightly. I favour more defensive types of funds,

		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		

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including many of the low-volatility and dividend-focused funds. I lean to U.S. equities with a slight overweight, but I may move to more neutral positioning if we continue to see valuations pushed higher or significant weakness in earnings.

For fixed income, I favour lower-duration, higher-quality issues. I remain underweight high-yield issues, because if we see a meaningful slowdown, there are a significant number of BBB-rated issues that may be downgraded, putting pressure on prices and pushing up yields.

In this environment, I remain consistent with my investment outlook, as shown in the accompanying allocation matrix.

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

Understanding our Fund Ratings…

The ABC of our ABCs

One of the questions I get asked frequently by investors is why certain funds that I really like rate so poorly on my rating system. It's a really good question that deserves a more detailed answer. With literally thousands of mutual funds available I wanted to develop a way to be able to quickly review as broad a universe as possible and identify those funds that are worth conducting a more detailed research analysis. But how to do this?

A very quick and easy method used by many analysts and data suppliers is to simply look at the historic returns and quartile rankings of funds over different time periods and focus on the best performers. The problem with this is that it focuses only on return, and like the disclaimer says, past performance does not guarantee future performance.

Another problem with the raw historic method is that it looks at returns exclusively and sets aside the risk a manager has taken on to earn those returns. Moreover, looking at annual numbers doesn't really show the full path a fund has experienced.

To solve this problem, I looked at several of the better mutual funds around. I then went back five years to look at how the funds had performed previously. Through this analysis, I found some similarities that were present in those funds. Very simply, higher-quality funds tended to consistently generate value-added performance with less volatility than other funds. I also found that the "better" funds also tended to look different than their benchmarks.

Quantitative factors

With this insight in my pocket, I started looking at the following specific metrics to help quickly measure this the manager risk factor:

Alpha. This is the excess return that a manager has been able to generate. The higher the Alpha, the higher the score.

Sharpe Ratio. This is a measure of risk-adjusted performance, indicating how much return an investment has delivered for each unit of risk assumed. The higher the Sharpe Ratio, the more return the investment has delivered for each unit of risk.

Standard Deviation. This is a measure of volatility, or risk that gauges the fluctuation that an investment has exhibited. The higher the standard deviation, the more fluctuation the fund has shown, so the lower the score it receives in the ratings model.

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Information Ratio. This ratio measures how consistently a manager has outperformed the fund's benchmark. It is basically the Sharpe Ratio of the monthly excess returns. As with the Sharpe Ratio, the higher the better.

Batting Average. This is another measure of how consistently the fund has outperformed. While the information ratio will factor in the level of outperformance, batting average is a measure of how frequently. It's like the win/loss percentage in baseball. A batting average of .500 means the fund has outperformed as often as it has underperformed. The model favours funds that win more than they lose. The higher the batting average, the better the score.

R-Squared. This is a statistical measure that shows how much of an investment's return is the result of the benchmark. The higher the R-Square, the more the fund behaves like the benchmark. And as we know, if you want to beat the benchmark, you can't be the benchmark. The model favours those funds that have a lower R-Squared.

Each month, every fund in my universe is put through my model. My model measures each of these factors and assigns a score between 1 and 5. The score is based on how the fund measures up compared with its benchmark. The better it performs on these metrics, the higher the score.

The scores are added up, and a rating assigned based on how the fund scores, as shown in the accompanying table.

Fund Score	Rating
More than 80%	A
65% to 80%	B
55% to 65%	C
40% to 55%	D
Below 40%	F

The funds are then grouped by fund type and sorted by rating followed by Sharpe Ratio. Now some would think that the process is now complete. Not so. This is really where the more difficult work begins. After the funds are put thorough the model, all I really have is a list of funds that have characteristics that have been found in funds that go on to outperform.

But what I don't know is how those returns were achieved. Without that understanding there is no indication of whether those results were from manager skill or luck. To better help us separate luck from skill, we need to do a qualitative review that looks to understand the investment manager, their investment process, buy and sell criteria, portfolio construction methodology, and risk management framework.

Once that process is complete, I have a much better understanding of the fund and its management. I am therefore in a much better position to assess whether the historic return is likely to be repeatable.

Qualitative analysis

Now where I think some of the confusion comes in is that the ratings consider only the quantitative aspects of a fund. However, it is the qualitative analysis that really sheds light on the fund.

The way I use the ratings is two-fold. First, I identify high-quality funds that are worth a more detailed qualitative review. Second, I use the ratings as an early warning signal for erosion to the risk-reward metrics of a fund. If I notice a fund is falling in its quantitative scores or starting to lose position relative to its peers, I will investigate the qualitative part to understand why this is occurring.

In a perfect world, I would be able to do the full qualitative analysis on all funds. The reality is that with several thousand funds available, it is simply not practical to do so, so I need to filter my results.

Now this brings us to the question of why some of the funds I really like rate so poorly. Simply put, they don't necessarily score as well on the quantitative analytics but still have excellent management teams using disciplined

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and repeatable investment processes that I believe are more likely to deliver above-average risk-adjusted returns than their peers.

A great example is a recent review I did on the **Mawer Balanced Fund**. I see it as an excellent, high-quality fund, yet it is ranked a D. Digging deeper, while it may have that D rating, it is ranked number 22 out of more than 185 global balanced funds. Further, if I look at the Sharpe Ratio, it would be ranked in the top five.

Looking specifically at the factors, the Mawer fund loses points for having an R-squared that is higher than some of its peers, which hurts its final score. However, the investment management team and the investment process they use are top tier. So, while the rating may be lower than some others, the qualitative aspect more than makes up for it, making it a fund to consider.

While this not a perfect system, it has proven to be very effective in helping me identify very strong funds. I hope that with this insight into my rating system, it will prove helpful to you as well when analyzing funds for investment.

Funds of Note

Management changes at Franklin Templeton and Manulife funds…

Franklin U.S. Rising Dividends Fund manager change – In late March, Franklin Templeton announced that long-time manager Don Taylor will retire as fund manager on Sept. 30, after 37 years in the business. As a result, as of April 1, portfolio manager Nick Getaz, who has worked with Mr. Taylor for eight years, has been named co-lead manager. Matt Quinlan, an analyst and portfolio manager with Franklin Templeton for 13 years, has also been named co-lead manager.

At this stage, there are not expected to be any changes to the strategy, or the implementation of the investment process and Mr. Getaz is expected to provide some continuity. Still, anytime there is a meaningful change to a management team, there is the potential for some disruption.

I will continue to watch the fund closely for any meaningful change to the risk-reward metrics, both to the positive and the negative.

Manulife Dividend Income Plus Fund (MMF 4548 – Front End Units, MMF 4748 – Low Load Units) – Last month, we highlighted the Manulife Dividend Income Plus Fund as one of our Top Funds for March. Imagine my surprise on March 29 when we learned that lead manager Duncan Anderson would be leaving Manulife at the end of September.

On the surface, this appears to be unfortunate. But closer investigation reveals it's not nearly as bad as it first appears. First, while Mr. Anderson is one of the leads, he is part of a very well-staffed Value Equity team which has ultimate responsibility for the management of the fund. Veteran manager Alan Wicks, who heads the Value Equity team and has been with Manulife since 1996, remains. Still, Mr. Anderson was a key member of the team, and his departure will most certainly be felt.

Second, the transition period is very long. Mr. Anderson will step down at the end of September, providing significant runway for his replacement, Prakash Chaudhari, Managing Director and senior portfolio manager, to seamlessly transition into the role and provide continuity for investors. Mr. Chaudhari is well equipped to assume the role, having worked closely with Duncan Anderson and Alan Wicks for more than 12 years.

There are not expected to be any significant changes because of this departure, but I will continue to monitor the fund closely to ensure there is no meaningful erosion in its risk-reward metrics.

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

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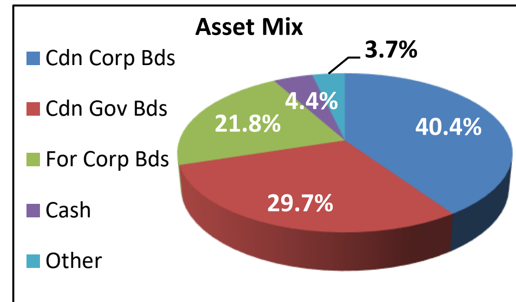
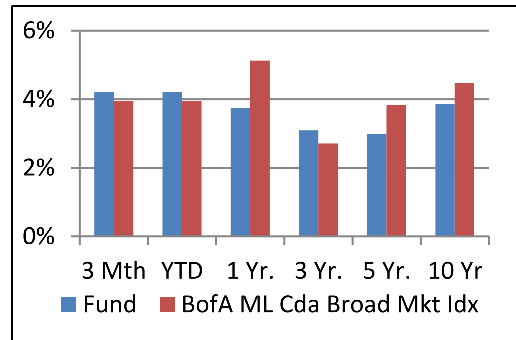
Franklin Bissett Core Plus Bond Fund

Fund Company	Franklin Templeton Investments
Fund Type	Canadian Fixed Income
Rating	D
Style	Top-down macro analysis
Risk Level	Low
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Darcy Briggs since December '14 Thomas O'Gorman since July '10
MER	1.43%
Fund Code	TML 200 – Front-End Units TML 515 – Low-Load Units
Minimum Investment	$500





ANALYSIS: Despite a rocky 2018, this continues to be one of my favourite Canadian bond funds. Most of the pain was felt in the fourth quarter of 2018, where it trailed the index and peer group, owing to its overweight to corporate bonds. But that positioning has led to its strong first-quarter outperformance, as corporates strongly outpaced governments.

This remains one of my top picks. The fund targets returns in excess of between 50 and 150 basis points over the benchmark with a Canadian-focused mandate that allows the managers to invest across the Canadian fixed-income universe.

Headed by Tom O'Gorman, the management team uses a process of top-down macro analysis and bottom-up sector and security analysis. The top-down analysis looks at broad global economic trends in interest rates, growth, inflation, central bank policies, and sector fundamentals to determine the most attractive areas for investment.

Individual security selection is done using a bottom-up credit analysis process that considers valuation, duration exposure, strength of the underlying financials and fundamentals, quality of management, and liquidity.

This is a "core plus" mandate, so the managers have some additional tools in the toolbox. Up to 25% of the portfolio can be held in high-yield issues. It can also invest up to 30% outside of Canada, of which 10% of currency exposure can be unhedged.

Over the long-term, performance has been above average with the fund marginally outpacing its peers over the past five years, but handily outperforming over the past three years, with an average annual compounded rate of return of 3.1% compared with 2.2% for the peer group. Year to date, it is also well above the peer group.

Volatility has been in line with the index. Most impressive, though, is the way the fund has protected capital in down markets. Over the past three years, it has participated in only two thirds of the market drawdowns, and just shy of 70% over the past five years. This, combined with the relatively low 1.43% MER for advisor-sold units, make the fund a compelling option in the Canadian fixed-income category.

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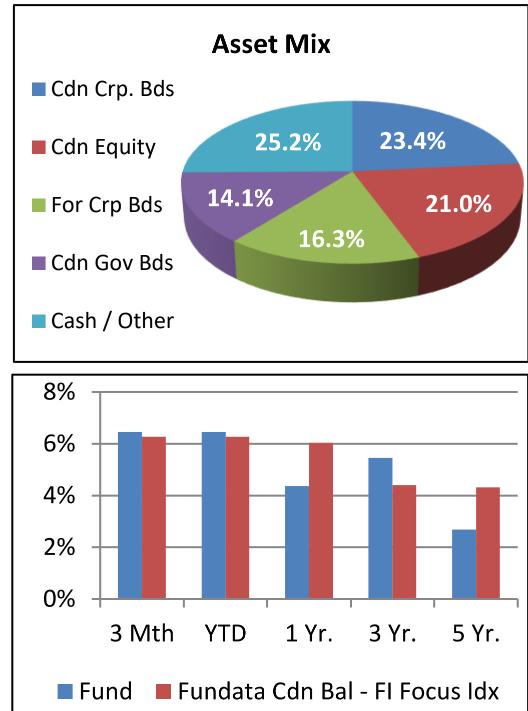
Invesco Monthly Income ETF Portfolio

Fund Company	Invesco Canada
Fund Type	Canadian Fixed Income Balanced
Rating	D
Style	Blend
Risk Level	Low
Load Status	Optional
RRSP/RRIF Suitability	Good
Managers	Duy Nguyen since January 2010 Jacob Borbridge since Jan 2010
MER	1.70%
Fund Code	AIM 612023 – Front-End Units AIM 61207 – Fee-Based Units
Minimum Investment	$500



ANALYSIS: One of the fastest growing areas in the ETF sector is the introduction of funds that invest in a basket of underlying ETFs. Among the several options available, this offering from Invesco looks to generate a high level of monthly income and some growth of capital over the long-term.

The fund changed its mandate in early 2018 to ETFs from mutual funds. Understandably, it has a heavy bias towards income-generating investments, with a target asset mix of 57% fixed income and 43% equities. At the end of March, it had just under 2% in cash, about 35% in equities, and the balance in fixed income and preferred shares. It achieves this mix by holding Invesco ETFs.

The fixed-income holdings are very well diversified across term structure and credit quality, including government and corporate bonds, high-yield bonds, and bank loans, along with preferreds.

On the equity side, the fund focuses on dividend and low-volatility stocks with 70% of its assets in Canada, 23% in the U.S., and the rest around the globe. The underlying asset mix is rebalanced periodically. Portfolio turnover is expected to be very low with the spike in 2018 a result of the change in its mandate.

As a result of its preferred share holdings, which sold off indiscriminately in the fourth quarter of 2018, the fund fell 3.6% in 2018, trailing the index and peer group. For the 12 months ending March 31, performance has improved significantly, rising 4.4% and handily outpacing its peer group.

Given the fund's broad fixed-income diversification and the defensive equity positioning, I would expect it to do well in periods of elevated volatility. Still, if we do hit a recessionary environment, we may see some increased volatility in the high-yield and levered loan holdings.

Costs are extremely reasonable, with an MER of 1.70% for the advisor-sold units, 0.91% for the do-it-yourself units, and 0.55% for the fee based units. At current prices, the fund's monthly distributions yield 2.48% for advisor-sold and 3.6% for fee-based units. For more conservative investors looking for a very modest cash flow, this may be a fund to consider. There may be better options for those seeking growth.

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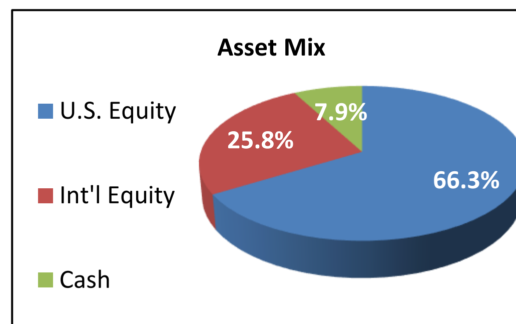
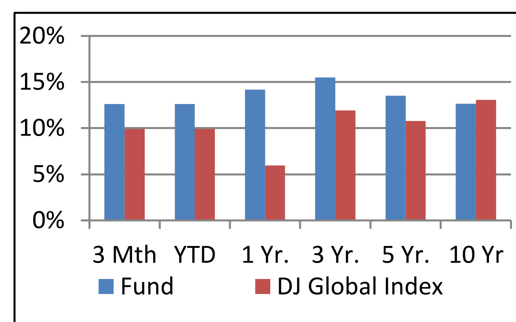
Dynamic Global Dividend Fund

Fund Company	Dynamic Funds
Fund Type	Global Equity
Rating	B
Style	Large-Cap Growth
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	David Fingold since March 2006
MER	2.26%
Fund Code	DYN 031 – Front-End Units DYN 431 – Low-Load Units
Minimum Investment	$500





ANALYSIS: This global-focused dividend fund targets a concentrated portfolio of high-quality, dividend-paying stocks that are trading at a price below what manager David Fingold believes them to be worth.

Using a fundamentally-driven, bottom-up process, the manager's approach is benchmark agnostic and focuses on companies he believes can generate above-average returns over the next three years. This is a dividend fund, but in fact it focuses more on the total return rather than just yield.

Sector mix and geographic exposure are dependent on the security selection process. However, the fund tends to run with an overweight exposure to the U.S., with just under 70% invested in the U.S. at the end of March.

While security selection is bottom up, Mr. Fingold also looks for positive industry fundamentals in an effort to avoid sectoral headwinds.

The fund's performance has been excellent, with top-quartile returns over the past one-, three-, five-, and 10-year periods. Volatility has been roughly in line with the index and the broader market, resulting in better-than-average risk-adjusted returns.

The fund outperformed in rising markets, with upside capture ratios of more than 100% for the past three- and five-year periods. Downside capture has been roughly in line with the index, suggesting performance comparable to the index in declining markets. This marks a change from a few years ago, when the fund was well known for its strong downside protection.

Fortunately, what it has lost in downside protection has been more than made up for through stronger upside, much of which has come from the manager's positioning the portfolio towards growth-type stocks. The portfolio is significantly overweight in healthcare, which makes up nearly a quarter of the fund. The manager is very active, with a portfolio turnover ratio averaging about 140% over the past five years.

Costs are slightly below average with an MER of 2.26% for the advisor-sold units and 1.11% for fee-based units. Those looking for a strong total return profile may find this to be a fund to consider as a core global equity fund.

While it is a dividend fund, it does not pay a regular distribution, so would not be suitable for those looking for a regular cash flow.

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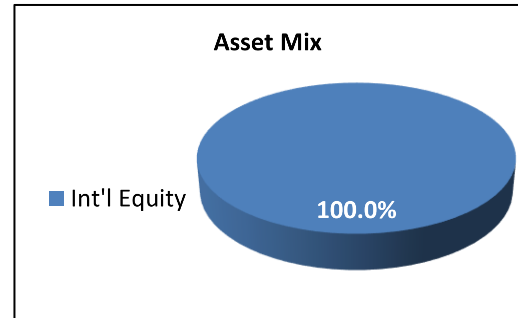
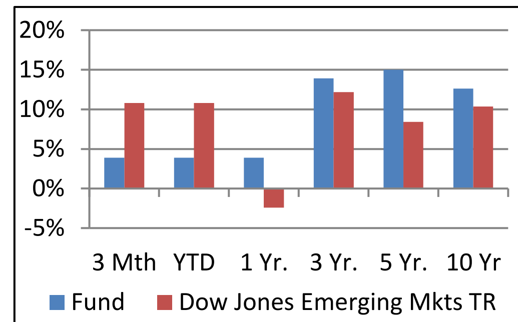
Sun Life Excel India Fund

Fund Company	Sun Life Global Investments
Fund Type	Geographic Equity
Rating	B
Style	Large-Cap Growth
Risk Level	High
Load Status	Optional
RRSP/RRIF Suitability	Fair
Manager	Atul Penkar since August 2011
MER	2.76%
Fund Code	SUNL 100 – Front-End Units SUNL 300 – Low-Load Units
Minimum Investment	$250





ANALYSIS: There are many reasons to like India. It is one of the world's fastest growing economies with GDP growth rates forecasted to be more than 7% for the next couple years. Helping the cause has been a continued rise in domestic consumption combined with an increase in infrastructure spending.

And India investments have consistently outperformed the more widely followed China indexes, with the MSCI India Index delivering an annualized 10-year return of 11.6% (USD) to March 31, about double the MSCI China A Index's 5.6% return.

There are risks, of course, including a high current account and budget deficits, which could weigh on growth. The country is also susceptible to domestic and more global geopolitical risks. Still, relative to more developed countries, the outlook is very positive.

There are only a couple mutual funds that invest in India, including the Sun Life Excel India Fund and the HSBC Indian Equity Fund. Managed by Atul Penkar of Mumbai-based Sun Life Birla Asset Management, the Sun Life fund has handily outperformed the HSBC version on both an absolute and risk-adjusted basis.

The fund is actually structured as a "fund of funds," investing in units of an underlying fund that in turn holds securities of companies located in India. It's actively managed, logging portfolio turnover levels averaging more than 100% over the past five years.

Performance has been strong, with 5-year average annual compounded rate of return of 15.1%. But the fund can be volatile (it lost more than a third in 2011 and gained more than 50% in 2014). Understandably, standard deviation is well above both the S&P/TSX Composite and the S&P 500.

Cost is another drawback, with an MER of 2.76% compared with 0.69% for the BMO India Equity ETF and 1.00% for the iShares India ETF. While it might be tempting to favour the ETFs for their lower cost, I tend to prefer active management when investing in emerging economies.

Because of its risk, this is certainly not a fund for everyone. Most investors may be better off with a more diversified emerging markets entry. However, this would be a good fund to consider for those looking to add India-specific exposure.

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