Top Funds Report

Stocks build on gains in April

U.S.-China trade tensions pose a risk...and an opportunity.

The market rally that started off 2019 continued to roll on in April, with equities ending the month mostly higher. The S&P/TSX Composite Index gained 3% in the month, while the S&P 500 Composite Index advanced 4.1% in U.S. dollar terms and the MSCI EAFE Index rose by 2.9%.

Bond yields shifted slightly higher across the curve in April, and short-term bonds outperformed long-term maturities. Long-term yields on Canadian government bonds ended the month at 1.99%, up from 1.90% at the end of March. Yields on the 5-year Canadas rose 2 basis points to end the month at 1.54%.

Corporate bonds outperformed government bonds, as investors were willing to pay more for the higher yields offered by corporates, which helped narrow credit spreads.

Developed markets outperformed emerging markets in April, with the MSCI Emerging Markets Index climbing 2.8% in Canadian dollar terms. The U.S. dollar gained relative to other currencies, not so much a consequence of the U.S. dollar strengthening as of other currencies losing value. Many global central banks reiterated their commitment to more accommodative policies, meaning that interest rates around the globe are likely on hold for the balance of 2019. As a result, investors sold other currencies in favour of the U.S. dollar.

For Canadian-based investors with unhedged currency exposure, the swing to the greenback ended up being a positive. The S&P 500 gained nearly 4.8% in Canadian dollar terms, factoring in the weaker loonie. The MSCI EAFE Index returned 3.6% to Canadian investors with unhedged currency exposure.

Crude oil rallied after President Trump vowed tougher restrictions on Iran, giving the energy sector a boost. Also helping to buoy investor sentiment were stronger-than-expected quarterly earnings results from many companies. Yes, expectations had been dialed down significantly, but the number of upside surprises was high, helping to boost investor confidence.

Economic numbers were also positive. In the U.S. GDP surprised to the upside, while a drop in the pace of growth of the Canadian economy was largely due to poor weather conditions.

While this backdrop has been a net positive for equity markets, there are still many risks on the horizon. The U.S. still does not have a trade deal in place with China, and on May 10, the U.S. administration added additional tariffs on more Chinese goods.

We have also seen some weakness in consumer and business spending in the U.S. However, the leading indicators continue to show positive economic growth, albeit at a more muted pace.

		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		

In this environment, I remain positive, but somewhat defensive. Right now, I favour equities over fixed income.

Within equities, I continue to favour funds and ETFs that have a distinct quality bias. I believe that these types of companies have the potential to deliver better-than-average returns in the next little while.

I continue to favour the U.S. and Canada, as there are still headwinds in Europe and Asia that may weigh on equities in the regions. And I lean towards developed markets over emerging markets. However, as the U.S. and China get closer to a trade deal, I'm likely to start looking more to emerging markets.

In fixed income, I favour corporate bonds over government bonds because of their higher yields. Still, I am focused more on investment-grade and higher-quality investment-grade issues.

In this environment, I am not making any changes to my investment outlook, as shown in the accompanying allocation matrix.

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

SPIVA Report…

Many active managers continue to disappoint

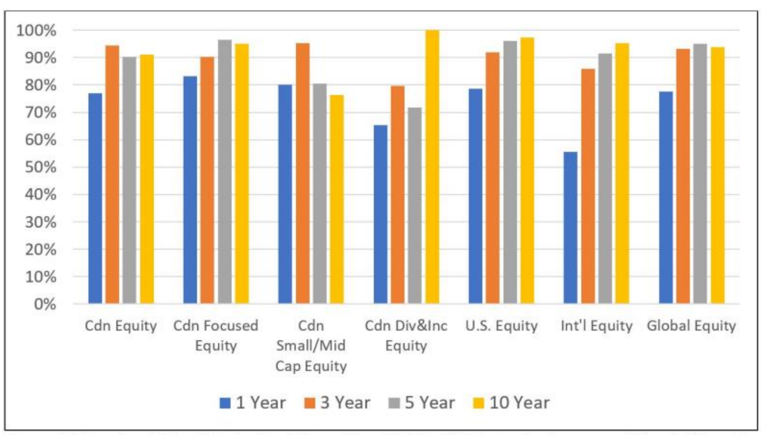
I am a very firm believer in active management. However, there are times when that faith gets tested.

Last year, and the fourth quarter particularly, were certainly one of those periods. One of the key arguments for active management is an active manager can outperform in a falling market because the manager can tactically position the portfolio to protect against falling markets.

However, when we look at the results, the reality doesn't always match up well with the theory.

On April 29, S&P Dow Jones Indices released their latest SPIVA report. SPIVA stands for S&P Indexes vs. Active management and compares the performance of actively managed funds with their respective benchmarks across a variety of fund categories.

Quite bluntly, the results are not good. The chart below highlights the number of funds that trailed their respective benchmarks over the past 1-, 3-, 5- and 10-year periods.



Source: S&P Dow Jones Indices LLC, Fundata. Data as of Dec. 31, 2018. CIFSC categorizations are used. Financial information provided by Fundata Canada Inc. Past performance is no guarantee of future results. Table is provided for illustrative purposes.

First, let's start with the positive. For the year, the best-performing category was the International Equity, which saw 44% of the managers outperform their benchmark. In comparison, only 23% of global equity managers managed to outperform. Why this discrepancy?

Digging deeper, I believe the difference stems from the underlying asset mixes. The average global equity fund has approximately half the portfolio invested in U.S. equities, with the balance in European and Asian equities. Historically, because of their extremely liquid market and high level of analyst coverage, U.S. equities have been extremely difficult to outperform. On the other hand, international managers have many different countries from which to draw potential investment candidates. This has resulted in marginally better performance for international managers relative to their U.S. brethren.

Perhaps the biggest disappointment was the poor showing from active Canadian equity managers. Less than one quarter of active managers were able to outpace the benchmark. What makes this so disappointing is that a falling market is one where an active manager should be able to outperform.

I have spoken to a few Canadian equity managers in both the traditional and alternative space, and the common theme among them is the fourth quarter of 2018 when all the market damage occurred and when all stocks fell in tandem. As is often the case, in periods of extreme market volatility, correlation approaches 1. That is what I am told happened this time around.

When all the stocks are doing the same thing, there is no opportunity for an active manager to add any value. The only defense would have been to quickly raise cash balances to protect against the drawdown.

Another consideration with these types of studies is that they don’t fully consider the effect of fees. While this would have been a very valid point several years ago, it is becoming less of a factor with the availability of low-cost passive options. For example, BMO’s ZCN and iShares’ XIC, the ETF offerings that track the S&P/TSX Composite Index, both carry management fees of 5 basis points.

Does this mean the days of active management are over? No, not at all. It has always been difficult for managers to beat their benchmarks, and that is unlikely to change.

It is also very difficult to find high-quality active managers. I follow approximately 2,500 mutual funds, of which only a portion are worth looking at in more detail. In the end, quality managers who follow disciplined and repeatable investment processes have the potential to outperform over the long-term, regardless of the asset class. Unfortunately, those managers are few and far between.

Funds of Note

Funds removed from our Focus List, plus a closer look at the Purpose weed fund…

Dynamic Advantage Bond Fund (DYN 258 – Front-End Units, DYN 538 – Low-Load Units) – In March, it was announced that Michael McHugh would be retiring from the investment industry after a long and successful career. Mr. McHugh will continue to manage the fund until his retirement in June. He will be replaced by Derek Amery, a portfolio manager with more than 20 years of investment industry experience. Most recently, Mr. Amery was at HSBC Global Asset Management, where he oversaw more than $6 billion in fixed-income assets under management.

In addition to losing Mr. McHugh as a portfolio manager on several Dynamic mandates, he will be missed as the leader of the Dynamic Fixed Income team. A departure of this magnitude is likely to cause some spillover effects within the team and ultimately the fund. While we cannot say whether this change will be positive or negative, it will likely create uncertainty. Given that potential uncertainty, I am removing the fund from the Focus List effective immediately. I will continue to monitor the fund closely under the new management team.

CI Signature Select Canadian Fund (CIG 677 – Front-End Units, CIG 1777 – Low-Load Units) – This has been, and continues to be, a decent fund, offering index-like returns over the long-term. However, in the past couple of years, I have noticed an erosion in the risk-reward metrics, particularly an increase in relative volatility. I have also observed a noticeable worsening in downside protection. This is highlighted by the performance in 2018, when the fund fell more than 14% compared with an 8.5% drop in the S&P/TSX Composite Index. Given this erosion in the risk reward profile, I am removing the fund from the Focus List effective immediately.

Mackenzie Ivy Foreign Equity Fund (MFC 081 – Front-End Units, MFC 3158 – Low-Load Units) – This had long been one of my favourite global equity funds, particularly for volatile markets during which the fund had done an outstanding job protecting capital. A key reason for this downside protection, particularly of late, has been the fund's substantial cash balance, which at the end of March was at more than 25% of the fund. I was particularly disappointed and frustrated when the manager did not use periods of market weakness to put some of that dry powder to work.

As a result of this continued high cash weight, the upside capture, a measure of how the fund does in rising markets, continued to fall. Over the past three years, the fund has participated in roughly half the upside of the market, while experiencing 80% of the downside.

In the first quarter of the year, the high cash balance was a significant headwind for the fund, which gained 4% compared with a 10.2% rise in the MSCI World Index. The fund was also hit by some security-specific issues in the consumer staples sector, which further dragged performance. While I am pleased with the downside protection of the fund relative to the peer group, I continue to be frustrated by the high cash weight and its drag on upside participation. Consequently, I am removing it from the Focus List effective immediately.

Purpose Marijuana Opportunities Fund (RAM 1420 – Front-End Units, RAM 2420 – Fee-Based Units) – This has been the best-performing fund in the cannabis space year-to-date, gaining 61%. For the past year, the advisor-sold units have nearly doubled, gaining 99% for the year ending April 30. It's unique because it is the first actively managed cannabis-focused mutual fund in Canada.

Managed by industry veteran Greg Taylor, the fund invests in companies operating in the cannabis and related industries. Mr. Taylor's investment approach blends a top-down industry overview with a bottom-up security selection process.

The top-down analysis reviews the industry globally and looks to avoid those areas of the market and countries where the manager believes companies are likely to face regulatory issues. The bottom-up security selection process uses a fundamental approach, evaluating each company relative to its growth potential. Mr. Taylor will also monitor valuation levels and is not afraid to raise cash when valuations look rich. At the end of April, the fund held rough 13% in cash.

The portfolio is concentrated, with fewer than 40 names. However, the manager has been extremely active, with a level of portfolio turnover of more than 370% in the first 11 months of operation.

The fund is diversified across the different sub-sectors of the cannabis industry, including growers, integrated cannabis companies, those involved in the financing of cannabis companies, and those involved in the medical marijuana sector. Currently, roughly half the fund is invested in growers.

Geographically, the fund is focused in Canada, with about 60% exposure at the end of April, mainly because Canada is well ahead of many other regions on legalization, making our industry more mature than others. However, as the global industry evolves, the fund's exposure is likely to shift accordingly.

It is a volatile fund, which is not surprising given the industry in which it is investing. While recent performance has been nothing short of stellar, it is not sustainable. I expect we'll see returns moderate as the industry matures and consolidation takes place, with the stronger companies acquiring the smaller players.

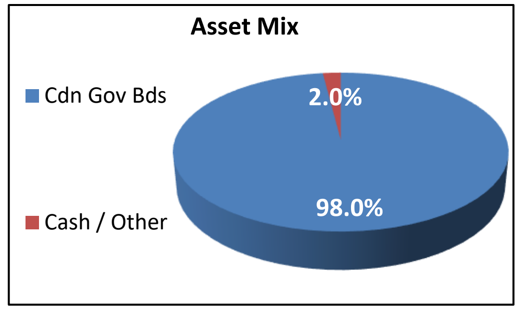
For a sector-specific fund, the cost is fairly reasonable. The management fee for advisor-sold units is 1.75%, which translates into an MER of 2.13%. For do-it-yourself investors, an ETF version is available (TSX: MJJ).

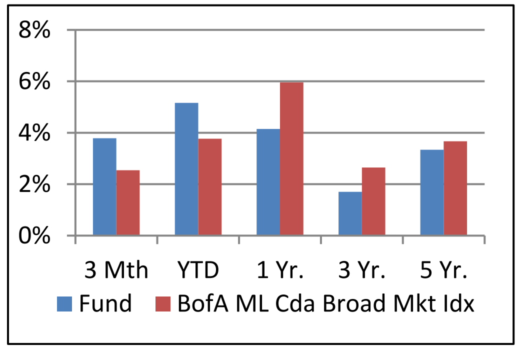
Given the volatility, combined with the relative "newness" of the cannabis industry, this is not a core holding. Unless you have an extremely high appetite for risk and are comfortable with big swings in the value of your investment, you'll likely want to watch this one from the sidelines.

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

PH&N Inflation Linked Bond Fund

Fund Company	RBC Global Asset Management
Fund Type	Cdn Inflation Protected Fixed Inc.
Rating	D
Style	Top-down macro analysis
Risk Level	Low
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	PH&N Management Team
MER	0.93%
Fund Code	RBF 6650 – Front-End Units RBF 4650 – Low-Load Units
Minimum Investment	$500





ANALYSIS: One way to protect your fixed-income holdings against the threat of inflation is to invest a portion of your bond allocation in real return bonds (RRBs), whose coupon rate moves with the rate of inflation in the economy. The principal amount of the bond is also adjusted to move in line with inflation. In Canada, there are very few such funds available, and this fund has been one of the strongest performers in the category, delivering a 5-year average annual compounded rate of return of 3.8% to April 30. That compares with 3.5% for the FTSE Canada Real Return Bond Index.

The portfolio is concentrated, with roughly a dozen bonds. This level of concentration doesn't indicate a high-conviction call by the manager but is more a reflection of the limited number of real return bonds available in Canada. In fact, according to Bloomberg data, there are only 74 real return bonds in Canada, with the majority being government issues.

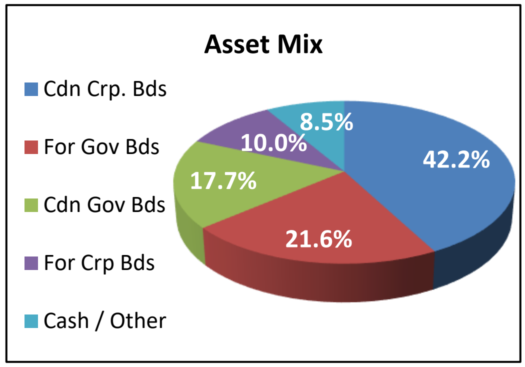
The maturity profile of the fund is longer-term, with an average term to maturity of nearly 17 years, resulting in a duration of 14.5 years. This high duration makes the fund sensitive to rate fluctuations. Because of this, the fund tends to be more volatile than the broader bond market. At the end of March, the annualized standard deviation of the fund was 7%, compared with 3.8% for the FTSE Canadian Bond Universe Index. The fund is also more volatile than many of its peers.

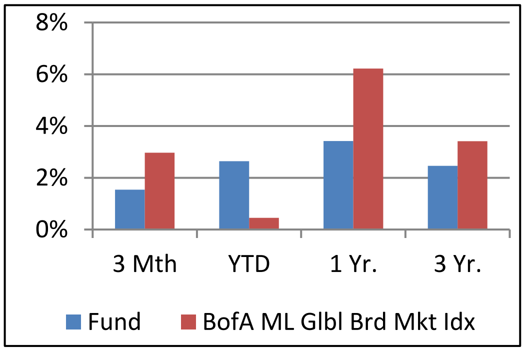
Yet despite its higher volatility, the fund has rewarded investors with returns that are well above average. In fact, according to Morningstar, the fund has posted above-average returns in every calendar year after 2013. A key contributor to this outsized return would be its lower cost. The MER for the advisor-sold units is listed at 0.93%, while the category average MER is calculated at 1.27%.

While the outlook for inflation remains muted in the near term, it has a way of creeping back. This fund provides a good way for those seeking to add some inflation protection to their fixed-income portfolio. However, it is *not* a core bond holding, as it can be more volatile than the broader bond market and very sensitive to movements in interest rates. Instead, consider it a nice addition to an otherwise well diversified bond allocation.

CI Investment Grade Bond Fund

Fund Company	CI Investments
Fund Type	Global Fixed Income
Rating	B
Style	Active
Risk Level	Low
Load Status	Optional
RRSP/RRIF Suitability	Good
Managers	Paul Sandhu since Dec. 2014
MER	1.59%
Fund Code	CIG 2185 – Front-End Units CIG 1185 – Low-Load Units
Minimum Investment	$500





ANALYSIS: Managed by Paul Sandhu of Marret Asset Management, this global bond fund can invest in Canadian, U.S., and European corporate bonds. Mr. Sandhu builds a core portfolio using a combination of top-down macro analysis combined with fundamental, bottom-up security selection.

Once the portfolio is set, he then uses an overlay strategy to tactically hedge interest rate, credit, and currency risks. In addition, he will actively trade the portfolio, looking to take advantage of short-term opportunities. At the end of April, the fund held 42% of assets in Canadian corporate bonds, 22% in foreign credit, 18% in Canadian government bonds, 10% in foreign government bonds, with the remainder in cash. Geographically, 65% of assets are in Canada, and just shy of 35% in the U.S.

While the portfolio is diversified, with nearly 200 individual bond positions, credit quality remains high, with an average credit rating of A. The managers are very active in managing the duration exposure, and at the end of April, the duration was 5.7 years, compared with 7.1 years for the index.

Performance has been disappointing, with a 3-year average annual compounded rate of return of 2.5% to April 30, compared with the category average of 3.6% and the Bloomberg Barclays Global Aggregate Index's 2.2%. However, volatility has been well below the index and the peer group, resulting in above-average risk-adjusted returns.

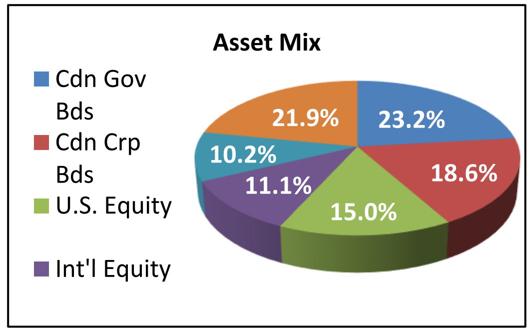
Costs are reasonable with an MER of 1.59%, compared with 1.74% for the average of the global bond funds I follow.

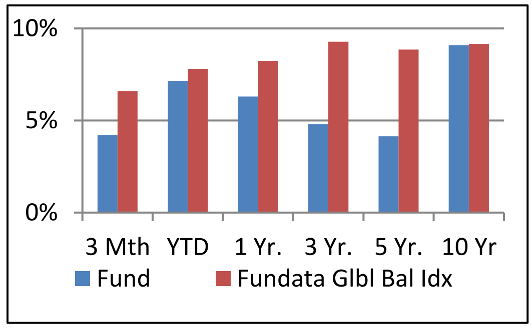
With its fundamental security selection, active duration strategy, and focus on risk management, this fund is worth considering for a portion of the fixed-income sleeve of your portfolio. Bear in mind that there may be times when the managers don't get their high conviction calls exactly right, which could result in periods where they lag the broader market and peer group.

If you prefer an ETF structure, a substantially similar mandate is available in the First Asset Investment Grade Bond ETF (TSX: FIG).

Cambridge Global High Income Fund

Fund Company	CI Investments
Fund Type	Tactical Balanced
Rating	B
Style	Tactical
Risk Level	Low to Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Bob Swanson since Dec 2012
MER	2.32%
Fund Code	CIG 6803 – Front-End Units CIG 6823 – Low-Load Units
Minimum Investment	$500





ANALYSIS: Lead manager Bob Swanson has been running this Tactical Balanced fund of funds since 2012. He assesses the macro outlook and then sets the asset mix accordingly, allocating the portfolio to other Cambridge-managed funds. Mr. Swanson has complete discretion on investment strategy and is not restricted by asset class or geography.

For equities, the managers invest in companies of any size that have defensive business models, a history of intelligent capital allocation, and a management team whose interests are aligned with the shareholders. The bottom-up approach is very active, and managers will use periods of rising volatility to better position the portfolio. The equity sleeve is cyclically positioned with an overweight to energy, materials, and industrials. It is underweight consumer discretionary, tech, and real estate.

The fixed-income sleeve is managed by Paul Marcogliese, who took the reins in January 2017. He invests mainly in Canadian bonds but can invest in foreign bonds as well.

Portfolio turnover has been modest, coming in at 60% for 2018. This is down significantly from 2014 to 2016 where portfolio turnover averaged approximately 130%. The portfolio is defensively positioned with more than half invested in bonds. The fund is also carrying nearly 10% in cash.

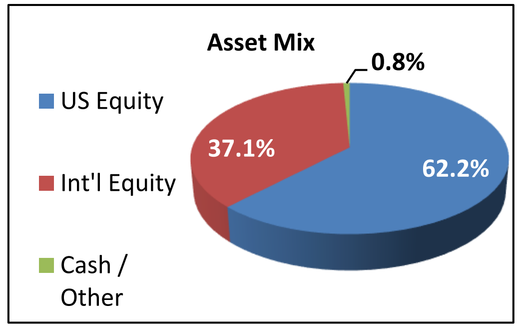
Increasing the fixed-income sleeve over the past couple of years while raising credit quality has acted as a cushion in periods of market volatility. However, the defensive positioning has been a headwind, as the fund lagged in the market rally of the first four months of the year. Still, a 7.2% gain is very reasonable given the circumstances.

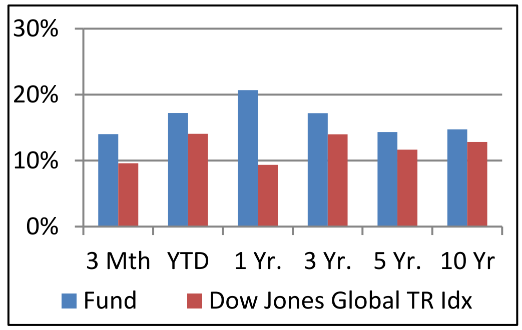
Looking out longer term, performance has been middle of the pack with a 5-year average annual compounded rate of return of 4.1%, matching the category. However, the manager has done an excellent job of managing risk, with volatility well below the index and peers. Furthermore, the fund has done a solid job protecting capital in down markets, participating in less than 70% of the downside of the markets.

On balance, with its disciplined and repeatable investment process combined with a focus on capital preservation, this is a fund to consider for those looking for an actively managed balanced offering.

Canoe Global Equity Fund

Fund Company	Canoe Financial
Fund Type	Global Equity
Rating	C
Style	Large-Cap Growth
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Nadim Rizk since August 2010 Andrew Chan since August 2010
MER	2.39%
Fund Code	GOC 1041 – Front-End Units GOC 1044 – No-Load Units
Minimum Investment	$500





ANALYSIS: After taking over this fund from Fiera last October, Canoe very wisely kept the management team headed up by Nadim Rizk and Andrew Chan, as Mr. Rizk has been successfully using the same investment process since 2006.

The managers look for best-of-breed companies with strong growth potential that are trading at reasonable valuations. They like well-managed companies with sustainable competitive advantages operating in industries with high barriers to entry.

The fund has an all-cap, go-anywhere mandate that relies on basic screens focusing on quality, valuation, and growth measures to help identify potential investment candidates. Managers conduct a detailed fundamental analysis focusing on both company and industry factors that help them determine their estimate of a company's intrinsic value, screening further for companies with a potential minimum return of at least 50% over the next three years.

The investment process is benchmark-agnostic, and country and sector weights are a byproduct of the managers' stock selection process. The result is a concentrated, yet diversified, portfolio that will typically hold around 40 names. Of the current 39 names, the top 10 comprise 42% of asset value.

The fund is overweight financial services, industrials, consumer defensives, and healthcare. It has no exposure to real estate, telecom, or energy.

The managers typically take a long-term view when analyzing a stock, so it is expected that portfolio turnover will be modest. For the past five years, turnover has averaged roughly 20%, which corresponds to an approximate holding period of about five years.

Performance has been excellent with a 5-year average annual compounded rate of return of 13.3%, placing it firmly in the top quartile. In comparison, the MSCI World Index returned an annualized 12.4% for the same period.

The fund's volatility has been running slightly higher than the index and the peer group, but the better-than-average returns have more than offset this risk. Given that the fund has outperformed in both rising and falling markets, it remains one of my favourite global equity offerings.

