Top Funds Report

Stock markets gain on rate dovishness

Easing trade tensions also contributes to June rallies...

Global equity markets rebounded nicely in June after May's trade-trouble-induced selloff. Helping calm sentiment and push stocks higher were comments from the major central banks hinting that rates cuts were likely. We also saw tensions easing on the trade front, as separate talks between U.S. President Donald Trump and China's President-for-life Xi Jinping at the G20 summit in Japan apparently made some progress towards a deal.

U.S. equities rallied sharply higher, gaining more than 7% in U.S. dollar terms. International stocks also rallied, with the MSCI EAFE Index rising nearly 6%. Canadian equities advanced as well, but trailed the pack, moving higher by only 2.5%.

With a more positive tone surrounding trade issues, Emerging Markets benefitted in the month, with the MSCI Emerging Markets Index rising by 6.3%. China was a clear benefactor, as Chinese equities rallied sharply higher, gaining 8.1%

Canadian bonds were slightly higher as yields on the short end of the curve crept up a few basis points, while the long end fell. Globally, we generally saw yield curves steepen. Long-term bonds outperformed short-term maturities as yields on the long end of the curve declined more.

With rate cuts in the U.S. back on the table, corporate bonds rallied higher as spreads tightened and investors demanded less return for the risk of holding corporate bonds over government bonds with comparable terms. Government bonds were up approximately 0.9% in June, while corporate bonds gained more than 1.1%.

Economically, while there are some signs of slowing growth, there are also signs the global economy is on a strong foundation. In Canada, the recent weakness in GDP growth appears to have been temporary, as the economy grew by 0.3% in April, building on the 0.5% gain in March.

Business sentiment was positive, indicating we may see an uptick in business spending. This makes it unlikely that the Bank of Canada will need to cut its overnight rate when the other central banks – primarily the U.S. Federal Reserve – do. This is reflected in the market expectation for interest rates, and it also helps explain why we saw the Canadian dollar strengthen in U.S. dollar terms, rising to US$0.7641 by month-end from US$0.7393.

This also boosted any investment that had a fully hedged currency position. For example, while the S&P 500 gained 7.1% in U.S. dollar terms, that gain was cut in half thanks to the movement in currency. In Canadian dollar terms, the S&P 500 was up a more modest 3.5%.

In the U.S., if you were to look only to the bond market, you might be under the impression that the economy is on the verge of trouble. However, data do not bear that out, as a strong U.S. domestic economy is supported by robust personal and income data along with rebounding core goods orders and shipments.

In recent days, markets have realized this and dialed back their expectations for Fed rate cuts. A couple of weeks ago, markets were expecting a 50 basis-point (bp) cut at the next Fed meeting. As of July 8, that had been cut to an estimate of a 25 bp hike and more modest expectations going forward.

Globally, despite apparent signs of progress at the G20 meeting, the ongoing trade wars are taking a toll, with economic softness in Europe and Japan. In this environment I remain cautiously positive. I favour equities over fixed income, but again, only modestly.

While markets continue to favour growth stocks, I continue to favour funds and ETFs with a distinct quality bias. While the economy is still growing, I believe we are reaching the point where higher volatility is likely. Higher-quality equities are expected to hold up better in volatility.

Similarly, in fixed income, I am favouring corporate bonds over government bonds because of the higher yields. But I prefer high-quality corporate bonds, and I am underweight in lower-quality and high-yield issues.

Consequently, I am not making any changes to my investment outlook and positioning, as shown in the accompanying matrix.

		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		

Please send your comments to:
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Smart Beta and Factor ETFs…

Alternative to plain-vanilla, passive index trackers

In our May issue, we did a quick overview of the ETF industry in Canada, highlighting some of the larger ETFs. This time around, I thought it might be interesting to cast a wider net and look at some of the different types of ETFs out there. There are really three main types of ETFs: passive; smart beta; and active strategies.

Passive ETFs – These are what comes to mind for most of us when we think about ETFs. They are designed to provide broad, low-cost exposure to the main market indices. Quite simply, most of these ETFs track an index that has been constructed using market capitalization as the main driver for security weightings in the portfolio. Typically, the larger the company, the bigger the part it plays in the index.

Some may fault this methodology, arguing that market capitalization is not an indicator of quality and that using it as a weighting scheme could result in the most overvalued stocks having a bigger weight in the index than fundamentals may warrant.

For example, the S&P/TSX Composite Index, the S&P 500 Composite Index, and the MSCI EAFE Index are market-cap indices that have been used as the foundation for many ETFs. In addition to these main indices, there are several other passive options, including indices from FTSE/Russell, Solactive, and others.

Passive ETFs have several advantages, including low cost, full transparency, and more favourable tax treatment. They are really a great building block for many portfolios.

As has been shown many times over, the majority of active managers struggle to outperform their benchmarks, and passive ETFs provide a cost-effective way to access the very benchmarks many of the active managers are trying to beat.

Obviously, the biggest drawback to investing only in passive strategies is that you will never be able to outperform the benchmark, because your return will be simply the return of the index less the costs (and some friction for trading costs, tracking error, and premiums/discounts).

Smart beta ETFs – "Smart beta" is really a catch-all term that is used to describe ETF strategies that are built using a weighting strategy that is not based on market capitalization. Such strategies tend to be rules-based, systematic, and quantitative in nature. They can range from the very simple to the very complex.

A simple smart beta strategy would be the equal weight strategy, in which the ETF invests in an equal weighting of each of the companies that make up an index. A more complex smart beta strategy may involve scoring a universe of stocks on several fundamental factors, including book value, cash flow, sales, and dividends. Each stock is scored, and the best-rated stocks make up a larger piece of the index than those companies with less favourable scores.

Within the smart beta space, there are a few different types, including these more popular strategies:

Fundamental – These ETFs score a universe of stocks on a variety of fundamental criteria. One of the better-known companies involved in the fundamental space is Research Associates, a Newport Beach, California investment management firm founded by Rob Arnott.

The premise of fundamental indexing is that companies are scored on fundamental factors that have historically been found to lead to outperformance. This methodology also eliminates the criticism of cap-weighted indexing where the most overvalued companies constitute the largest portion of the index.

The theory is very sound, but the performance results to date are mixed. Typically, fundamental ETFs are more expensive than cap-weighted ETFs.

Factors – This has evolved into one of the most popular forms of smart beta strategies of late. There have been many new entrants into the factor space, including mutual fund giant Fidelity. Other very active entrants include Vanguard, Invesco, and iShares.

The premise of factor-based strategy is that academic research has found various factors, or common traits, in securities that have gone on to outperform. There are new factors being identified, but the main ones include volatility, momentum, quality, value, dividend yield, and size.

- *Volatility* – Historically, we have been taught that if you want to earn higher returns, you need to invest in riskier investments. There is some truth to this in that over the long term, equities tend to outperform bonds, which tend to outperform cash. However, within the equity sleeve, an anomaly has been identified that shows that funds that have lower levels of volatility have actually outperformed those that have higher levels. To capitalize on this, these factor ETFs will score each company based on its risk level and then weight the company accordingly in the portfolio.
- *Momentum* – These strategies look to capitalize on market trends by investing in stocks that have shown positive price movement over a certain period.
- *Quality* – This is most like what a traditional fundamental manager does. The quality factor scores stocks on several metrics, including profitability, earnings quality, financial leverage, asset growth, and corporate governance. Historically, those companies that score well on quality metrics are likely to outperform those that score lower.
- *Value* – This is the simple concept of investing in stocks that are inexpensive. Screens are run to find companies that are trading at valuation levels well below the index or the peer group. It is believed that over the long term, stocks with lower valuation will outperform those trading at higher multiples.

- *Dividend Yield* – Dividends have been shown to be a significant contributor to the total return of a stock over time. Some studies have shown that reinvested dividends can make up more than half to two thirds of the total return over time. Dividend funds rank stocks based on the dividend yield, with those with a high, sustainable dividend yield making up a larger portion of the index than those with lower yields.
- *Size* – Small cap stocks have been shown over the long-term to outperform their large-cap brethren. These strategies focus on small- and mid-sized companies.

Active ETFs – These are about as close to a traditional mutual fund as you can get. With active ETFs, there is a portfolio manager who is making active buy-and-sell decisions in the portfolio. In terms of numbers, there are not nearly as many active ETFs available in Canada as there are in the U.S. There are a couple of reasons for this.

The first is that many portfolio managers are hesitant to show their full portfolio and potential buy lists to market makers in real time, which limits the number of entrants. Another reason is that these ETFs tend to carry much higher costs than the passive ETFs.

Most of the growth in active strategies has come from mutual fund companies that are taking existing mutual fund mandates and offering them as ETFs. Some of the bigger players in the active space include Horizons and Mackenzie. While I'm typically a fan of ETFs, I'm not certain we'll see the active versions catch on the same way that other ETF strategies have. However, we could also eventually reach a point where there are investments offered across various structures, including mutual funds, pooled funds, and ETFs. Time will tell.

Next time around, I'll highlight some of the more attractive ETFs in each of the main categories.

Funds of Note

PenderFund takes over management of Vertex Value Fund…

Matt Wood leaves VertexOne – On June 20, Vancouver-based Vertex One announced that Matthew Wood had resigned as an officer and director. Management of Mr. Wood's value-focused mandates will be taken over by Vancouver-based PenderFund, with PenderFunds's Dave Barr acting as lead manager.

Mr. Wood had been managing value-focused strategies for Vertex since 1998. But his very contrarian views have led him to areas of the market, including energy and materials, that ended up hurting performance.

The fund lost more than 39% in 2018 and has dropped another 9.2% year to date to the end of May. In fact, in May alone, the fund lost 16%, wiping out year-to-date gains. Its 5-year average annual compounded rate of return to May 31 was -4.9%, trailing the category average by more than 1,000 basis points for the period.

By comparison, the Pender Value Fund, a go-anywhere, concentrated portfolio of the investment team's best ideas, posted a return of 8.2% in the same 5-year period, and is up 10.8% year-to-date. Manager Dave Barr takes a long-term, patient outlook seeking high-quality, predictable businesses trading well below what he believes them to be worth, providing a margin of safety.

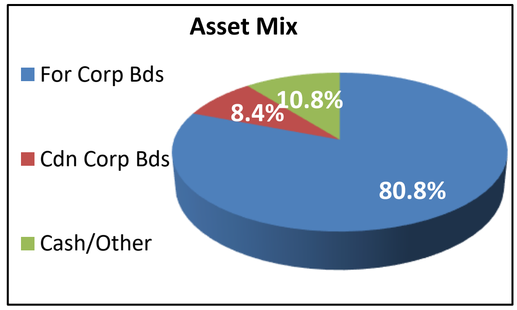
Given Mr. Barr's discipline, the transition process may take between six and 12 months. They want to ensure that all moves made within the fund are in the best interest of investors. The manager noted that there were still some unique opportunities in the Vertex Value Fund that are likely to remain.

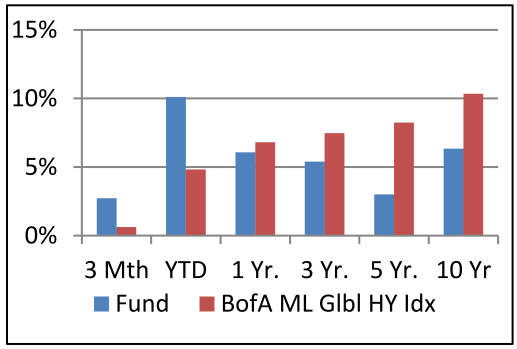
Overall, I see this manager change as a positive for the fund. I expect we'll see performance improve and perhaps more importantly, I reckon the portfolio volatility will be dialed down substantially, from its high 5-year annualized standard deviation of 20%, closer to the 10%-12% levels of other Pender funds.

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

Renaissance High Yield Bond Fund

Fund Company	CIBC Asset Management
Fund Type	High Yield Fixed Income
Rating	C
Style	Bottom-up Credit Analysis
Risk Level	Low to Medium
Load Status	Optional
RRSP/RRIF Suitability	Fair
Manager	Nicholas Leach since Jan 2013
MER	1.81%
Fund Code	ATL 908 – Front-End Units ATL 667 – Low-Load Units
Minimum Investment	$500





ANALYSIS: Apart from a brief blip in May when worries over the trade war weighed on investor sentiment, risk assets have been on a tear in the first half of 2019. Equity markets are all sharply higher, as are the riskier parts of the bond market, including high-yield debt.

That risk appetite is a key reason this Renaissance fund was the top-performing fixed-income fund in the first half of the year.

In the first six months of 2019 ending June 30, the Renaissance High Yield Bond Fund gained more than 10%, handily outpacing the nearly 7% gain in the Canadian bond market and the 5% rise in the U.S. bond market.

The fund has been managed by Nicholas Leach since January 2013 and has a mandate to invest in a basket of high-yield offerings from companies around the world. Currently, the fund is invested very heavily in North American issuers, with the U.S. making up more than half the portfolio, Canadian issuers around a quarter, with the balance from global issuers.

The fund is very concentrated in issues rated BB and B, and the portfolio has an average credit quality of B. For comparison, BB is one rung below investment grade.

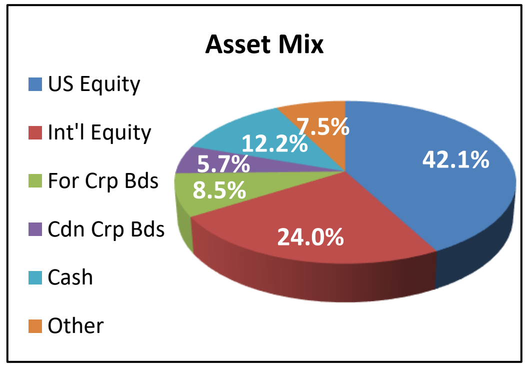
Performance over the past few years has been average, with a 5-year average annual compounded rate of return of 3%, slightly trailing the peer group. Shorter-term performance has been very strong – more than 6% for the 12 months ending June 30, nearly doubling the peer group. Volatility has been above average, which has resulted in slightly below-average risk-adjusted returns.

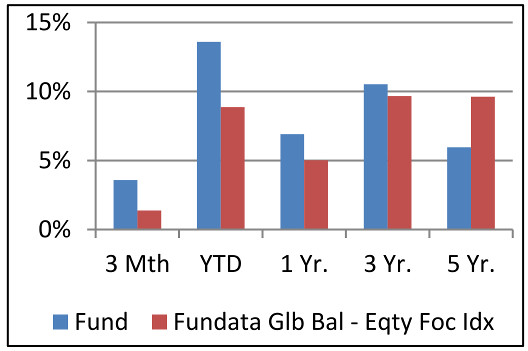
Costs are a touch on the high side with a management fee of 1.50%, which results in an MER of 1.81%. The average MER of the high-yield bond funds I follow is 1.71%.

Despite the sharp improvement in short-term performance and the stellar year-to-date numbers, I'd want to continue to follow the fund before giving it any serious consideration. While this is not a bad fund, I believe there are more attractive options available that I would consider before this offering. Invesco, Leith Wheeler, RBC, and CI each have offerings I'd consider in the near term.

IA Clarington Global Allocation Fund

Fund Company	IA Clarington Investments
Fund Type	Global Equity Balanced
Rating	D
Style	Active
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Managers	Dan Fuss since February 2015 Eileen Riley since February 2015
MER	2.39%
Fund Code	CCM 2470 – Front-End Units CCM 2471 – Low-Load Units
Minimum Investment	$500





ANALYSIS: Managed by Loomis Sayles, this has been one of the strongest performers in the category over the past three years with an average annual compounded rate of return of 10.5% to June 30. It has also been one of the top performers so far in 2019, with a first-half gain of 13.6%, handily outpacing the benchmark and peer group. Advisors are starting to notice, with healthy inflows of new money over the past year.

The portfolio and the underlying investment process are based on the same process used by the Loomis Sayles Global Allocation Fund. That fund was launched in May 1996 and has delivered a 10-year average annual compounded rate of return of 11.6% to June 30.

The investment process is very opportunistic with a long-term horizon of seven to 10 years, giving managers the ability to invest anywhere in the world. The asset mix is determined by the available opportunity set and equity has historically ranged between 35% and 60%.

The equity sleeve is managed using a fundamentally driven, bottom-up, benchmark-agnostic approach, as managers seek high-quality companies trading below what they believe the company to be worth.

On the fixed-income side, the managers have a wide mandate across the fixed-income spectrum, with an investment process is very much a blend of top-down macro analysis and bottom-up security selection.

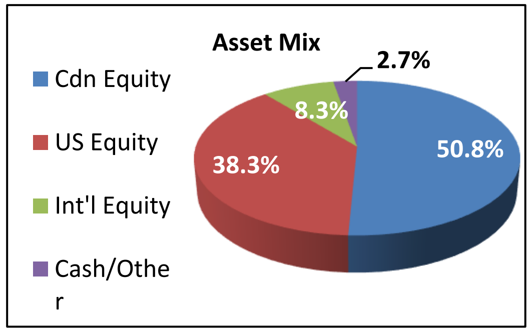
The top-down analysis helps the team find the most attractive opportunities anywhere across the quality curve. It has tended to focus more in the AA to BB range, looking for credits that are attractively priced and that can add potential return.

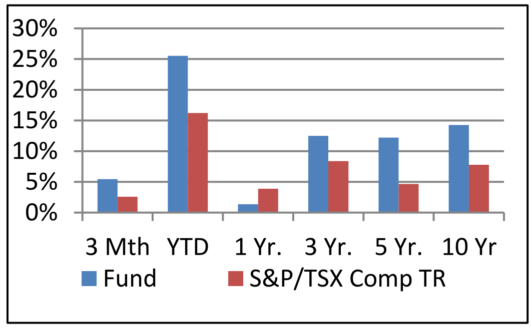
Overall volatility is slightly higher than the peer group, but this has been more than offset by the better-than-average returns. And the fund has also done a good job at protecting capital in down markets.

With its recent performance improvement, deep management bench strength, and disciplined investment process, the fund is a solid global balanced offering that could potentially be a cornerstone of an otherwise well diversified portfolio.

Fidelity Canadian Growth Company Fund

Fund Company	Fidelity Investments Canada
Fund Type	Canadian Focused Equity
Rating	A
Style	Bottom-up
Risk Level	Medium to High
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Mark Schmehl since March 2011
MER	2.25%
Fund Code	FID 265 – Front-End Units FID 065 – Low-Load Units
Minimum Investment	$500





ANALYSIS: With a year-to-date return of more than 26%, this growth-focused offering managed by Mark Schmehl has been one of the best-performing funds so far this year. Part of this strong showing can be attributed to the tailwind that growth stocks have been experiencing, as they continue to outpace more value-focused issues.

The manager's somewhat unconventional approach is another contributor. He looks for companies that are undergoing some sort of fundamental change he believes will be a catalyst to unlock share price appreciation and ideally deliver above-average growth over 12-18 months.

He can invest in companies of any size but tends to focus more on large- and mid-caps. Slightly more than half is invested in large-caps, about a third in mid-caps, and the balance in small-caps.

Security selection is very much a bottom-up approach, so the portfolio will typically look much different than the benchmark. Sector and capitalization mix will change over time based on the opportunity set. At the end of May, the fund was overweight technology and consumer discretionary, led by holdings in software and IT services companies. While Canadian-focused, the fund can invest up to 49% in foreign securities (about 46% as of May 30). Top holdings include Shopify, Etsy, Suncor, and Manulife.

Since taking the reins in 2011, Mr. Schmehl has delivered outsized returns, posting above-average gains every year except for 2018, when it was down 9.0%, driven by a 20% fourth-quarter loss. Longer-term numbers are strong, with 5-year annualized return of 12.2%, well above the index and peer group.

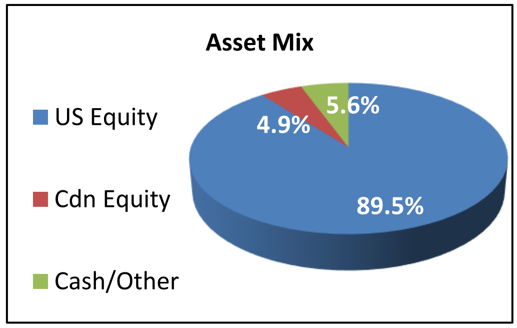
However, volatility is well above the index and peer group. Despite this, it has done a solid job protecting capital in down markets, participating in roughly 90% of the downside over the past three years, and slightly more than half in the past five years.

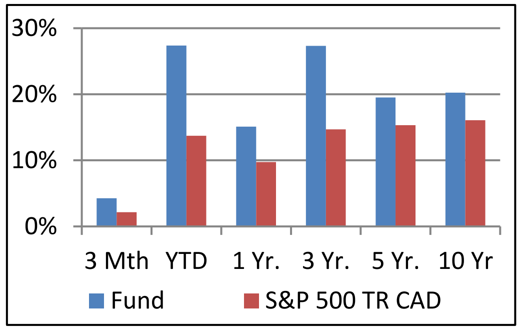
I don't expect the absolute levels of return to be repeated. With global growth moderating and valuation levels stretched, I expect returns to moderate. The fund could also struggle if market leadership shifts towards more value-focused securities.

It's a solid fund, but not a core holding owing to its volatility. Instead, I see it as a return enhancer when used as a piece of your Canadian equity allocation.

Dynamic Power American Growth Fund

Fund Company	Dynamic Funds
Fund Type	U.S. Equity
Rating	B
Style	Large-Cap Growth
Risk Level	Medium to High
Load Status	Optional
RRSP/RRIF Suitability	Fair
Manager	Noah Blackstein since July 1998
MER	2.43%
Fund Code	DYN 004 – Front-End Units DYN 604 – Low-Load Units
Minimum Investment	$500





ANALYSIS: With growth stocks continuing to outperform not only value stocks but also the broader equity markets, this hyper-growth fund's outperformance isn't surprising. To June 30, it gained more than 27%, nearly tripling the return of the average U.S. equity fund. The first quarter was phenomenal, up more than 22%, outpacing the index and peer group.

Managed by Noah Blackstein using a bottom-up approach, this is a growth-focused mandate highly concentrated in its sector mix and number of holdings. At April 30, the fund held 57% in technology, 20% in consumer discretionary, and the balance in healthcare. It also had a modest cash balance of just over 5%.

It held 22 stocks, with very few being what I would consider to be household names. Top holdings included cloud computing company ServiceNow, customer service software provider Zendesk, and cloud communication platform Zilio rounding out the top three. The top 10 holdings make up roughly half of the portfolio.

Mr. Blackstein is an active manager, with portfolio turnover averaging more than 200%. In other words, he turns the portfolio over roughly four times per year. But it seems to have worked, generating a 10-year annualized gain of more than 20%.

While I've been impressed with the results, we do need to put them into context. First, Mr. Blackstein has made very concentrated bets in growth sectors that have paid off handsomely. However, this level of excess return is not sustainable, unless you believe that it will be a growth-fueled market for the next several years.

Another concern with the fund is its volatility, which has been nearly double the broader market. The fund has also experienced significant drawdowns and participates in more than 120% of the market's declines. This is a win big, lose big fund.

It's not core holding for most investors, but rather a potentially strong return enhancer for those who have the stomach to withstand the volatility. If you have held this fund for any length of time, take some profits now before the next market selloff. Your remaining exposure will depend on your appetite for risk. I would also be cautious of taking on a new position in the current environment unless you are comfortable accepting a big drawdown.