Top Funds Report

July highs usher in season of volatility

Trade tensions, fading growth fears cast a shadow over July's market records...

July was a mixed month for global equity markets. U.S. equities led the way up in the month, reaching fresh record highs. The tech-heavy Nasdaq Composite Index gained 2.4% in U.S. dollar terms, while the S&P 500 Composite Index rose by 1.4%.

Much of the rally in U.S. equities was driven by anticipation of a cut in interest rates by the U.S. Federal Reserve. The Fed fulfilled that anticipation, cutting its benchmark federal funds rate by 25 basis points on July 31.

Also helping to fuel gains was a series of rather upbeat economic numbers released in July, including better-than-expected job creation, strong retail sales, and continuing strong consumer confidence data.

Still, with a lot of talk on the trade front, none of which has been productive, much uncertainty remains. The U.S. and China are no closer to a deal now than they were a few weeks ago. And U.S. President Donald Trump managed to ramp up the stress level by imposing tariffs on $300 billion of Chinese goods that weren't already subject to tariffs, and then easing back on some portions of that in August.

This is expected to create even more friction and uncertainty in the economy, reflected in steep market selloffs in August.

As a consequence, markets are expecting further rate cuts from the Fed. According to the CME Group's Fed Watch tool, markets have priced in another 25 bps of easing at the September meeting, and a further cut in October.

Elsewhere, things took a turn for the worse, as European and Asian markets sold off, ending July in the red. The MSCI China Index was down 50 basis points on trade worries. And Europe was lower by nearly 2% on concerns over Brexit, after Boris Johnson replaced Theresa May as the U.K.'s Prime Minister. Emerging markets also struggled with the uncertainty, with the broad EM index falling 1.1% in the month.

Closer to home, the S&P/TSX Composite Index gained a marginal 0.3% in July. The materials sector turned in the best performance of the month, propelled by strength in gold-mining companies, and helped keep the overall index afloat in July.

With growing uncertainty about the sustainability of global economic growth, bond yields have moved steadily lower, causing investors to flock to the safe haven of gold, which closed July above $1,400 per ounce, and continued climbing to over $1,500 per ounce in August.

Consumer and growth names were also strong contributors to the S&P/TSX in July. But the biggest headwind was the healthcare sector, which was pulled lower by weakness in weed stocks. The sector was weighed down by troubles at cannabis grower CannTrust, which sank after Health Canada found irregularities and violations at their facilities. As a result, healthcare fell by more than 13% in the month, but is still higher year-to-date by nearly 18%.

Turning to the bond market, Canadian bonds ended the month a hairline 0.1% above breakeven in July, as corporate bonds outperformed government bonds. Short-term bonds ended the month in negative territory as yields crept higher, while longer-term bonds outperformed as the longer-dated credits saw yields push lower.

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As we head into what has historically been the most volatile period of the year for investment markets, I remain cautious. In this environment, I am moving my fixed-income weights back towards neutral as shown in the accompanying matrix. While bonds have been very richly valued, I like their volatility-dampening qualities at the moment.

There is a lot of uncertainty lingering on many fronts including the trade war, Brexit, Hong Kong protests, and worries over a weakening economy. Consequently, I am taking a defensive stance, focusing on high quality, lower-volatility equity funds and ETFs. If we do see more volatility, I would expect to see these types of funds hold up better. In the fixed-income space, I continue to favour higher-quality, investment-grade issues over higher-yielding and unrated bonds.

		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:
feedback@paterson-associates.ca

Top Picks: Passive and Smart Beta ETFs…

My review, update, and recommendations for Canada's top-performing ETFs

Over the past few months, I have been looking at different ETF options. Last issue I reviewed the ETF space in Canada, looking at overall growth, and where the money is flowing. This month, I thought I would highlight some of my top picks across the passive and smart beta ETF options. I am highlighting only Canadian-traded ETFs.

Passive ETFs

As discussed, these ETFs are usually designed to track a well-known market index. Personally, I like to stick with the main indices from the bigger providers like S&P, MSCI, or FTSE. I may consider some of the other providers where there is a real advantage to do so, but mostly I like the big names.

Here's a look at some of my picks.

Vanguard Canadian Short-Term Bond Index ETF (TSX: VSB) – This is my top pick for broad-based short-term bond exposure. Despite carrying an MER that is 1 basis point higher than the iShares version (XSB), I prefer it for its higher credit quality and greater exposure to government bonds. I have always viewed short-term fixed income as a safe haven, and with my expectation of higher equity-market volatility in the next few months, I believe this offering will hold up slightly better than XSB.

iShares Core Canadian Universe Bond Index ETF (TSX: XBB) – Designed to track the FTSE Canadian Universe Bond Index, this ETF is my top pick for broad-based Canadian fixed income exposure. It provides exposure to the largest government and corporate bonds in Canada and has provided a modest level of outperformance to its peers, the BMO Aggregate Bond ETF (TSX: ZAG) and the Vanguard Canadian Aggregate Bond Index ETF (TSX: VAB).

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The portfolio has a bit more exposure to corporate bonds than VAB, which offers a slightly higher yield and a slightly lower interest rate sensitivity. Costs are roughly in line, although VAB and ZAG are a basis point cheaper. Still, I currently favour XBB as my top core bond holding.

iShares Core S&P/TSX Capped Composite Index ETF (TSX: XIC) – This cap-weighted ETF provides exposure to the benchmark S&P/TSX Composite Index. Costs are low with a management fee of 5 basis points (bps), resulting in an MER of 0.06%. Performance between this and the BMO version (ZCN) has been similar; however, the higher share price of XIC would be expected to result in modestly lower trading costs when commissions and spreads are taken into account.

Vanguard S&P 500 ETF (TSX: VFV) – This is designed to track the S&P 500 Index. It is also available in a fully currency-hedged version (TSX: VSP). I am currently favouring the unhedged VFV because I expect volatility to increase. Historically, when volatility increases, the U.S. dollar has strengthened on a flight-to-safety trade. When that happens, the losses for those with unhedged exposure are reduced, helping protect capital better. I favour this Vanguard offering over the iShares version (XSP or XUX) because of its lower cost – 8 basis points compared with 11 bps for XUS.

BMO MSCI EAFE Index (C$ Hedged) (TSX: ZDM) – The pickings for international and global ETF offerings are significantly lower than what is available for Canadian and U.S. ETFs. That makes finding a good solution a bit more difficult. Another challenge with the international and global offerings is that they tend to come at a higher cost than Canadian and U.S. versions, making them much less attractive to using actively managed mutual fund offerings. But if you're looking for low-cost, passive international equity exposure, this BMO offering would be my pick. It offers exposure to the broadly diversified MSCI EAFE Index, has outperformed other passive EAFE options, and does so at a cost of 22 basis points.

Smart Beta ETFs

While the passive ETFs typically use market capitalization to determine the weights of securities in the portfolio, smart beta strategies use an alternative weighting scheme that could be based on many different things, such as fundamental strength, dividend yield, or other style factors.

Here are some of my top picks in the smart beta space.

Invesco S&P/TSX Composite Low Volatility ETF (TSX: TLV) – The consensus is that to earn higher returns, you need to take on higher risk. This has held true across asset classes, with bonds earning more than cash, and equities gaining more than bonds. However, within equities, there is an anomaly where the least volatile stocks have outperformed in many different market environments, resulting in long-term return numbers that are in line with the broader markets, but with much less volatility.

In the past few years, we've seen many new low-volatility ETFs and funds come to market, each using their own unique spin to take advantage of the anomaly. In the Canadian equity space, this ETF from Invesco is my top pick. It invests in the 50 least volatile stocks that trade on the TSX. It has no constraints on sector weights or market cap, meaning concentration risk may be a potential concern, but looking at historic performance, it has tended to be the least volatile of the available offerings, making it a good pick for a potentially volatile period.

Invesco Canadian Dividend ETF (TSX: PDC) – Dividends have made up a substantial portion of the total return of equities over the long-term, and there is little sign that this will change into the future. That makes dividend investing a solid strategy for most investors.

This offering from Invesco is one of my favourites in the Canadian dividend category. It invests in liquid, high yielding Canadian equities that have a track record of growing dividends. To be included in the index, a company

must have paid stable or growing dividends in each of the past five years. There are no limits on sector exposure, so it can get pretty concentrated from a sector perspective. Unlike some of the other dividend mandates, this focuses more on larger companies. It has historically offered a nice balance of return and lower volatility.

iShares MSCI Minimum Volatility USA ETF (TSX: XMU) – This iShares ETF tracks an index that is designed to provide exposure to a portfolio of lower volatility stocks. Unlike Invesco's TLV discussed above, which invests in the least volatile stocks, the methodology uses more of an optimization approach to build the portfolio. While the focus is on low volatility, the sector mix is roughly in line with the broader market.

The index providers then use an optimization process to build the mix of securities that provides the best risk-return trade-off. It tends to be a touch more volatile than the Invesco version, but the returns have also been slightly higher. I have found that this methodology has produced slightly better results in the U.S. and international markets, making this my top pick.

BMO U.S. Dividend ETF (TSX: ZDY) – ZDY invests in a portfolio of U.S. dividend-paying stocks. The portfolio is constructed using a rules-based approach that considers a stock's liquidity, three-year dividend growth rate, dividend yield, and dividend payout ratio. These factors are scored, and the top 100 or so most attractive stocks make up the fund's portfolio. It's been a very solid pick in the U.S. dividend category.

Absolute returns have trailed the broader U.S. market slightly, but with the lower volatility, risk-adjusted returns have been comparable. This version is unhedged, while hedged version (ZUD) offers the same underlying investment exposure with all of the foreign currency exposure hedged back to Canadian dollars. I prefer the unhedged version as it tends to be less volatile, particularly in a market selloff.

iShares MSCI EAFE Minimum Volatility ETF (TSX: XMI) – This ETF is built using a very similar approach to XMU, discussed above, with a key difference being that it uses the MSCI EAFE Index as its benchmark. It roughly matches the country mix and sector exposure of the broader index and is optimized to produce the best risk-reward balance. Returns over the past five years have outpaced the broader market with lower volatility. More recently, it's trailed modestly.

This is one of the few international equity offerings that doesn't include U.S. equities. I am more likely to blend this with a U.S. equity option when building my own portfolio, rather than using an option that incorporates both U.S. and international stocks. Costs are reasonable, coming in with a management fee of 35 basis points, compared with 20 bps for the broader EAFE Index.

BMO International Dividend CAD-Hedged (TSX: ZDH) – Like ZDY discussed above, this ETF provides exposure to a diversified portfolio of high-yielding equities, with the key difference being that this one is focused on non-U.S. equities.

The investment process is identical, using a rules-based approach that considers a stock's liquidity, three-year dividend growth rate, dividend yield, and dividend payout ratio. These factors are scored, and the top 100 or so most attractive stocks make up the portfolio. This version is fully hedged to Canadian dollars, while its companion ZDI is unhedged.

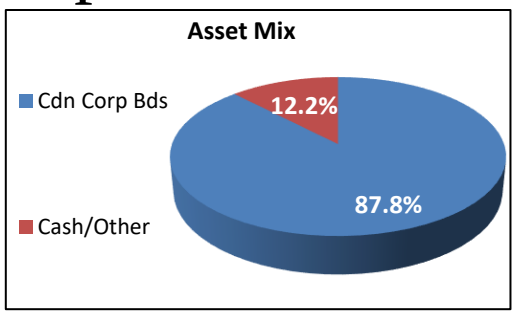
Unlike the U.S. version, the fully hedged fund has resulted in a more favourable risk-reward profile. More than 70% of the portfolio is invested in Europe, and with the uncertainty caused by Brexit and the overall economic environment in the region, I am not bullish on the outlook for the euro. That leads me to favour this fully-hedged version.

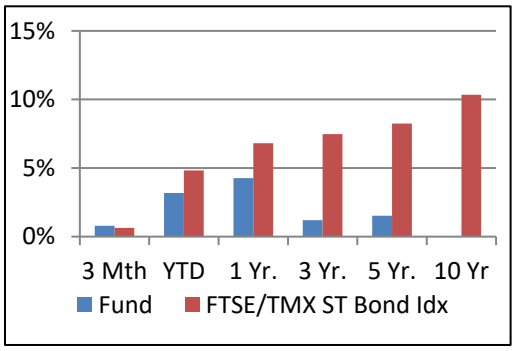
Next time: I'll review my top picks for Active Strategy ETFs.

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

Invesco 1-5 Yr. Laddered Corp. Bond Fund

Fund Company	Invesco Canada Ltd.
Fund Type	Canadian Short-Term Fixed Income
Rating	F
Style	Rules-based/Laddered
Risk Level	Low
Load Status	Optional
RRSP/RRIF Suitability	Fair
Manager	Invesco Management Team
MER	0.99%
Fund Code	AIM 53203 – Front-End Units AIM 53207 – Fee-Based Units
Minimum Investment	$500





ANALYSIS: The recent drop in yields on Canada bonds created a strong environment for fixed income, and this fund was one of the best performers in the Canadian Short-Term Fixed Income category. For the quarter, it gained 1.3%, outperforming the 0.9% rise of the FTSE/TMX Short-Term Bond Index. This was largely due to the fund's overweight exposure to corporate bonds, which outperformed government issues in the quarter.

The fund uses a passive approach and is designed to replicate the performance of the FTSE/TMX Canada Investment Grade 1-5 Year Laddered Corporate Bond Index. It invests only in investment-grade corporate bonds, and only those rated BBB or better can be considered for inclusion in the index.

The index uses a laddered methodology and is divided into five equally weighted term buckets with maturities from one to five years. Each of these term buckets receives an equal 20% weight in the portfolio. Each term bucket holds 10 bonds equally weighted. Bonds must meet credit quality, liquidity, and issue-size requirements before they can be considered for inclusion in the index. Within each of the term buckets, the 10 largest, most liquid issues are included in the fund.

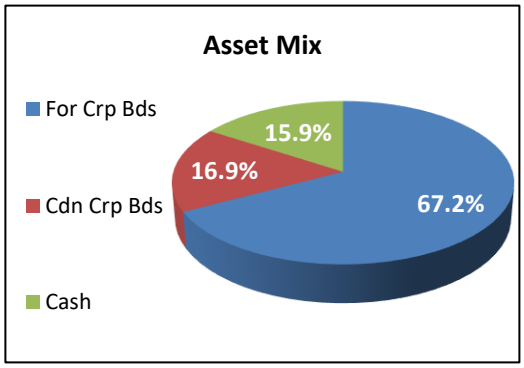
The portfolio is re-run every June, with the result that bonds in the one-year term bucket will be removed, while bonds in each of the other term buckets will roll down to the next bucket. As a consequence, duration will jump after each rebalancing because new, longer-dated bonds are added to the portfolio while the shortest-dated bonds roll off. Over the year, the duration gradually falls, only to have the cycle repeat.

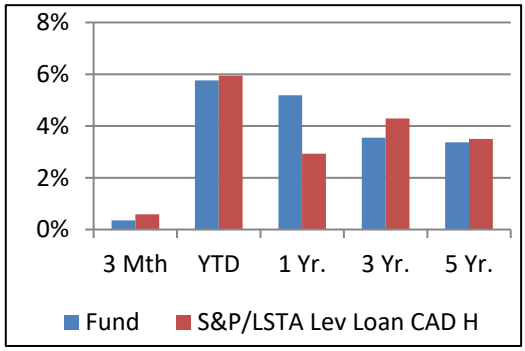
I like this Invesco offering because it is fully transparent, and you fully understand what you are investing in. Its yield will likely be higher than other more diversified short-term issues, because of its corporate bond bias, and it's likely to outperform in most market environments. But in a market selloff or flight to safety, it will likely lag.

It is reasonably priced, with an MER of 0.99% for the full freight dealer-sold units, and 0.39% for the fee-based units. It's also available as an ETF for those who wish to "do it yourself."

IA Clarington Floating Rate Income Fund

Fund Company	IA Clarington Investments
Fund Type	Floating Rate Loans
Rating	A
Style	Bottom-up Credit Analysis
Risk Level	Low to Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Managers	Jeff Sujitno since November 2013
MER	1.85%
Fund Code	CCM 9940 – Front-End Units CCM 9944 – Fee-Based Units
Minimum Investment	$500





ANALYSIS: In the very low interest rate environment we have been experiencing, funds focused on floating rate bonds and leveraged loans have garnered a significant amount of investor interest. There are now more than 15 available, with this $1.2 billion IA Clarington fund being the largest in the category.

Managed by Jeff Sujitno and his team, the fund uses a very conservative credit analysis investment process looking for issues from high-quality companies that can deliver strong free cash flow, sustain or grow revenues, and keep their balance sheets fundamentally sound. The portfolio is well-diversified, holding between 100 and 125 loans, issued primarily in U.S. dollars, so all currency exposure is fully hedged.

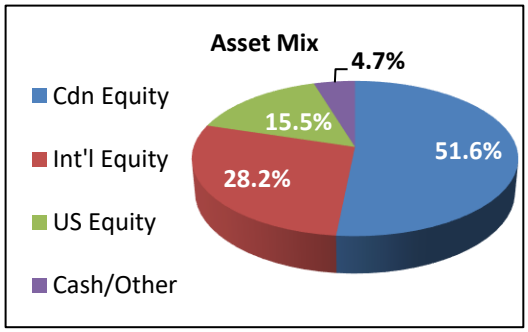
Unlike some of their more active peers, the manager is quite content holding quality while collecting a reasonable level of coupon income. Consequently, the fund's volatility has been well below the peer group over the past three- and five-year periods. Absolute performance has been roughly middle of the pack. But below-average volatility has helped the fund to category-leading risk-adjusted returns. Other peer-group funds have also done an excellent job at delivering outsized absolute returns, but I'm not sure those levels of outperformance are sustainable going forward.

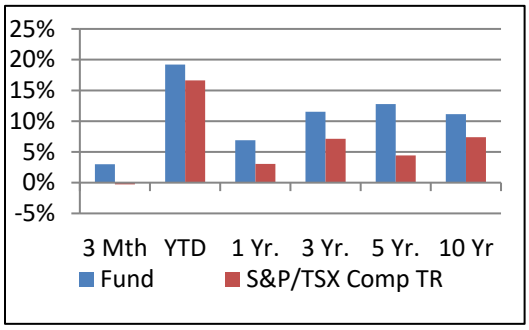
Along with the positives, there are also many risks associated with these investments. For example, looking only at a fund's volatility when assessing its risk can be misleading. While many believe that low-volatility floating-rate instruments are a great short-term parking spot for their cash, these instruments are often unrated or below investment grade, meaning they carry a significant amount of credit risk. In addition, some 80% of leveraged loan debt is "covenant lite" with many of the investor protections of earlier issues removed.

In the event we see default rates move higher, I believe the conservative, credit-focused investment style of this fund will help to better protect capital in the event of potential defaults, compared with some of the more aggressive funds out there. As a result, this remains my top pick in the Floating Rate Fixed Income category.

Mackenzie Canadian Growth Fund

Fund Company	Mackenzie Investments
Fund Type	Canadian Focused Equity
Rating	A
Style	Bottom-up
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Dina DeGeer since August 1995 David Arpin since November '12
MER	2.46%
Fund Code	MFC 640 – Front-End Units MFC 090 – Fee-Based Units
Minimum Investment	$500





ANALYSIS: Back in March, I added this fund to my Mutual Fund Focus List and with a category-leading second-quarter return of 6.1%, it did not disappoint.

Managed by the team of Dina DeGeer and David Arpin, the fund has a concentrated portfolio of well-managed, niche companies with sustainable competitive advantages, a history of strong free cash flow generation, and a growth rate higher than both the economy and their peers.

Furthermore, unlike some other growth-focused managers, valuation plays a part of DeGeer and Arpin's security selection process. To make sure they don't overpay for growth, they build out a valuation model based on a company's free cash flow to provide them with an idea of what the company is truly worth. Only those companies trading at a meaningful discount to what they believe a company is worth are added to the portfolio.

The portfolio is concentrated, holding 30-35 names, with the top 10 making up nearly 45% of the portfolio weight.

Not surprisingly, the portfolio has a growth tilt to it, with an overweight to technology, industrials, healthcare, and consumer names. As result, valuation levels are well above the broader market. However, the forward-looking growth rate looks very strong, which makes the valuation levels more reasonable.

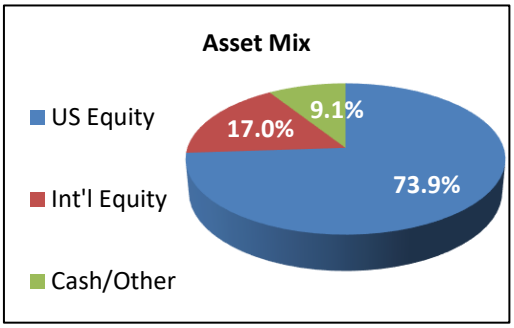
With interest rates likely to remain flat or move lower, it is expected that growth-focused investments will continue to benefit compared with more value-focused names, which is a positive for this fund.

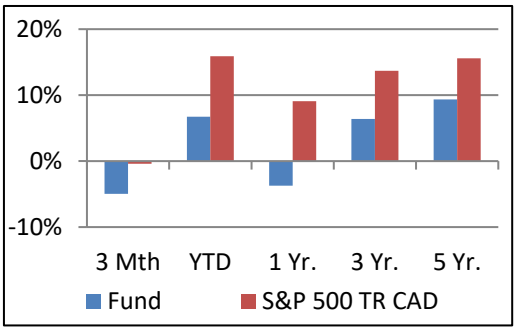
While I don't expect the recent outperformance to continue indefinitely, the skilled management team and their disciplined investment process should allow the fund to continue to perform better than average in the near to medium term.

Given its growth tilt and current levels of valuation, I would suggest being very active in taking profits in this fund. If you experience a reasonable level of growth, take some profits and bring the allocation back to a level that is in line with your investment objectives and risk tolerance. This will help to increase your overall returns over the long term and help to preserve capital in the event of a significant selloff in the markets.

Capital Group U.S. Equity Fund

Fund Company	Capital International Asset Mgmt
Fund Type	U.S. Equity
Rating	F
Style	Large-Cap Blend
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Good
Manager	Chris Buchbinder since Jan. '14 Barry Crosthwaite since Jan. '14 Mark Hickey since Jan. '14
MER	2.01%
Fund Code	CIF 847 – Front-End Units CIF 827 – Fee-Based Units
Minimum Investment	$500





ANALYSIS: This fund is modelled on the firm's oldest portfolio, the Investment Company of America, launched in 1933, which boasts a strong track record of performance. Like all Capital Group funds, it is managed using a multi-manager approach, divided into different sleeves that are managed independently by managers of different backgrounds and styles. A portion of the fund is also made up of the top picks from the firm's analyst teams. The result is a style-agnostic portfolio.

Overseeing the fund is the firm's Portfolio Coordinating Group, which monitors it in real time and is responsible for setting the manager mix, based on their outlook. With the top-down overview to set strategy, the security selection is very much bottom up, resulting in a sector mix much different than the fund's index. Of the 70 names in the portfolio, the top 10 comprise just over a third of the fund.

The portfolio has a bit of a growth tilt, with an overweight to technology and healthcare. Despite this, valuation levels are roughly in line with the broader market.

The managers take a longer-term outlook to investing, which is reflected by their very modest 23% average annual portfolio turnover. Capital Group is well known for its high level of manager co-investment in the funds. Nearly all the firm's managers had more than $1 million invested in their mandates, aligning their interests with their investors.

Costs are very reasonable, with an MER of 2.05%, which is well below the category average.

Despite its blue-chip provenance, the fund has struggled recently, lagging in the second quarter, owing to a poor showing from some holdings in the consumer staples, healthcare, and energy sectors.

Frankly, I was a little surprised at the poor showing, and I'm watching closely for a turnaround. Given the well-staffed management team, the disciplined investment process, the alignment of manager interests with investors, and the long-term track record of the firm and the fund, I remain confident performance will normalize, with index-like returns or better.