Top Funds Report

Market anxiety ratchets up in August

Concurrent macro events drive flight to safety...

August was a volatile month for stock and bond markets, driven largely by trade headlines and worries that a yield curve inversion that occurred in the month was signaling an impending recession.

The month did not start off well, with U.S. President Donald Trump announcing a 10% tariff on another batch of Chinese goods. These new tariffs were to start on September 1. Markets did not take this news well, selling off sharply in the days following the announcement.

About halfway through August, Trump announced these tariffs were going to be delayed until December. All was good in the world again. Then, about 10 days after that, China announced it would be raising tariffs on U.S. goods starting in September with another round to come in December. As would be expected, Trump fired back with a plan to hit China with even more tariffs.

In the wake of all this nonsense, investors undertook a classic flight-to-safety trade, escaping the equity market and flooding into gold and the long end of the bond market. In fact the stampede into long bonds was so fast and so widespread that the yield curve on U.S. government bonds inverted with the yield on the 10-year bond falling below that of the two-year bond. Historically, this has been a key indicator that a recession is likely a few quarters out.

By the time the dust settled, global equity markets were mostly lower, and bonds, particularly U.S. Treasuries, rallied strongly, ending in positive territory.

The S&P 500 Composite Index fell 1.6% in U.S. dollar terms, and the MSCI EAFE Index retreated 2.6%. Not surprisingly, with trade rhetoric from the U.S. and China amped up to ear-splitting levels and investors wildly looking for safe havens, emerging market equities sold off steeply, ending down more than 5% on the month.

Closer to home, Toronto's equity benchmark, the S&P/TSX Composite Index, finished higher, gaining 0.4% on the month. The influential gold sector was a key driver for the TSX in the month, as gold mining stocks benefitted from a 7% surge in the price of gold during the month as investors sought refuge from the turbulent equity environment in the classic safe haven precious metal.

Things settled down somewhat towards the end of the month and going into September as trading rooms got back to their full complement after summer vacations. Heading into the fall, however, I still remain cautious. And not just because the last quarter of the year is typically volatile.

The U.S.-China trade tensions are starting to create some meaningful friction in the global economy. Still, economic growth continues to be fairly solid, but is

Continued on Page 2

		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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showing signs of weakness, especially in Europe and China. There are a lot of lingering macro risks, including trade, the apparently unresolvable Brexit problem, and growing unrest in Hong Kong, to name just three headline issues. Many more continue to lurk.

In this environment, I continue to focus on high-quality, lower-volatility equity funds and ETFs. If we do see more surges of sudden volatility, I would expect to see these asset classes hold up better than the broader market.

In the fixed-income space, I continue to favour higher-quality, investment-grade issues over higher-yield and unrated bonds.

My investment outlook remains consistent as shown in the accompanying matrix.

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

Top Picks: Active-strategy ETFs…

I review two of my favourite Horizons picks in the active-strategy ETF space…

Over the past few months, we have been looking at different ETF options, with a focus on actively managed alternatives to the classic passive, index-tracking ETF model.

This month, we wrap up the series by highlighting some of the available active ETF options, and I am highlighting Canadian-traded ETFs only.

Active Strategies

Active ETF strategies are still somewhat rare with only a handful of options currently available.

Quite frankly, at the moment, if you're looking for high-quality actively managed investments, you're still better off using a traditional mutual fund. There is a much wider selection of high-quality mutual funds available than there are active ETFs. But that is very likely to change in the not so distant future.

As more of the conventional mutual fund companies begin to offer more ETF products, I expect we'll see ETFs becoming even more widely available as they begin offering new active mandates or wrap some of their current active offerings into an ETF structure.

We have already seen a few companies come to market with ETF versions of existing mutual fund strategies. BMO, Mackenzie, and Invesco are a few that have done that already, with more likely to follow.

I expect that one day soon we'll see funds being offering in both ETF and mutual fund structures, with the main difference being how you purchase them. Most of the current fund company ETF offerings are already structured in that way, with fees matching those charged for their fee-based units.

For this list, I have focused only on those actively managed ETFs that are only available in an ETF structure. Of the currently available offerings, two of my favourites include the following:

Horizons Active Corporate Bond ETF (TSX: HAB)

This is an actively managed bond ETF that is run by the fixed-income team at Fiera Capital. Fiera is a Montreal-based Canadian money manager with more than $144 billion in assets under management. This ETF is managed using a blend of top-down macro analysis and bottom-up security selection.

The process starts with an overview of the economy and bond market, with managers considering the outlook, their expected outcomes, and how the market has priced each area. This helps to identify any mispricing of assets and the consequent potential for outsized gains. The managers will also review current trends and develop some projections for central bank activity and the direction of yields.

Once this research process is complete, managers will then look for the sectors that offer the most attractive opportunities, seeking to identify individual issues where the true value has not been fully recognized by

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the market. The managers have the flexibility to invest in the areas where they see the best opportunities, irrespective of the constraints of a benchmark.

The portfolio is expected to be overweight corporate fixed-income issues in most scenarios as corporates tend to offer higher yields and less interest-rate sensitivity than government bonds. That will lead to outperformance in most market environments, compared with government bonds. However, it is likely there will be underperformance if we see significant market volatility leading investors to seek safe haven in government bonds.

While more expensive than the passive bond options, costs for this ETF are very reasonable. The management fee is 0.50%, which results in an MER of 0.59%.

Horizons Active Canadian Dividend ETF (TSX: HAL)

This systematically managed ETF has delivered very strong absolute and risk-adjusted returns for investors since its launch in February 2010. Its 5-year average annual compounded rate of return to July 31was 6.1%, outpacing the S&P/TSX Composite, which returned 4.4% over the same period.

Manager Sri Iyer and his Systematic Strategies team at Guardian Capital look for Canadian companies that have the ability to pay, sustain, and grow their dividends. The team uses a rules-based screening process that analyzes 31 different factors, looking for positive rates of change. These factors focus on growth, payout ratios, efficiency, valuation, and investor sentiment.

The result is a well-diversified portfolio of around 45 names, with the top 10 making up roughly a third of the ETF's holdings. The managers can invest in companies of any size, and approximately half the portfolio is allocated to large-cap names, with the balance in small- and mid-caps.

The sector mix of the fund is dramatically different than the broader Canadian market, with an overweight in energy, real estate, and utilities. It is significantly underweight financials, which is rare for a dividend-focused mandate.

Valuation levels are slightly higher than the broader market and the peer group. However, the stronger-quality metrics, combined with the higher forward-looking earnings growth rate, more than offsets the higher valuation, making this fund one of the more attractive options in the dividend ETF category.

The fund has also been one of the least volatile in the category, while delivering well above average returns. Looking at the defensive positioning of the portfolio, there is nothing to indicate a higher level of volatility ahead. The biggest knock on this ETF is its cost, with an MER 0.79%, which is well above the category average. Still, the alpha generated has more than offset this higher cost.

Funds of Note

This month we look at the sale of Vertex One funds and PIMCO's flagship income fund

Vertex One funds to be sold

Last issue I wrote about the takeover of the Vertex Value Fund by Vancouver-based PenderFund Capital Management after the departure of Vertex's Matt Wood. In late August the other shoe dropped with an announcement that the remainder of the Vertex Funds with some $380 million in assets under management were being sold, with PenderFund and Toronto-based Picton Mahoney Asset Management the buyers. The transactions are expected to close by year-end pending approvals.

In addition to the Vertex Value Fund, PenderFund will also acquire these funds:

- Vertex Enhanced Income Fund
- Vertex Growth Fund
- Vertex Fund
- Vertex Managed Value Fund

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Once the deals are finalized, several of the funds are likely to be merged into existing Pender offerings. Several funds have already eliminated their performance fees, which is a good PR move. In practice, many of the funds are so far underwater that it will be a while before they generate performance fees again, in any case. Still, I applaud the investor friendly way in which this was done.

Pender has done an excellent job in managing their own funds historically, delivering very strong risk-adjusted returns for investors. Still, one concern I have is that the rapid influx of a large amount of new money into Pender's asset base may result in some difficulty for the managers in continuing to execute their investment strategy, which has been so successful in their smaller asset base. In time, I expect this is something that can be overcome by a competent management team.

While I ultimately expect this to be a positive, I would likely avoid new purchases into the directional Vertex strategies or the Pender funds until this transaction can be absorbed.

Meanwhile, Toronto-based Picton Mahoney Asset Management is acquiring the remainder of Vertex's funds:

- Vertex Arbitrage Fund
- Vertex Arbitrage Plus Fund
- Vertex Liquid Alternative Fund
- Vertex Liquid Alternative Plus Fund,
- Vertex Bond Alpha Fund

Vertex managers Craig Chilton and Tom Savage will continue with Picton Mahoney. The arbitrage strategies are being transferred to Picton with their management teams in place. The funds have performed largely as expected, and significantly outpaced the more directional Vertex offerings.

PIMCO Monthly Income Fund update

In a recent note to investors, PIMCO outlined some of their recent changes and positioning for the second half of the year (see https://www.pimco.ca/en-ca/insights/investment-strategies/strategy-spotlight/income-strategy-update-favoring-a-responsible-approach-over-yield-chasing).

One of the changes was the addition of agency mortgage-backed securities, that is, those issued by one of three quasi-governmental agencies: Government National Mortgage Association (GNMA); Federal National Mortgage Association (FNMA); and the Federal Home Loan Mortgage Corporation (Freddie Mac).

Bonds issued by GNMA are backed by the U.S. government, while FNMA or Freddie Mac securities do not carry this same guarantee. However, the risk of default is negligible.

According to PIMCO, the valuation on these securities was very attractive in part because the U.S. Federal Reserve had been selling agency MBS over the summer. While these were attractive, the managers still prefer non-agency MBS for their higher yield potential and very strong liquidity characteristics.

The managers generally prefer housing-related issues over other corporates because they believe the fundamentals underpinning the housing market are stronger than for generic corporate debt.

They also note that the market technicals are also favourable with predictable cash flows, minimal issuance, and generic structures. This helps insulate them from much of the volatility associated with traditional corporate bonds.

They are avoiding non-financial corporate credit owing to a deterioration in underwriting standards, an uptick in leverage, and high levels of new issuance.

Managers have built liquidity concerns into the investment process. As a provider of liquidity in times of crisis, the fund can pick up higher-quality securities at very attractive yields. As we head into a potentially more volatile period, this may prove to be a solid strategy. In addition, the managers are also focusing on more defensive and more liquid parts of the bond markets

This remains one of my top picks in the global fixed-income category, providing investors with a diversified portfolio of global bonds with a solid track record of performance. It is available either as a mutual fund or as the **PIMCO Monthly Income Fund – ETF Series (TSX: PMIF; TSX: PMIF.U**).

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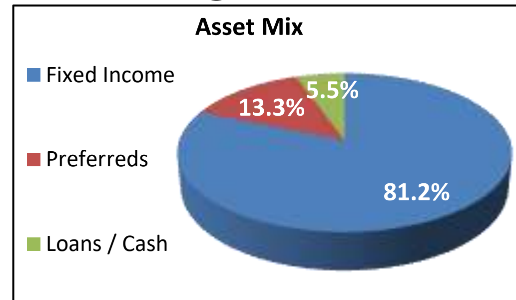
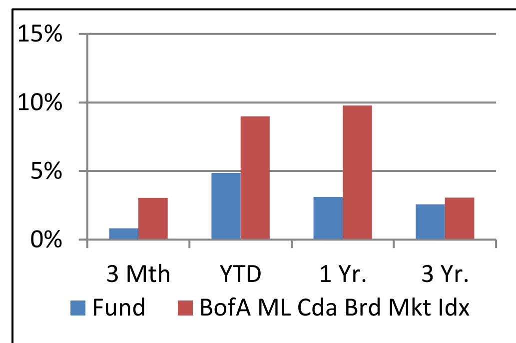
Leith Wheeler Corporate Advantage Fund

Fund Company	Leith Wheeler Investment Cnsl
Fund Type	Canadian Corp. Fixed Income
Rating	A
Style	Top-down Macro/Bottom-up Security Selection
Risk Level	Low
Load Status	Front End
RRSP/RRIF Suitability	Fair
Manager	Leith Wheeler Mgmt team
MER	0.79%
Fund Code	LWF 021 – DIY Units LWF 032 – Fee-Based Units
Minimum Investment	$25,000





ANALYSIS: This is an actively-managed Canadian bond fund from employee-owned Leith Wheeler, based in Vancouver. It invests in a diversified portfolio of fixed-income securities, including investment-grade bonds, high-yield bonds, loans, preferred shares, and convertibles.

While the manager has some flexibility, the fund will be focused mostly in investment-grade issues.

The fund can, however, hold up to 20% in bonds that are less than investment grade and up to 30% in preferred shares. This high-yield and preferred share exposure is likely to come from holding other Leith Wheeler funds that invest in those assets.

The investment process starts with a top-down analysis that reviews the economic and interest rate outlook. The managers then set their duration, sector, and credit quality targets.

Security selection is very much a bottom-up process, involving fundamental credit analysis that looks for credits trading at reasonable levels for both return and yield.

At the end of June, the portfolio was allocated 80% to bonds, 13% to preferred shares, and 5% to loans. Within the bond sleeve, nearly 85% was rated investment grade.

Over the past five years, the fund has delivered an average annual compounded rate of return of 2.8%, compared with 4.2% for the FTSE Canada All Corporate Bond Index. Performance year-to-date has lagged, though, with the fund ahead 4.7% compared with 5.6% for the benchmark, a result of the preferred share exposure (the Leith Wheeler Preferred Share Fund is down 7.7% year to date).

Despite this recent hiccup, this is a well-managed, corporate bond-centric offering, with a deep, well-resourced investment team, using a disciplined investment process. Moreover, their access to some non-core strategies would be expected to allow the fund to deliver decent relative returns with modest levels of volatility. I do not see this as a core holding, but rather a part of an otherwise well-diversified fixed-income sleeve of a portfolio.

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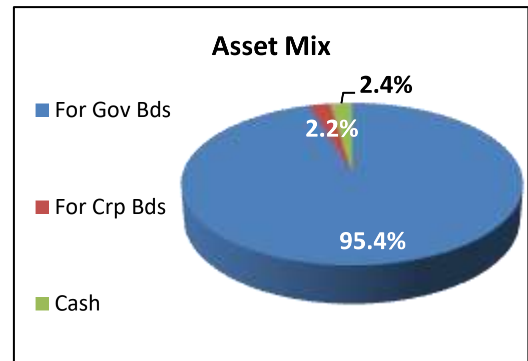
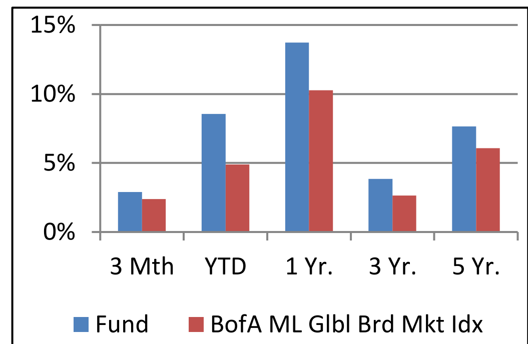
RBC Emerging Markets Bond Fund

Fund Company	RBC Global Asset Management
Fund Type	Emerging Market Fixed Income
Rating	C
Style	Top down Macro Bottom up security selection
Risk Level	Medium
Load Status	Optional
RRSP/RRIF Suitability	Fair
Managers	David Nava since Dec. 2018
MER	1.79%
Fund Code	RBF 797 – Front-End Units RBF 697 – Fee-Based Units
Minimum Investment	$500





ANALYSIS: Typically, emerging markets (EM) investing conjures up visions of very high risk, but potentially rewarding, equity investments. But we often forget about the fixed-income markets of these developing nations, which have grown substantially over the past decade as fiscal fundamentals improve.

EM debt has a very attractive correlation profile to other asset classes, making it a strong diversifier in a portfolio. But given the complexity of the broader EM debt market, this is certainly an asset class you'll want to leave up to the experts.

This RBC offering, under new lead manager David Nava, is one of the more attractive options. The fund debuted in August 2010 and invests in a mix of government and corporate bonds of companies in developing economies. At the end of July, it held 64% in government debt and 35% in corporate credit

Credit quality currently skews more to non-investment grade, with more than half rated BB or lower. Yield to maturity is attractive, at nearly 5%, well above the yield offered by Canadian investment-grade issues

The portfolio is very well diversified, with more than 800 individual bonds. The top 10 holdings represent approximately 15% of the assets. The country mix is also very well diversified. The largest weighting is to Indonesia, at just under 5% of holdings, followed by Russia, Peru, and South Africa.

Performance has been solid, particularly over the longer-term. The 5-year average annual compounded rate of return to Aug. 31 is 7.65%, leading the category. However, volatility is substantially higher than with more traditional bond funds, and this fund tends to be one of the more volatile in the category.

With a very strong start to the year, EM bonds are vulnerable to a pullback in the face of macro headwinds (e.g., the trade war). Longer-term, though, with the higher yield and strong diversification benefits offered, EM bonds could be a piece of an otherwise well-diversified portfolio. This is *not* a core bond holding. Given its higher volatility and overall risk, it is more appropriate as a smaller piece of a diversified fixed-income allocation.

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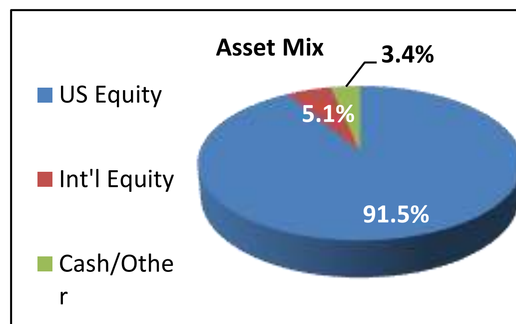
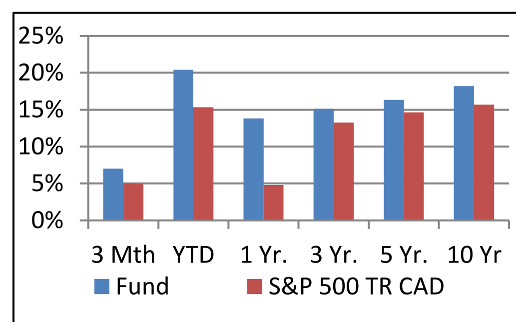
Mawer U.S. Equity Fund

Fund Company	Mawer Investment Management
Fund Type	U.S. Equity
Rating	C
Style	Bottom-up Growth
Risk Level	Medium
Load Status	No Load
RRSP/RRIF Suitability	Excellent
Manager	Grayson Witcher since May 2009 Colin Wong since January 2016
MER	1.15%
Fund Code	MAW 108 – No-Load Units
Minimum Investment	$5,000





ANALYSIS: There is really only a handful of active strategies worth considering in the U.S. equity category, and this Mawer offering is certainly one to take a look at.

Managers Grayson Witcher and Colin Wong look to build out a focused, yet diversified, portfolio of well-managed, wealth-creating companies that are trading at a discount to their long-term value. They've succeeded not only in delivering solid returns, but also managing the overall risk profile of the fund. The fund's 5-year average annual compounded rate of return to Aug. 31 is 16.4%, compared with 14.7% for the S&P 500. Year-to-date, it's up more than 20%, while the index is up more than 15%.

Volatility is slightly lower than the index and category, and the fund has delivered roughly 100% of the market return in a raging bull market, while participating in only 80% to 85% of the market's downside. This all comes down to Mawer, its culture, investment process, and investment team.

Mawer's strong corporate culture means investment style is unlikely to be flashy, and managers avoid taking big bets on any stock or sector. Another key to their success is the ability to look at portfolios using a realistic lens that weighs many different scenarios and outcomes, helping them adapt to changing market environments.

Their approach is long-term and patient, with a significant amount of research work at the front end on any position in the portfolio. This allows them to give holdings a bit of runway and management time to execute their strategy.

Changes to the portfolio are made for only three reasons: a better opportunity; an erosion in fundamentals; or a change in valuation. They use a very bottom-up approach and do not target specifically any industries or sectors.

A couple of things the managers have recently been watching include valuation levels, which may be getting ahead of fundamentals, particularly for some of the higher-quality, more defensive names, and the geopolitical environment. Brexit and Trump's trade war with China continue to create uncertainty and friction, which has the potential to dial back growth expectations.

I expect this fund to continue as one of the better U.S. equity funds. I don't expect the current level of outperformance to be sustainable, but I still expect the management discipline to allow for category-beating numbers.

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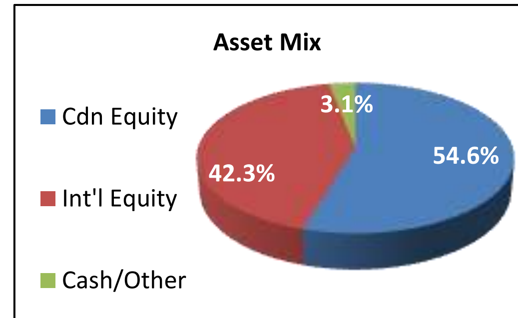
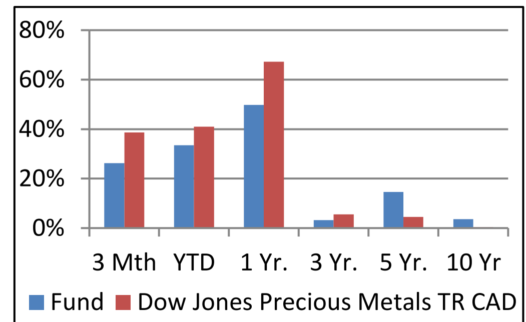
Dynamic Precious Metals Fund

Fund Company	Dynamic Funds
Fund Type	Precious Metals Equity
Rating	B
Style	Small Cap Growth
Risk Level	High
Load Status	Optional
RRSP/RRIF Suitability	Poor
Manager	Robert Cohen since Nov. 2000
MER	2.71%
Fund Code	DYN 046 – Front-End Units DYN 1646 – Fee-Based Units
Minimum Investment	$500





ANALYSIS: The past few months have been marked by rising levels of fear and uncertainty resulting from many concurrent macro events. These include unrest in Hong Kong, the mess that is Brexit, the trade war between the U.S. and China, and the potential for more Fed rate cuts, which could push down the U.S. dollar. Thanks to its safe-haven status, gold bullion is up 20% in the first eight months of the year. Silver has also shown a strong run, gaining more than 33%.

The mining sector has benefitted even more, as year-to-date, the S&P/TSX Gold Index is up nearly 48%. Precious metals funds have enjoyed the ride, and while this Dynamic offering is not the strongest performer in the space year-to-date (up “only” 33%, but trailing the category), it’s one of my favorites.

Manager Robert Cohen uses a fundamentally-driven, bottom-up investment process looking at companies anywhere in the world involved in the exploration and production of precious metals. The fund may also hold gold bullion directly.

In practice, given the active management, the fund tends to be concentrated in small- and mid-sized companies, unlike the benchmark, which is weighted by market capitalization. So it’s notable, given the volatility of the smaller-cap space, that the manager takes a very patient approach, with portfolio turnover averaging only 30% over the past few years. At the end of July, the fund had 55% invested in Canadian equities and 40% in Australian companies. The balance is held in cash.

Like all precious metals funds, performance has been volatile – nearly four times that of the broader market. Another drawback is that the fund is highly dependent on the outlook for gold. While it’s been strong recently, it has experienced several periods with disappointing results, sinking well into double-digit negative territory from 2011 to 2013.

The 5-year average annual compounded rate of return to Aug. 31 was 14.7%, which led the category and outpaced the broader Canadian market. I don’t expect this blistering pace to continue, unless we see the geopolitical environment deteriorate substantially. Still, for investors looking for a solid fund that provides exposure to gold and precious metals companies, this one is at the top of my list.

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