Sept 12, 2016

Volume 22

Issue 9

ETF & MUTUAL FUND UPDATE

In This Issue...

Market Radar		
Markets	**TSX Composite**	**S&P 500**
P/E	17.26	19.94
Yield (%)	3.02	2.48
YTD Performance (%)	13.78	6.72
Top Performers	**ETF**	**Mutual Fund**
1-Month	FT AlphaDex EM Div ETF	TD Emerald CDN Bond Index
YTD	BMO Junior Gold ETF	AlphaNorth Resource Series A
3-Year	BMO India Equity ETF	Excel India
Market data as of September 9, 2016; top performers as of month-end.		
Note: We are no longer including leveraged ETFs in top performers list		

Challenges Mutual Fund Managers Face VS ETFs

By Peter Hodson, CFA

Most investors by now know the benefits of an ETF over a mutual fund. Typically, the main ETF advantage is a lower fee structure. Lower fees, over time, amount to significant savings—more money in your pocket.

I was a mutual fund manager for nearly 20 years. Now, I have seen the light and have completely gone against them. Some call me a pariah in the industry. But if I can stop just one investor from buying a high-cost mutual fund and thus help them achieve a better retirement because of it, then I have won.

We all know index ETFs have lower fees than funds, and perform better because of this. Let's look, though, at some significant non-fee advantages that your index ETF has over actively-managed funds. Most investors do not consider these, but they are also big factors in why your index ETF performs better than your actively-managed fund.

Indices have no ego

There are lots of egos in the investment industry. By its nature, the financial industry attracts Type A personalities. This can cause an active manager to experience bouts of foolishness (see below) or to be more aggressive in their mutual fund to prove that they are the alpha male (or female). The result: volatile and often weak investment performance.

Indices do not get bonuses

Mutual fund managers can get large bonuses for doing well. So, suppose you are a manager and it is September, and your fund is underperforming. If you can 'turn it around' you might get a giant bonus in January. So, as a manager, what do you do? You take bigger bets to try and improve your fund's performance. Some—like me—call this gambling.

Indices do not take vacations

Most active managers take their jobs very seriously. In my entire career, I only had five calendar days when I was not connected to my Bloomberg somehow (I was hiking in the Yukon with no Internet). But, vacations, time zone differences and illness still took me out of the loop from time to time. I was constantly worried about 'missing something' when I was

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on a plane. Index ETFs, of course, have no worries here. Index changes are made on a regular, usually consistent basis (for the TSX, every three months, unless there is activity due to takeovers and the like). Simply put, an index ETF manager is very likely to never miss anything at all.

Indices do not have to follow all stocks

As a small-cap manager, I was expected to know every company, in every sector, in every country of the world, as long as it was less than a $1 billion market cap. I remember earnings season, when I would sometimes have 20 companies I was following reporting at the same time. Fun? No! At some of the companies, I had some research assistants to help out, but not always. Needless to say, following everything is an impossible task, and actively managed fund performance can suffer immensely because of it. Index ETF managers, on the other hand, simply buy the 40 or 60 stocks in the index, and that's it. They don't even have to look at quarterly reports. Wow, I can't even imagine how nice that would have been.

Indices are not stubborn

Countless investors—and managers—have had bad years and made bad investment decisions when they 'knew they were right' on a stock, even when evidence piled up against them. These managers would keep buying into losing positions, increasing their fund's weight in a particular stock, only to see it continue to fall. We have seen fund managers destroy their careers by being stubborn on particular stocks. Recent Canadian examples might be Valeant and Concordia International, two stocks that effectively went straight down all year, yet managers kept buying. Index ETFs, on the other hand, just buy and hold what's in the index. Since most indices are market-cap weighted, they will never by design buy more of a losing position.

Indices do not get scared

Suppose you are a fund manager, and it is early 2009 in those dark days of the financial crisis. The markets have been plummeting for months, you don't know which financial institution is going to go belly up overnight, and you don't know how much money investors are going to pull from your fund tomorrow morning—forcing you to sell stocks to meet redemptions. Yep, it was a scary time, certainly the worst time for me in my career. Was I scared about doing the wrong thing? Buying the wrong stocks? Managing redemption cash calls? You bet. I couldn't sleep. I had never seen anything like it. Neither had anyone else. I made some good moves then, and some bad moves. But an index doesn't get scared. It simply owns what it is supposed to. It doesn't fear the next day. It doesn't worry about its job.

Indices do not worry about cash flows

As an active manager, I have had some very good performance years in my career. Most of the time, this caused problems. You see, when you have a 'hot' mutual fund, everyone wants to buy. Investors chase performance. As a small-cap manager, getting a lot of money into your fund in a short period can be a bit of a curse. It is harder to keep buying your favourite companies when you are managing $400 million instead of $50 million. But hot funds can get 'cold' too, and then you can be faced with big withdrawals from your funds as this 'hot' money leaves for other hot funds. Managing outflows of cash is usually harder than managing inflows. Handling cash flow and buying/selling, of course, can negatively impact an active fund's investment performance. But an index ETF, by definition, is never 'hot'; it is the market. ETF market makers have a much, much easier time managing cash flow into their funds.

We haven't even mentioned fees or commissions in this discussion. Keep the above points in mind when deciding between a mutual fund and ETF.

Mutual Fund Spotlight: Mawer International Equity

By Michael Southern

The Mawer International Equity fund (the "fund") has established itself as a flagship holding for international equity exposure since its inception in 1987, and currently has over $4.7 billion in assets under management. The fund has won multiple awards including the prestigious Fundata FundGrade A+, which is only awarded to about 200 funds every year out of a universe of over 36,000 funds. The lead Portfolio Manager is David Ragan, who has managed the fund since 2010 and has been with the firm since 2004. The fund also has a "Gold" rating from Morningstar. Mawer's strong performance on many of its equity funds has led to a marked increase in assets, which the firm has managed responsibly, capping funds when appropriate.

A Focus on Process and People

Success at Mawer can be traced back to process strength and the multiple approval layers that a stock must meet prior to becoming a portfolio position. Mawer invests in strong management teams and "wealth-creating" firms that have sustainable competitive advantages trading at a discount to intrinsic value. When managers refer to "wealth-creating", they mean those that deliver a return of capital greater than their cost of capital over time. Analysts then use a discounted cash flow model to determine their valuations, which the firm then puts through rigorous scenario analysis and stress tests to determine a level of conviction and to measure the risks inherent in their estimate. While this may sound like a 'given' to the educated investor, it is often easier said than done and Mawer has demonstrated clear abilities here. To determine position size, managers plot stocks on a matrix based on their opinion of a company's quality and potential upside. Once they identify a suitable stock and size, managers like to hold for the long term to allow for corporate growth and to minimize transaction costs.

From a people perspective, the fund has benefitted from stable portfolio management tenure. Gerald Cooper-Key managed the fund since the 1987 inception and passed the title to Mr. Ragan in 2010. Mr. Ragan has built an enviable track record on this fund since taking over lead responsibility in 2010. Ragan is supported by co-manager Jim Hall who has been with Mawer since 1997 and has been managing the highly successful Mawer Canadian Equity fund since 1999. Hall also serves as the firm's Chief Investment Officer.

A Stellar Performance Record

The fund boasts an 8.2% annualized return since its inception. Over the last 10-year period, the fund has a 6.7% annualized return versus the MSCI EAFE benchmark of 3.2% and has beaten its benchmark in seven of the last ten calendar years. The consistent generation of alpha demonstrates the strength of Mawer's processes/people and bottom-up process, as the majority of the portfolio's return since Ragan took over the lead manager role has come from security selection. According to Morningstar, since Ragan took over as lead manager, the fund has captured just 77% of market declines. In addition to the downside protection, investors have still enjoyed all of the gains during market rallies with a 100% upside capture. During his tenure, from April 2010 to May 2016, Ragan's risk-adjusted return has ranked in the top decile in its category, as measured by the Sharpe and Sortino ratios.

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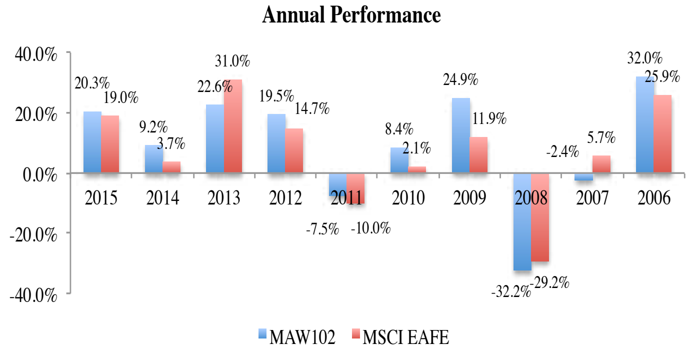

Annualized Performance (net of fees)							
	YTD	1-year	3-year	5-year	10-year	Since Inception
MAW102	-2.1%	5.4%	14.0%	11.1%	6.7%	8.2%
MSCI EAFE	-1.1%	-6.5%	9.4%	7.9%	3.2%	

Setting Future Expectations

With the fund's positions delivering strong returns, valuations have risen to higher levels. When forced to choose between valuation and quality, Ragan and the team will usually favour quality, a criterion we support, as we would rather pay more for an excellent company than a lower valuation for an 'ok' stock. However, this judgment has resulted in the portfolio looking expensive. Here, the fund's success does pose some risks. Currently, the fund trades at a forward P/E and dividend yield of 19.1x and 2.6%, respectively, versus the MSCI EAFE benchmark at 15.2x and 3.8%. While higher valuations could create 'bumpy' short-term performance should markets stumble, over the long-term, the portfolio should deliver strong risk-adjusted returns if the underlying stocks deliver in the quality and/or growth prospects.

Portfolio Construction

The fund's largest single country allocation is to the United Kingdom (UK) at 23.9%; however, the remainder of Europe accounts for 39.2% of the allocation. There is also a 25.0% allocation to Greater Asia, split equally between Japan and emerging Asian countries. Managers highlight that they look beyond the geographic or country exposure and try to determine the revenue exposures of holdings. For example, while the portfolio has an overweighting to the UK, underlying revenue exposures from those holdings are actually distributed roughly one third each to the United States, European Union, and Asia.

Managers target a weight limit for an individual holding and industry to 6% and 20%, respectively, to limit risk. The 'Top 10' holdings account for 34.0% of the equity allocation, or an average position size of 3.4%. Currently, the fund is slightly tilted to financials and consumer staples. We like this yield focus and their pairing of defensive staples with what can be higher beta financial stocks. There is also a 22.0% allocation to mid- and small-cap stocks. Holdings are required to have at least $1 billion in free float at the time of purchase. The managers favour a fully invested and low turnover strategy, with an average holding period of close to five years. The firm does not hedge foreign-currency exposures.

Our Thoughts

With the S&P500 trading at a P/E valuation of 20x and a yield of 2.5%, many other international markets look well priced in comparison, Europe being a highlight here. One exception would be the UK with the FTSE100 trading at a P/E of 21.7x (but offering a 4.0% yield). We feel MAW102 is well positioned to take advantage of these long-term opportunities. With a higher quality portfolio and strong performance, the fund itself is expensive which may dampen immediate performance/upside. Otherwise, the fund serves as an example to the rest of the mutual fund industry: a strong investment team with minimal personnel turnover, investor-friendly policies, strong risk management, and a well-defined investment process applied consistently. What helps make the Mawer offering all that more appealing is that investors can access these strengths for a lower cost.

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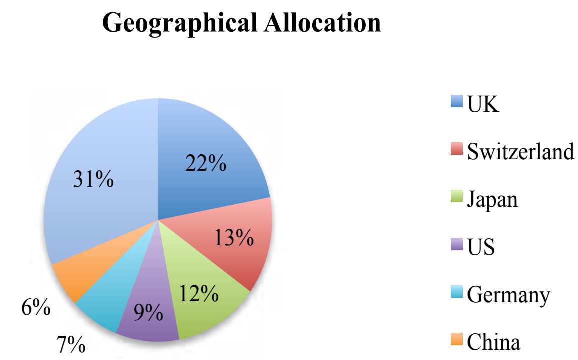
According to Morningstar, the 1.52% management-expense ratio is one of the lowest among actively managed funds in the international equity category. A key factor is the absence of a trailer commission to compensate advisors for selling the fund. A minimum $5,000 initial investment is required, however. In our opinion, MAW102 is a core holding for investors seeking diversification outside North America. Investors looking for funds that rank high in long-term returns and yet do so with relatively low volatility would be well-served by considering MAW102.

Fund Details	
Fund code	MAW102
Price (2016/08/18)	54.0
AUM ($M)	4,700.0
Inception date:	06/11/1987
MER (%)	1.5
Since inception return (%)	8.2
Trailing 12-month yield (%)	0.7



Introducing the ETF Recommended List - Part 2

By Michael Southern

We first introduced the ETF Recommended List (the "list") in Part 1 of this series. We discussed what we look for in an ETF, along with how investors should use the list. Here, we will continue the discussion, look at some portfolio construction topics and provide brief commentary on position, performance and valuation. The list will be a quarterly feature going forward.

Quarterly Update

Geographical equities had a solid quarter with each of our recommended ETFs showing positive performance over the last three months. Even VE, the UK-tilted International ETF managed to edge out a 1.4% return on the heels of Brexit. Interestingly, the poor data that markets were expecting after the Brexit has not surfaced as most thought it would, helping to lift this region. The big winner was emerging markets with VEE up 15.3%. As traders push back bets on higher US interest rates, this dampened the pace of the USD appreciation. A strengthening USD tends to accelerate capital outflows from emerging economies and can increase debt-servicing costs. Rising oil prices were also a driver here as well, which likely contributed to a general 'risk-on' investor sentiment, exemplified by the small-cap ETF (IWO) being up 8.9%.

The commodity rally continues to grab headlines this quarter. Indeed, the shine of gold continues to captivate investor intention and the metal's hedge-like properties in conjunction with lower interest rate expectations have pushed XGD up almost 100% over the last year. How much further does the commodity bounce have to run? It is anyone's guess but valuations are looking stretched: XGD and ZEO trade a forward P/E multiple of 37.5x and 31.0x. The effects aside, investors have not yet forgotten the volatility that kicked off 2016. In a search for yield and stability, investors continue to move utility and telecommunication stocks higher. The utility sector has hit 5-year highs and yields have come down in general; however, ZUT continues to offer an attractive yield of 4.6%, which is not too far from historical norms.

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Portfolio Construction Methodology

It is important to understand that the list does not constitute a suggested portfolio and it is not necessary to go out and buy the entire list (or even a majority of the ETFs). An investor could easily construct a complete portfolio from three or four of these ETFs. Which ETFs you choose and how you weight them are left to the reader's discretion. However, we will provide some portfolio construction guidelines that should help you adhere to portfolio management best practices.

As the name suggests, the investor should always prioritize the core portfolio holdings as they are the foundation or anchor of the portfolio. Depending on how many regional exposures you choose to employ, we prefer limiting holdings to one or two ETFs per region. The core ETFs found in the list are representative of an entire market and multiple broad-market strategies to the same region only creates redundancies. It is worth noting that if you already hold a large portfolio of geographically diversified stocks (i.e. 30 – 40 stocks) a broad-market ETF is not necessary. In this case, using an ETF simply creates a "closet indexed" portfolio and adds minimal value in the way of diversification. This also comes at the cost of an MER.

A popular strategy amongst more sophisticated investors is "sector rotation" or tilting the portfolio to sectors that are believed to outperform. While we have provided sector ETFs for this purpose, we caution to always be mindful of achieving equity returns through diversification versus creating concentration risks in one or two sectors. In general, we would prefer to limit any single sector allocation to a maximum of 15% to 20%. We believe each sector plays a role in the success of the portfolio and would suggest a minimum 5.0% in each sector. There are 10 TSX sectors (although REITs can be considered an 11th now).

When choosing a weight for an ETF, we think the investor needs to consider a minimum of 5.0% in the context of the equity portfolio. Any amount lower than this means the underlying holdings begin to play a lesser role in overall performance, as some ETFs hold upward of 100 securities. The 5.0% benchmark is true for any equity ETF in our list. Core ETFs could be benchmarked at a 10.0% to 20.0% equity portfolio weight due to the broad market diversification. The fixed income ETFs differ from the equity counterparts in our view. For example, one could argue holding a large degree of a fixed income portfolio in one or two ETFs. As long as the overall credit quality of the fixed income holdings is high, we believe that geographical diversification is of less importance compared to equities. Obviously, the higher risk a fixed income position (high yield, convertible, etc.), the more appropriate diversification across the asset class would be.

Market-cap weight vs. equal weight

There is a strong presence of ETF products from Blackrock (iShares) and Bank of Montreal (BMO). This provides the investor different weighting strategies when choosing to build an exposure: iShares ETFs generally hold underlying positions at a market-cap weighting whereas BMO ETFs use an equal weight approach. In general, we have a preference for the equal weight strategy as this adheres to the spirit of diversification and also allows each underlying holding to have a meaningful impact on performance. However, there are circumstances that would make a market-cap strategy appealing to some investors, particularly if they have a strong conviction in the top holdings but at the same time want to maintain some exposure to the larger investment universe. The list below should help readers to sift through the growing list of ETF products and help concentrate energy on the more viable options out there.

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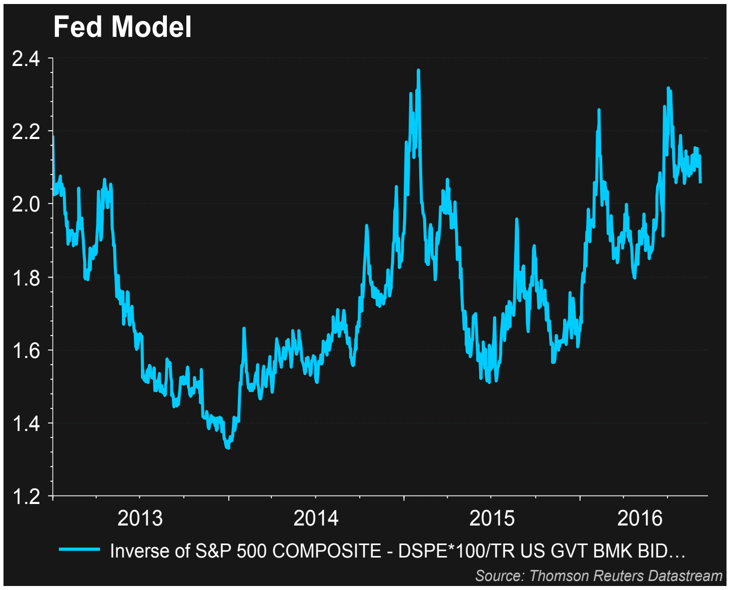
Broad Market 'Core' ETF								
Name	**Ticker**	**Region**	**Strategy**	**3-month return (%)**	**1-year return (%)**	**P/E (NTM)**	**Yield**	**Comments**
iShares MSCI World	XWD	Global	Broad market	4.5	2.8	17.7	2.8	If you can only hold one ETF, this should be the one. XWD offers the broadest global equity diversification with good sector balance.
S&P/TSX 60 Total Return	XIU	Canada	Broad market	5.3	12.2	16.9	3.3	The largest ETF in Canada with almost $12 billion in AUM. Roughly a 40.0% allocation to the financial sector.
Claymore CDN Dividend & Income Achievers	CDZ	Canada	Dividend	2.7	1.6	15.5	4.9	For a Canadian strategy there is a good balance across sectors. Even split over small/mid/large-caps.
Vanguard U.S. Total Market	VUN	United States	Broad market	7.0	1.1	19.5	2.2	A total market approach offers an advantage over traditional market-cap weighted indices in that there is better representation from small-caps.
Vanguard U.S. Dividend Appreciation	VGG	United States	Dividend	4.9	4.4	20.4	2.2	Sector tilts make a good pairing to balance out Canadian sector bias.
Vanguard FTSE Developed Europe All Cap	VE	International - Europe	Broad market	1.4	-11.7	16.6	3.6	Good diversification from a sector and country perspective. The U.K. is a roughly 30% allocation.
Vanguard FTSE Emerging Markets All Cap	VEE	International - Emerging Markets	Broad market	15.3	3.1	13.3	3.6	There are many ways to play the region: EM, BRICS, single country exposure. VEE is the low cost leader in the EM category.
BMO MSCI EAFE (CAD-Hedged)	ZDM	International - EAFE	Broad market	4.6	-9.6	15.9	3.7	Efficient method to gain exposure to both greater Europe and Asia (developed). A low cost leader in the EAFE category.
Specialty 'Satellite' ETF								
First Asset Morningstar Canada Momentum	WXM	Canada	Momentum	6.0	-2.8	19.9	2.4	WXM screens for above average returns on equity, with an emphasis on upward earnings estimate revisions and price momentum indicators.
BMO Covered Call Canadian Banks	ZWB	Canada	Covered call	3.7	6.4	11.8	4.4	Covered call writing will give income investors extra yield over traditional dividend stocks at the cost of capital appreciation in an upward market.
PowerShares Buyback Achievers Portfolio	PKW.US	United States	Buybacks	3.8	-1.9	16.3	2.1	Share buybacks are often an overlooked source of income. PKW makes a good compliment to the traditional dividend portfolio.
iShares Russell 2000 Growth	IWO.US	United States	Small/micro-cap	8.9	-5.1	23.1	1.0	A useful compliment to funds such as VUN for investors looking to grow the portfolio. There is a 90.0% allocation to small/micro-cap equity.
iShares S&P/TSX Completion	XMD	Canada	Mid/small-cap	6.3	8.4	19.1	3.1	A useful compliment to funds such as XIU. Allows investors to access the small/mid-cap space not addressed by market-cap weighted products.
Sector ETF								
iShares S&P Global Consumer Discretionary (CAD-Hedged)	XCD	Global	Consumer Discretionary	4.4	-3.8	16.6	2.3	With many globally recognized brands such as Starbucks and Addidas, we find it hard to limit exposure to the Canadian sector.
Vanguard Consumer Staples	VDC.US	United States	Consumer Staples	5.7	11.5	22.0	2.5	The sector is poorly served within Canada and domestic ETFs typically hold less than 10 stocks.
BMO S&P/TSX Equal Weight Oil & Gas	ZEO	Canada	Energy	7.1	14.5	31.0	4.8	With higher sector volatility, the equal weight strategy is appealing to limit any single stock exposure.
BMO S&P/TSX Equal Weight Banks	ZEB	Canada	Financials	3.9	9.2	11.8	4.4	Exclusively the 'Big Six' banks. A higher conviction strategy than the U.S. counterpart with approx. 16.0% weight per equity position.
BMO Equal Weight REITs	ZRE	Canada	Financials - REIT	1.4	5.0	13.2	5.6	Like the equal weight aspect, as peers are top heavy in a few names, notably the Riocan REIT
iShares Global Healthcare (CAD-Hedged)	XHC	Global	Healthcare	6.0	-7.8	21.1	2.0	The sector is strong in the U.S. and greater Europe. We like the high conviction with 26.0% allocated to the top five names.
BMO S&P/TSX Equal Weight Industrials	ZIN	Canada	Industrials	5.1	9.8	12.6	2.2	The sector is well-represented in Canada. Stocks are typically smaller in size vs. global peers. Average market-cap is $3 billion.
iShares S&P Global Industrials (CAD-Hedged)	XGI	Global	Industrials	3.2	0.9	17.1	2.4	Despite a strong Canadian sector, we always side with diversification. Average market-cap is $40 billion.
iShares S&P/TSX Global Gold	XGD	Global	Materials	15.3	98.0	37.5	0.8	Higher volatility is almost assured in the general commodity space. We like the idea of gold as an insurance/flight to safety hedge.
iShares NASDAQ 100 (CAD-Hedged)	XQQ	United States	Technology	10.4	4.4	21.8	1.3	Top five stocks account for 35.0% of the allocation and are some of the biggest technology brands globally: AAPL, FB, GOOG, MSFT, AMZN
Vanguard Telecommunication Services	VOX.US	United States	Telecoms	10.0	22.8	15.8	3.2	There are no sector ETFs in Canada or that trade in CAD$, which could be expected as the sector is dominated by a handful of names: T, BCE, RCI.B
BMO Equal Weight Utilities	ZUT	Canada	Utilities	5.9	14.1	27.8	4.6	Investors should recognize many 'Steady Eddy" names here. Like the equal weight aspect, as peers are top heavy in a few names.

Fixed Income ETF								
Name	**Ticker**	**Region**	**Strategy**	**3-month return (%)**	**1-year return (%)**	**Duration (years)**	**Yield to maturity**	**Comments**
iShares Canadian Universe Bond	XBB	Canada	Broad market	1.7	1.0	7.7	1.8	One of Canada's largest bond funds with exposure across the total fixed income market. Primarily invested in government bonds.
iShares 1-5 Year Laddered Corporate Bond	CBO	Canada	Corporate	-0.2	-1.9	3.3	1.7	The financial sector accounts for 60.0% of issuers; an average credit rating of 'A'.
iShares S&P/TSX Canadian Preferred Share	CPD	Canada	Preferred Share	5.4	-5.4	N/A	5.0*	Good tool for some diversification for the income investor. Both perpetuals and reset prefs (reset to the 5 year Gov. of Canada bond).
iShares U.S. High Yield Bond (CAD-Hedged)	XHY	United States	High Yield	4.4	-0.6	3.8	5.6	Suggest a maximum 10.0% fixed income portfolio weight. Sector allocation of 25.0% to communication companies, mostly small-cap.

*Trailing 12-month yield

Data as of August 20, 2016

One Chart Worth Noting



Investors show concern over stock market valuations as markets seem to continually climb upward over the last few years. While we have no intention of trying to call whether markets are over or undervalued, the Fed Model helps illustrate that stocks are actually cheap relative to bonds. The Fed Model looks at the spread between the earnings yield of stocks (Earnings/Price) and ten-year government bonds. The higher the spread, the more attractive stocks are relative to bonds.

One Table Worth Noting

Proportion of firms in the S&P 500 that beat estimates for Q2 2016

Market/Industry	Earnings	Revenue
All of S&P 500	71%	52%
Consumer Discretionary	74%	45%
Consumer Staples	67%	40%
Energy	62%	49%
Financials	66%	55%
Health Care	82%	72%
Industrials	67%	47%
Materials	58%	46%
Info. Tech.	92%	76%
Telecom	60%	20%
Utilities	54%	11%

Worry surrounded the recent quarterly releases and whether companies could continue to grow and justify lofty valuations in a low-growth world. These fears were answered this quarter with a fairly strong showing that saw just over 70% of stocks in the S&P 500 beating earnings estimates. Admittedly, expectations have trended lower going into the quarter but the statistic is still another inconvenient metric the Bear crowd must come to terms with.

Questions and Answers from 5i Research

Question:

I would like to have a decent return but preservation of capital is a priority. Please provide your opinion on CIBC Canadian Bond Index Fund – Premium Class CIB585. I am aware that you recommend the ETF 'CBO' so would appreciate your comparison. This would be in a non-registered account.

Answer:

The fund has had a 3.7% return since 2011, versus CBO with a 5 year return of 2.68% (the fund has a much longer tenure than the ETF). Fees on CBO are 0.27% versus 0.39% on the fund. The fund is heavily skewed towards government bonds whereas CBO is corporates (generally higher risk). It should provide regular income (reinvested) and decent stability. All bonds are subject to interest rate risks, but as part of a fixed income allocation, we think this fund would be acceptable and at a lower degree of risk than CBO generally, for only a slight fee bump.