TSX DIVS

QUARTERLY COMMENTARY

Evolve Active Canadian Preferred Share Fund

DIVS seeks to provide holders of Units with stable income and long-term capital appreciation by investing primarily in a diversified mix of preferred shares of primarily Canadian issuers, in addition to U.S. and international issuers.

For the month ending March 29, 2019

TICKER: DIVS

SUB-ADVISOR: Foyston, Gordon & Payne, Inc.

Foyston, Gordon & Payne Inc.
INVESTMENT COUNSEL

Active management in Canadian Preferred Shares continue to be an attractive investment opportunity. Foyston, Gordon & Payne Inc. has managed Canadian Preferred Shares since 2012 and the FGP Preferred Share Fund since November 22, 2015.

OVERVIEW:

The economic weakness experienced at the end of 2018 carried into the first quarter of 2019. Domestic growth has certainly slowed, weighed down by the combination of lower investment spending, slower household spending and a drop in exports. Further weighing on growth were the usual suspects: global trade tensions and geopolitical uncertainties. Responding to these events, interest rates fell throughout the quarter.

Despite the slowdown, North America economies are still performing adequately despite being expected to slow after the good performance in 2018, particularly in the tax cut-fueled U.S. In contradiction to more than a few financial market pundits, a recession does not appear to be imminent in 2019 even as the central banks in Canada and the U.S. recently indicated that a pause in their respective tightening cycles is warranted. The subject of rate cuts has not been publicly discussed. Certainly, several economic challenges remain over the balance of the year, but the bond market appears to have already priced in a negative outcome.

Shorter-dated yields dropped slightly more than longer-dated yields reflecting the growing sentiment that North American central banks have reached the end of their respective rate hiking cycles. The benchmark 10-year Government of Canada bond yield fell by approximately 40 basis points in the quarter and the two-year to 30-year yield spread widened by almost five basis points.

During the quarter there continued to be reactionary selling pressure in pockets of the Canadian preferred share market. Selling activity has been less focused on company and security quality and more focused on movements in underlying reference rates. As a result, pricing in the preferred share space continues to be significantly dislocated from long term value and credit quality which has been a drag on performance given the portfolio's focus on lower risk companies and credit risk-adjusted returns. We expect a reversion to a more properly priced environment as expectations of moves lower in the reference rates become less volatile and the yield advantage becomes more easily apparent.

Even though risk assets (equities, corporate bonds, etc.) performed strongly to start the year, the preferred share market in Canada has been a little slower to rebound. We anticipate that in the coming months the market will gradually recognize the high dividend levels of preferred shares (even in the absence of moves higher in key interest rates) and the further improved valuation relative to more widely followed asset classes that have rebounded strongly this year.

When viewed with a longer-term investment time horizon we remain quite comfortable with our underlying investments in the fund as well as the asset class itself, being attractively valued and offering a significant yield advantage over other fixed income options available in the market today.

OUTLOOK AND PORTFOLIO STRATEGY:

Despite the domestic economy moderating from the higher levels seen in previous years, it is our expectation that we will see positive growth in the near term which should work to support risk assets going forward. Given this positive view the FGP outlook is for Canadian interest rates to gradually trend higher over time. Combining fundamental strength with firming interest rate levels should provide additional stability to market prices for preferred shares while allowing for modest capital appreciation. As mentioned above, the asset class is currently attractively valued and offers a significant yield advantage over other fixed income options available in the market today – a further source of support.

Overall the portfolio strategy has made modest changes to remain positioned in companies and their securities that are undervalued relative to the inherent credit risk profile. We continue to allocate capital towards investment opportunities that offer the highest probability for superior risk-adjusted returns throughout a cycle.