TSX DIVS

MONTHLY 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 May 31, 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:

What a difference a month makes. After reaching record highs in early May global stock markets fell back over the balance of the month. This was the first drop in equity prices this year and was of a similar magnitude to the declines seen in October and December of last year. The TSX, while still down, did fare better than most developed markets despite being weighed down by lacklustre Q2 bank earnings as well as a drop in crude oil prices late in the month. A rapid deterioration in trade talks with the Chinese and an end-of-the-month threat to impose a 5% tariff on all Mexican imports to the United States on June 10th (rising to 25% by October) sent a chill through financial markets.

Even as the North American economies continue to perform reasonably well, expectations for continued growth into next year are being reduced. This is clearly reflected in the performance of the bond market which saw yields come crashing down. Almost the entire Treasury curve has now seen yields drop by 100 basis points or more from their peaks of little more than six months ago. Central banks in North America have tried to stabilize expectations by reiterating that policy rates are still accommodative and supportive of growth and that there is no need to cut rates based on fundamentals. However, the central bankers are concerned about the eventual impact on the economy if the trade war deepens or persists for the remainder of the year. The market is priced for two Fed rate cuts by year-end. With a lower overnight rate compared to the Fed and with an inflation rate that is running above it, expectations for the Bank of Canada to cut rates is less dramatic – a bit more than a 50/50 proposition for one cut by the end of the year. The benchmark five-year Government of Canada bond yield fell by almost 20 basis points in May, ending the month at 1.37%.

The preferred share market experienced renewed pessimism to finish the month as the credit environment weakened and concerns grew over the trade war eventually having a notable impact on growth. That said, the pref market is at historically low levels and currently offers yields and spreads that are exceptionally wide versus other income producing assets. We anticipate that pref yields are now at such relatively aggressive levels 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). When viewed with a longer-term investment time horizon we remain quite comfortable with our underlying investments in the fund as well as with an increased allocation to the fund itself as the asset class is attractively valued and offers a significant yield advantage over other fixed income options available in the market today.



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The Fund's strategy continues to focus on lower risk companies and credit risk-adjusted returns. We expect this asset class to revert to a more properly priced environment as sentiment improves towards the space from stability in the economic data and rates. Currently the pricing dislocations are extremely elevated implying there will be significant opportunity for added value in the coming years.

## OUTLOOK AND PORTFOLIO STRATEGY:

Even though the domestic economy has moderated from the higher levels seen in previous years, it is our expectation that we will see 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 keep 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.