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 June 28, 2019

ETF TICKER: DIVS (Unhedged)
MUTUAL FUND FUNDSERV CODE: EVF100 (Class F); EVF101 (Class A)
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 Canadian preferred share market has had a tumultuous period since the Fall of last year. The market was hit by the severe risk off tone that resulted from the beginning of a trade war as well as public attacks on Federal Reserve policy by the US administration. This pressure abated to begin the year and most large risk asset markets had some form of recovery. However, preferred shares continued to suffer from a general aversion to the asset class despite a material yield advantage over other income producing assets. With the trade war being reignited during Q2, uncertainty in the markets was heightened which continued to stoke fears of a recession. This has once again translated into negative sentiment in risk markets and general pessimism. However, fundamental data continues to be much better than what the markets are pricing in and in many cases better than estimates. 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 which will likely lead to easing by the Fed.

All that being said, the pref market is at historically low levels and currently offers yields and spreads that are exceptionally wide versus other income producing assets. Additionally, flows within prefs have been focused on pref type or the reference rates despite significant credit spread dislocation. Our portfolio currently has a gross yield of 5.9% which will actually increase slightly over time if interest rates remain at current levels. This is the result of rates being so low throughout all of 2015, 2016 and half of 2017 which makes resettable securities in 2020/21/22 have higher dividends which will continue to increase the yield level on the portfolio.

What does this mean for the outlook on preferred shares? Well, at a 5.9% dividend yield as a starting point, return expectations for pref portfolios are quite elevated. The primary driver of performance through a cycle for this strategy is security selection, not interest rate anticipation. The FGP portfolio is constructed based on thorough credit research and associated valuation methodologies to identify undervalued securities relative to the market. 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. 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 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 healthy 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.