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 July 31, 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:

Much of the month of July was spent in anticipation of interest rate announcements from a number of central banks around the world – from the Fed and the ECB in particular. The ECB did not lower rates further into negative territory on July 25th but signalled that it soon would. The Fed cut its rate by 25 basis points on July 31st, disappointing financial markets that had some expecting a 50 basis point reduction and very few expecting the somewhat hawkish press conference that the Fed chief, Jerome Powell, held following the announcement.

So, despite a positive month overall for the S&P 500, and another new all-time closing record high for the index on July 26th, equity markets fell dramatically to end the month. The TSX fell in sympathy and ended the month almost unchanged from the end of June. Little progress has been made on the laundry list of problems that do have global economic implications – China/U.S. trade, a no-deal Brexit, growing tensions with Iran – and to that list a couple of more have been added: the clear economic slowdown across Europe, Germany in particular, as well as the increasingly violent standoff between Hong Kong and China. Needless to say, interest rates fell globally and, as the month ended, the number of investment-grade bonds trading with a negative yield surpassed $14 trillion.

Economic fundamentals have taken a back seat to the flow of funds around the world and those flows are not overly sensitive to the positive growth seen in the U.S. in the second quarter or the surprisingly strong growth seen in Canada with a core inflation rate above the Bank of Canada's target. At least the Bank of Canada can sit comfortably on hold for now while the continued pressure on the Fed for further rate cuts is intense. The benchmark five-year Government of Canada bond yield actually increased marginally during the month, up about 5 basis points to 1.46%.

The Canadian preferred share market firmed up in July as sentiment about the continuation of the current economic cycle improved after the Fed made it clear that it would follow through on an easing policy stance. However, the renewed escalation of trade tensions will likely limit additional positive moves in the short term in most risk assets (equities, prefs, etc). Despite the continued uncertainty in the markets the outlook for preferred shares continues to be positive driven mostly by the significant yield relative to other asset classes. With 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 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.

Th most interesting development related to the preferred share market in Canada was actually a bond issued by BMO. BMO issued a USD bond structured to be compliant AT1 capital. The structure was slightly different than the issue by BNS back in 2017 (5+5+5.... versus 5+float) but from a pref market perspective should have the exact same impact – less bank issuance moving forward. The reason for this is that each bank is only required to have a certain level of AT1 capital so any bond issuance that complies with the AT1 rules reduces the amount of preferred shares that same bank will need outstanding. On the back of this news bank preferred shares rallied as the market now expects slightly less total bank issuance. Currently only BNS and BMO have gone this route to raise capital under the current regulatory rule set (Basel III), however, if either of these banks make further use of this funding source or if the remaining banks become involved it would likely lead to meaningful strengthening in the prices of outstanding bank preferred shares. We must note that this avenue would be attractive for banks except that they are not able to deduct the interest paid for tax purposes. From our understanding this has prevented the banks from making broader use of this source of capital.

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. 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.