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 September 30, 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 economy, thus far, has weathered the trade war storm reasonably well. With many foreign economies reporting weak second quarter activity – especially in manufacturing and trade – Canadian GDP advanced by a healthy 3.7% led by gains in industrial production and net exports. Housing has made a comeback too, supported by lower borrowing rates. The third quarter, however, won't look as good because the reality of slowing global growth has had a negative impact. Combined with flat retail sales growth and continued high levels of consumer indebtedness, it is easy to conclude that growth will indeed slow. The Bank of Canada (BoC) appears to be content being patient with monetary policy – not wanting to re-inflate the housing market by lowering interest rates at a time when headline and core inflation rates are either at or above target. Also, the U.S. Federal Reserve's seeming reluctance for further easing removes pressure on the BoC to act. The market has priced in only a 25-basis point rate reduction through 2020. It would take a serious downturn in the economic data or the global economic backdrop for the BoC to reconsider its position.

MARKET INSIGHTS:

Despite a consistent economic backdrop in Canada, global geopolitics led to heightened financial market volatility during the quarter. The Canadian preferred share market was broadly weaker for the majority of August. Spreads on almost all issues moved dramatically wider for much of the month, only to undergo a sharp reversal at the end of August, as geopolitical tensions temporarily subsided. This reversal allowed a more positive tone to return to the preferred share market, which continued throughout the month of September. While market sentiment continues to seemingly shift on a tweet-to-tweet basis, the longer-term fundamental underpinnings of preferred shares in Canada remain robust. The Canadian preferred share market is attractively valued relative to historical levels and should outperform other fixed income segments of the market.

Our portfolio has a dividend yield of 6.0%, providing a significant yield advantage relative to other fixed income options available in the market today. For example, compared to corporate bonds, our preferred share portfolio offers investors additional yield of 330 basis points above the FTSE Canadian Corporate Bond Index. This yield will increase slightly over time, even in the absence of an upward move in key interest rates. This is because the reference interest rate today remains well above the ultra-low levels seen in 2015, 2016 and the first half of 2017. During this time, the average yield on the 5-year Government of Canada bond was 0.75% while it finished the quarter (unchanged from the last quarter) at 1.4%.

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Approximately 80% of our portfolio is invested in rate-reset preferred shares. As long as the reference interest rate remains above the levels seen from 2015 to mid-2017, this will be supportive of dividend levels on preferred share securities with rates resetting 5-years from 2015 to mid-2017 (i.e. 2020 to mid-2022). Despite this, the preferred share market is trading at historically low levels, and currently offers yields and spreads that are exceptionally wide versus other income producing assets.

OUTLOOK AND PORTFOLIO STRATEGY:

Our outlook for preferred shares continues to be positive, largely driven by the significant yield advantage preferred shares offer relative to other fixed income options available in the market today. With a 6.0% dividend yield as a starting point, the cumulative return from dividends alone over the next 5 years is 30%. Furthermore, the primary driver of performance through a cycle for this strategy is security selection, not interest rate anticipation. Our portfolio is constructed based on thorough credit research and associated valuation methodologies to identify undervalued securities relative to the market. The portfolio'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.

We see meaningful upside in our portfolio however, in the short term, the market is a mechanism that reflects sentiment, not value. At its present level, the preferred share market implies an incredible opportunity for investment gains. These types of opportunities for outsized returns over the medium term from investing in low-risk companies are rare. In the two years following the last correction which bottomed in February 2016, the broader preferred share market saw returns of 39%. We see similar opportunities for outsized returns in the preferred share market today and believe investors who take a long-term view will be rewarded.