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 October 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:

The month of October brought a welcome respite from recent market volatility-inducing geopolitical headlines. The U.S. and China are slowly moving towards a 'Phase 1' trade agreement and a potentially destructive 'no deal' Brexit has been avoided, for now, with the European Union (EU) granting U.K. parliament an official 3-month extension to ratify the terms of the country's withdrawal. The EU went on to say that the new January 31st deadline will be the last extension granted but a degree of skepticism about this is certainly warranted. The U.K. parliament then promptly called a December 12th general election with Boris Johnson's Conservatives polling well at the outset. Unrest in the Middle East, Hong Kong and the start of an impeachment inquiry of President Trump did not significantly move markets.

More impactful were interest rate announcements from the U.S. Federal Reserve (the Fed) and the Bank of Canada (BoC) near the end of the month – both on the same day. The Fed cut its interest rate by 25 basis points for the third time in three meetings, taking the rate down to 1.50%-1.75%. Consistent with his earlier characterization of this rate-cutting cycle as being a short one, Fed Chair Jerome Powell, signalled a potential pause as the committee remains relatively comfortable with the strength of the U.S. economy. The BoC left its rate unchanged at 1.75%, marking a full year with no change. The BoC did however revise its 2020-21 projections for GDP growth downward, warning the economy's resilience thus far will be tested by trade conflicts and geopolitical uncertainty. Healthy employment levels in Canada and recent housing market strength have been overshadowed by increasing risks from global trade disputes and a surprisingly strong Canadian dollar, leading the markets to conclude that the BoC will be considering a rate cut at future meetings.

MARKET INSIGHTS:

The relative optimism from the Fed and the relative pessimism from the BoC were reflected clearly in the equity markets as the S&P/TSX Index (CAD) fell by 1.5% and the S&P 500 Index (CAD) rose by 1.4% in October. Despite some continued volatility in rates, there was very little change in bond yields for the month. The benchmark five-year Government of Canada bond yield rose just 2 basis points to 1.42% and the equivalent issue in the U.S. fell by 3 basis points to yield 1.53%.

Sentiment in the Canadian preferred share market improved in October as volatility abated. The positive tone carried forward from September and continued throughout the month of October. The one notable exception was the meaningful

weakness experienced on the day after dual interest rate announcements by the Fed and the BoC. The Canadian preferred share market continues to exhibit fundamental characteristics that are historically attractive and imply returns that should outperform other fixed income market segments.

OUTLOOK AND PORTFOLIO STRATEGY:

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 325 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 October at 1.45%. 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. Additionally, flows within preferred share space have been focused on the type of preferred share or the reference rates, despite significant credit spread dislocation.

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.