HAJ Quarterly Commentary

June 2018

Market Review

In the Emerging Markets (EM) realm, the crises in Argentina and Turkey have garnered a lot of attention and resulted in that grouping falling out of favour as investors look for history to again repeat itself with problems spreading to other nations. Against this, a major EM crisis appears to be a low probability event, and with the exception of Argentina and Turkey, there are still few red flags waving from a macro standpoint. Overall, EM growth momentum remains in place, supported by the continued expansion in developed markets and the broad firming in commodity prices. China has largely defied expectations of a more significant slowdown in its still-rapidly growing economy, maintaining its above-potential pace of expansion through the start of the year and leaving it well-positioned to meet its official annual growth target of 6.5%. However, there are ample risks to the outlook, with the most pressing being the fraying trade relationship with the U.S.

Portfolio Review

In the second quarter (Q2 – the first three months ending June 30, 2018), the MSCI Emerging Markets Index (the Index) was down 6.00% in Canadian dollars. The Horizons Active Emerging Markets Dividend ETF (HAJ, or the Portfolio) underperformed the Index by 117 bps.

The Portfolio underperformed in 6 of the 11 sectors led by Consumer Staples, Utilities and Information Technology. Industrials, Financials and Materials were the largest contributors to relative performance.

Industrials was the largest contributor to relative performance during the quarter primarily as a result of stock selection. Airport companies, Aeroportuario Del Centro Norte, Aeroportuario Del Sureste and Aeroportuario Del Centro Pacifico drove the outperformance in the sector.

The Financials sector was the second-largest contributor to relative performance due to positive stock selection as well as an underweight to the sector. Outperformance in the Financials sector was driven by HDFC Bank, Banco de Chile and ICICI Bank.

The Materials sector also contributed to relative performance due to positive stock selection as well as an overweight position in the sector. Sasol, Vale and Socieded Quimica Y Minera de Chile were the largest contributors to relative performance in the sector.

The Consumer Staples sector was the largest detractor from relative performance primarily due to stock selection. Ambev, Embotelladora Andina and Compania Cervecerias Unidas were the largest detractors from relative performance.

The Utilities sector was the second largest detractor from relative performance driven primarily by stock selection. Companhia De Saneamento Basico Do Estado De Sao Paulo and Enel Americas were the largest detractors from relative performance.

The Information Technology sector also detracted from relative performance due to an underweight to the sector as well as stock selection. ASE Technology Holding, Taiwan Semiconductor Manufacturing and Netease were the largest detractors from relative performance.

Portfolio Activity:

In Q2, the Portfolio purchased China Petroleum & Chemical Corporation, Huaneng Power International and Sinopec Shanghai Petrochemical Company. Additionally, the Portfolio sold Advanced Semi-Conductor Engineering, Siliconware Precision Industries, Compania Paranaense and Ultrapar Participacoes.

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Positioning:

Based on the economic backdrop and outlook on economies and valuations, our core view on uses of cash investment recommendations are to own stocks that deploy cash in a shareholder friendly way that reflects the current late stage of the economic cycle of rising interest rates, de-regulation, increased capex and marginal expansion. We look to position in stocks with low price to book values, high cash/assets, strategic M&A/assets ratio, sustainable net buyback yields, and growing dividend yields. As well, we continue to emphasize higher yielding names that have the lowest probability of a dividend cut.

The Portfolio has an overweight in the Consumer Staples, Telecommunication Services and Materials. Underweight sectors are Information Technology (-14.8%) and Financials. The dividend yield at the end of Q2 was 2.91% and the Portfolio has a large-cap, high-quality bias.

The current market environment requires continued immunization to rising interest rates on a relative basis to our peer group. We continue to increase diversification, finding yield outside of the traditionally defensive sectors favoured by our peer group.

Outlook:

U.S. foreign policy is keeping geopolitical risks high, with concerns stemming from the ongoing negotiations with North Korea over denuclearization and the sanctions against Iran being brought back into relevance with the U.S. withdrawing from the Joint Comprehensive Plan of Action (the agreement governing Iran's nuclear program). The largest risk to the outlook, though, relates to American trade policy. The world's largest economy's made an aggressive shift toward protectionism that began almost immediately following inauguration with the withdrawal from the Trans-Pacific Partnership.

An environment in which economies are running against capacity constraints and price pressures are firming is one in which a reduction in monetary policy support is justified, if not encouraged, in order to keep risks to the inflation outlook balanced. That said, the risks to the growth outlook suggest that some caution is warranted and the still-moderate inflation with well-anchored expectations gives central banks the scope to continue to unwind the crisis-era monetary stimulus at a gradual pace.

Despite the fact that there has been a move among developed economies central banks to start to normalize policy, rates remain low globally and financial conditions are still highly accommodative and likely to remain that way for the foreseeable future. The U.S. Federal Reserve (the Fed) has been the pace-setter among monetary policymaking bodies, but it has been taking a fairly gradual path having now raised its policy rate seven times since it started tightening in December 2015. Policymakers at the Fed are projecting a pickup in the pace with another five hikes before the end of next year (bringing forward another hike into 2018 and three more penciled in for next year) when it will move to the "tight" side of policy dial.

The increase in volatility in the market and the ample risks to the outlook speak to taking a more defensive tilt in equity market positioning and adding exposure to income/dividend strategies. These strategies typically outperform in periods of flat and down markets – periods with greater uncertainty in the marketplace which are generally accompanied by heightened volatility – as the dividend cushion softens the downside risks and can create positive total returns as investors are paid to wait in otherwise directionless markets. A willingness to look across borders also permits even better income opportunities– not to mention the fact that the relative underperformance of international markets despite strong earnings has made for a more compelling entry point with respect to valuations or that the geographic diversification from adding international exposure is beneficial from a risk management standpoint as well.

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In our opinion, we must buy based upon model fundamentals that cover all three facets of investing – namely, relative opportunities, intrinsic conviction and objective non-human analysis through machine-learning methods. Based on our reading from our model, we believe fundamentals should ultimately prevail as companies continue to deliver double-digit earnings growth on the backs of a U.S. tax catalyst and global synchronized growth. One should also not forget the concept of shareholder yield as the benefits from above discussed events will also be reflected in larger buy backs and further de-leveraging of debt. One should also not be naïve in assuming bond proxies will provide down side protection or for that matter naïve low volatility strategies might not reflect the true realities of where risks lie. Yield for yield sake is not the right approach and we feel, stocks exhibiting consistent earnings strength, or those that signal shareholder friendly activities like dividend increases or buybacks with respect to cash flow usage should allow for the best opportunities to buy.

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