Mackenzie Cundill Value Fund – Series C

Q2-2015 COMMENTARY

Performance Summary

- During Q2 2015, the Fund returned -0.6 % vs. the MSCI World Total Return Index (net CAD) which returned -1.1%.

Contributors to Performance

- From a regional perspective stock selection added value with the largest benefit derived from stock selection in the U.S., the Netherlands and Canada. Allocation to cash also helped performance as global equities finished the quarter lower. From a sector perspective, both sector allocation and stock selection added value, driven primarily by performance of portfolio's holdings in Financials, Industrials, and Materials sectors.
- Key contributors to performance at the stock level included portfolio's U.S. financials - **Bank of America Corporation**, **Citigroup Inc**., and **AIG Inc** - which are also among the portfolio's top five holdings. **AIG**, portfolio's largest position, was the biggest contributor to returns in Q2. The company reported earnings that beat expectations, boosted by a gain on the sale of legacy real estate. AIG sold 90% of its residual equity position in airplane leasing company AerCap for $4.2 billion. As a reminder, AIG sold its plane leasing business to AerCap in May 2014 for $3 billion in cash and shares which at the time were worth $2.4 billion. Since then the share component has increased to $4.8 billion, resulting in total proceeds to AIG of approximately $7.8 billion, a material transaction given AIG's market cap of approximately $82 billion. We expect the bulk of these latest proceeds to be devoted to additional share repurchases, which in turn should further boost intrinsic value. The company has repurchased 30% of its shares, all well below book value, since the portfolio made its major initial investment in AIG in May 2011. During our holding period, the stock more than doubled, and yet still trades below our assessment of its fair value. In the years to come we expect AIG to improve its P&C businesses profitability toward peer levels, utilize its large tax assets, continue its record of outstanding capital stewardship, handsomely benefit from a potential rise in interest rates, and in the process get re-rated toward peer levels.
- Another notable contributor to portfolio performance in Q2 was **TNT Express NV**, Netherlands-based international courier delivery services company. After UPS's bid for TNT failed two years ago, TNT's leading position in European express road network, net cash balance sheet, and strategic importance continued to stand out. Following that, our extensive due diligence led us to buying TNT shares with over 30% margin of safety by our estimates. We continued to take advantage of the short-term volatility (from earnings miss or the general pessimism) to build our position in this company, even until Q3 2014 when the share price fell as low as €4.95/share. At the beginning of Q2, in a not so surprising, but a welcome move, FedEx made an all cash €8.00 per share bid for TNT, which represented a 43% premium over TNT's average share price over the 30 days prior to the offer.

Detractors from Performance

- From a geographical perspective, out of benchmark exposure to South Korea, combined with unrewarding stock selection in Japan and Germany were among the most meaningful detractors. At the sector level lack of exposure to Health Care and an overweight in Energy negatively impacted performance. Stock selection in Energy and Consumer Discretionary also weighed on returns.
- At the stock level, the largest detractors included the portfolio's South Korean holdings, led by **Hyundai Motor Company**. The business continued to be challenged by foreign exchange environment that has hindered Hyundai's ability to compete, particularly against Japanese automakers on the back of strength in the Korean Won relative to the Japanese Yen. Stock price further came under pressure following the company announcement that both domestic and overseas sales in May weakened for the second consecutive month. While Hyundai regained market share in the U.S., largely on the back of higher incentives on their ageing Elantra model, the company faced pressure in China from local OEMs (original equipment manufacturers). However, we expect that it will improve its competitive position in the largest global auto market with the launch of new Tuscon and Sonata models this year. Not only is China important to Hyundai in terms of unit sales (together with their joint venture partner BHMC they sell more vehicles in China than in any other foreign market), but it is also the most profitable region for Hyundai. Management expects demand to continue to be strong in China and we expect they will continue to benefit from this trend as they increase their capacity over the next few years.

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- Performance of Energy and related companies continued to be impacted by volatility in the price of oil and gas, which has soured investor sentiment in **Chesapeake Energy Corp**. The market may have taken a view that the collapse in energy prices has made it more difficult for the company to continue its restructure, threatening to offset the internal improvements made over the past several years. The company reported its fiscal Q1 results, noting that it has dramatically ramped down drilling activities to preserve capital. Drilling rigs dropped by over 60% from the previous quarter and are expected to be down another 45% by year end. However, despite this, production guidance has slightly increased. In our view, this is the direct result of efficiency improvements at Chesapeake, which we believe is outpacing the broader industry. Importantly, we believe the company may achieve cash flow break even by end of 2015, which may help alleviate the street's long-held concern that Chesapeake is unable to live within its cash flow means and potentially lead to re-rating of the company. Despite the volatility in the energy prices and Chesapeake's share price, the portfolio continues to receive 5.75% yield on the convertible preferred shares which constitute majority of the portfolio's position in this name. This, combined with the convertible feature of the preferreds, combined with a smaller position in equity, offers a strong option on what we believe are significantly undervalued shares.

Portfolio Activity

- **Encana Corporation,** a position we have been reducing for some time, was finally exited. In recent quarters the company spun off PrairieSky Royalty in an IPO (initial public offering)and subsequently reinvested the cash in assets in the Permian basin in the U.S. The market seemed to like the transaction, but we did not think the acquisition was the best use of capital. This gave us the opportunity to continue to exit the position which was completed in Q2.
- We also added to several of existing holdings and initiated one new position which we will comment on once it has been fully accumulated. Furthermore, several of our existing positions were trimmed, largely on valuations.

Outlook

- Markets remained expensive at the end of the quarter. As we had noted previously, expensive markets are not necessarily good indicators of short-term performance, however, expensive markets tend to be correlated with sub-standard long-term returns. At present, we believe market long-term returns will be well below the results experienced over the past 5 years.
- Although long-term government yields rose during the quarter, they still remain at very low levels and offer very low real returns. We are of the belief that real rates have to eventually normalize (i.e. offer positive rates of return) and our funds are positioned for this eventuality. Because real rates have been close to zero for such a long time, investors have flooded into bonds and bond proxies, such as consumer staples, utilities, REITs and Healthcare stocks causing the majority of these assets to become richly valued. We have mostly avoided these assets, as we believe they offer uninteresting long-term returns. As such, our portfolios have almost no exposure to these assets.
- At the same time the portfolio is tilted to areas of the market that we believe are significantly undervalued. One area that we have been focused on since the second half of last year is Energy, which attracted our attention given the speed and the severity of decline in the stock prices triggered by the collapse in the price of oil. Investor sentiment toward this space remains impaired, but we believe that it has been overdone and expect that our exposure to companies in this area will help drive long-term returns for the portfolio. We have been impressed with the speed at which many of the companies have been able to extract costs out of their businesses and believe this is a positive development.
- Another area that we have been exploring for some time is South Korea. The country in general remains significantly out of favour for several reasons, which include currency and the relative strength of the Korean Won vis-à-vis Japanese Yen. As a result we have found a few companies in South Korea that are extremely cheap.

PORTFOLIO MANAGEMENT TEAM:

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† Effective July 19, 2013 Lawrence Chin is named lead manager of the Fund

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*To the extent the Fund uses any currency hedges, share performance is referenced to the applicable foreign country terms and such hedges will provide the Fund with returns approximating the returns an investor in a foreign country would earn in their local currency.

Fund and Benchmark Performance as at: June 30, 2015	1 year	3 years	5 years	10 years
Mackenzie Cundill Value Fund Series C	2.8	15.0	9.7	4.0
MSCI World Total Return Index (net CAD)	18.7	22.3	16.8	6.6

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