# Mackenzie US Dividend Fund* – Series A

Q2-2015 COMMENTARY

## Performance Summary

- For Q2 2015, Mackenzie U.S. Dividend Fund returned -3.0%. This compares with the S&P 500 Index ($CDN) return of -1.1%. The Fund underperformed the index due to overweight in the energy and industrial sectors.
- **Over the last 12 months, the Fund is up 18.1%** compared to the Morningstar U.S. Equity peer group which returned 20.1%.

## Contributors to Performance

- The top contributor to performance was one of the Fund's core holdings, **Altera**, after its announced takeover by Intel Corporation. Altera operates in a duopoly in the programmable semiconductor business. We believe the Company is one of the best businesses in the technology sector with sustainable competitive advantages stemming from the company's operating system and design tools. The Company has underperformed the last several years prior to the takeover because investors expected faster growth. The company will now be able to use Intel's scale to accelerate the product lines that it could not do on its own. The optionality in Altera's business was always there but the company needed Intel to help accelerate it. While this is the second takeover of a core position in as many quarters and we dislike losing high quality compounders like Kraft and Altera, we applaud management on the merger as we believe it is the right course of action for the company at this time. Altera is an example of how purchasing high quality companies at depressed valuations and waiting can reward investors.
- Another top contributor was **YUM! Brands Inc**. We wrote about Yum Brands in our Q3 2014 letter. YUM! is the second largest convenience food chain in the world. The company has three core brands; Kentucky Fried Chicken, Pizza Hut and Taco Bell. The company has two business models largely depending on the location of the operations. In developed markets like U.S. and Europe where sales have matured, the company operates under a franchise model where the company collects a 5% royalty on sales from franchisees. In developing markets like China the company has chosen to own the restaurants in the initial phases of development. The company's model is recycling royalties from developed markets and funding expansion in China. Unfortunately, every couple of years the Company has to deal with supplier contamination issues as was the case in the past year. When this happened and the company suffered from negative sales in China (which is more than half of the business), shares fell and we were able to buy shares at a discount. Since then, the Company was able to fix its problems and sales and shares have rebounded.

## Detractors from Performance

- The top detractor for the portfolio has been **Wynn Resorts**, the luxury casino operator in Las Vegas and Macau. The Company is shifting its business from the declining Las Vegas to Macau. At the time of purchase the Chinese government was amidst the largest anti-corruption probe in the country's recent history. Anyone with wealth in China has been reluctant to go to Macau in fear of being flagged by the government. In addition, the Macau government is making it tougher for tourists to visit by restricting visiting visas due to overcrowding and banning smoking in all casinos. Wynn's response to the slowdown in Macau was a temporary cut in the dividend to preserve the balance sheet and finish building its large Macau project. Once completed management has indicated they would like to once again increase the dividend. As investors we don't want to see a dividend cut for any reason; however we understand why it makes sense to cut the dividend in the near term instead of taking on additional debt. While this continues to be a time of uncertainty for Macau as the gaming capital of the world, we believe that this is the time to invest in the region. Macau is evolving from a gambling haven to what we believe will become one of the top entertainment destinations in the world. To ensure that this will happen, the government would have to ease recent restrictions. Even though we are seeing early signs of this, the environment still remains difficult. Our approach to investing in Macau is to invest with the best capital allocator in the business. Between Wynn Resorts and previously as CEO of Mirage Resorts, Steve Wynn has been one of the best long term allocators of capital generating returns in excess of 20% for shareholders over the last 30 years. He has built a luxury brand out of Wynn Resorts which attracts the wealthiest and most profitable gamblers. Just like in Las Vegas we believe that the best operator will win in Macau. The Company's newly built $4 billion resort (the most expensive in Macau) is slated to open by mid-2016 and should have a significant impact on results. Until then we believe the pressure on Macau should continue to ease. While we are not happy with the performance of Wynn shares, we view the shares as an attractive risk/ reward proposition for the portfolio. We believe patient investors in Wynn will be rewarded.
- Another detractor from performance was **Motorola Solutions**, the largest position in the Fund. The leader in public safety radio and systems with 70% global market share was the target of takeover talks earlier in the year. When a price could not be agreed upon, shares fell and arbitrageurs that expected a deal were forced to sell. Over the last 12 months the company has bought back 20% of its shares and continues to use its cash flow to reduce share count. In the next 12 months the company is expected to shift its focus to cost cutting and streamlining their operations. In addition, for the first time in several decades we are seeing large cities like New York and Los Angeles add public safety officials which may directly benefit the company. Motorola has one of the most compelling valuations in our portfolio with a free cash flow yield approaching 9% and a 2.6% dividend yield. We believe Motorola is a high quality compounder and a core holding in the U.S. dividend fund.



Mackenzie INVESTMENTS

## Portfolio Activity

- The Fund's newest investment is **Interactive Corporation** ("IACI") which owns a collection of digital media assets. The company is controlled by Barry Diller who has a long history of creating value for shareholders. In the last ten years the company has spun-off brands such as Expedia, Tripadvisor, Ticketmaster, Lending Tree, and Home Shopping Network—all of which have created significant value for shareholders post-spin. Recently, Interactive announced it will be spinning off the Match Group, the largest online dating company. Match currently accounts for 80% of the value of Interactive Corporation. The Company operates under the brands Match.com, OkCupid, Tinder and recently acquired Plenty of Fish. The company will have a combined user based of 180 million people. The company has two business models for its websites, a subscription model and free ad-supported model. Currently, the majority of revenues come from the 3.5 million subscribers and from the Match.com and OK Cupid brands. The optionality in the Company is the social networking dating app, Tinder. Tinder has a user base estimated at 55 million users growing at 40% per year swiping over 1 billion matches per day. Each swipe creates an advertising opportunity for the Company. IACI just started monetizing the Tinder platform in the last quarter and currently generates very little in revenue. We believe the market underestimates the advertising potential of Tinder and at current valuation we are getting the business as a free option. This type of optionality is a common feature our investment team looks for. IACI shares are selling at a reasonable projected forward multiple of 10x enterprise value to EBITDA with a dividend yield of 1.7%.

## Outlook

- The U.S. markets took a pause in the quarter on the back of macroeconomic headlines were dominated by three themes this quarter: Greece's future within the European Union, China's economic growth, and the timing of a U.S. interest rate hike. All three events have caused U.S. equities to take a pause and the U.S. dollar to continue its ascent, particularly against the Canadian Dollar. The Fund invests in global companies that have exposures to both Europe and China and therefore we monitor the risks in those geographies to try to capitalize on market dislocation in high quality dividend paying companies based in the U.S. The Fund has largely benefitted from a strong U.S. Dollar; however, many of the companies have been adversely impacted by translational exposure overseas. This has been most evident in the underperformance of the Fund's energy and industrial exposures. It is becoming clearer that after the collapse in the oil price, OPEC is easily offsetting the potential decrease in North American production for the intermediate term. With both Saudi Arabia and Iran pumping more oil than anyone predicted, energy markets are likely to be weak for the foreseeable future. After a temporary overweight position the Fund has a market weight of 7% in the energy sector focused on high quality, dividend-paying oil-centric companies with self-improvement opportunities.
- The situation in Greece has been at a critical level for the last four years which has perpetuated fears that Greece could be Europe's Lehman Brothers and send the global banking system into disarray. We believe that both the European Union and Greece have it in their best interests to stay together. Greece has no interest in hyper-inflation and depression and the European Union has no interest in having Russian submarines in the Mediterranean Sea. Contrary to most people's understanding, Greece has been undergoing austerity by firing nearly 30% of its government workers in the last five years. In addition the hundreds of billions of dollars that have been given to Greece have been used to pay back ill-fated loans made by European banks, not wasted on pensions. However, the key on why this is unlikely to cause a banking crisis is the level of liquidity mandated in the banking system by central banks. Risk-taking activities have been diminished and balance sheets shored up to handle a one in a 70 year financial event. J.P. Morgan alone has nearly $500 billion of liquidity deposited at the Federal Reserve, greater than Greece's entire $300 billion debt load. We will revisit the risk in the global banking system when the Republicans push for a more relaxed regulatory environment.
- The risk of a slowing Chinese economy has also been well documented. Chinese growth is expected to drop to under 7% from 8% in recent times. In addition, the early development of the Chinese stock market has shown volatility with the Shanghai Composite doubling early this year and falling 30% more recently. We believe these are normal conditions for an emerging economy. We are more encouraged by the actions taken by Bank of China to improve the balance sheets of State Banks with the newly launched asset swap program, the Chinese version of TARP in a time where no panic is present. From a global perspective, China's slowdown is being offset by India where a regime under Modi is accelerating growth from 5% to 8%. Again, we understand we cannot predict short term macroeconomic events. Instead we look to invest in high quality compounders that are global leaders in developed and developing markets. We believe these companies can sustain a high return on operating capital employed from advantages are difficult to replicate, such that they will be in a position to increase cash flow and dividend payments in almost any environment. In doing so we believe this will provide investors with acceptable risk-adjusted returns over the long run.

## PORTFOLIO MANAGEMENT TEAM:

**Darren McKiernan,** Senior Vice President, Investment Management, Mackenzie Investments
**Eugene Profis,** Vice President, Investment Management, Mackenzie Investments

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*Registered version also available. The investors in Mackenzie U.S. Dividend Registered Fund are restricted to certain registered plans whose planholders are residents of Canada or the U.S. for tax purposes, as more fully described in the Fund's simplified prospectus.

| **Fund and Benchmark Performance as at**: June 30, 2015 | 1 year | 3 years | 5 years | Since Inception (April 2014) |
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| Mackenzie US Dividend Fund Series A | 18.1% | N/A | N/A | 16.7% |
| S&P 500 Total Return Index CDN | 25.8% | N/A | N/A | 22.5% |