MACKENZIE
Investments

MACKENZIE IVY FUNDS

Quarterly Report – Q2 2017

Ivy Quarterly Report – June 30, 2017

There is no such thing as a bull market without a bear market. While it would be nice if stock markets only went up, we would have no value proposition to offer our clients. Markets fall from time to time, which is why many investors require professional investment advice and management.

Why do stocks prices fall? They can certainly fall en masse during periods of severe uncertainty and panic, the timing of which is unknowable. These events usually follow prolonged periods of loose monetary policy that encourage a dramatic expansion of the money supply by the commercial banking system, which in turn leads to asset bubbles; but stocks can also fall on an individual basis if the price that is paid is too expensive or if there is a deterioration in the underlying business fundamentals. If one is disciplined with respect to price and is thorough in the due diligence process, we believe it is possible to limit the downside potential of your investments.

Periodic recessions and bear markets are necessary evils that help to improve economic fundamentals and drive future economic growth. They do this by returning overpriced assets to levels that better reflect their long-term earnings power. Access to capital quickly dries up during times of uncertainty and recessions help to differentiate between companies that truly generate wealth and those that simply consume capital.

Much has been written about the behavioural aspects of investing and how the longer a bull market persists the more complacent investors become. Wall Street fuels the flame with seductive "can't miss" investment themes that promise to lead to early retirement, etc. This is bad enough, but the complacency in this particular bull-run is being aided and abetted by a factor that far outweighs anything that Wall Street can conjure up – central banks' intervention in stock markets i.e. manipulating them higher. Whether it is the Japanese Central Bank, which explicitly intervenes in stock markets whenever they fall; the Fed, which cites deteriorating financial conditions (falling stock markets) to justify their policy accommodation; or the European Central Bank, which promises to "do whatever it takes," central banks are all-in in their attempts to nationalize the stock market.

Why is this a bad thing? Stock markets serve a number of very valuable purposes, but we believe that the most important one is to serve as a mechanism to match those with excess capital (savings) with those who have a need for capital to produce goods or services. An individual's risk tolerance and time preference will lead to different capital allocation decisions. The price of a stock is supposed to be a reflection of the cumulative views of many other investors, who each have their own risk tolerance, time preference and most importantly, skin in the game i.e. something to lose. The riskier the potential investment, then the lower the price and vice versa. Over time, companies that do good things with the capital and grow it can easily access more capital when it is needed and continue to do more good things. This is a net benefit to society, GDP and stock markets, which grow as a result of true wealth creation.

Conversely, poorly run businesses find it increasingly difficult to access capital, as investors start to doubt whether or not those companies can generate a return on investment or even a return of the investment itself. Companies that consume capital rather than grow it are eventually starved of capital and go out of business. This is also a net benefit to society, as less "good" money is thrown after "bad." Of course, it is not good for the employees of that business and can lead to significant individual hardship. That is why, on the fiscal side of things, we have training programs and unemployment benefits to help such employees adapt and find alternative employment; hopefully with a business that contributes to society, rather than extracts from it. The alternative, bailing out bad behavior with more good capital, eventually results in significantly higher levels of unemployment and hardship.

The fact that this has been the slowest economic recovery in the post-war era is no surprise to us. It is not, as some would have you believe, due to some natural global economic stagnation that somehow came out of left-field. It is a direct result of central bank manipulation of asset prices through quantitative easing and the resulting misallocation of capital.

Warren Buffet once said that it's when the tide goes out you find out who was swimming without a bathing suit. Well we are now experiencing the largest central bank driven skinny dipping party of all time and everyone seems to be really enjoying themselves, but as we have previously written, there is not so much wealth creation happening these days, but rather a redistribution of wealth and thus growing wealth disparity. Of course central banks cannot forever prevent the tide from going out and when it does, there will be lot of people standing there naked; however, these people won't mind the temporary moment of embarrassment because by then they would have already made off with most of your retirement savings. This would not have been possible if central banks had not prevented the tide from exposing those who have been steadily sucking wealth out of the system.

If you know that stocks can fall, you might want to afford yourself some downside protection in your portfolio; however, downside protection comes at a cost, in the form of some foregone upside capture when markets are rising. The trouble is that no one knows how long this bull market will last; we certainly do not. Also, the longer markets go without a correction, the more people are convinced that downside protection is not worth the cost. As the bull market ages, those on the sidelines such as market commentators, journalists and even regulators, join in on touting the benefits of low-cost passive investing strategies. The cost of professional advice and professional investment management are simply viewed as a drag on your performance. This sort of mindset is a result of simply extrapolating recent events into the distant future and makes life difficult for those who attempt to act responsibly for clients. If we do have another significant downturn in the markets, those on the sidelines are not the ones who will have to look their clients in the eye and let them know that half of their retirement savings are gone.

Over this eight year bull market, the Ivy Funds have compounded in the 10% per annum range after fees. We have been able to achieve this by carefully allocating our clients' capital to very well-run businesses and doing so at what we think are appropriate valuations. Earlier in the bull market, when valuations were more attractive, we were more or less fully invested; today, we are not due to lofty valuations. For those who are investing their clients' capital carefully, it will be difficult to maintain credibility the longer this bull market lasts. The alluring promises of early retirement will increasingly sway the investing public to join central banks on the road of eternal rainbows and buttercups. Preventing our clients from falling victim to this sort of thing is exactly what we get paid for and carefully participating in as much of the upside as we can in the meantime. No one said it would be easy. If it was, it would not be worth paying for.

Canadian Equity

In the second quarter, the Canadian market continued to underperform relative to the US and global markets, making it the worst performing stock market in the developed world YTD. The primary contributor to the underperformance in the quarter was the outsized exposure of the TSX Index to the energy and financial sectors, which were impacted by declining oil prices and housing related concerns. The Ivy Canadian Funds performed well through this environment on a relative basis, with limited downside capture. Both the Ivy Canadian Equity and Ivy Canadian Balanced Funds were down approximately 0.5% in the quarter vs. the TSX, which was down 2.4%. The primary detractors to our performance were, not surprisingly, concentrated amongst our investments in oil producers, while the positive contributors were more widespread across sectors and geographies. Our top three positive contributors were Onex (Private Equity), Oracle (Technology) and Gildan (Apparel).

Patiently Waiting

Over a cycle, we expect our cash position to fluctuate based upon our assessment of expected returns and whether incremental returns justify putting capital at risk. Despite some recent moderation of Canadian valuations, we found more opportunities in the quarter to trim our equity holdings than to add. On a net-basis, we have been building cash as we stick to our discipline and patiently wait for our expected return thresholds to be met.

The Energy Opportunity

Our investments in oil producers were negatively impacted by the lower price of oil during the quarter. Over a full cycle, we expect improvements in profit and share prices, but it is difficult to predict where oil prices will go in the short term given the multitude of fundamental and speculative factors at play. To protect against this uncertainty, we have thoughtfully constructed a portfolio of low cost producers with great asset bases, solid management teams and strong balance sheets – giving us confidence that they can successfully navigate their way through a sustained low oil price environment. From the current starting point, we expect our investments in this sector to provide outsized returns over a cycle. While higher profits, predicated on higher oil prices, reduced costs, or both, are required for our return expectations to be met, we believe that none of these are required for us to make positive returns given the current valuations and low break-even cost of production for our holdings.

The Accelerating Pace of Change

One of the key fundamental factors that stands to impact our companies over the next investment cycle is the increasing role that technology is playing in our daily lives. This stands to be a disruptive force, providing companies with new opportunities to grow their businesses and improve profitability, while also introducing new threats, particularly to those that rest on their previous sources of success. In some cases, new entrants are able to pave over longstanding moats with disruptive new business models, enabled by technology. The impact that the sharing economy has had on the taxi industry represents a great case study for disruption, but only scratches the surface of its potential impact, with broad implications across many industries. Sometimes, these implications are foreseeable, such as the potential for a shift from personal to commercial car insurance, as more people use ride sharing and fewer people own their own cars, but in many more instances, technology will change consumer behaviours and competitive dynamics in ways that cannot yet be predicted. With this in mind, we think it will become increasingly important for businesses to think long term, focus on their customers and protect themselves against the unexpected by continually reinvesting in their value proposition and maintaining financial flexibility. These traits are fundamental to our investment criteria at Ivy and have been for 25 years.

US Equity

US equity markets continue their upward climb driven largely by continued valuation expansion. It seems the only real volatility in the market is that which occurs when a company is deemed to have exposure to Amazon's every expanding ambitions. Costco was our most recent holding to be pulled into the market's black hole of Amazon fear while Grainger has been the most impacted by the phenomenon this year. It is true that products are being distributed in different ways and that the shift to digital channels and direct-to-customer delivery are structural and real. Will all business models fall at the feet of Amazon? Probably not. Will Amazon find the magic point of scale and density they are working towards – if that is actually the goal? Hard to say. Is there risk in their ambitions? Would seem so. Does the market care? Not at this point. Our job is to focus on companies with sensible and sustainable strategies in the context of their competitive advantages, industry dynamics, and capacity for execution. We have to be careful to be on the right side of structural changes and be cognizant of current and potential competitors, but we also believe some business model fundamentals shouldn't be ignored and we need to take advantage of opportunities that occur when the market thinks they can be.

European Equity

European markets were roughly flat in the quarter in local currency terms, but Canadian investors benefited from a rising euro. Ivy's European holdings generally performed in line with the market. Hearing aid maker Sonova was one of the best performers, while H&M declined. From a sector perspective, the Ivy Funds have little exposure to European financial stocks, which were the best-performing group over the quarter. Conversely, we had little direct exposure to the worst-performing sectors, Energy and Materials.

We closed the book on our 17-year investment in Danone, removing it from all portfolios, with the exception of a very small position in Mackenzie Ivy European. There have been several twists and turns along the way, but in the end, it came down to the balance sheet. The global leader in yogurt recently acquired WhiteWave, a US owner of several natural and organic food brands. This was Danone's biggest acquisition and it stretched its balance sheet quite significantly. In principle, we do not mind when companies add debt to make sensible acquisitions. Our preference for strong balance sheets is in part due to the flexibility it gives companies to take advantage of such opportunities; however, we expect this debt to be paid down relatively quickly from free cash flow and it is here that Danone falls short. Danone has announced their intention to de-lever, but only part way. In other words, they intend to run with leverage that is higher than their historic levels and higher than we are comfortable with. In the context of integrating a large (and expensive) acquisition, as well as dealing with ongoing issues in the core European fresh dairy business, we believe the risk level is too elevated and that the quality (of which we consider the balance sheet to be a key component) has deteriorated.

Overall, our long investment in Danone has delivered mixed results. With an annual total return of six to seven per cent in local currency terms over 17 years (similar in CAD, a bit higher in USD), Danone was well ahead of the broader market, but a bit behind what we typically expect to earn. Most of that outperformance came in the early stages of investment. Over the past 10 years, both the absolute return and relative return were disappointing (ahead of the MSCI Europe Index, but behind the MSCI World Index, as well as many of its peers – see Nestle, below). There was no single reason for this, but rather a "two steps forward, one step back" progression of solid growth and profitability punctuated by executional missteps and questionable capital allocation. There is still a lot to like about Danone, but our approach to quality leads us to take a holistic view of a company's internal capabilities and culture, industry attractiveness and balance sheet. We currently believe Danone does not quite measure up.

Readers may have heard us mention the term "intellectual honesty" in the past, as something that we value within the Ivy Team culture. To better understand what we mean by this, it might be helpful to point out an example where it is glaringly absent. Near the end of the quarter, activist hedge fund Third Point published a letter disclosing a significant stake in Nestle, along with a brief analysis outlining things they believe Nestle should do to improve shareholder returns. Their thesis was that Nestle has "significantly underperformed most of their US and European consumer staple peers," and "has fallen behind over the past decade," which was illustrated by some one-, three-, five-, and 10-year total return charts. It did not mention that the comparisons used each company's respective local currency, which in the case of Nestle, is the Swiss Franc; however, all of these companies are global in nature. Nestle's largest market is the US and emerging markets account for over 40%

of sales. Switzerland has very little to do with Nestle's results. A more appropriate and "intellectually honest" comparison would convert all returns to the same currency. On this basis, Nestle comes out on top on a 10-year basis, behind on five-years, middle of the pack on three-years and is one of the best in the past year – hardly a sign of a disappointing company. The low returns reported by Third Point reflect the fact that the Swiss Franc has appreciated substantially over the past decade. We suspect Third Point is sophisticated enough to understand this.

Skating past the fact that the original observation of Nestle's underperformance is false, what do we make of the suggestions for the company? In terms of margin improvement, it is true that Nestle's profit margins are lower than several peers (though product mix may play a role here), and there is likely scope for some improvement, as there is for most companies; however, not all costs are "bad." Nestle prides itself on investing continuously in its brands, its products and its organization to drive long-term growth. This approach is in stark contrast to some of their peers who have taken to cutting costs aggressively while revenue declines. As long-term investors, we look for companies that we believe will still be strong and growing in ten years' time, so we prefer Nestle's investment-led approach to the alternative. In terms of their balance sheet, Third Point called on the company to add debt to buy back shares. Shortly afterwards, Nestle announced that it would do just that. In principle, we dislike this type of financial engineering, but it should be noted that after the buyback is finished, Nestle will still have one of the best balance sheets in its industry (and much better than activists would like). There is a lot going on at Nestle, which we continue to evaluate, but ultimately, we believe that this is a very good company that has served its long-term investors very well and does not need outside "help."

The discussions on Danone and Nestle above, and recent changes at Unilever, reflect the higher-than-normal drama taking place in the traditionally boring consumer products industry. This is related to a slowdown in industry growth, lower barriers to entry and new emerging business models. Companies are pressured to find new avenues to deliver historical levels of earnings growth. Meanwhile, valuation multiples for these companies are quite elevated compared to the higher-growth years (adding more pressure to not "disappoint" the Street). In this context, it should not be surprising that Ivy's exposure to CPG stocks has declined. There are still some great businesses in this space, but quality at an acceptable price has become increasingly elusive.

Far East Equity

Much like Q1, Far East equity markets appreciated in Q2, with the MSCI Asia Pacific Index up 5.9% in US dollar terms, outpacing the MSCI World (+4.2%). Korean markets were especially strong, up 10.7% in the quarter (local currency). This was driven in part by expectations for improved corporate and market transparency and reform, following the results of the Presidential election in South Korea. Hong Kong markets were also strong, up 8.5% in local currency, driven by the Financial and Technology sectors. Japanese markets were notably stronger in Q2 compared to Q1. Notwithstanding some volatility during the quarter, most Far East currencies were broadly unchanged compared to the end of Q1.

Ivy's Far East holdings overall performed in-line with broader Far East markets. Once again, the stand-outs were Samsonite and Techtronic Industries. Samsonite's share price has continued to appreciate following its Q4 F2016 results (reported in January 2016), which showed indications that business performance is improving following a modest slow-down in the first half of 2016 (especially in Asia) and also due to good execution thus far with the integration of Tumi (acquired in August 2016). Techtronic's share price also performed strongly in Q2, continuing the strong performance from Q1 on the back of strong F2016 results and eased concerns about the potential impact of protectionist trade policies in the US. Unfortunately, the share prices for both Samsonite and Techtronic may have appreciated faster than what their fundamentals would indicate, making them more expensive from a valuation perspective. We therefore modestly trimmed our position in both stocks across various Ivy Funds.

We initiated a position in CK Hutchison Holdings (CKH) in the Ivy Foreign Equity and Ivy Global Balanced Funds in Q2. CKH is a Hong Kong-listed conglomerate that operates in a select set of industries – infrastructure, ports, telecom, retail and energy. The company operates globally, with particular focus on the UK/Europe, Asia (including China & Hong Kong) and Australia; their preference is to operate in regions with well-developed and transparent regulatory regimes and market structures. CKH owns and operates a number of high quality assets, which have been accumulated over time through a combination of counter cyclical investment and capital recycling. It owns various utilities (gas and electricity distribution, water utilities, waste management, renewable energy), a leading global health and beauty retail chain (AS Watson), a pan-European mobile telecom operator (Three Europe), a large investment in Husky Energy and a leading global container terminal operator. More broadly, CKH seeks to own leading businesses in industries that exhibit stable/recurring earnings and have high barriers to entry and attractive structures. The company entered into its current form in June 2015. It was formed as a result of the combination of Hutchison Whampoa and Cheung Kong Holdings. The predecessor companies owned a number of property businesses, all of which were spun off into Cheung Kong Property Holdings (CKP), while all the non-property businesses (reference above) were kept inside CKH. While we watched CKH's predecessor companies in the past, we were deterred by the presence of the property businesses, which exhibit a high degree of cyclicality and earnings volatility. Our main attraction was to the non-property businesses; however, it was not possible to only invest directly in these businesses, until the reorganization referenced above was initiated. We believe CKH exhibits a unique combination of: 1) stable/recurring earnings with modest growth from its existing businesses, 2) the opportunity to grow through additional capital deployment across a number of industries and countries and 3) a long-term approach to running the business and counter-cyclical investment.

There was some additional portfolio activity in the quarter, largely focused on Japan due to the strength of the market. We trimmed our position in Bridgestone, Suntory Beverage & Food, and Hoya across various Ivy funds during Q2.

On May 24, Ansell, a holding in the Ivy Global Balanced and Ivy International Funds, announced that it agreed to sell its Sexual Wellness business for $600 million USD to a consortium of Chinese buyers. This had been anticipated for a long time, but the valuation that the business fetched was more attractive than we (and possibly the market) had initially expected. We agree with the rationale behind the sale. While this is a very good business backed by strong brands, Ansell was competing with global Consumer Product heavyweights who are able to invest more aggressively in marketing and promotion, leaving Ansell potentially disadvantaged over the long term. We expect Ansell to use the proceeds wisely, likely through a combination of share repurchases and strategic acquisitions. Ansell employs a disciplined return-on-capital framework, which guides its capital deployment decisions.

Seven & I Holdings announced in early April that it will acquire the majority of Sunoco's Fuel Retail business in the US for $3.3 billion USD. The acquired assets are comprised of 1100 stores located in Texas, Northeast US and Southeast US, along with the well-known Stripes food service brand. We believe Seven & I paid a fair and full price for these assets, despite Sunoco being a distressed seller. That said, the acquisition is fully aligned with the company's strategy and while it will increase their exposure to fuel, it will also give them much more scale in a market that is still highly fragmented. We believe the acquired stores are of good quality, as they used to belong to the once publicly-traded Susser Holdings, which had a well-developed merchandise and food offering.

We visited the US operations of Amcor in late June. As part of the trip, we had an opportunity to tour several of the company's plants in various segments (Rigid Plastics, Flexible Packaging, Tobacco Packaging) and meet with various levels of management and operational personnel. The visit gave us greater insight into the strength of the culture and management at Amcor, as well as the high level of focus on operational excellence and customer service. We believe Amcor has multiple avenues for growth across these segments and expect the pursuit of this growth to be guided by Amcor's strong capital discipline.

In late June, we participated in Bridgestone Americas' Investor Day, which was held in Nashville. We had good access to management at a number of levels and gained greater insight into the culture of the company, personalities of management, as well as the work that the company is doing from an innovation perspective.

As we stated last quarter, it has become increasingly difficult to identify opportunities to purchase high quality businesses at attractive valuations. Many of the valuation opportunities that we saw in the summer and fall of 2016 are no longer available, as Asian markets have rallied significantly over the last 12 months. In this environment, it is important to remain patient and exercise valuation discipline. We continue to deepen our Far East watch list, as we believe this approach will allow us to capitalize on opportunities when they do arise.

We continue to believe that the most significant risks for global markets are the unintended consequences related to several years of ultra-loose monetary policy, the impact of excess leverage in various pockets of the global economy and excessive valuations. The US Federal Reserve has now began initial discussions about unwinding their balance sheet; other central banks like the Bank of England and the ECB have started to follow suit with discussions of their own, with Japan being a notable exception. Should this unwinding actually materialize, we could witness the largest buyers of government/corporate debt over the past several years finally step away from the market. We believe this has the potential to impact valuations for various asset classes, not just high quality bonds/credit, in ways that many market participants may not anticipate.

We remain 'underweight' Japan relative to most Far East/EAFE benchmarks, due to high valuations. We have a higher weight in Australia and Hong Kong relative to most benchmarks, due to our holdings in what we believe are attractively-priced high quality cyclical stocks.

The Mackenzie Ivy Team

   

    

Top row, left to right: **Hussein Sunderji**, Portfolio Manager (Far East equities); **Matt Moody**, Portfolio Manager (European equities); **Robert McKee**, Portfolio Manager (US equities); **Paul Musson**, Head of Mackenzie Ivy Team and Portfolio Manager. Bottom row, left to right: **Adam Gofton**, Associate Portfolio Manager (US equities); **Graham Meagher**, Associate Portfolio Manager (Canadian equities); **James Morrison**, Associate Portfolio Manager (Canadian equities); **Zain Shafiq**, Senior Investment Analyst (Canadian equities); **Jason Miller**, Senior Investment Analyst (European equities).

Disclosures:

As at June 30, 2017	1 year	3 year	5 year	10 year	15 year	20 year	Since inception	Inception date
Mackenzie Ivy Canadian Fund	14.0%	8.5%	10.5%	4.2%	4.6%	5.8%	7.1%	Oct-1992
Mackenzie Ivy Canadian Balanced Fund	14.8%	8.4%	9.3%	4.3%	4.8%	5.9%	6.8%	Oct-1992
Mackenzie Ivy European Class	-2.7%	3.1%	9.0%	4.2%			5.5%	Nov-2002
Mackenzie Ivy Foreign Equity Fund	-0.1%	7.8%	12.1%	6.0%	5.1%	7.0%	7.9%	Oct-1992
Mackenzie Ivy Global Balanced Fund*	4.0%	7.6%	10.6%	5.4%	4.7%	5.3%	4.9%	Nov-1993

All fund returns refer to Series A.

***Mackenzie Ivy Global Balanced Fund:** On May 15, 2001, the Fund changed its mandate from pursuing long-term capital growth consistent with preservation of capital by investing primarily in large-cap stocks, securities carrying above-average investment ratings, government guaranteed securities, cash equivalents or gold-driven instruments, to pursuing long-term capital growth by balancing current income and capital appreciation. It now invests primarily in stocks of companies that operate globally and in bonds of governments and corporations around the world. The portfolio managers have the flexibility to hold any proportion of stocks and fixed income securities they feel is appropriate, however the portfolio is generally balanced. The Fund's former strategies also sought to concentrate investment in six particular market regions. The past performance before this date was achieved under the previous objectives and strategies.

GENERAL INQUIRIES

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