MACKENZIE
Investments

MACKENZIE IVY FUNDS

Quarterly Report – Q3 2018

Ivy Quarterly Report – September 30, 2018

Share Buy-Backs and Income Disparity

The world is experiencing increasing levels of income disparity. And while share buy-backs are not the sole contributor to this, they have received a lot of criticism of late and justifiably so. By purchasing shares at inflated process – valuations are higher today than they ever have been by some measures – share buyback programs reward stock owners with even higher valuations, and company executives with higher pay coming from their company stock options. Many believe that companies should instead be investing more capital back into their business to improve productivity and create more jobs. While this criticism is at times well deserved there are other times when share buy-backs make perfect sense. For instance, if a company's share price is significantly below its intrinsic value, then buying back shares can be a very good use of capital. However, companies rarely buy back shares when it makes sense to do so. Instead they pile into their own shares as they become increasingly expensive. We are now in the longest and one of the most expensive bull markets in history, yet share buy-backs are hitting all-time highs. No net wealth is being created by these actions; it's only being redistributed. Market players seemingly no longer have the patience to invest in companies that create true wealth over time with business models that benefit all constituents. Instead, many investors are increasingly focused on getting rich quickly, evidenced by the increased stock turnover and much shorter holding periods, turning the markets into a zero sum game where a few gain at the expense of the rest. It's akin to a poker game where there is no net wealth created, only winners (sometimes only one) and losers.

If buying back shares when they're expensive isn't a good use of capital, then why is it happening and who is responsible? In our opinion there are two broad categories of players involved; one directly and the other indirectly. But first a little background. Prior to 1981, most companies would seldom participate in share buy-backs because they were afraid of being accused of manipulating their share price. And if they did buy back their own shares it was primarily through tender offers rather than open market purchases. But then the SEC put in place safe harbor provision 10b-18, which enabled companies to buy back their own shares in the open market without fear of prosecution. In the SEC's own words "Rule 10b-18's safe harbor conditions are designed to minimize the market impact of the issuer's repurchases, thereby allowing the market to establish a security's price based on **independent market forces without undue influence by the issuer**." One of these safe harbor conditions states that companies must not buy back more than 25% of their total shares traded in any one day. While that made perfect sense some forty years ago, in today's world of high-frequency trading, hedge funds and algorithms, a cap of 25% is ludicrous. Any company that trades up to 25% of the daily volume in its own stock would likely see its share price ramped higher. However, due to the SEC's safe harbor provision, these companies would technically not be doing anything wrong, or at least nothing illegal. In our view the 25% rule is hopelessly outdated; time has moved on and the rule obviously needs to be changed. A disturbing question is, "why hasn't it?"

Given the lack of concern over the state of valuations generally, it seems that few have minded stock price manipulation, as long as those prices are being manipulated higher. But make no mistake, the consequences of stock price manipulation do not depend on the direction of the price movement. The question is simply one of timing. Manipulating share prices lower can result in more immediate consequences, while the impact of manipulating them higher are simply pushed into the future.

A number of players have helped make the great share buy-back bonanza possible. Over the last decade, in our opinion, the Federal Reserve has kept interest rates far too low for far too long and printed trillions of dollars to improve "financial conditions" i.e. drive asset prices higher (manipulate them higher than the market would otherwise dictate). The cheap financing has also encouraged activist shareholders to target strong balance sheet companies and threaten corporate executives with removal from office if they don't take on debt and buy-back shares. Wall Street analysts joined in, claiming that these companies are irresponsible in that they have an "inefficient" balance sheet i.e. they don't have enough debt. The rationale given is that higher levels of debt serve to improve the company's return on capital as debt is a cheaper form of financing than equity. While this is true, the benefit to the business is minimal while the damage done to the balance sheet potentially puts the business at risk and limits future investment opportunities. In addition, there is the opportunity cost which is not seen i.e. the benefits the company and remaining shareholders would have experienced if instead of buying back overpriced shares, management had reinvested that money in the business. Once the company's balance sheet can no longer service any more debt the activist shareholders move on to their next target, leaving the remaining long-term shareholders with a debt-laden company that has spent the last number of years underinvesting in its business. When management extracts money from the business to buy their own overpriced shares, they do so at the expense of the business and the remaining long-term shareholders.

If markets come crashing down as a result of these policies (possibly taking the economy along with it), there will be plenty of blame to go around. The obvious targets will be those in plain sight; direct players such as activist shareholders and corporate executives. And while their actions are hardly noble, we believe most of the blame should justly lie with the indirect players who could have put a stop to it at any time: policy makers. It's very easy to delude oneself about the longer-term consequences of one's actions when there are enormous short-term benefits to be gained in terms of wealth, ego and power. Their actions, or inactions, have led to wealth being concentrated in fewer and fewer hands. The fallout from all of this could be significant and while it would be extremely painful for a lot of people, it would also be an opportunity to finally put an end to asset price manipulation and its side-effects of rising income disparity. The last crisis was wasted. Let's hope that if we have another one, that this time the root causes will be correctly recognised and dealt with accordingly.

Canadian Equity

In the third quarter, Canadian equities languished, extending the divergence between domestic and foreign market valuations. From the peak of the last cycle in 2008, the TSX has generated an annualized total return of only 4%, while the S&P 500 and MSCI World Index have returned approximately 13% and 10%, respectively in Canadian dollars. Although this can be partly explained by sub-par growth in Canada, valuation multiples have also diverged to the point where US and global market multiples are near record highs, while Canadian market multiples remain more reasonable. This is reflected in our current allocation, with 2/3 of our equities invested within Canada.

The percentage of our fund allocated to cash has been steadily decreasing over the past three quarters to the current level in the high single digits. In the second quarter, we were able to take advantage of a sell-off in the global Consumer Staples sector. In the third quarter, we increased our allocation toward Canada as we recycled capital out of rising US equities such as W.W. Grainger and Henry Schein and deployed it along with a portion of our cash position into a collection of Canadian equities. Our largest addition was to an existing position in Dollarama following a marked sell-off that we discuss below. We also added three new positions: Brookfield Property, Premium Brands and Encana. Finally, we exited our position in Raging River after its sale to Baytex.

Dollarama

One of the key detractors to our performance in the quarter was our investment in Dollarama. The company reported lower than expected same-store sales growth (SSSg), which has at least for now called into question the sustainability of its historical growth rates and the appropriateness of its high-growth valuation multiple. Our investment thesis and expected return factors in slowing growth and a corresponding normalization of its valuation multiple, but this is not to say that we expect slow growth. One would be hard pressed to find another retailer in today's hyper competitive environment where 12% EPS growth would be considered disappointing. We believe that SSSg in the low single digits, coupled with the continued build out of its store network and strong free cash flow will generate growth for years to come. Following a discussion with management and our analysis of peer results, we believe we have a firm grasp on the root causes of the slower than expected SSSg. Two key drivers were limited inflation coupled with management's choice to reinvest in its business at the expense of short-term growth, which we view as a hallmark of a high-quality company. While the sell-off has hurt our short-term performance, we believe that this event will be quite positive for our long-term performance as it has allowed us to meaningfully add to our position.

Brookfield Property Partners

We initiated a direct position in Brookfield Property Partners (BPY), which added to the indirect exposure we have through our holding of its parent company, Brookfield Asset Management (BAM). BPY is a diversified developer and operator of high-quality real estate. It has established a reputation as a disciplined acquirer with a proven ability to reposition assets and create value using its development, operational, and multi-asset class expertise. The company recently completed a significant acquisition that increased its exposure to the retail sector at a time when e-commerce is disrupting traditional retail distribution channels and this has weighed on the stock. While we believe that the predicted rise in online sales penetration presents a headwind to traditional bricks-and-mortar retailers, Brookfield is well positioned to navigate its way through this evolving competitive landscape, with a focus on high-quality real estate and the ability to repurpose underperforming retail by incorporating other uses such as office, residential, and hotel. The negative sentiment around Brookfield's increasing exposure to retail allowed us to initiate a position in the stock at a near record 40% discount to its publicly reported net asset value, which we believe represents a significant margin of safety for a high-quality, diversified portfolio with stable cash flow and strong growth potential.

Canadian Equity *(cont'd)*

Premium Brands

We initiated a position in Premium Brands Holdings Corp. (PB) this quarter, taking advantage of what we believe to be an unwarranted sell-off. PB owns a diversified collection of higher-growth downstream niche food businesses with products that share quality, authenticity, and convenience characteristics. PB has grown rapidly on both an organic and inorganic basis, but this is not a short-term consolidate-and-cut costs acquisition strategy. Rather, PB is a disciplined resource allocator, choosing to partner with established businesses who already have exceptional management, brands, and growth prospects. At the head office level, PB acts as a facilitator of organic growth, leveraging the entrepreneurial and accountable cultures of each individual business. Each management team operates autonomously, but is supported with capital rigour, shared services, expertise, and distribution capabilities. This behavior is unique and the PB corporate culture (long-term, risk averse, and a focus on people) closely reflects our view of quality. The result has been strong but disciplined organic growth, which we expect will continue as PB capitalizes on major consumer demand trends in the North American food sector including a shift towards higher quality, authenticity/artisanship, a higher protein diet, and increased snacking/convenience.

Encana

We also initiated a position in Encana, a high-growth oil and gas company located in low-cost resource basins with diversified access to end markets. The company's operations are spread across four core properties, including the Permian Basin and the condensate-rich Montney. A change of leadership in 2013 has proved to be positive for the company, resulting in a disciplined culture that prioritizes capital returns over production growth. We expect that this discipline, coupled with production costs that are estimated to be within the bottom quartile across North America should allow it to grow faster than peers, while generating attractive incremental returns on capital.

Raging River

Earlier this year, Raging River agreed to merge with Baytex Energy in an all-share transaction. Despite our belief that the pro-forma portfolio of assets is high quality, significantly more diversified, with a lower decline rate, we decided to exit our position as we found the leverage resulting from the combination to be too high.

US Equity

2018 has been a strong year from a participation perspective for our US holdings despite market gains being driven by continued strong gains in technology related shares where we don't have a large exposure. **Henry Schein** contributed in the quarter and has recovered much of the weakness it experienced last year as results have been steady, some of the Amazon dominance fears appear to have dissipated and interest in the decision to spin out Vets First Choice is starting to percolate. Henry Schein is combining their Animal Health business with a company called Vets First Corporation to form a new company. Vets First Choice is a leader in pharmacy services for veterinarians. Vet pharmacy businesses have been under some pressure by web-based players. Vets First Choice provides a front-end web-page for ordering and has direct-to-consumer fulfilment capabilities which will be enhanced by Schein's supply chain. Vets First Choice also helps with compliance and renewals which increases total revenue for the vet but also for the manufacturer. Aligning with Henry Schein's animal health business will allow for accelerated selling into Schein's market leading global customer base along with the opportunity to leverage Schein's supply chain for better service levels and potentially new products over time. We see the spin-off as a sensible way to improve both businesses for the benefit of Schein's shareholders.

Finding investments that meet our return hurdles has been extremely difficult in the past few years and we've been worried about getting into situations where returns look good because you are taking on unknown risks. We really like the companies we own but recognize that longer-term returns from this point are likely to be very low and that a risk-rerating in the marketplace could subject us to a significant drawdown. We have a balance of stable companies that likely won't provide much upside but should provide portfolio stability with some return along the way along with some more sensitive companies in financial, industrial and consumer discretionary sectors that should participate more if the economy stays strong. Our participation in the past few years has been low but we are moving forward and increasing total return while being mindful the best long-term return path at this point may very well be not being subject to a significant drawdown and getting reinvested at better rates of return. It has been a very tough balance especially as US markets continue to soar and particularly in sectors where we don't have exposure. It's a tough time in the cycle for us and this has been an extraordinary cycle but we remain focused on our objectives of outperformance with a better path.

European Equity

European markets were modestly higher in the quarter, but were slightly negative when measured in Canadian dollars. Ivy's European holdings outperformed the MSCI Europe Index by a substantial margin, driven by a few individual holdings rather than any broad theme.

We have discussed our investment in **H&M** at length in prior reports. To summarize, it is an apparel retailer with some great attributes and advantages, but struggling with some internal missteps and a rapidly changing industry. H&M's fiscal third quarter results were encouraging on several fronts, as some of the investments they have been making to improve their assortment and omni-channel capabilities have started to pay off. There has been a lot of negativity around the company and its prospects in the past year, so these results were enough to prompt a sharp rally in the share price.

Aggreko, the world leader in the provision of mobile modular power, also saw sharp share price gains after reporting encouraging results. They have some exposure to the booming oil & gas market, providing off-grid power to shale operators in the US, and are growing in other segments as well. This is a volatile business by nature, impacted by such diverse factors as mining activity, emerging market grid failures, and post-hurricane blackouts. Aggreko has the scale and diversity to manage this volatility well, and the financial strength and long-term mindset to invest in new technological capabilities in the field of temporary power.

Burford Capital, our newest European name in the Ivy European and Ivy International funds, was the third holding to post a strong quarterly gain. Burford is an investment management company that is focused on the growing niche of legal finance. As with H&M and Aggreko, Burford's stock price jumped after reporting a good set of results.

It is important to stress the long-term nature of investing. Ninety days is often not a very useful timeframe for judging the performance of a business or a stock. Take the examples above. Last quarter, we had highlighted Aggreko as one of our biggest detractors, and less than two weeks into the fourth quarter Burford had given back much of its third quarter gains. What is most important is whether or not our long-term investment thesis in a company remains intact, and in all three of these cases the reported results were encouraging.

Other contributors were **Reckitt Benckiser**, **Admiral Group**, and **Sonova**, while **Publicis** and **Domino's Pizza Group** detracted from performance. In Ivy European and Ivy International, **Rotork** was removed for valuation reasons, and we reduced our positions in **Sonova** and **Nokian Renkaat**.

We often get asked if European stocks are "cheaper" than those in other regions. At first glance, this would appear to be true: using rough guides like forward P/E ratios, European indices are well below the S&P 500. However, this is mostly a reflection of sector mix. Europe has relatively few technology stocks compared to the US, and these stocks currently attract high P/E multiples. Comparing apples to apples, there is no discernable difference between the two regions. So, a European tech stock has a similar multiple to an American tech stock, a European industrial firm is priced similarly to an American industrial, and so on.

There are two material exceptions to this observation. One is Consumer Discretionary, which has a much higher multiple in the US, but this is skewed heavily by the (briefly) $1 trillion company Amazon and its high P/E ratio. The second exception is Financials, where European stocks look "cheaper". This is in our opinion a reflection of relative quality; our research shows European banks, in general, have weaker balance sheets and profitability than their American counterparts (to put it charitably).

So overall, we consider valuations in Europe to be similar to those seen elsewhere, and in general we don't find them to be too attractive, especially if adjusted for cyclical factors. Broad market weakness since the end of the quarter has made things more interesting, and we are hopeful that some of the high-quality names on our watch list will come within range.

Far East Equity

Far East markets were relatively flat in local currency terms during Q3; Japan led the pack, with the TOPIX advancing 5.7% (local currency), while the Hang Seng showed continued weakness with a 2.5% decline. Once again, Asian markets significantly lagged the S&P. Ivy's Far East holdings generally outperformed the broader Asian indices during the quarter, in local currency terms. The strongest performers were **Brambles**, **CK Hutchison Holdings**, **Hoya**, and **Seven & I Holdings**; the weakest performers were **Ansell** and **Amcor**.

Brambles reported good F2018 results in August. The business continues to grow well in North America and Europe, and the Company has been able to pass on a fair portion of raw material cost increases to customers. Brambles also announced plans to de-merge the IFCO Reusable Plastic Crates (RPC) business; the IFCO RPC business has grown significantly since Brambles acquired it in 2011, and the long-term growth opportunity remains attractive. However, the investment profile required to capture this long-term opportunity is inconsistent with Brambles' core pallets

Far East Equity *(cont'd)*

business, and the return on invested capital objectives of the Company. Therefore, management believes that the full value of the IFCO business can be better realized as a separate entity. Brambles' share price reacted positively to the news of the F2018 results and IFCO separation; our investment thesis on Brambles' pallets business is unchanged, and we await the outcome of the IFCO de-merger process.

CK Hutchison Holdings' (CKHH) H1 2018 results were strong, showing good revenue and profit growth. The Retail, Infrastructure, and Energy segments have been particularly strong, while the Ports and Telecom businesses have delivered mix performance of late. We believe CKHH offers very attractive value with a good combination of earning stability and growth potential, given its multiple avenues for capital deployment and long-term / counter-cyclical approach to running the business.

Amcor announced in early August that it will acquire US-based Bemis in an all-stock deal. Bemis is a leading flexible packaging company that operates mainly in North America and Latin America; its operating footprint is highly complementary to that of Amcor. Bemis' performance has come under pressure of late due to customer issues, as well as weakness in Latin American markets. Bemis has been on Amcor's radar for quite some time, and we believe Amcor is being opportunistic in its approach to Bemis at this time. Amcor's share price reacted negatively to the acquisition announcement, and has also been pressured by concerns about the impact of rising raw material costs on short-term earnings. While the Bemis acquisition is a large undertaking, we believe the deal has significant strategic merit for Amcor, and good financial upside through cost synergies and better business diversification. We believe Amcor's current share price offers very compelling long-term value.

Ansell reported good F2018 results and solid F2019 guidance in August. Management's outlook commentary was generally positive, however they struck a somewhat cautious tone around the impact of US import tariffs on China, and the path of raw material costs. This caused the market to become concerned about the near-term earnings trajectory, thereby leading to weakness in the share price. We believe management was being prudent in its assessment of the near-term outlook; we are encouraged by the underlying business trends (best organic growth in several years) and the discipline that management is showing with capital deployment.

We initiated a position in Japanese-listed **Fanuc** in the Ivy International Fund during the quarter. Fanuc is a leading provider of factory automation equipment and software – the Company has leading global market share in industrial robots, components for computerized machine tools, as well as integrated machining centres. Fanuc is well known for its deep customer focus, industry leading product quality and innovation, and its highly efficient and highly vertically integrated business operations. Fanuc manufactures the vast majority of its products in its highly automated facilities in Japan, but sells its products and services globally, including in China where it has significant direct and indirect exposure. The share price has been hit of late due to concerns about the impact of trade tensions on industrial demand and capex in China and Japan, as well as general weakness in some of Fanuc's key end markets (semiconductors and auto). While we acknowledge that Fanuc is a cyclical business and could experience volatility in the near-term, we believe the current share price offers a compelling long-term risk/reward for what we believe is a very high quality business. We are further comforted by the fact that Fanuc has a very strong balance sheet with significant net cash.

We exited our position in **Hyundai Motor Company** (HMC) in the Ivy Foreign Equity fund during Q3. We have been shareholders of HMC for over five years; we still believe the business is well run and has several attractive attributes including a good cost position and global sales / production footprint, vertical integration, strong and improving brands, and a good balance sheet. However, the overall operating environment has become much more difficult over the last while, particularly in China and the US, and we do not see a clear path to improvement over the medium term. In addition, HMC has faced some company specific issues over the past few years, including its model mix in the US and China which has led to high levels of discounting, ill-timed capacity expansions in China, and heightened levels of investment required across the business. For these reasons, as well as the highly cyclical nature of the business and underlying industry, we modestly downgraded our quality assessment of the stock and opted to exit the position.

The lingering trade dispute between the US and China is now starting to have a more material impact on Asian equity market sentiment, and has led to a decline in the share prices and valuations for several stocks on our Far East watch list. Some of these businesses have a high degree of economic sensitivity and therefore we must exercise caution given the potential for further downside. However, the negative sentiment is now starting to impact less cyclical stocks as well, which are businesses that we generally view as being more attractive. Following the end of Q3, we initiated a position in a Hong Kong-listed consumer discretionary business that we will discuss in greater detail in the next Ivy Quarterly.

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); **Yining Zhang**, Associate Investment Analyst.

Disclosures:

As at September 30, 2018	1 year	3 year	5 year	10 year	15 year	20 year	Since inception	Inception date
Mackenzie Ivy Canadian Fund	2.3%	6.9%	6.9%	6.0%	5.1%	5.4%	6.7%	Oct-92
Mackenzie Ivy Canadian Balanced Fund	2.7%	6.6%	6.6%	5.5%	5.0%	5.2%	6.5%	Oct-92
Mackenzie Ivy European Class	1.4%	2.0%	5.2%	6.0%	5.7%			Nov-02
Mackenzie Ivy Foreign Equity Fund	7.7%	4.0%	7.7%	7.8%	6.2%	6.2%	7.6%	Oct-92
Mackenzie Ivy Global Balanced Fund	7.3%	6.0%	7.6%	7.3%	5.8%	4.4%		Dec-93
Mackenzie Ivy International Fund*	2.5%	2.9%	4.5%	4.7%	4.5%	2.7%	3.7%	Oct-85

All fund returns refer to Series A.
*Mackenzie Ivy Team assumed management of the Fund on June 21, 2016.

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Mackenzie Ivy Canadian Balanced Fund
On May 1, 2013, there was a change of strategies such that the investment style of the fixed-income portion of the Fund changed from a passive and conservative approach to a value investment style.
On August 14, 2014, there was a change of investment objective to permit flexibility in order to optimize the Fund's risk/return profile in all market conditions.

Mackenzie Ivy Canadian Fund
On April 9, 2010, there was a change to the investment strategies so that the Fund may invest in derivatives for hedging and non-hedging purposes.

Mackenzie Ivy Global Balanced Fund
On May 1, 2013, there was a change of strategies such that the investment style of the fixed-income portion of the Fund changed from a passive and conservative approach to a value investment style.On August 14, 2014, there was a change of the investment objective to permit flexibility in order to optimize the Fund's risk/return profile in all market conditions.

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