MACKENZIE Investments

# MACKENZIE IVY FUNDS

## Quarterly Report – Q4 2018

# Ivy Quarterly Report – December 31, 2018

The last few months of 2018 were extremely volatile. The Trump tariffs may have contributed to the uncertainty, but we believe that rising interest rates in the United States and slowing growth in global liquidity were also partly responsible. We believe that the US Federal Reserve's apparent choice to favour asset price manipulation, rather than efficient allocation, has backfired, preventing stronger and more sustainable long-term growth and adding to recent market volatility. In our view, monetary policy is still extremely accommodative, and the Federal Funds Rate has only risen to what in other economic cycles would be considered emergency levels. We believe that simply being less accommodative could be enough to stop the economy in its tracks. After all, the economic recovery was built primarily on a mountain of debt and consumption and less on investment.

The current economic cycle is getting very long in the tooth. The main problem with a debt-driven growth policy is that ever increasing amounts of new debt are required to achieve the same amount of economic growth. The larger the debt pile, the less able the economy is to operate under its own steam. If the cost of that debt is growing at the same time, it only serves to restrict the economy's ability to grow even further.

The typical policy response to an economic slowdown has been to lower interest rates and encourage the creation of debt. Over the last ten years, US public debt doubled, resulting in the debt-to-GDP ratio rising from 63% in 2007, to 104% in 2018. Corporate debt also nearly doubled . This recovery also saw a monumental increase in the money supply through trillions of dollars being printed via quantitative easing. The Federal Reserve, the ECB and the Bank of Japan added debt and liquidity to help the economy recover. After which, we think, central bankers expected to start raising interest rates closer to the natural rate (the natural rate can only be determined by market forces); at least if your goal is to foster the efficient allocation of capital which in turn leads to the most optimal productivity growth. However, as rates have started to rise and the Fed's balance sheet only slightly reduced, central bankers appear to have discovered that the economy still requires stimulation. We believe the Central Bankers have not learned the lessons of the last crisis, and their policy decisions have been a significant contributor to synchronized economic slowdowns in US, Europe, Japan and even China.

The effective Federal Funds Rate sits at 2.40%; far lower than at any time in the '70s, '80s or '90s. In fact, the only time it has been this low over the last fifty years was in the mid-2000s, just before the Global Financial Crisis. Not only is monetary policy still extremely accommodative, but so is fiscal policy. Ten years into a recovery, we feel that this is an extremely short-sighted policy which has helped to prevent the inevitable healing process that needs to take place before the economy can continue to grow through investment and productivity rather than debt.

As we have written before, we believe that one of the main issues for policy-makers and the investment industry is that people tend to focus on symptoms rather than fundamentals. They'll focus on the symptoms of a rising stock market, or GDP growth. Both of these measures can be boosted quickly by printing money, but at the expense of fundamentals such as a strong balance sheet and efficient capital allocation, which lead to greater productivity growth. The consensus appears to be that there is no recession (a recession is symptomatic of poor fundamentals) in sight, but sometimes recessions are only evident in hindsight. For example, in June of 2008, Ben Bernanke thought that the US economy was still expanding until subsequent data showed that the recession had already started back in December 2007.

We believe that with central banks constantly bailing out stock markets and driving asset prices higher a sense of entitlement seems to pervade some investors and policymakers. At Ivy, we are very patient and certainly don't believe that we are entitled to anything we haven't earned. This attitude comes from the pursuit of intellectual honesty that is the bedrock of our investment philosophy. Intellectual honesty is the pursuit of truth rather than the pursuit of hope. It can be extremely difficult to practice because it requires one to not only be brutally honest with oneself, but also with others. And it's difficult because you often end up saying things people don't want to hear and it can make you very unpopular at times. Being unpopular is a lifelong practice at Ivy, and that's because intellectual honesty can never be perfected. But the willingness to pursue this is the key advantage we believe we have over others.

Intellectual honesty is what enables us to focus on fundamentals rather than symptoms. But the problem with fundamentals is they are not helpful in making short- to medium-term predictions. You might know that fundamentals are poor, but you have no idea when they will manifest into bad symptoms. For instance, you know that a poor diet and excessive smoking and drinking will eventually result in symptoms that are evidence of poor health, but the symptoms can be largely absent for a considerable period of time. In fact, the symptoms can at first appear favourable e.g. life-of-the-party. Over that time, policy-makers are there to tell you that not only can you have your cake and eat it too, but you should have "another" piece of cake. They'll use sophisticated jargon and complex models to explain how all this cake will not result in poor fundamental health. In fact, they'll attempt to convince you that it's your patriotic duty to eat that cake. Not only will you gain the psychological pleasure of eating it, but it will benefit society at large. Who wouldn't want to hear that? This is the argument often given for consumption over investment. We don't believe that policymakers are intentionally trying to cause economic harm. Rather it's that they feel the need to make an immediate impact and can only do so by focusing on short-term results/symptoms with the hope that given time the economy will then heal itself. The main symptom that they focus on is GDP growth and favouring consumption over investment leads to stronger GDP growth in the short-term at the expense of slower growth in the long-term. With greater investment, the economy becomes more productive and provides for greater and more sustainable consumption in the future. While fundamentals can be poor predictors of short-term outcomes, they are very good predictors of long-term outcomes, but patience on behalf of policy-makers and investors is usually left wanting. We believe that most policy-makers are unwilling to focus on fixing fundamentals that will result in deteriorating symptoms (GDP growth) today only to have their successors benefit from their actions at some point in the future. Investors are often unwilling to take a longer-term approach based on fundamentals as the symptoms of being careful (i.e. underperformance), often leads to a loss of faith from their clients and capital flight. This behavior is rational but destructive, and occurs due to poorly structured and misaligned reward systems.

A good example of how ultra-low and even negative interest rates serve to slow economic growth is their role in the creation of zombie companies; companies whose interest expense is more than their operating profit for an extended period of time. The way capitalism is supposed to work is that capital is allocated to the most productive utilizers of capital. Those that are less productive, or indeed lose money, are starved of capital. However, central banks have helped to ensure that companies that destroy capital can survive much longer than they would otherwise and thus have the opportunity to destroy even more capital. But don't take our word for it. This from a study on Zombie firms by the Bank for International Settlements (BIS) back in 2016; "Our results indeed suggest that lower rates tend to push up zombie shares, even after accounting for the impact of other factors." And their take on the impact of Zombie companies: "Zombie firms are less productive and crowd out investment in, and employment at more productive firms." The BIS estimated that over 12% of non-financial firms were effectively Zombies, which is a record and compares to less than 3% back in the early '90s (things have likely gotten worse over the last couple of years as interest rates have started to rise).

The short-term benefits of an economy supported by cheap monetary policy that keeps Zombie companies alive are lower unemployment and stronger GDP. Thus, the central banks behind these policies look like heroes. But these companies are being kept alive by increasing levels of debt (i.e. paying interest expense with debt rather than earnings) and continue to destroy capital. We believe the result will be slower economic growth and a less productive economy.

If the primary focus is on short-term symptoms and one ignores their potential consequences on long-term fundamentals, then central bank actions make perfect sense. But this only serves to delay the eventual day of reckoning, which will be made that much worse by putting it off.

If we were to experience a severe bear market and recession, one would expect that even the Federal Reserve would come to realize that their policies were detrimental to longer-term economic health. However, this did not occur after the last crisis. Instead, they doubled-down on their misbegotten policies in order to somehow justify the very behaviour that caused the problem in the first place. The ability of people to delude themselves about longer-term consequences from beneficial short-term actions and the invisibility of second-order effects help to ensure the current state of affairs will likely continue. At least until income disparity becomes so grotesque and economic growth so slow that populist movements finally force Congress to act and change the Fed's mandate to focus on longer-term fundamentals that benefit society at large rather than shorter-term symptoms that favour the select few.

# Canadian Equity

Volatility returned to global stock markets in the fourth quarter, with an initial step down in market values in October that was followed by another in December. Over the course of the quarter, the TSX composite index generated a return of -11% while the MSCI World Index return was -13%. With this as the backdrop, Mackenzie Ivy Canadian Fund's return of -8.5% was comparatively good in relation to the market and our peers, despite being negatively impacted by a few idiosyncratic issues that coincided with the market sell-off.

Although the drawdown in the market over the fourth quarter was certainly material and reflective of the many risks at play in the market today, it's too soon to say whether it represents a harbinger of more to come or a pause in the continuation of a liquidity-fueled bull market. We continue to position our fund, as we always do, carefully invested in a diversified portfolio of reasonably priced, high-quality businesses so that we can participate in the long-term growth of the market while protecting our client's capital through episodic periods of volatility.

During the quarter, we initiated new positions in **CCL Industries** and **TransCanada Corp**, while meaningfully adding to our existing holdings in **Encana** and **Premium Brands**. We also opportunistically exited our positions in **Procter & Gamble** and **Omnicom**. We discuss the theses of our new investments below.

## CCL Industries Inc.

CCL Industries is a global specialty packaging company and the world's largest label maker. CCL's strength is its ability to provide innovative, reliable, secure products for global supply chains, as a single accredited vendor. CCL services the largest global customers in the consumer, healthcare, electronics, automotive, and retail sectors, giving it exposure to several defensive end markets. We have admired

CCL for a long time but had to remain patient until valuation multiples became compelling enough for us to invest. The share price corrected in the latter half of 2018 due to high polymer input costs and general market sentiment – both of which we view as temporary.

Over time, we believe CCL will leverage its large global reach, deep customer relationships, manufacturing expertise, and materials science advantages to provide high-quality, innovative label solutions. We expect CCL will use its strong financial profile to consistently reinvest in the core businesses, complete strategic acquisitions, expand manufacturing reach and capabilities, and take advantage of the trend towards premiumization in global label and packaging. We believe this will support strong organic growth and returns on capital, which will translate into above-average share price performance.

### TransCanada Corp.

TransCanada develops and operates oil and gas pipelines, with the majority of its revenues derived from transporting natural gas. The company operates one of the largest gas pipeline networks in North America, moving a total 25% of continental supply on its system, and also owns the Keystone oil pipeline. Their network is concentrated in two of North America's lowest-cost gas regions, which we believe will support future growth through continued production growth and the resulting demand for pipeline capacity. The company's stable, recurring cash flow is supported by long-term, take-or-pay contracts that are negotiated in advance of construction to achieve attractive risk-adjusted target returns without taking on meaningful commodity price or volume risk. Although TransCanada has a significant backlog of development projects, a key risk to our investment thesis is the growing social objection to pipeline development. This risk is partially mitigated by TransCanada's weighting toward less controversial natural gas projects and rising demand for natural gas across North America.

Since late 2016, rising long-term bond yields have driven TransCanada's valuation multiple down in line with the low reached in 2009 and well below its historical interest rate-adjusted average multiple. This provided us with an opportunity to acquire a high-quality, growing business with an attractive margin of safety.

## US Equity

The fourth quarter of 2018 felt like a tug of war as market participants assessed growth levels and the impact of higher discount rates and political instability on asset price levels. It's hard to know the root cause of the volatility or really how much of it was driven by trading programs, fundamental concerns, or emotions. Our US holdings held in quite well in the first bout of volatility in October but weren't spared in December's pull-back. We've seen some companies report results and some non-holdings like FedEx and Apple have highlighted economic weakness while we've seen some holding companies like Nike highlight strong demand and delivering solid results. There is cost pressure in the US. in particular which is impeding the flow-through of solid demand to the bottom line. There wasn't any significant activity in the quarter though we did reduce our Oracle position despite inline results as the pace of the current stock buy-back gives us some concern. We have always felt comforted by the large net cash position Oracle has had on the balance sheet and seeing it move to net debt while the business is still in transition increases the range of potential outcomes and warrants a smaller position. We did add to UPS as growth concerns hit what we see as an already attractively valued stock though we recognize if we do see a recession the stock would likely move down by as much or more than the market. We won't know how much of FedEx' growth issues were company-specific until UPS reports results in late January. We also won't know whether the cost of delivering a strong operational peak season came at the cost of higher expenses. It appears that new capital investments have helped and we expect to see better more efficient network performance going forward as UPS works their way through the network upgrade. As we look out into 2019, we continue to believe cyclical growth remains overpriced on average and we see continued speculative elements in technology. It's difficult to know how many new business models in the consumer and enterprise technology world are viable given such a generous fundraising environment but lower growth, higher discount rates or simply lower risk appetites may soon expose the answer.

## European Equity

The fourth quarter of 2018 saw declines in stock markets globally, and Europe was no exception with main European indices falling more or less in lockstep with the rest of the world. Sectors traditionally viewed as more defensive, such as Consumer Staples and Health Care, held up better than the rest. This is the type of environment where Ivy's style tends to work well, and that was the case in Q4 and 2018, with substantial outperformance for Ivy's European holdings and Mackenzie Ivy European Class.

Ivy has a long history of careful investing, and worrying is a key part of our DNA. We try to be careful about the businesses we buy, to be careful about the prices we pay for these businesses, and at times hold cash when prices seem excessive across the board. Sometimes, as in 2017, being careful in these ways proves detrimental to short-term returns. In welcome contrast, it paid to be careful in 2018, particularly in the fourth quarter.

For the year as a whole, the hardest-hit areas in European markets were banks, auto-related stocks, and tobacco. We had no exposure to any of these areas, aside from a position in tire-maker **Nokian Renkaat** in Ivy European, which we sold in the fourth quarter (see below). In Q4 specifically, weakness in the market was much broader, but as mentioned more defensive areas generally held up better.

Being careful on prices was particularly helpful this year, as it led us to remove or substantially reduce our positions in **Sonova, Rotork**, and **TGS Nopec Geophysical**, all of which corrected very sharply in Q4 after strong gains early in the year. When we sell positions due to elevated prices, we don't do so with the expectation that they will soon decline. Rather, the high prices signal to us that the returns we can expect to earn by holding these stocks over the coming years are low and that there is a greater risk of price correction. The fact that these stocks dropped shortly after we sold was simply luck but is an example of how being careful on prices can be rewarded when the market environment suddenly becomes more risk averse.

Apart from price, we will also occasionally sell stocks when we believe the original investment thesis has changed and the company no longer meets our quality benchmarks. This was the case with **Nokian Renkaat**, which was a holding in Mackenzie Ivy European Class since 2014. Nokian specializes in winter tires and has been remarkably profitable for many years. We have become increasingly concerned about long-term industry developments as well as changes in Nokian's strategy, so we sold the stock in October.

Cash levels have been high in the Ivy funds, including Mackenzie Ivy European Class, for some time. As mentioned, this is another way of being careful, when we believe expected returns for quality stocks are low. Having cash obviously helps when markets decline, and this was a substantial contributor to fund performance in the quarter and the full year.

The weak environment in Q4 led to some interesting opportunities to buy high-quality stocks at what we believe are attractive prices, and we added four new European stocks to the funds during the past three months. The first was **Husqvarna**, a Swedish maker of chainsaws, trimmers, robotic lawn mowers, Gardena-brand garden equipment, and related products. Husqvarna has struggled in the US. for a while now, which has masked some very good and improving performance in Europe and elsewhere. They recently decided to walk away from a large portion of their US business, which causes short-term disruption but we believe it is a positive step in the long-term. The stock price reacted negatively to these short-term issues, which provided an opportunity for investors with a longer-term perspective. Husqvarna is now a holding in Mackenzie Ivy European Class.

**DCC** is a new addition to Mackenzie Ivy European Class and Mackenzie Ivy International Fund. DCC's core businesses of propane distribution (LPG) and gas stations, among others, don't look obviously attractive at first glance. What attracted us was the quality of the business' management culture, which excels at acquiring and operating businesses using a strong return-on-capital approach. This has led to an admirable long-term track record, which we believe can be sustained.

Two other businesses were added in the quarter, including one in Mackenzie Ivy Foreign Equity Fund, but we will disclose them later as we are still building the positions.

These new holdings, as well as additions to some existing names, have brought cash levels in Mackenzie Ivy European Class down by roughly 10% in recent months. Cash remains elevated, but the market correction has brought several quality stocks closer to an investable range. There are certainly more opportunities in Europe than a year ago, and we will continue to evaluate them while remaining careful on business quality and price.

## Far East Equity

Global markets were very weak in Q4 and exhibited significant volatility. Far East markets were no exception, however, some regional markets performed better than their global counterparts. The TOPIX (Japan) declined 17.7% in Q4, underperforming other global markets in local currency terms, while the KOSPI (Korea) declined 12.7%. However, the Hang Seng (Hong Kong; -6.7%) and S&P/ASX 300 (Australia; -7.7%) both outperformed their global counterparts in local currency terms. Most Asian markets peaked well before European and US markets, however, and officially fell into bear market territory in Q4; for the full year, the MSCI Asia Pacific Index fell 13% compared to -8.2% for the MSCI World (in US dollars).

Ivy's Far East stocks as a group outperformed the Asian components of the broader global indices during Q4 and for the full year, in local currency terms. Key contributors during Q4 were **Seven & I Holdings**, **Suntory Beverage & Food (SBF)**, Bridgestone, and Amcor. SBF, Seven & I, and Amcor all benefited from valuation support in a turbulent market due to stable underlying business performance. Bridgestone's share price was stable despite reducing its F2018 guidance when it reported Q3 results in November – business performance has been relatively steady despite short-term impact from volatile raw materials and currencies.

Key detractors in the quarter were **Samsonite**, **CK Hutchison Holdings**, and **Techtronic Industries**. Samsonite's Q3 results were weaker compared to recent trends due to challenged consumer sentiment in Asia and North America. Our long-term view of the business has not changed and we view the current valuation as attractive; we modestly increased our position in Samsonite in the Mackenzie Ivy International Fund during the quarter. CK Hutchison Holdings' (CKHH) share price has been hit due to broad market declines, and also due to negative sentiment related to weakness in the British Pound and concern about the pace of improvement in its European telecom segment. We believe CKHH's underlying business offers good relative stability in a turbulent economic environment, and view the current valuation as very attractive. Techtronic's (TTI) share price weakened during Q4 due to concern about a slowdown in US housing and the general economy, as well as the impact of US/China trade tension on TTI's supply chain. We believe TTI is well positioned relative to peers and has good long-term growth prospects, as well as diversified end markets. We modestly increased our position in TTI during the quarter in the Ivy International Fund. We also modestly increased our weight in Ansell in the Mackenzie Ivy International fund in Q4 due to attractive valuation – business performance has been good and in line with our expectations, however, the share price weakened as the market became concerned with short-term earnings impact of supply chain disruption due to US import tariffs against China.

We initiated a new position in Hong Kong-listed **ANTA Sports** in the Mackenzie Ivy International Fund during the quarter. ANTA is a leading manufacturer and seller of athletic apparel and footwear in China; they have top market share in China among domestic players and are #3 overall (behind Nike and Adidas). ANTA was founded as a contract manufacturer for Nike and Adidas, and over time has evolved into a brand owner by launching its own ANTA brand and through astute acquisitions and growth of additional brands (such as FILA and Descente). Today, ANTA is positioned as a multi-brand, multi-price point, multi-channel brand name player with a national retail and distribution footprint, and strong brand awareness. The company is majority owned and run by founder Ding Shizhong and his family; we believe that management runs the company in a prudent manner with an eye on sustained, long-term growth, yet is nimble in its decision making. ANTA has shown impressive growth and good capital allocation over time – we believe their culture and competitive advantage will enable them to continue to benefit from solid underlying growth of the Chinese athletic wear market over the long term.

We exited our position in **Hoya** in the Mackenzie Ivy International Fund during Q4 due to valuation reasons. Hoya has been a holding since June 2016; we had been trimming our position for some time as the valuation became progressively more demanding due to share price appreciation over time. We continue to believe Hoya is a high-quality company and will continue to monitor the business.

We trimmed our position in **Seven & I Holdings, Bridgestone**, and **Brambles** in various funds during the quarter. The reductions were executed for a variety of reasons including valuation, better alignment between security weights and business quality/cyclicality, and to fund additional purchases in the fund to optimize risk and reward.

**Sonic Healthcare** announced late in Q4 that they will acquire US-based Aurora Diagnostics for $540 million USD. Aurora offers anatomical pathology services through a national footprint in the US, which it has built through acquisitions over time. We believe the rationale for the acquisition is sound – Aurora will provide Sonic with a broader footprint in the US and will provide Sonic with better hospital relationships and enable cross-sell opportunities with Sonic's existing business. The acquisition is modestly accretive to earnings in the near-term, but there is good potential for long-term growth for the combined business. The deal was funded through an equity offering; we participating in the financing and were able to accumulate more shares at an attractive valuation.

We welcome the recent market volatility, as we believe this may further offer opportunities to own great businesses at attractive prices. Asian markets have been weak since early 2018, and have endured more protracted and steeper declines over the past 12 months than most of their global counterparts. So far, most opportunities we have seen have been in stocks and sectors that are more cyclical and economically sensitive. We have been able to take advantage somewhat, however, we find that valuations for the highest quality companies on our Asia watch-list are still not very compelling. Therefore, we will take a measured and cautious approach to adding more cyclical exposure in the portfolios, and will remain patient while waiting for better prices for more stable businesses.

# 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 December 31, 2018 | 1 year | 3 year | 5 year | 10 year | 15 year | 20 year | 25 year | Since Inception | Inception Date |
|---|---|---|---|---|---|---|---|---|---|
| Mackenzie Ivy Canadian Fund | -8.8 | 2.5 | 3.9 | 5.9 | 3.9 | 4.4 | 6.2 | 6.4 | Oct-92 |
| Mackenzie Ivy Canadian Balanced Fund | -6.6 | 3.3 | 4.1 | 5.4 | 4.0 | 4.5 | 6.1 | 6.1 | Oct-92 |
| Mackenzie Ivy European Class | -1.2 | 0.1 | 2.5 | 5.6 | 5.0 | | | 5.0 | Nov-02 |
| Mackenzie Ivy Foreign Equity Fund | 3.0 | 1.5 | 5.6 | 7.7 | 5.8 | 5.3 | 7.5 | 7.5 | Oct-92 |
| Mackenzie Ivy Global Balanced Fund | 0.0 | 3.1 | 5.6 | 6.7 | 5.3 | 3.5 | 4.9 | 4.8 | Dec-93 |
| Mackenzie Ivy International Fund* | -4.5 | -1.5 | 1.7 | 5.2 | 3.4 | 1.6 | 3.2 | 4.7 | 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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