MACKENZIE
Investments

MACKENZIE IVY FUNDS

Quarterly Report – Q1 2019

Ivy Quarterly Report – March 31, 2019

Given that the S&P500 dropped close to 20% in the fourth quarter of 2018, we've been asked why we didn't significantly reduce our cash positions. The simple answer is that there were few opportunities to do so. Yes, the US market fell double-digit, but the starting point in terms of valuation was rather obscene; by late December it was merely ridiculous. Indices such as the MSCI World and EAFE also fell, but not as much as their starting point in terms of valuations, although expensive, were not as extreme as that in the US. In addition, most of the stocks that had significant pull-backs were the types of businesses where it is more difficult to have a long-term view in terms of the sustainability of their competitive advantage (technology),or which are at times difficult to analyse (financials). Among stocks that fell, there were some we would be interested in, but these were more cyclical in nature and thus require a greater margin of safety in terms of valuation. Having said all that, we were able to carefully allocate a bit of our cash. These market events highlight the importance of focusing on the fundamentals of valuation rather than the symptom of a price chart.

Here's some context. By the end of the fourth quarter, the price-to-sales (P/S) ratio for the S&P500 was 1.89x compared to a low of 0.82x in March of 2009, and 33% higher than the average of 1.42 since 1990. However, if you're focusing on the symptoms of charts, you would have noticed that the P/S ratio for the S&P 500 peaked at 2.27x at the end of September. But the fact that it subsequently fell to 1.89x does not make it a buying opportunity; at least not from a valuation and investment perspective (since 1990 the P/S ratio has been lower than this 83% of the time).

It's akin to someone whose ideal weight should be 180 lbs. who then goes on a binge and balloons to 288 lbs. When some discipline returns, they manage to get down to 240 lbs. Yes, it's better than 288 lbs., but the person is still 60 lbs. (33%) overweight.

Some might say that due to a lower tax rate a higher P/S ratio is justified. Perhaps, but we would make two points. First, you'd need confidence that corporate tax rates have been permanently reduced. Second, you need to assume that excess profitability will not be competed away (even on a net basis) over time as usually happens in a free market economy.

Looking at the Shiller P/E, at the lows in December it was approximately 28x vs. a long-term median of 17x and 33x at the end of September. Even the non-cyclically adjusted S&P500 P/E was approximately 19x vs. a long-term median of 15x and 22x in September. And while a low interest rate does justify higher multiples, it only does so if the future growth rate is unchanged and that is decidedly not the case. In 2010, the Federal Reserve estimated that long-term real GDP for the United States would grow 2.5-2.8%. Today they assume 1.9%.

One might say that with markets falling close to 20% that the Federal Reserve was bound to come to the rescue. On that assumption, you should have stayed fully invested. Anyone saying that would have been proven right by the subsequent market rebound and have done quite well. But that's not investing. Trying to predict whether or not the Fed will (or be permitted to) continue to jump in to perpetually drive stocks to ever higher valuations at the expense of the fundamental health of the economy may be a valid strategy, it's not an investment strategy. At Ivy, we're determined to stick to investing and letting fundamentals dictate our investment decisions. We believe that this will best enable us to get our clients to their long-term goals and help protect their capital when the inevitable bear market arrives.

The world seems to be on an unstoppable and reckless path of spending funded increasingly through debt and less through productivity. This matters a lot. The consequences are always far in the future, but by the time the future arrives, it's too late to do anything about it. It's impossible to know when the piper will make a call to be paid. One thing is certain: there's no free lunch. Whenever you obtain something without first producing something else yourself, you're effectively taking that something from someone else, either with or without their permission or perhaps even knowledge. This is an irrefutable fact. But many on Wall Street and some policymakers want you to believe that they are your answer to the golden path to riches and easy street. Statements such as, "Any nation that prints its own currency cannot default on its debt" are the height of intellectual dishonesty. We discussed this years ago in previous quarterly reports. Printing money to pay your debts, while not a technical default, is an effective one for those who are currently in a net asset position i.e. part of their wealth was just stolen from them.

The theft is neither obvious, nor direct. More importantly, because it comes with a lag, those being harmed are not aware of the cause of their diminished standard of living. Indeed, they don't even see that their standard of living is diminished as the higher standard they would have had is never achieved.

Printing money does this in two ways. First, it results in prices that are higher. We accept this as a necessary part of a growing economy. On the other hand, policymakers can also justify printing money to hold prices flat rather than allowing them to drop. When prices drop, you can buy more and that increases your standard of living. In either scenario, a percentage of your hard-earned wealth secretly stolen from you before you had a chance to enjoy it.

Over the last five, ten and fifteen years, the Ivy Funds have compounded in the range of 5-10%. This growth rate has served to move our clients closer to their longer-term financial goals. Providing our clients with a narrow dispersion of outcomes helps them to plan in terms of how much money they need to save on an annual basis in order for them to retire comfortably.

While it's always possible to grow at a faster pace, it usually comes at the expense of higher risk and greater potential downside when markets fall. Ivy strives to carefully strike a balance between reward and risk, of always attempting to grow no matter what the market conditions. We are now in the longest bull market in history and as long as it continues it seemingly won't pay to be careful. If markets only go up, is there really any need to pay for active investment management?

We honestly don't know for how long central banks will be allowed to distort asset prices at the expense of economic fundamentals and growing income disparity. Committed to intellectual honesty as the Ivy team is, we can admit that the longer this distorted reality continues, the more difficult it will be for Ivy Funds to keep pace.

Those who trust Ivy know our strategy. We'll continue to focus on old-fashioned fundamentals such as competitive advantages, corporate cultures, strong balance sheets, growth, returns on capital and strong free cash flow. As long as we get this right, then we believe we will successfully get our clients across the finish line of long-term financial security. We may not be first every time, although we might be and often have been. On the other hand, if a significant market decline inevitably happens, some investors may not make it to the finish line. However, we believe that Ivy will still make it. In this scenario, Ivy could even be among the first ones to arrive.

For higher-risk strategies, the two outcomes may be: first and earlier than expected across the finish line (perpetual bull market) or possibly never getting there (significant drawdown).

For the Ivy strategy the two outcomes may be: not being first across the finish line, but still earlier than expected (perpetual bull market), or getting across the finish line later than expected, but still getting there (significant drawdown).

We know that we sound like a broken record with respect to central banks' role in destroying the global economy by distorting asset prices higher. However, if there were the slightest of doubts remaining in the minds of anyone who has been following this tomfoolery over the last ten years, Jerome Powell's historic cave on January 4th should put them permanently to rest. After central banks around the world had triumphantly declared victory in restoring the global economy back to health, they all started the process of ending quantitative easing (ECB and BOJ) or even implementing quantitative tightening (FED). What's astonishing to us is that after encouraging the world to accumulate colossal levels of debt over the last decade, central banks actually believed they could take the world off of emergency policy accommodation without causing a recession.

Consider this, interest rates in Europe are 0% and -0.1% in Japan. In the US, the Fed Funds rate is 2.4% compared to a long-term average of 5.3% over the last 50 years. Over the last ten years, assets on the Federal Reserve's balance sheet went from around $900 bn to approximately $4 tn today and ten years into an economic recovery the government is running a fiscal deficit of 4% of GDP. The Bank of Japan's assets went from to $1.1 tn to $5.6 tn with a fiscal deficit also close to 4%. Meanwhile, the European Central bank assets went from EUR 1.5 tn to about EUR 4.7 tn, although they do have a lower fiscal deficit due to the strong fiscal surplus in Germany. And monetary and fiscal stimulus in China is off the charts. And yet with all of this monetary and fiscal stimulus, the Fed is worried the world economy is about to slip into recession; they should be. The world is slowing not because monetary and fiscal policy have been too tight, it's because for ten years they've been too loose. The piper is knocking on the door.

As painful as the next recession may be, it's a necessary part of the healing process that's required to deal with the monumental misallocation of capital that has occurred as a direct consequence of central bank policy. People sometimes get upset when we speak this way, but we're just telling it like it is.

There's too much at stake to simply pretend that this bull market is justified by economic fundamentals; it simply isn't. If it were, then central banks wouldn't have had to come to the rescue every few years to drive it forward by distorting asset prices.

Here is another example of delusional thinking we encounter. We hear commentators say that central banks rescued the economy and made it strong again, yet these same commentators now all agree that the Fed should stop raising interest rates and shrinking its balance sheet because the economy can't handle it. Well, they can't have it both ways… Either the economy is fixed and interest rates can be normalized, or something else is going on.

Perhaps it's that central banks around the world printed money at unprecedented levels and dropped interest rates to negative territory. This policy prompted the largest debt pile the world has ever known and distorted asset prices resulting in a monumental misallocation of capital which in turn served to reduce productivity and slow economic growth. We think it's the latter.

Canadian Equity

Markets were up significantly in the first quarter, effectively reversing the losses incurred in Q4. Although the past six months have almost been a wash from a market perspective, high levels of volatility tend to negatively impact individual investors, who are often whipsawed in and out of the market at precisely the wrong times. This pro-cyclical behaviour was highlighted once again in December, when industry net redemptions hit a record high! After having experienced the losses of Q4 and left the market, many investors weren't around to benefit from the market reversal in Q1. To those left on the sidelines, markets being back at previous levels is of little consolation. While no one could've predicted the path that markets would take, the December industry net redemptions highlight the importance of setting a plan and sticking to it. This is where a good investment advisor and a stable investment strategy can provide significant value, making it easier for investors to stay the course. Our objective at Ivy extends beyond outperforming our peers and the market, as we aim to do so in a way that helps investors realize the returns of our fund by staying invested through volatile markets. We endeavour to accomplish this by capturing as much of a rising market as possible, while always protecting our clients' capital from the risk of significant losses.

A smoother path to outperformance should make it easier for our investors to sleep at night and stay invested.

Ivy Canadian provided a total return of 10% in the first quarter, which compared to 12% for the TSX and 13% for the S&P 500. Strong performance from our Canadian holdings was partially offset by lower up-capture in the rest of the fund. Over the quarter, we were net sellers as we pared back many positions into rising valuations. However, we were still able to find opportunities to deploy cash as we initiated a new position in Canada with Emera, while adding meaningfully to **W.W. Grainger** in the US and **Reckitt Benckiser** in Europe. Below we outline the thesis supporting the addition of Emera.

Emera

Emera is an integrated utility that operates across multiple regulatory jurisdictions in North America. We believe that Emera has the potential to meaningfully grow its earnings, based upon near and mid-term capital plans that have been approved by its regulators. The need for the approved capital plan is supported by growing electricity demand and the requirement to transition away from coal in the jurisdictions that it serves. Given the regulated nature of utilities, the threat of regulatory intervention is of chief concern to us. We believe that this risk as it applies to Emera is mitigated by the favourable regulatory regimes in which it operates and the minimal impact that Emera's growth will have on rate-payers' monthly bills. There is also a near-term risk that Emera may be downgraded by one of its debt rating agencies because of the impact of US tax reform on the sector. Given the improving trajectory of the company's balance sheet, we view this risk as being temporary, however, we have analyzed the potential impact and would be comfortable if it were to occur.

US Equity

Zombies, Unicorns and the Price of Risk

Zombies and Unicorns. Critically-acclaimed horror series from Netflix or Amazon Prime? The latest mobile free-to-play game sensation? A direct-to-consumer retailer of organic cotton Halloween costumes? Could be. However, in this case we are talking about the US investment environment in 2019 where we are increasingly faced with debt-laden Zombie companies and venture capital financed Unicorns transitioning to public markets.

US stocks had a strong first quarter as the Federal Reserve communicated that in the face of volatile markets in Q4/18 interest rate increases will be put on hold. Our US holdings didn't keep pace with the market given technology and more deeply cyclical stocks did well where we are underweight. The only notably poor performer was Henry Schein post spin-off and Covetrus which was the spin-off itself. Both performed poorly given weak trends in their core businesses relative to expectations. We don't expect this to persist and are happy with the holdings. Danaher was a strong performer as their acquisition of GE's biopharma manufacturing assets was well received by the market. The acquisition makes good strategic sense and the price was reflective of the quality of the assets and the current pricing environment.

European Equity

European markets rose strongly in the first quarter, joining the global rally, although the gains were more muted when translated into Canadian dollars.

We added two new positions late last year, which we did not disclose in the last quarterly as we were still building our positions. We added another new name in 2019.

The first of these new investments is **Compass Group**, which we added as a small position in Ivy Foreign, Ivy European, and Ivy International. Compass is a contract catering company, operating cafeterias at offices, hospitals, educational institutions, and other facilities around the world. Compass has an attractive culture and a valuable scale advantage in food purchasing, two factors that have contributed to a track record of superior growth and profitability. The second new addition was **De'Longhi**, an Italian maker of espresso machines, kitchen machines, and other small appliances. This family-controlled business has a long-term approach to building and sustaining brands through innovation and marketing support, and a debt-free balance sheet that gives them the ability to acquire other brands. Finally, we added **Heineken**, one of the world's largest brewers with a broad portfolio of global and local brands. This is a well-managed business in a resilient industry, with a long-term vision supported by family control. Both De'Longhi and Heineken are held at small weights in Ivy European.

Although the brief market correction in late 2018 provided an opportunity to make these investments, we continue to believe that valuations for high-quality businesses are generally unattractive, particularly following the sharp market rebound in 2019. One illustration of this point is Nestle, which was sold from Ivy Foreign in the first quarter for valuation reasons. **Nestle** had been a mainstay in the fund for over 12 years, and in many ways exemplified what we look for: a well-run business in an economically resilient industry, with a wide moat, a long-term focus, good growth, and a strong balance sheet. Those attributes remain true, but less so than before. The industry has become more difficult as retailers struggle with sales channel shifts, consumer habits change, and the erosion of traditional barriers to entry for branded products. In this context, Nestle's revenue growth has remained near the top of its competitive set, but has come down from past levels. The company's balance sheet has always been a strength, and while it remains strong it is currently the least conservative it has been in the past decade.

One might think that a company with lower growth, a more uncertain external environment, a potentially narrower moat, and a less conservative balance sheet, would see these changes reflected in its valuation. In fact, the reverse has happened. Nestle is currently at or near decade-highs in terms of its price/sales and price/earnings ratios. Part of this simply reflects the impact of the decade-long bull market, but Nestle's valuation premium above the overall market is also near its highs. So while we believe Nestle remains a high-quality business, the expected return from holding the stock at the prevailing price became unattractive.

This is not an isolated case. Valuations of high-quality businesses, particularly when adjusted for the impact of economic cyclicality, are not particularly attractive in Europe or globally. There are pockets of potential opportunity, and things can change quickly (as witnessed last year), so we are hopeful in finding attractive investments, but as always, we remain disciplined on the prices we pay when allocating our clients' capital.

Far East Equity

Far East markets rebounded significantly in Q1 2019 after weak performance in Q4 2018. Ivy's Far East holdings broadly outperformed the Asian components of the broader global benchmarks in the quarter. The biggest contributors to performance were **Anta Sports**, **Techtronic Industries**, and **Amcor**; the most significant detractor was **Seven & I Holdings**.

Anta's share price appreciated meaningfully in Q1 due to a rebound in China / Hong Kong equity markets, and also due to continued strong business performance. Anta also successfully closed its tender offer for Amer Sports, a Finnish sporting goods and apparel company with several well-known brands such as Arc'teryx, Salomon, Atomic, Wilson, and others. The acquisition carried a large price tag (5.6 bn Euros) and full valuation, however we believe there is good strategic merit underpinned by compelling long-term growth and synergy opportunities.

Amcor reported steady H1-F2019 performance in February and continues to make progress towards finalizing its proposed acquisition of Bemis. The share price had declined following the announcement of the all-stock acquisition in August 2018, however it has now fully recovered due to steady business performance and the market's greater confidence that a deal will be completed. The acquisition is expected to provide Amcor with a broader flexible packaging footprint, and should result in material cost synergies and expanded revenue opportunities.

Techtronic's share price appreciated significantly in Q1 due to a rebound in China / Hong Kong equity markets, eased investor concern about a slowdown in the US housing and construction markets, and also due to the announcement of Techtronic's inclusion in the Hang Seng index. Techtronic also reported very strong F2018 results in March, as it continues to see benefits from growing the product offering in its Milwaukee professional business, and expanding its cordless platforms to new segments. While Techtronic is exposed to broader economic trends, we do not view it as a proxy for the US or global housing markets – we believe Techtronic has an attractive long-term growth opportunity due to continued expansion of its cordless platforms and new regional markets.

Seven & I's share declined sharply starting early in early March 2019, due in part to market concerns about potentially weak Q4 F2019 performance and a reduction to the company's F2020 guidance. In early April 2019, Seven & I reported F2019 results that were fairly steady and roughly in line with expectations, however management did reduce F2020 guidance by approximately 6% due to advanced investments in the Japanese Convenience Store and Financial Services businesses, and slower than expected profit improvements in the non-Convenience Store businesses. We believe management is making the right decision in investing for the long-term sustainability of the business, and we are comfortable with the overall pace of growth in the business. We also believe that the share price reaction has been overdone; we used the opportunity to modestly increase our position in various Ivy funds, after modestly trimming our position at higher prices earlier in Q1.

Our trading activity was modest in Q1 across the Far East universe. We increased the weight of **Seven & I** in various Ivy funds for valuation reasons, and we also modestly increased the weight of Fanuc in the Ivy International Fund early in Q1. We trimmed **Techtronic** and **Anta Sports** in the Ivy International Fund later in Q1 following significant share price appreciation and less attractive valuation, while also taking into consideration the relative cyclicality of these businesses.

Global equity markets have rebounded significantly so far in 2019, and many of the opportunities we were starting to see late in Q4 2018 have now vanished. The rebound has been broad-based, but has been most pronounced in cyclical areas of the market such as industrials and technology, and also with companies that have significant exposure to China. Business performance has slowed in Q4/18 and Q1/19, however many companies are holding on to hopes that performance will pick up in the back-half of 2019. Equity markets have responded. Time will tell as to whether or not the fundamentals will keep up with expanded valuations.

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 March 31, 2019	1 year	3 year	5 year	10 year	15 year	20 year	25 year	Since Inception	Inception Date
Mackenzie Ivy Canadian Fund	4.5	4.0	4.7	7.6	4.5	4.8	6.5	6.7	Oct-92
Mackenzie Ivy Canadian Balanced Fund	5.7	4.6	4.9	6.9	4.5	5.0	6.6	6.4	Oct-92
Mackenzie Ivy European Class	2.8	2.0	2.5	6.7	4.8			5.1	Nov-02
Mackenzie Ivy Foreign Equity Fund	6.9	3.4	6.1	8.6	5.7	5.4	7.5	7.6	Oct-92
Mackenzie Ivy Global Balanced Fund	6.0	4.8	6.2	7.6	5.3	3.9	4.8	4.9	Dec-93
Mackenzie Ivy International Fund*	2.7	4.4	2.8	6.9	3.4	1.9	3.3	4.8	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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