Mackenzie Monthly Income Portfolios are designed to provide regular, predictable income and capital preservation with reduced volatility. The Portfolios help investors stay invested in the market by providing downside protection on both the equity and fixed-income components. Our Portfolios currently use an options-based hedging strategy combined with geographic and multi-asset diversification to seek a performance profile with less downside than an unprotected mutual fund.*

**Hedging Explained**

Hedging strategies aim to improve the risk-adjusted return of a portfolio by reducing or eliminating losses in a negative market. Examples of hedging strategies include simple strategies that go to cash when markets drop by a certain percentage, or rely on Portfolio Managers to anticipate negative markets and pre-emptively shift into lower-risk mode. More sophisticated strategies use the options market to create downside protection. Finally, at the extreme, insurance contracts can be designed to eliminate all downside risk.

The key point to remember is that nothing comes for free—the more downside you eliminate, the more costly the strategy can be in terms of transaction costs and the upside you sacrifice. So any hedging strategy must be designed to match the goals the portfolio aims to deliver.

Mackenzie Monthly Income Portfolios currently use a custom option strategy to help protect capital and prevent extreme losses. Reducing downside exposure through the use of our proprietary options strategy is a highly effective way to protect a portfolio from large losses, because:

- Our current strategy is designed to provide continuous downside protection against large market declines;
- The portfolio’s strategy does not rely on a Portfolio Manager (PM) to forecast the direction of the market correctly;
- The level of protection in the current options strategy is designed to always contain a fixed minimum degree of downside protection; and
- The strategy is proportional, which means it is designed to not tilt excessively towards either too much protection with little upside, or vice versa. The strategy allows for upside participation alongside the downside protection.

* Mackenzie Monthly Income Portfolios currently employ and will commonly use the options-based protection described in this note. However, in addition to or instead of using options, the Portfolios may use derivatives such as swaps, futures and forward contracts for hedging and/or non-hedging purposes. The Portfolios are also permitted to use investments in non-derivative assets to reduce volatility, such as bonds and cash.
Introducing Options

Options are contractual agreements that give investors the right, but not the obligation, to buy or sell a specific asset at a predetermined price over a specific period of time. Options can be written on individual securities or on an entire market index. The Monthly Income Portfolios currently employ options that cover a particular market index. At a specified date, the option contracts expire and the investor’s right to exercise that option disappears. So timing is important! Options strategies are not set-and-forget—they benefit from management and oversight.

Investors can either buy an option, or they can take the other side and sell an option. The cost of buying an option (or the price a seller receives from selling an option) is its “premium”. Option prices, or premiums, change constantly as the price of the underlying asset changes, as market volatility changes and as the expiry date approaches. Even if the underlying asset’s price does not change and volatility is steady, the passage of time will cause option prices to change. Understanding how and why options prices change over time is a critical component in the design of any successful options strategy.

Put options

Put options give investors the right to sell an underlying asset at a set price, called the “strike price”, at any time up to a specific expiry date. If the price of the underlying asset falls below the strike price before the expiry date, the party that bought the put option can sell the asset at the higher strike price. This makes the option more valuable. Therefore, the value of put options generally moves in the opposite direction of the price of the underlying asset, within specified bounds.

A put option can limit the extent of portfolio loss in the event the underlying asset(s) declines in value. The cost of buying the put can be thought of as the cost of insurance.

Mackenzie Monthly Income Portfolios’ current options strategy buys put options on their equity and high yield bond exposures.

Call options

Call options are the opposite of put options: they give investors the right to buy an underlying asset at a set price. If the price of the underlying asset rises above the strike price, the holder of the call option benefits because they can buy the asset for less than it is trading for in the market.

On the other side of the call option buyer is the call option seller, or “writer”. The writer pockets the premium that the buyer paid to purchase the option, but if the price of the underlying asset increases above the strike price, the writer will have to deliver the asset to the owner of the call option at the (lower) strike price, even though the asset may be trading for a higher price in the market.

Why buy a call option? Because you believe the asset will gain in price, and options provide more leverage to the price gain than simply buying the underlying asset.

Why write, or sell, a call option? First, because you may believe the market has over-estimated the likelihood the price will rise, and are willing to gamble that it will not. Second, because you may already own the underlying asset and want to lock in a desirable selling price. In the event that the underlying asset doesn’t reach that selling price, that’s fine too because you still own the underlying asset (it won’t be called away) and have also collected the premium from the option buyer.

Mackenzie Monthly Income Portfolios’ current options strategy involves the sale of call options on their equity exposure, in effect locking in some upside gains and collecting premium income that may be used to offset the cost of (the insurance from) the put options bought for downside protection. Buying puts and selling calls together on the same index is called a “collar” strategy.
Introducing Beta

Beta is a measure of systematic risk. Beta indicates how volatile a security or portfolio is compared to the market as a whole. A beta of one indicates that the portfolio will move in line with the market index.

A beta of greater than one means the portfolio is more volatile than the market. For every one percent move up or down, the portfolio will move by more than one percent. In the event of severe market downturns like in 2008, a portfolio with a large beta would have lost much more than the market and underperformed the index.

Conversely, a beta of less than one means the portfolio will be less volatile than the market. It will have less downside risk, and also less upside capture. For example, from its low in March 2009 through end of 2013, the U.S. equity market was up 178%. A portfolio with a beta of less than one would have fared better during the 2008 international financial crisis but would not have captured all of the gains associated with the subsequent market recovery. That portfolio would have underperformed the market index from 2009 to 2013.

Which is better? That depends on investor preferences.

If we can be assured that markets will always rise, then maximizing exposure to that gain is best. But of course the future is unknowable. Even if we are somewhat confident markets will eventually rise, the path is uncertain and the timing impossible to forecast. Markets may spend years flat or in decline, or may experience severe bear markets such as the 2008 downturn. Investors have finite time horizons, limited savings and may need to draw income from their portfolios for daily necessities. In that case investors may prefer a beta of less than one to protect their savings from the risk of sudden erosion that would have a direct and adverse effect on their standard of living.

There is no escaping the fact that too much downside protection leads to too little growth, and vice versa, as the chart below illustrates. Based on research, Mackenzie’s Multi-Asset Strategies Team (the team responsible for the Monthly Income Portfolios) decided to adopt a beta of 0.7 on the equity portion of the Monthly Income Portfolios. This level produced the optimal combination of attractive long-term return with a desirable level of downside protection.

For illustrative purposes only
Mackenzie’s Hedging Strategy

While equity markets have historically produced decent long-term gains, the future is fraught with uncertainty. Markets are unpredictable and vulnerable to sharp declines. For some investors, it is critical to hold a portfolio with explicit built-in protection against sudden, large declines. The Monthly Income Portfolios currently purchase put options on their equity and high yield bond exposures to mitigate downside risk, and simultaneously may sell call options on their equity exposure to earn premium income and reduce hedging costs. If markets sell off sharply, the value of the puts will increase and they can be cashed in to offset the drop in value of the portfolio. That capital can be redeployed to capture gains as the market recovers.

The Mechanics of the Portfolios’ Current Protection Strategy on Equities

In general, equity put options are 5-10% out-of-the-money at the time of purchase, with maturities of 9 to 12 months. The equity call options are sold at 4-8% out-of-the-money with shorter maturities of 3 to 6 months. By structuring the equity option strategy this way, we believe the Portfolios are more likely over time to collect more premium income from the calls to pay for the puts.

Option prices are dynamic and move constantly every day based on time, volatility and changes in the price of the underlying market. Our equity options structure currently seeks to maintain a constant beta, or sensitivity, of 0.7 in the equity portion of the Monthly Income Portfolios to movements in the S&P 500. This means that under the current target, the equity portfolio will experience approximately 70% of the movements of the S&P 500. This beta is continuously monitored and the options strategy is rebalanced regularly. By maintaining a beta of 0.7, the portfolios limit downside risk while still allowing for upside participation in the market.

Importantly, the Portfolios’ hedging strategy does not require the Portfolio Management team to correctly express a view on the market in order to succeed in reducing downside. Said differently, the hedging strategy of Monthly Income Portfolios contains no bet on the market. The strategy simply aims to provide downside protection at all times by maintaining a predetermined beta (volatility level).

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The Mechanics of the Portfolios’ Current Protection Strategy on Fixed Income

The Monthly Income Portfolios also have protection built into their fixed-income component through their underlying fund, the Mackenzie Unconstrained Fixed Income Fund. This absolute return strategy invests in a diversified mix of fixed income securities across various credit ratings, durations, structures and sectors, including high yield bonds. Since high yield bonds can become extremely volatile during times of equity market weakness, Mackenzie Unconstrained Fixed Income Fund currently hedges hedge 90% to 100% of its high yield bond positions by purchasing put options on an ETF with exposure to a broad range of U.S. high yield corporate bonds, which we expect will mitigate the impact of extreme market downturns.

The current high yield bond hedging strategy is managed dynamically to ensure an appropriate trade-off between cost and protection. In general, the put options are purchased fairly out-of-the-money. The strike price and term structure of the puts are determined by the fixed income Portfolio Management team based on the current and expected volatility level and the cost of the options at the time of purchase.
Putting It All Together

Mackenzie’s explicit hedging strategy of using options is one powerful source of downside protection currently at work in the Monthly Income Portfolios. But there is another more subtle level of protection that comes from diversification.

We believe the multi-asset structure and, in particular, the allocation to global sovereign bonds, real return bonds and cash, provides a built-in offset to weak equity markets. The combined effect of the current 0.7 beta target to equity markets in the options portion of the Portfolios, the constant presence of the put protection on the high yield bond exposure, and the allocation to high quality fixed income assets within the multi-asset structure of the Portfolios means the ultimate beta to a declining market should actually be less than 0.7.

The graphs and data below provide an overview of the success of the downside protection strategy. Mackenzie Monthly Income Portfolios have demonstrated strong downside protection, especially during extreme volatile periods such as in August 2015, early 2016, and near the end of June 2016 around the U.K. Brexit vote, and after the 2016 U.S. election.

In conclusion, many clients are at the stage in life when they are no longer socking away large amounts in savings and are instead now drawing income from their investment portfolios. Their time horizons are shorter and many simply do not have the capacity or the desire to live through another big bear market in equities. These investors, with a lower risk tolerance, benefit from portfolios that incorporate some degree of downside protection. While downside protection always comes with some costs, Mackenzie Monthly Income Portfolios have been designed to provide that protection as efficiently as possible to minimize those costs. Since the Portfolios were launched, the design has proved highly effective in providing our investors with an attractive mix of regular, predictable income, downside protection, and investment growth.
The Mackenzie Monthly Income Portfolios

✔ Provides monthly income
  – 4% monthly distribution*

✔ Helps to protect your money during market downturns
  – implicit diversification across asset classes and regions
  – explicit hedging strategy on both equity and fixed income components

✔ Offer some growth potential to offset longevity and inflation risks

✔ Managed by seasoned team with extensive asset allocation and risk management experience

GENERAL INQUIRIES

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Find fund and account information online through Mackenzie Investments’ secure InvestorAccess. Visit mackenzieinvestments.com for more information.

Commissions, trailing commissions, management fees, brokerage fees and expenses may be associated with investment funds. Please read the prospectus before investing. Any indicated rates of return are the historical annual compounded total returns as of September 30, 2016 including changes in unit value and reinvestment of all distributions and do not take into account sales, redemption, distribution, or optional charges or income taxes payable by any security holder that would have reduced returns. Investment funds are not guaranteed, their values change frequently and past performance may not be repeated.

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To the extent the Fund uses any currency hedges, share performance is referenced to the applicable foreign country terms and such hedges will provide the Fund with returns approximating the returns an investor in a foreign country would earn in their local currency.

The Mackenzie Unconstrained Fixed Income Fund is used to fulfil the Absolute Return Strategy component of the Fund. Although the Mackenzie Unconstrained Fixed Income Fund’s objective is to seek a positive total return over a market cycle, you may lose money on your investment. There is no assurance or guarantee the fund will realize a positive return in any given year or over any time period.

*Series A, F, AR, PW, PWF, PWX, O.