Mackenzie Cundill Value Fund – Series F

Q4 -2020 COMMENTARY

Performance Summary

- For 4Q 2020, the Fund returned 11.2% vs. the MSCI World Total Return Index (net CAD) which returned 9.0%.
- The Fund had a strong final quarter as global economic sentiment improved following vaccine announcements in November.

Contributors to Performance

- Security selection in Financials followed by Materials and Information Technology added to performance
- Security selection in United States and an overweight to South Korea added to performance
- **Citigroup** re-rated significantly in Q4 as positive vaccine developments allowed the market to look beyond the pandemic to an economic recovery and a certain level of social life normalization. In an economic recovery we expect Citigroup to be able to reverse credit loss provisions and generate positive loan growth at better interest margins. The company has a strong capital position, having passed the Fed's stress tests each of the past few years. We believe shares are undervalued at Price/Book of 0.72X and Est P/E of 9.8X while paying a dividend yield of 3.3%
- Samsung has continued to report good results. DRAM is an important driver of our investment thesis on Samsung. DRAM supply is controlled by three players globally, Samsung, Micron and SK Hynix. According to our research, we are now in a period of supply and capex discipline demonstrated by all players in the market, which should lead to improving DRAM market conditions and industry profitability throughout calendar 2021. We believe the market will become undersupplied in 2021 as capacity additions have been limited, while demand continues to grow driven by PCs, graphics cards, cloud infrastructure and 5G smartphones. We continue to believe that Samsung is significantly undervalued, especially given its strong balance sheet (with a large net cash position).
- DXC is one of the largest IT service companies in the globe with annual revenue of $17 billion. Around 65% of the company's revenue is recurring and is driven by long term contracts. The company is undergoing a major transformation under new management led by Mike Salvino. In the past, DXC underinvested in its sales and delivery teams that negatively impacted client relationships. In addition, the company signed contracts that were not profitable. The new management is focused on renegotiating these contracts and is driving initiatives to improve client satisfaction. As a result, customer's perception of DXC has improved substantially as evident from third party surveys and sequential stabilization of sales. We expect these initiatives to drive operating margin from 5% to 9% due to improved contract terms and conditions and increased use of low cost delivery centers. We expect further margin improvement beyond 9% as DXC's competitors earn margins in the mid teens range. Currently, we believe the stock is significantly undervalued trading at Est P/E of 8.5x FY March 2022 earnings.

Detractors from Performance

- On a sector basis, the only detractor was the security selection in Industrials
- On a geographic basis, security selection in the France detracted the most followed by Germany
- During Q4 **SAP** announced its intention to ramp up investments and accelerate its cloud transition. As a result, SAP made significant downward revisions to its mid-term margin targets. Further, SAP expected muted revenue growth and flat operating profit growth through 2022 as the cloud transition appears to be costly and will not likely improve sales for the next few years. This development detracts from our original investment thesis for SAP and we believe there are no near or medium term positive catalysts to drive the valuation of the stock higher. As discussed further below, we decided to exit this position.

Portfolio Activity

- We initiated a new position **CarMax** (KMX). CarMax is the largest used car dealership group in the U.S. The company has over 200 locations and sold over 800,000 vehicles at its retail locations last year. CarMax also owns its lending business CarMax Auto Finance (CAF). CarMax has a strong brand in the U.S. with its low/no-haggle prices, superior customer service, and "CarMax Quality Certified" 125-point inspection. CarMax market share is still very small in the U.S. providing the company with significant opportunity to grow its locations across the U.S. and increase its same store sales as these locations mature. CarMax is also investing aggressively in its omnichannel capabilities across its locations. Customers can now complete the whole process online from browsing its inventories, buying, financing, appraising trade-ins and completing the paperwork. Overall, we believe CarMax is trading at a discount to its intrinsic value given its strong brand, growth opportunities and expansion into online sales.

- We also initiated a position in **Boston Properties** (BXP), which is the largest publicly traded pure-play Office REIT in the US with c.195 properties and 52mn square feet in rentable space. BXP's management is known for best in class execution, operating largely class A office buildings located in leading urban gateway markets across the US including Boston, New York, San Francisco, Washington, DC and Los Angeles. While COVID disruption has resulted in weak building occupancy levels with a greater impact on their non-office assets (<5% of their income), the operational metrics for BXP's office portfolio still remain healthy with 91% occupancy and over 99% rent collection. Strong rent collection is driven by BXP's exposure to large scale corporates with strong balance sheets. Moreover, their top 20 tenants including Sales force, Kirkland, Biogen, Google, the US Government, are well positioned to withstand economic downturns and are likely to maintain physical presence on the other side of this pandemic. Therefore, we see BXP as a solid recovery story as herd immunity post vaccine results in a return-to-work environment. Additionally, with only about 10% leases coming up for renewal in the next 2 years and weighted average lease tenure of 8 years, we see limited risk of materially negative rent adjustments in the near term. We believe that BXP is quality company currently trading at a substantial discount to its Net Asset Value which should narrow as macro trends start improving. Aside from improvement in building occupancy, macro recovery leading to job growth remains a key catalyst for stock re-rating in our view.
- We also initiated a position in **Merck** (MRK), one of the largest pharmaceutical companies globally. Merck focuses on oncology, animal health and vaccines. In pharma, Merck is best known for its cancer drug Keytruda. Keytruda was first approved for lung cancer but has since been approved for other types of cancer with non-lung cancers now accounting for 50% of U.S. sales and 30% of non-U.S. sales. The next opportunity for Keytruda is to expand into the adjuvant setting (Keytruda is only approved for metastatic setting – where cancer has already spread beyond the original organ). Beyond pharma, Merck is the third largest player in animal health globally. On the vaccine side, Merck is also the largest manufacture of HPV vaccine; which is being adopted globally at an accelerated rate. We believe that Merck should continue to rerate higher driven by sales growth (from Keytruda, animal health and HPV vaccine), margin expansion, and additional acquisitions to strengthen its pipeline, supported by strong balance sheet and free cash flows.
- We exited Alphabet in Q4 FY20 as the share price approached near our estimate of fair value. Though the company has strong growth potential, we are concerned about possible regulatory headwinds. The company has a monopoly like market share in product categories like search, and the Department of Justice (DoJ) is investigating anti-competitive practices employed by Google to build leading market share. In addition, the European Union is planning for digital taxes on large technology companies like Google that can impact longer term profitability of the company.
- We exited SAP in Q4 FY20 as the company is entering a transition period where it plans to accelerate investment in cloud products and move its core ERP base to a subscription model. We believe that SAP's margins and revenue will be under pressure during this period. In addition, the company might lose market share during this transition as competitors like Oracle have already built their cloud product lineup. As a result, we decided to exit the stock as the valuation was not reflecting the headwinds facing the company till FY23.

Market Review, Outlook and Strategy

- Over the summer months, we were following vaccine developments and determined that there was high probability of some positive news releases later in the fall. At the same time, valuation and prices of many cyclical stocks drifted back close to the lows of 2020.
- Therefore during the month of October we started increasing our exposure to cyclical companies, due to their extreme low valuation and the likelihood that positive vaccine and fiscal news could be catalysts for higher prices.
- We believe and history has demonstrated that value stocks lead in an economic recovery. We believe we are at early stages of a recovery and a new investment cycle.
- Vaccine development, distribution and administration are showing the "light at the end of the tunnel" of this pandemic. We can imagine some normalization of life over 2021 and 2022.
- High multiple growth stocks, especially technology stocks that benefitted from work-from-home and lockdowns, are extremely expensive in our opinion and could face difficult sales comparisons into latter half of 2021 and into 2022.
- Meanwhile, we believe depressed value stocks should have significant upside potential as the world recovers from the pandemic.
- Long term bond yields have climbed higher after hitting new all time lows this year and yield curves are steepening - both are historically correlated with value style outperformance.
- Election of two democrats to the US Senate increases the odds of additional fiscal stimulus being passed this year, which may further improve economic conditions and increase inflationary expectations, both of which should help cyclical value stocks.

PORTFOLIO MANAGEMENT TEAM:

Richard Wong, Senior Vice President, Investment Management, Mackenzie Investments

Effective September 21, 2019 Richard Wong is the sole portfolio manager of the Fund

Fund and Benchmark Performance as at: December 31, 2020	1 year	3 years	5 years	10 years
Mackenzie Cundill Value Fund Series F	-2.1%	4.6%	1.8%	3.9%
MSCI World Total Return Index (net CAD)	13.7 %	11.0%	10.4%	12.6%

MACKENZIE Investments