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Mackenzie Multi-Strategy Absolute Return Fund 2019 Year in review

Mackenzie Multi-Strategy Absolute Return Fund (MSARF):

MSARF is a multi-strategy absolute return fund that applies leverage and long-short investing in equities, bonds and other asset classes. The Fund's objective is to achieve a positive return over a market cycle with modest, balanced-fund-like risk over time, while maintaining low exposure to equity markets.

Observations on the general market environment

2019 was a very productive year for most asset classes. Global equity markets recovered aggressively in the first quarter from their December 2018 lows to hit fresh highs in March. After some mid-year volatility, the rally continued to new highs into year-end. All told, the MSCI World Index finished the year higher by 28.1% (in local-currency terms). However, as we note in Appendix X, the advance was somewhat narrowly concentrated in specific investment styles. Government and investment-grade bonds had a standout year of their own, returning mid-to-high single digits as central bank policies around the world took an unexpected accommodative turn in 2019. The high-yield market earned 14.4% (in local-currency terms) and outperformed the leveraged loan market, which still earned a decent 8.6%. It was a strong year for the Canadian dollar as it appreciated against most major global currencies. Cross-currency volatility was low in 2019 as accommodative policies across global central banks kept policy divergence at a minimum. Oil was up 22.7% and gold gained 18.8% (both in U.S. dollar terms). Outside of these two geopolitically driven themes, there was relatively limited cross-commodity volatility over the past year.

MSARF: expectations vs. results

The Mackenzie Multi-Strategy Absolute Return Fund aims to earn cash plus 5% to 9% (gross of fees) with a target volatility of 5% to 9% over a market cycle, while maintaining low exposure to equity markets. Over a reasonable holding period, we expect MSARF can potentially increase returns and reduce risk when paired with a balanced asset mix.

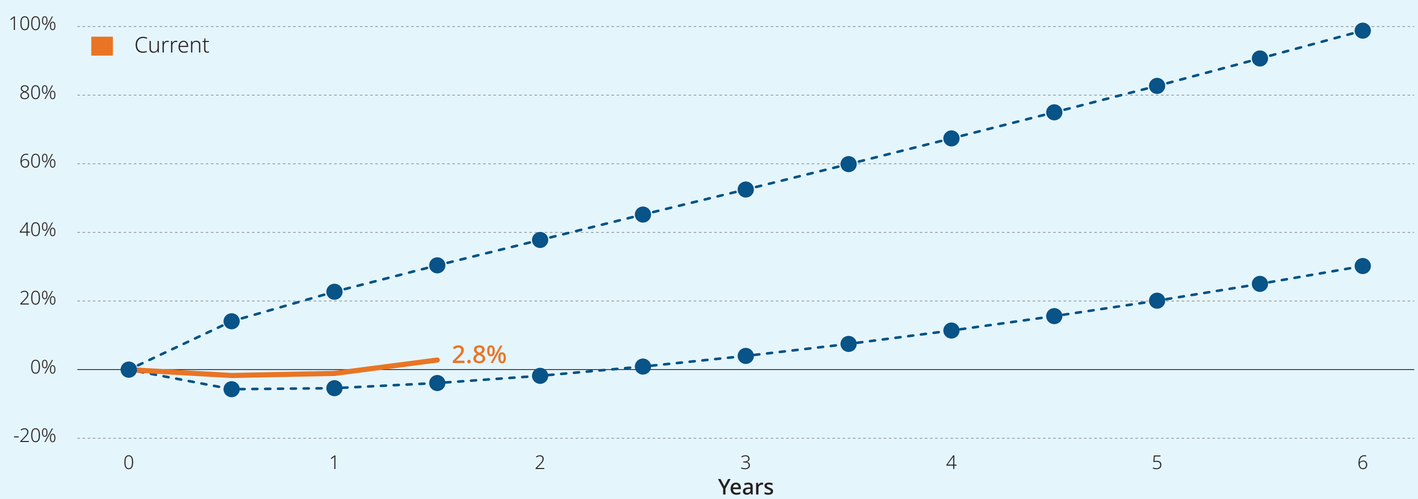
The table below presents 2019 return and risk metrics versus equities, bonds and a 60/40 balanced portfolio. MSARF undershot both its return and volatility targets for the year. While the Fund succeeded in providing a low beta to equities, as designed, 2019 just happened to be an exceptional year for equity beta!

2019	T-bills	MSCI World	Barc Gl Agg	60/40	MSARF	80% Bal 20% M
Return		21.9%	7.4%	16.1%	3.1%	13.3%
Standard Deviation		9.3%	2.5%	5.3%	3.5%	4.6%
Max Drawdown		-5.6%	-1.8%	-2.8%	-2.1%	-2.3%
Equity Beta		1.00	-0.08		0.14	

MSARF returned 4.6% gross of fees and 3.1% after Series F fees. Risk, as measured by standard deviation, was well below equities but was somewhat below that of a 60/40 portfolio. By month, it is interesting to note that weak months for equity markets in 2019 (May and August) were accompanied by stronger relative returns for MSARF. While MSARF is built to offer long-term returns without reliance on the direction of equities, several of the alternative strategies at work in the Fund can have defensive characteristics.

The accompanying graphic shows an expected range of cumulative performance outcomes over time for MSARF based on internal modeling. We expect to see MSARF's performance fall between the upper- and lower- bound 95% of the time, or 19 times out of 20 with a +/-5% allowance for error. We use this framework to gauge whether the strategy is performing within expectations. Although returns since inception are tracking below the central line of the cone chart, performance remains within expectations.

MSARF realized performance since inception and expected performance range over time (Cumulative and gross of fees)



By broad strategy, on a gross-of-fees basis, three of four segments of MSARF were additive to performance: Global Macro, Credit Absolute Return and the overlay account that helps achieve beta targeting, while the Equity Long/Short strategy had a difficult year. We discuss each strategy bucket in more detail below.

2019	Jan	Feb	Mar	April	May	June	July	Aug	Sept	Oct	Nov	Dec	YTD
Indices													
MSCI World GR CAD	3.7%	3.4%	2.8%	4.3%	-5.2%	3.1%	1.0%	-0.8%	1.8%	1.8%	3.9%	0.6%	21.9%
BBgBarc Global Aggregate TR Hdg CAD	1.0%	0.1%	1.7%	0.0%	1.4%	1.3%	0.7%	2.2%	-0.5%	-0.2%	-0.1%	-0.2%	7.4%
CIBC WM 91 Day Treasury Bill CAD	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.2%	0.1%	0.1%	0.1%	0.1%	1.6%
MSARF Total Return (Gross of fees)													
MSARF Total Fund	0.6%	-0.4%	1.4%	-0.4%	-0.5%	2.2%	1.1%	0.6%	-0.7%	-0.1%	0.0%	0.81%	4.6%
Contributions to total return by strategy bucket (Gross of fees)													
Global macro	-0.4%	-0.2%	0.3%	0.2%	-0.3%	0.7%	0.2%	-0.1%	0.0%	0.2%	0.1%	0.48%	1.1%
Equity long/short	-0.8%	-0.7%	0.0%	-1.2%	0.2%	-0.2%	0.3%	0.1%	-0.5%	-0.3%	-0.3%	-0.47%	-3.7%
Credit absolute return	0.4%	0.1%	0.5%	0.1%	-0.1%	0.8%	0.2%	0.7%	-0.4%	-0.2%	0.0%	0.64%	2.8%
Overlay	1.5%	0.4%	0.5%	0.4%	-0.2%	0.8%	0.3%	-0.1%	0.2%	0.2%	0.3%	0.17%	4.5%

Global macro

Standalone performance, gross of fees: 4.0%

Contribution to MSARF total return: 1.1%

The global macro sleeve is a collection of investment strategies that trade macro asset classes, currencies and commodities, both long and short, based on principles of relative value, macroeconomics and investor sentiment.

What went well?

- The strategy maintained positive exposure to equities for the entire year, which added value. This position grew over the year along with improving market sentiment, as concerns over the global economy faded. Equity valuations remain a little expensive but not unreasonable, and although global economic growth is tepid, accommodative policy from central banks continues to be supportive.
- The Fund maintained a modest positive exposure to interest rate risk via global sovereign bonds, which also added value. Valuation here does appear expensive, but a macroeconomic backdrop of low growth, weak inflation and accommodative central banks, combined with strong market sentiment early in the year for the asset class, was enough to justify a long position in global bonds. More recently, sentiment has deteriorated and the position has been trimmed accordingly.
- Currency trading also added value. Short positions in the Korean won and the euro were among our most profitable trades. The short euro position was originally based on relatively weak economic performance out of Europe versus North America, and on our conviction that monetary policy from the central banks in these regions would continue to diverge. The short position in the Korean won was originally a value trade, but our position has since grown as a result of weak sentiment on concerns about Asian trade relationships, and a deteriorating macroeconomic picture that includes a slowdown in Korean manufacturing. The exact opposite conditions are supporting a recently initiated long position in the Mexican peso. It appears undervalued, market views on the currency are improving and the macroeconomic picture is supported by improvements in manufacturing activity, which is linked to positive demand from the U.S. market and less trade-related uncertainty with the recent progress of the United States-Mexico-Canada Agreement.

What didn't go well?

- Our overweight position in Chinese equities versus North American developed markets was a detractor from performance as the China-U.S. trade war concerns and the Hong Kong protests hurt Asian equities.
- Commodity alpha had slight underperformance as we did not see many opportunities to deploy risk amid an environment of low cross-commodity volatility. Recall, this strategy does not make long-term beta bets in commodities, so investors should not expect MSARF to have a long-term strategic allocation to, say, gold or crude oil.

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Equity long/short

Standalone performance, gross of fees: -10.6%

Contribution to MSARF total return: -3.7%

The equity long/short sleeve contains quantitative market-neutral strategies that buy and sell equities based on a set of desired factor exposures and proprietary trading rules, with the objective of capturing alpha and eliminating beta. Beginning in December 2019, the strategy also contains a fundamental long/short strategy that buys and sells stocks to aim to generate alpha in the resources industry.

There is no sugar-coating the fact that the long/short equity sleeve had a terrible year. Remember that this was initially a purely quantitative strategy, a style of investing that historically has been productive but dramatically underperformed in both 2018 and 2019.

What went well?

- While the first quarter of 2019 has become known across the industry as the "2019 quant meltdown," from early June through mid-September our strategy did well and reversed much of its losses. It then treaded water for the remainder of the year until mid-December, when it experienced another leg downward. There are reasons to be hopeful that as market conditions become more conducive to quant equity, we will experience better performance.

What didn't go well?

- The environment for quant equity was almost unprecedentedly poor last year, and this was an issue right across the industry. Appendix 1 provides greater detail on industry-wide quant equity conditions. Historically, while poor conditions can persist indefinitely, the data in Appendix 1 shows they can also turn very quickly.
- Our traditional factor strategy detracted, as value and momentum both underperformed in 2019. This is unusual as these factors historically are negatively correlated with one another. The underperformance of the small size factor also hurt us.
- Our quantitative alpha strategy also struggled in 2019. This strategy buys and sells stocks in the small- and mid-cap space based on a set of models built around a proprietary, more granular interpretation of traditional factors like quality, momentum, value and low volatility. Ideal conditions for these strategies are such that there is wide dispersion in performance of "good" versus "bad" stocks, and when "good" stocks are rewarded and "bad" stocks are punished. Moreover, the statistical relationships built into factor and stock selection models need to be actionable—that is, the models need to provide reasonably clear signals. As Appendix 1 details, this was decidedly not the case in the 2019.

What are we doing?

- Since part of our process is not being rewarded for taking risk, it makes sense to dial back the risk until conditions improve. Accordingly, we have temporarily reduced our tracking error target in some long/short equity models.
- When some factors are being rewarded over others, we can try to rotate more rapidly and actively into those factors. This is difficult to achieve perfectly, but we have developed and implemented a regime timing model that has helped us tilt toward factors that the market is currently rewarding.
- We have diversified the equity long/short portfolio by adding a fundamental manager. Benoit Gervais is a highly experienced portfolio manager with a strong track record of stock selection in resources. The resources industry offers massive dispersion between winners and losers, making it a generally strong area of focus for a dedicated long/short equity strategy. This was added to the portfolio in late December.

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Credit absolute return

Standalone performance, gross of fees: 9.8%

Contribution to MSARF total return: 2.1%

The Credit Absolute Return strategy allocates tactically between major fixed income asset classes based on relative momentum. It also contains a strategy that will invest long and short in select credits based on thorough fundamental analysis.

What went well?

- The momentum-based asset allocation strategy was successful in 2019 as it positioned the Fund for long exposure to high-yield bonds, emerging markets bonds, loans, investment-grade corporate issues and government bonds—all of which had a very productive in 2019. Our conservative use of leverage allowed us to enhance returns from these asset classes in a very measured way.
- The credit selection side of the strategy also added value. One of the more productive trades was a long Uber, short WeWork credit pair trade that was initiated in June 2019. We were skeptical of WeWork's ability to successfully execute its IPO given its large losses, massive cash burn and questionable governance and accounting practices. We paired the trade with Uber, which was another "unicorn" company that successfully transitioned to the public markets and provided some income to offset the cost of carrying the short, as well as providing some capital gains on the appreciation of the bond.

What didn't go well?

- The overall long/short credit strategy was negative for the year. Short credit tends to struggle during a bull market for credit, such as we had last year. While some of the shorts were offset by corresponding longs, the strategy was net short and lost some ground, particularly in the latter half of the year. The vast majority of the total credit sleeve is composed of the momentum sleeve, so the drag from the long/short credit strategy had a very modest impact.

Overlay

Contribution to MSARF total return: 4.5%

The overlay sleeve exists to manage the Fund's overall equity exposure, which we generally expect to be a small positive most of the time. In 2019, the overlay added incremental equity exposure to the Fund, which contributed to returns as equity markets were up significantly over the year. Going forward, we will integrate this equity exposure decision into the Global Macro strategy, where the remainder of the equity index trading strategies reside.

Changes in strategy allocations

Outside of the addition of fundamental long/short resources to the equity sleeve, there were no significant adjustments made to the mix of alternative strategies within MSARF over the year. We continue to seek the optimal combination of return-generating liquid alternative strategies that can deliver positive returns over a market cycle alongside low beta to equity and fixed income markets.

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Appendix 1—The worst of times for quant equity

Why did quant equity do so poorly, for everyone, across the board? Let's look at what these types of strategies are trying to achieve: good returns from stock-picking on the long and short side, but without any help from beta or the general direction of markets. To do that, Mackenzie's long/short equity strategy does the following:

- It identifies broad drivers of stock returns (called "factors," such as growth, value, quality, momentum, etc.);
- selects the factors that have generally been responsible for positive stock returns over time;
- organizes the entire equity universe according to stocks that score well on exposure to those preferred factors and stocks that score poorly on these factors; and
- selects, from this organized ranking, a targeted list of candidates to go long and to short.

This strategy should do well when the equity market environment features considerable dispersion between "good" stocks and "bad" stocks, and when "good" stocks are rewarded and "bad" stocks are punished. These conditions ensure that the hunting ground is fertile and what you catch is indeed what you are hunting for!

There are two ways we measure market conditions. The first is what we call the IC (Information Coefficient) Regime Index. It measures the extent to which the factors that we like (i.e., that are good return drivers) are correlated. When they are correlated, our factors models will all generally agree on which stocks look good and which ones look bad. If they are not correlated, the models will be at odds with each other—one of our preferred factor models will like a stock but another one will not like it. The more agreement, the better and more robust will be the list of candidates for us to go long and short. Exhibit 1 shows the IC Regime Index over 2019. The higher the number, the more agreement between the models and the more ability we have to hunt in the right places, and vice versa.

Next, stock selection. After you find fertile hunting ground (i.e., your models are functioning well in identifying potential stocks to buy and short), success also requires your longs to do well and your shorts to do poorly, and for reasons that are not random but correspond to your models. You need to be rewarded for your choices. To measure this, we create a "Similarity Index" to see how much of returns are being driven by different factors. If the Similarity Index is low, the market is being driven by many things and you are more likely to be rewarded. If the Similarity Index is high, a small number of drivers are driving the market and any diversification you have toward other drivers will not be rewarded. Exhibit 2 shows the Similarity Index over 2019.

Exhibit 1 – IC Regime Index

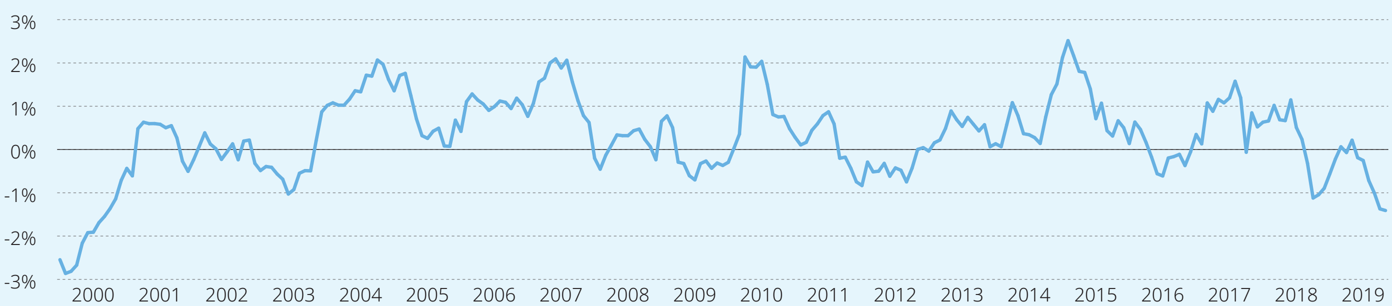

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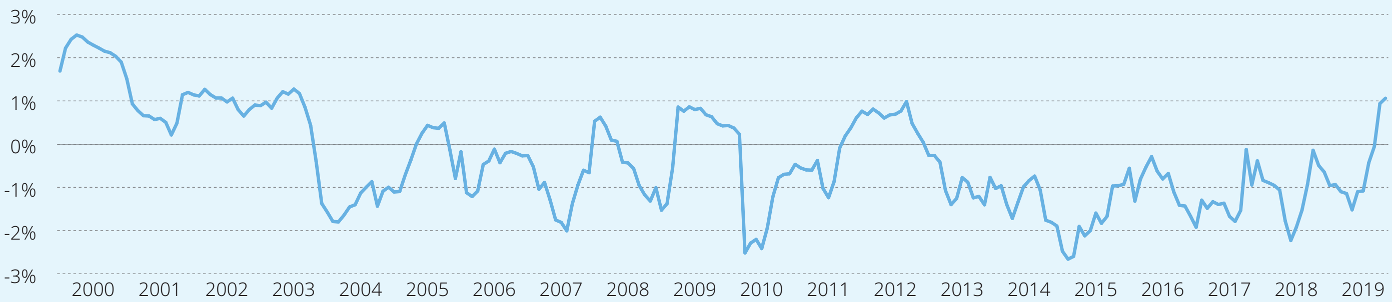
Exhibit 2 – Similarity Index



Exhibits 1 and 2 demonstrate the extremely challenging quant equity environment. The IC Regime Index is as low as it has been in two decades, so quant models are not agreeing on which stocks they like and dislike. This explains a lot of the challenges our stock selection process has experienced. The Similarity Index is as high as it's been since 2012 and the early 2000s, which means stocks are being driven by a very narrow set of drivers—and we know what these are: growth and momentum! Selecting for anything beyond those two factors has been a losing game.

Fortunately, while both indicators are currently at extremes, the graphics above show that conditions appear to reverse rapidly from time to time, with bad environments quickly followed by better environments. In fact, we don't even need these two indicators to reverse positions: even if they both move toward their median, our strategies will work much better.

Speak to your Mackenzie Sales Representative today to learn more about Mackenzie Multi-Strategy Absolute Return Fund.

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