Mackenzie Bluewater Team

Q1-2019 COMMENTARY

After a difficult end to 2018, equity markets came back strongly around the globe over the past quarter. The fourth quarter sell-off began with Federal Reserve Chairman Jerome Powell stating that the Fed was anticipating considerable tightening. In early October, Chairman Powell suggested that "Interest rates are still accommodative, but we're gradually moving to a place where they will be neutral" and "We may go past neutral, but we're a long way from neutral at this point, probably." Bond yields immediately spiked upwards and equity markets began to fall the next day. Over the past several months, in response to rapidly worsening global economic data, the Federal Reserve reversed course, moving from a strong tightening bias to a neutral or potentially even loosening stance. With the change in tone, combined with the suggestion that the Fed may begin to slow bond sales from their balance sheet, bond yields fell significantly, and equity markets began to rapidly recover, leading to an extremely strong first quarter in 2019.

In our view, the significant build up in debt globally over the past decade has made the global economy more sensitive to interest rates than in the past. As a result, moving rates back up to more "normal" levels will likely create a large headwind to growth. Somewhat belatedly, the Federal Reserve appears to have reached a similar conclusion, with the Fed moving to a "data dependant" stance, relying more on actual economic activity, rather than model-based forecasts. The decline in rates has begun show up in a strengthening of the US housing market, which as we have highlighted in the past tends, to be tightly tied to economic cycles in the US. More broadly, global economic data continues to be soft. Europe has been unexpectedly weak, while economic growth in Canada continues to be anemic.

Although it seems tempting to suggest that the Fed is simply a poor forecaster, the unfortunate truth seems to be that economists (and people in general) significantly over-estimate their ability to determine what the future holds. A recent paper by Andrew Brigden, chief economist at Fathom Consulting, entitled "The Economist Who Cried Wolf", showcases the difficulty economists have in accurately forecasting recessions. The International Monetary Fund (IMF) publishes their World Economic Outlook twice a year, providing an opportunity to use hindsight to see how accurate their predictions were. Over the past 30 years, across 194 countries, there have been 469 recessions. The IMF predicted a total of four, one year in advance. If we narrow the list to developed countries only, where the greater availability of data would be expected to increase forecast accuracy, the IMF correctly predicted precisely zero.

Curiously, there is nothing particularly unique about the problems the IMF has had with recession forecasting. Even a cursory look across the research evaluating "expert" forecast accuracy across many different fields suggests very strongly that experts are rarely more accurate than a random coin toss. In fact, they are often noticeably worse. This leads to the somewhat troubling question: "if accurate forecasting is extremely difficult, and equity investing is (ultimately) about future business results, how can an investment philosophy work?" In our view, the answer is quite clear. Investors should minimize their reliance on forecasts.

The next question, naturally, is how to go about doing that. In many ways, when you consider our investment philosophy, honed over multiple decades of experience, we attempt to minimize the need for forecasts by emphasizing companies where future outcomes are more predictable. We do not invest in deeply cyclical businesses that perform extremely well during periods of strong economic growth, but falter when things unpredictably start to slow. We do not invest in highly levered businesses that rapidly get into financial trouble when times get tough. We do not invest in concept stocks where valuations are based on some rosy outlook of endless rapid growth.

Instead, what we invest in are businesses that have been around for a very long time, that have proven much more resilient when economic growth is slower, and that operate in less competitive areas. We watch industries closely for signs of disruption and structural change, because even well-established areas can be rapidly upended by new technologies and unconventional business models.

Finally, valuation discipline is a core to our philosophy and has been one of our hallmarks for decades. When you overpay for a business, you are presuming that the company you are buying will only see smooth sailing. Experience suggests that even the greatest companies inevitably hit some unexpected bumps along the road. Fairly valued businesses tend to have their stocks bounce back reasonably quickly, while overvalued businesses can see long term loss of investor capital.

During the first quarter, the Fund added several new positions including Quebecor, Premium Brands, Danaher, and Estee Lauder.

Quebecor is an integrated cable, wireless and media company focused principally in the province of Quebec. With a relentless focus on customer service and investing in a superior network, we view Quebecor to exhibit many of the attributes that attracted us to our core holding Telus, albeit on a regional scale.

Quebecor enjoys significant brand loyalty in Quebec, particularly among the francophone population. This province is somewhat less susceptible, at least for now, from over the top services such as Netflix with cord cutting roughly half the rate as the national average. This is largely due to the importance of local French content in the province, which is lacking on these services. As such, Quebecor has focused on producing local, French content and packaging it through over the top services like their Club illico brand, to better differentiate themselves. This has helped them fend off competition. Following Bell's fiber rollout in Quebec City, Videotron had managed to maintain nearly 60% market share with only moderate ARPU degradation. Cable losses to Bell were few and far in between in the francophone areas, with losses focused in the anglophone regions. To better target the anglophone population and younger adults, Quebecor is launching Fizz Internet, which is a no-frills, all-digital self service offering. In addition, they are launching the Comcast X1 platform cable service as part of their Helix TV offering. Third, the ability to bundle all four services (wireless, TV, internet, phone) has provided significant defense against competition, with churn nearly ten times lower than a single product customer. Combined with their best-in-class service, we feel Quebecor is well positioned to compete in a province that is enjoying some macro tailwinds – certainly an outlier in Canada!

We have previously opined that in an environment of network and device parity, a critical differentiating factor for telecom providers is customer service. With their Videotron brand ranked number one in Eastern Canada according to JD Power, it is no surprise that Quebecor has captured nearly 16-17% of the Quebec market since launching their wireless network and are capturing close to 25% of gross subscriber additions. We view favorably their strategy of focusing on bring your own device (BYOD) customers as they do not require a handset subsidy and generate superior profitability. While this is excellent for EBITDA and free cash flow – it does dilute ABPU growth because there is no subsidy as part of the customer bill. Given these customers tend not to be sticky, it is quite remarkable that Quebecor has been able to deliver monthly churn of 1.4% despite nearly 50% of their subscriber additions being BYOD. This is just a hairline away from incumbent average churn of 1.34%, who enjoy 2-year contracts. They do this through exceptional customer service, and value-add products such as their mobile Club illico. Recently, the company has launched a prepaid wireless service, branded Fizz Mobile. Following some technical issues in the fourth quarter, it is currently seeing incredible success thus far. Prepaid is increasingly becoming an important avenue for growth – first due its ability to capture the price sensitive customers, and secondly, as a low-cost source of future postpaid customers.

With consistent superior underlying growth, accelerating free cash flow generation as capex intensity wanes, and an improving balance sheet following the buyout of the Caisse stake in Quebecor Media Inc, Quebecor is a company that fits squarely within our investment philosophy.

Premium Brands is a leading Canadian specialty food manufacturing and food distribution company. The company has come a long way under the stewardship of George Paleologou, transitioning from a commoditized pork processor nearly 30 decades ago to a specialty brands manufacturer with over 50 brands under its umbrella.

Premium Brands differentiates itself from other leading national and international competitors by focusing on quality, convenience, health and/or lifestyle. As customers diversify away from center of the store and processed foods, the company has been on trend with its offerings, including fresher foods that use natural, locally sourced ingredients (organic, natural, antibiotic-free, and/or contain no hormones or preservatives). As such, they do not compete on price, but rather product innovation and quality and have a very strong market position in many of the verticals they operate in, including an 80% market share in meat snacks in Canada.

The business has a strong entrepreneurial culture. The company tends to retain the entrepreneurs of the companies they acquire and give them equity stakes in the company. The decentralized structure allows these leaders to focus on what they do best and define the acquisitions and growth strategy. The mothership provides a layer of financial scrutiny to keep everyone honest. This also provides a degree of nimbleness that allows the company to react quickly to changing market conditions. They can quickly reformulate products, discontinue or launch new products, or even shift focus with changing market conditions.

These factors have allowed Premium Brands to deliver an exceptional track record of organic growth. This is a company that is highly acquisitive, but disciplined in their approach, requiring 15% returns of all investments, including M&A. Their acquisitions supplement and enhance organic growth, which has averaged ~5-6% over the last decade and ~8.0% over the last 5 years. Longer term, they target ~6-8% organic growth across the business. Starbucks is nearly ~13% of their business and has been a meaningful growth driver since the program began in 2014. While many have expressed concern that its slowing growth will dilute the company's overall growth rate – our conversations with management suggest that they are already forecasting low to mid single digit growth out of Starbucks – and still guiding to nearly 10% organic growth in the next year! There are significant growth opportunities in each of their six platforms (meat snacks, sandwiches, seafood, protein, bakery and distribution) to continue to drive growth.

The next step of the journey is replicating the success of this model in the US market. Approximately a third of their revenues are derived from the US, up from ~18%, only five years ago. The US has been the focus of much of their growth strategy, including acquisitions. Demand thus far has been significant, and capacity constraints and labor shortages have impacted short term results. While demand outpacing their ability to supply is a first-class problem to have, it is a problem and they will be investing in capacity, acquiring capacity, or apportioning capacity across their geographies. These short-term hiccups provide an opportunity to invest in a company that we have followed for many years, but valuation had left us on the sidelines.

The fund initiated a position in US-based **Danaher** during the quarter. We have followed Danaher for close to two decades and believe it is one of the best managed companies in the world. Danaher is an unusual company, in that the core expertise of the business is the Danaher Business System (DBS) which is a system for operating businesses. DBS grew out of Kaizen—which is a process for continuous improvement used most prominently by Toyota—but has expanded well beyond this starting point over the years.

When we first began to follow Danaher, the company was an industrial conglomerate, operating businesses in somewhat pedestrian areas (motion control, electronic test, safety equipment). In many ways, the company followed a "value" oriented acquisition strategy; buying businesses which often needed substantial improvement. After acquisition, Danaher would apply DBS to materially improve operations. The CEO at the time, Larry Culp, realized that this strategy was ultimately somewhat self limiting, in that once the businesses were fixed, they tended to be low growth and cyclical, which put Danaher on an acquisition treadmill to continue to grow. Gradually, Danaher began to refocus on businesses in different areas, looking for companies that they believed could be substantially improved, but that operated in higher growth and less cyclical industries; increasingly in healthcare.

The gradual portfolio reshaping accelerated with the 2016 spin-off of Fortive, a new business which was created to hold most of the remaining industrial businesses in Danaher. This was followed by the mid-2018 announcement that Danaher intended to spin-off their lower growth Dental segment. The remaining Danaher businesses are extremely attractive. The company operates in 3 main segments, Life Sciences (tools and instrumentation), Diagnostics (molecular and lab), and Environmental (water quality). Each segment is in a GDP-plus growth area, consists of companies with strong brands and reputations, that have high recurring revenues and lower cyclicality. In our view, at the time of our purchase, the company was undervalued. Unexpectedly, the discount disappeared abruptly as Danaher announce the acquisition of General Electric's Biopharma business in late February (GE Healthcare). Danaher had hinted strongly that they were pursuing a material acquisition, and

GE Healthcare was an extremely attractive target that fits very well within Danaher's existing businesses. As always, we expect that as DBS is deployed, GE Healthcare will see improvement on several dimensions, including growth rate, margin, and free cash flow generation, resulting in continued strong results for Danaher.

The fund re-established a position in US-based global cosmetics leader **Estee Lauder** during the quarter. The global cosmetics industry is extremely attractive, with steady above GDP growth and limited economic sensitivity. In our view, Estee Lauder is the leading business in cosmetics globally.

Estee Lauder manages a portfolio of cosmetic brands, with a collection of large brands (Estee Lauder, MAC, Clinique), scaling brands (Aveda, Tom Ford, Jo Malone), and earlier stage rapid growth developing brands (Too Faced, Smashbox). The company is focused on "prestige cosmetics", with brands that have higher price points than mass market cosmetics. Prestige has been steadily outgrowing mass market, as consumers continue to gradually trade-up to superior products. Despite the steady trade-up, there continues to be substantial runway for further expansion of prestige, particularly in developing economies, where the prestige share is often in single digits versus 40%+ in many developed countries.

From a financial perspective, Estee Lauder is a remarkable company. The business has extremely strong margins, with gross margins maintained at around 80%, a level that is extraordinary for physical goods companies. In addition, Estee Lauder has a strong balance sheet and generates around US$2 billion in free cash flow per year.

The primary challenge for us, as investors, is that the combination of above average growth in a superior, less cyclical, business causes Estee Lauder to tend to trade at a high valuation. Fortunately, the market provides opportunities, often driven by very short-term concerns. We originally purchased the company in the spring of 2017, when "the story" was that problems at mid-tier malls in the United States (a significant distribution point for the company) would cause Estee Lauder's US growth to slow. This caused a significant drop in Estee Lauder's share price, which subsequently reversed as it became clear that US consumers continued to buy Estee Lauder products—just increasingly from non-mall-based retailers and on-line. The extremely strong stock run-up (it doubled over 15 months) resulted in our position being eliminated for valuation reasons. This time around, "the story" was China; a slow down in trade with the US was going to cause significant weakness in Chinese consumer cosmetic purchases (yes, we had trouble connecting the dots here too). After the company reported strong results, with 20%+ growth in the Asia/Pacific region, the stock rapidly recovered.

Outlook

In general, the global economy continues to expand while inflation remains muted. Based on the rapid recovery of equity markets in the first quarter, it appears that the slowdown driven by higher interest rates is expected to reverse as interest rates have come back down. We are suspicious that high debt levels globally will continue to make the economy more interest rate sensitive than in the past, which may continue to lead to a lower growth rate of global GDP over a cycle.

As always, we continue to own 30-35 companies that are leaders in their respective niches. We believe each investment will continue to outgrow their peers while showing superior profitability, strong free cash flow generation, and maintaining the balance sheet flexibility necessary to weather difficult economic environments. We have invested through many different cycles and environments in the past and continue to believe that companies with these characteristics, bought at sensible prices, will outperform over time.

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Index performance does not include the impact of fees, commissions, and expenses that would be payable by investors in the investment products that seek to track an index.

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On November 10, 2006, the Mackenzie US Growth Class acquired the assets of another Mackenzie-sponsored fund in a merger that was considered a material change for the Fund. Therefore, the Fund's performance is provided from the date of the merger rather than its inception, as required under applicable securities laws.

Fund and Benchmark Performance as at: March 31, 2019	1 year	3 years	5 years	10 years
Mackenzie Canadian Growth Balanced Fund – Series F	6.7%	9.3%	10.7%	9.6%
65% S&P/TSX Composite TR and 35% FTSE TMX Canada Universe Bond Index ($CDN)	7.3%	7.0%	5.0%	7.8%
Mackenzie Canadian Growth Fund – Series F	7.6%	12.6%	14.2%	12.6%
Blended Benchmark* ($CDN)	8.9%	10.9%	8.5%	11.8%
Mackenzie Global Growth Class – Series F	10.0%	14.1%	10.7%	13.4%
MSCI World Index ($CDN)	7.8%	11.9%	10.9%	13.1%
Mackenzie US Growth Class – Series F	16.7%	15.1%	12.2%	13.2%
S&P 500 Index**	13.5%	14.7%	15.2%	16.6%

*The Mackenzie Canadian Growth Fund's benchmark was changed in March 2017 from the S&P/TSX Composite Index to a blended benchmark of 60% S&P/TSX Composite Index, 30% S&P 500 Index, and 10% MSCI EAFE (Net) Index, in order to better reflect the long-term average geographic composition of the Fund. **The Mackenzie US Growth Class benchmark was changed in March 2017 from the Russell 1000 Growth Index to the S&P 500 Index in order to better reflect the long-term average geographic composition of the fund.

The Bluewater Team assumed leadership of Mackenzie Global Growth Class and Mackenzie US Growth Class effective August 9, 2016.

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