Mackenzie Global Equity & Income Team

Q1 2019 COMMENTARY

During Q1 2019, **Mackenzie Global Dividend Fund** (Series F) returned 12.0%, and has now returned 12.3%, annualized, since portfolio manager change. This compares with the MSCI World Net Return Index ($CDN) Q1 return of 10.0%, and 11.4%, annualized, since portfolio manager change. Stock selection in Health Care and Consumer Staples contributed positively to relative performance during Q1. Stock selection in Materials detracted from relative performance.

Mackenzie US Dividend Fund returned 12.8% during Q1 2019 and has now returned 12.0% annualized, since inception. This compares with the S&P 500 Total Return Index ($CDN) Q1 return of 11.2% and 15.4%, annualized, since inception of the Fund. Stock selection in Health Care, Consumer Staples, and Energy contributed positively to relative performance in Q1, while stock selection in Information Technology detracted from relative performance.

Global stocks staged their best quarterly performance in more than eight years in the three months to March after the US Federal Reserve (the Fed) signaled that it no longer held to forecasts it issued in December when it indicated it expected to conduct two rate increases in 2019, the US government delayed increasing tariffs on Chinese imports and reports showed the US economy was expanding at a manageable pace. The surge overcame rising doubts over the Eurozone economy and uncertainty over the UK's departure from the EU. During the quarter, all 11 sectors rose in US dollar terms. IT (+20%) and Real Estate (+16%) rose the most while Healthcare (+8%) rose the least. The MSCI World Index rallied 10%, its best performance since 2010.

US stocks rose after the Fed repeatedly signaled it would be easier on tightening. Specifically, it no longer expects to pursue two rate increases in 2019. In another shift that was a boost for stocks, the Fed said that by the end of September it would stop reducing its balance sheet. The bank's balance sheet grew large from three spurts of quantitative easing, or asset buying, since the GFC of 2008. Previously, the Fed said it would reduce its balance sheet to a set timetable. All this despite the data suggesting that the economy remains in relatively robust shape, as an economic report showed the US economy expanded at an annualized pace of 2.2% in the fourth quarter. Even if the recent minor inversion of the US yield curve is of significance, there can often be a lag before the economy and stock markets peak. While impossible to predict with any great accuracy, the housing market's response to lower rates may indicate that the economic cycle in the US still has a little way to go.

Concerns about trade tensions between China and the US eased after President Trump said trade talks with China had progressed enough for him to meet Chinese President Xi Jinping to "conclude an agreement". In additional political news, the investigation into Russian interference in the 2016 election headed by Special Counsel Robert Mueller found that Trump had not colluded with Russia's meddling during the campaign, according to a synopsis that Attorney-General William Barr sent to congress.

European stocks rose after the European Central Bank indicated it could aid the economy if needed and the central bank announced new cheap loans for banks. Another boost came when the EU granted the UK an extension on its March 29 deadline for leaving the EU so it had more time to work through its increasingly messy divorce. Despite low unemployment and decent household expenditure data, economic reports showed the Eurozone economy is tepid. A key report showed the eurozone economy only grew 0.2% in the fourth quarter, meaning the euro area expanded 1.8% in 2018.

In Asia, Japanese stocks rose after a report showed Japan's economy returned to growth in the fourth quarter, when it expanded at an annualized rate of 1.4%. Chinese stocks surged after the People's Bank of China cut reserve requirements for commercial banks to encourage lending, the government applied some fiscal stimulus and trade tensions eased, and on a decision that the MSCI China Index would hold a greater weighting in world indices. Both regions have been impacted by the trade issues, and their markets have benefited from expectations that a resolution is coming.

Given the volatility investors have faced the last two consecutive quarters, we feel this might be an opportune time to assess where we are and put some context around recent history. The bull market that began in March 2009 passed its 10th anniversary last month. It's fair to say that at the time in 2009 when stock markets around the world were hitting generational lows and people were questioning the viability of the global financial system, NO one was thinking about – or cared – what the world might look like ten years out. As members of the team have been running a global equity product since that time, a simple observation should be made: many people (which includes friends and family, clients, competitors, and all shades of Wall Street experts) have been calling for the next significant bear market and/or recession throughout this entire time period. We've often commented to investors that this has been the worst-feeling bull market in our 20+ year career as most everyone seems permanently scarred from the Global Financial Crisis and are constantly waiting for the bogeyman to jump out from around the corner. This is not to say there have not been bouts of volatility that have *felt* like bear markets. The European sovereign debt crisis in 2011 helped take global markets down over 20% (from high to low) at one point during the year. From mid-2015 to early 2016, driven by a recession scare and subsequent commodity sell off, markets came down almost 18%. And, of course, just last quarter when from Sept 20 to Christmas Eve markets came off over 18% (and over 20% if one measures performance from their late January 2018 highs). And yet despite these dislocations and investors seemingly in a constant state of apprehension, markets compounded, after rev-invested dividends, at over 12% per annum over this time i.e. more than tripling in those ensuing ten years. In each case, if one attempted to adjust their portfolio significantly to ex-post economic data or, worse yet, macro and/or geopolitical predictions, investors would have added little value and actually hurt performance.

As for the next ten years? We still think owning a collection of high-quality, reasonably priced, dividend paying equities will produce very attractive long-term real returns. Stocks have gone up on average two out of every three years since World War II, and with ten-year government yields around the world still at low absolute and relative levels, benign inflation, and valuations that do not appear overly stretched, there is reason to believe those odds will continue to hold over the next decade. Will there be scary bouts of volatility, some of which will leave us all scratching our heads or blaming it on the vagaries of faceless yet increasingly influential market "participants" such as passives (which can include a range of vehicles, from index ETFs to algorithmic trading programs)? To that we answer: 100% yes. Despite knowing this will occur, we still feel that owning stocks will prove to be more rewarding than almost any other asset class.

What contributed positively to performance?

The China A-Share market as a whole was up almost 30% for the quarter and, not surprisingly, our one A-share holding (**Kweichow Moutai**) was up over 45%. Indeed, all of our other China-centric names were up above the global market returns for the quarter. In fact, our single-best performing stock was **New Oriental Education**, which was up over 60% as the market got clarity on regulations and gross profit margins showed signs of bottoming. Besides the aforementioned trade war concerns easing, China's efforts to clean up its shadow banking sector have more or less drawn to a close and economic activity has once again begun to pick up.

In Q1-19, Mackenzie Global Dividend Fund's top contributor and third-best absolute performer was **Micro Focus International plc**, now a habitué of quarterly mentions. In Q1-18, it was our largest detractor – ever – with the largest single day stock drop in the history of the fund. In Q2-18, it was a top performer, as it rebounded but remained below its initial level. In Q1-19, the stock returned 48%. This performance reflects two things. Obviously, the market rebounded, which helped. From January 1 to February 13, 2018, the stock rose 9.7%. Then on February 14, 2018, the company delivered its long overdue annual report for the year ended October 31, 2018…and showed a very strong performance. The stock rose 12% in one day, and 20%+ over the next weeks.

This was an interesting investment where the market was proven wrong on several dimensions: it priced Micro Focus as though its leverage was unsustainable. This proved false. The market believed that Micro Focus would not be able to get sales to develop in range with the initial business plan for the HPE acquisition. The annual report showed that despite very difficult internal challenges at HPE, including with IT systems and a sales channel restructuring, Micro Focus was able to stabilize the revenues. The pro-forma revenue decline **of -5.3%** for 12 months ended FYE October 31, 2018, beating the guidance of -6% to -9%, while the market was skeptical they would even meet guidance at all. The management has also delivered faster on deleveraging than their business plan, achieving a 24-month target of 2.8x net debt/EBITDA in 14 months, while also buying back $500M of stock.

The fact that the stock is up almost 50% in a quarter indicates that the market's expectations and view of the business was completely wrong. How wrong? At the low share price of March 22, 2018, the market capitalization was just under $4B, with debt, the group had an enterprise value of ~$8B. So a company worth $6.2B bought another company for $8.5B, and a year later the combined is worth $8B? The market had no faith despite Micro Focus' management's 30% IRR on transactions over the decade prior…The market grossly underestimated the intrinsic value of a fast-growing division, SUSE, which management crystalized with a sale for $2.5B, or a rich 26.7x EBIT. Adjusting for the sale of SUSE, the Enterprise Value at the lows falls to $6B. The investor could invest at an equity value of $4B, for a company that in 2018 generated FCF to Equity of $755M and is expected to achieve 2020 FCF to Equity of >$900M.

In its annual report, the firm demonstrated that the continued execution risk had been grossly over-estimated; that their operational efforts are working; and that the debt level is very manageable. The share price collapse suggested the firm had an unsustainable level of debt. The annual report shows the firm could eliminate its entire debt in under 2-3 years should it want to. In fact, Micro Focus has chosen to return $1.8B of the proceeds from the sale of SUSE…so an investor who paid $4B for his equity in March 2018, is getting $1.8B back in the spring of 2019. The equity investment cost a net $2.2B, on which he or she will enjoy free cash flow of $900M next year. To quote our own letter in Q1-18: "*We believe the market overreacted, and valued the stock irrationally. It is normal to have integration issues; it is also expected that there will be higher sales force attrition given merger uncertainty. Those turned out to be higher than the market expected, but variability is part of business. Those problems will be solved, while the customer stickiness, and its concomitant cash flows, will persist.*"

Dentsply Sirona rebounded strongly after falling nearly 60% from its peak and 30% from where we purchased shares. Towards the middle of last year the company put a restructuring plan in place to optimize the business, a move we applauded and believed should have been put in place a long time ago. The optimization showed up in the results almost immediately and the share rose nearly 20% on an upbeat earnings report. Dentsply Sirona is the largest manufacturer of dental consumables and equipment. The company merged with hardware provider Sirona, which makes computer assisted imaging and manufacturing equipment (CAD/CAM). Today, Dentsply is the market leader with a 21% share of the $21 billion market. The company's sales are 35% in the U.S., 40% in Europe and 25% in the rest of the world. The business has been very defensible and inversely leveraged to the unemployment rate. To date, the merger has under-performed expectations due to a slowdown in consumables and equipment from Sirona. While only 18% penetrated the CAD/CAM machine is too expensive for all dentists to have. The recent trend toward dental groups with offices joining efforts to gain more bargaining power and to share resources is largely responsible for the slowdown. While we believe this trend will not end, it is likely to moderate. Dentsply Sirona's consumable dental supplies include endodontic (root canal) instruments and materials, dental anesthetics, prophylaxis paste, dental sealants, impression materials, restorative materials, tooth whiteners and topical fluoride. Consumables represent 55% of the company's sales and are largely recurring in nature. Small equipment products include dental handpieces, intraoral curing light systems, dental diagnostic systems and ultrasonic scalers and polishers. The company's diverse product offering isolates the company from any one product significantly impacting sales. We are optimistic about Dentsply's new focus on operational excellence and continue to hold our position.

Another standout performer was **Kinder Morgan**, the largest natural gas pipeline company in the U.S. The company transports an estimated 40% of all U.S. natural gas. The company has been working to de-lever its balance sheet while its customers and competitors continued to spend capital to grow. At the direction of its founder and largest shareholder Richard Kinder, the company cut its dividend in 2016 and started paying down debt. This has resulted in Kinder Morgan having the best balance sheet in the sector allowing the Company to once again increase its dividend yield. The Company has four businesses: natural gas pipelines, terminals, liquids pipelines and a CO2 injection business. Nearly 70% of Kinder Morgan revenues and earnings come from take or pay contracts from the pipeline and terminals businesses. An additional 22% of the business are fixed fee contracts. These are volumetric based contracts and are paid out as long as volumes do not decline. The company is at the center of several structural growth dynamics in natural gas including: LNG shipments from the U.S. starting this year, as well the continued conversion to natural gas power generation. The company has averaged 13% ROI and 20% ROE on its projects because of it is able to achieve higher returns due its advantage positions in interstate pipelines which are 40-year assets. The company has increased its dividend to 5% and has communicated they will increase it again as the debt repayment concludes. We view Kinder Morgan as one of the safest ways to gain exposure to the cyclical energy industry and continue to hold shares.

What detracted from performance?

Kraft Heinz was the worst performer in the quarter after declining 30% in a single session on earnings guidance, a dividend cut, and announcing it was subject to a probe by regulators. Not exactly the sort of "trifecta" that is greeted kindly by the market. The company also wrote down the value of underperforming brands by US$15.4 billion. Kraft Heinz was assembled with the merger of Kraft Foods and Heinz, by Brazilian finance group 3G Capital and Warren Buffet's Berkshire Hathaway, who still own 50% of the company. The company, which was viewed as a roll-up vehicle for the sleepy food group, has not completed an acquisition in nearly three years and therefore earnings growth has been flat. Management's strategy was to take out costs and nearly double margins from its predecessor companies. Initially management believed they could cut costs and grow top line, however this proved too difficult. The company acknowledged that to grow, they would have to invest and give back margin in a difficult processed food category in the

U.S. The structural decline in the category coupled with poor execution caused a 65% decline in the shares, erasing all gains in shares from the time of the Heinz merger with Kraft. We now view this business and the rest of the U.S. food category as a structurally challenged category going forward. While the company still has valuable brands such as Heinz Ketchup and Philadelphia Cream Cheese, given these challenges combined with a debt ratio of over 4.5x, we have chosen to move on and sold what small position remained in our global portfolios.

CME Group which was among our best performers in Q418 and provided tremendous downside protection during the entire year, was down -14% this quarter as its annual "special" dividend (on top of its normal 60% payout) came in below expectations and the market started to discount the lower likelihood of future rate hikes. This comes as no surprise as the company's role in the portfolio was meant to provide solid diversification for a dividend-centric mandate i.e. do well in a rising rate environment when most yield-oriented stocks underperform and lag the market when interest rates decline. We continue to own not just CME Group but several financial exchange operators globally, as these companies provide not just similar interest rate "counter-cyclicality" but also are among the best businesses from a margin, ROIC and capital return perspective in the world.

Sony Corp. has underperformed relative to our portfolio in Q1, as the market became concerned about the potential competitive threat from cloud gaming and a muted near-term earnings growth. We want to re-iterate our confidence in the business is based on its world-class content portfolio across music, picture and games, where true synergies have yet to be realized. In addition, we believe Sony's dominant imaging sensor and equipment businesses are significantly undervalued compared to its peers. In total, we have an intrinsic value estimate almost twice its market price today. Sony's management is aware of the depressed share price and we therefore think investors should expect additional corporate actions to unlock the company's value.

What changes have we made to the Mackenzie Global Dividend Fund?

Otsuka Corp is a Japanese IT services firm focused on servicing small-to-medium size enterprises (SMEs). The scope of the company's business activities includes distributing and helping customers set up a wide range of office hardware and software products, as well as providing servicing, maintenance, and support on all the product it sells. With the latter, Otsuka earns a recurring and profitable stream of after-sales revenue which is the basis for the company's high business stability. The backbone of the company's operations is its 6,400 sales and technical support personnel that are stationed close to customers across the company's nationwide branch network. With this workforce, Otsuka serves 1.1 million accounts across Japan (roughly 25-30% of all registered enterprises in the country), the majority of which are SMEs. The market for SMEs has traditionally been neglected by many of Japan's major IT services firms which tended to focus their resources on servicing large corporations and multinationals rather than fussing over small, fragmented accounts. However, Otsuka has turned the challenging task of profitably servicing a fragmented base of SME customers into its own competitive advantage, enabled by the company's industry-leading sales force efficiency, and establishing itself as the undisputed leader in the SME market where there is absence of sizable competition. As we know, Japan is a market mired in aging and shrinking demographics. While this is an impediment to growth for many industries in the country, Otsuka is a rare exception in that it is well positioned as a beneficiary of this structural issue. This is because Japan's demographic challenge is exacerbating the labor shortage of internal IT personnel at many SMEs, allowing Otsuka to increasingly take on the role of what is essentially an outsourced IT department for its clients. In addition, Japanese companies are seeking to offset labor shortage through achieving higher labor productivity, which is resulting in a multi-year boost to IT investment spending in the country. These structural tailwinds, supported by Otsuka's leading industry position and strong business execution, have allowed the company to deliver very healthy topline and operating profit growth totaling 35% and 42% over the last five years. We took advantage of the market wide sell-off in the first quarter to accumulate shares of Otsuka, which we believe have been oversold, at roughly 13 times net profit and 6% free cash flow yield excluding cash on balance sheet.

Murata Manufacturing Ltd is the world's largest maker of multi-layer ceramic capacitors (MLCCs) with 40% global market share. MLCCs are small electronic components whose main purpose is to carry and store electricity within a circuitry and are important building blocks of smartphones and other electronics products. The Japanese consumer electronics industry has seen better days in the past, but despite the electronics industry moving away from Japan over the past two decades, a handful of Japanese components makers such as Murata have continued to grow and prosper globally by being attuned to the shifting landscape in end markets and continuously investing to deepen their technological leadership. We believe Murata's business is protected by a wide moat around the company's technological and scale-based dominance, and the company's growth prospects look promising across its key end-markets of smartphones, automotive, and home electronics. In the smartphone market, we expect model upgrades and functionality improvements to continuously drive increases in MLCC value and content per device. Notably, 5G will take shape over the coming years which is expected to materialize into growing demand for a substantial portion of Murata's product line. Meanwhile, automotive is a fast-growing end market for MLCC usage, driven by vehicle electrification across all areas including drivetrain, assisted/automated driving, infotainment, and safety. Electric vehicles with a high level of assisted driving and other features could contain up to 8,000 units of MLCC per vehicle, which is roughly six to eight times the number found in high-end smartphones. Whether its smartphones, cars, or home electronics, we believe Murata will play an enabling role for a world that is set to become increasingly digital and connected. In the first quarter, we funded the new position in Murata by selling down our stake in **Nidec**, another Japanese electronic component company and the world's largest maker of motors. The decision was primarily valuation driven. While we continue to think highly of Nidec's business, the large gap in valuation between the two companies could not be justified, at 16 times net profit for Murata versus 28 times for Nidec, as we see the two businesses as comparable in terms of business quality with a similar growth profile and return on invested capital. The result of this switch is that we have been able to trim valuation while upholding the business quality of the portfolio.

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MACKENZIE
Investments

Fund and Benchmark Performance (%) as at: March 31, 2019	**1 year**	**3 years**	**5 years**	**Since PM Change***	**10 years**
Mackenzie Global Dividend Fund F	7.9	10.2	11.3	12.3	13.4
MSCI World Index NR (CAD)	7.8	11.9	10.9	11.4	13.1
*PM fully implemented new strategy February 1, 2014. Inception on July 12, 2007					
	1 year	**3 years**	**Since inception****		
Mackenzie US Dividend Fund F	0.5	9.7	12.0		
Mackenzie US Dividend Registered Fund F	0.6	9.6	11.8		
S&P 500 Index (CAD)	13.5	14.7	15.4		
**Inception on April 24, 2014					