Buying 50 cents on the Dollar: Top 3 Reasons to own Mackenzie Cundill US Class

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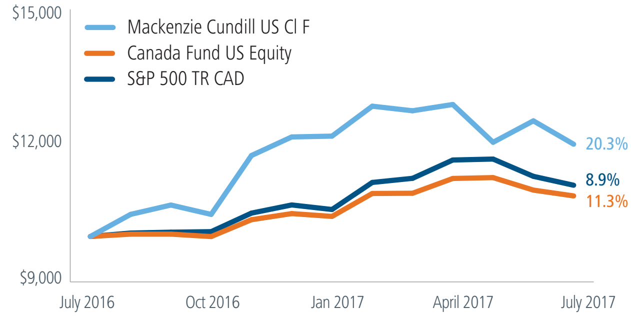
We sat down with Jonathan Norwood, Co-Head of the Mackenzie Cundill Team and Portfolio Manager for Mackenzie Cundill US Class, to ask him why he is so enthusiastic about the holdings in the Fund when so many investors are concerned about what they feel is an expensive US market.

Below are some compelling reasons to own Mackenzie Cundill US Class and a Q&A with Jonathan Norwood.

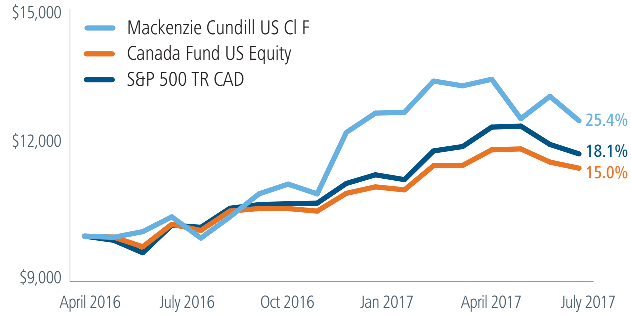
The top 3 reasons to own Mackenzie Cundill US Class are:

1. The Fund is very affordable. Jonathan believes the Fund's holdings, on average, trade close to 50% of their estimated worth. Benjamin Graham, the father of Value investing, was dedicated to finding stocks that were worth $1, but trading for 50 cents. On traditional metrics, the Fund trades at a price to earnings multiple that is 25% lower than the broad US market, as measured by the S&P 500 and an astonishing 75% discount to the market's price to book value.[1]
2. The Fund's small size allows it to be very nimble and own smaller companies that are under the radar of many Wall Street analysts. This factor gives a portfolio manager a real edge in terms of finding hidden gems that are not strongly followed or well known, so as to exploit the hidden value.
3. Jonathan is a seasoned value manager, having won the API Asset Performance Inc. Performance Achievement Award in both 2011 and 2013 for the top-performing fund in the API US Equity Universe category for the Louisbourg US Equity Fund, which Jonathan managed at Louisbourg Asset Management. Since joining Mackenzie in 2016, Mackenzie Cundill US Class is performing at the top of the pack. The Fund has delivered a 20.3% 1-year return to July 31, 2017, beating 96% of peers in the Morningstar US Equity category. The Fund trounced its peer group return by 11.3% and handily beat the S&P 500 index by 9.0%. Furthermore, since the portfolio manager took over management of the Fund on March 24, 2016, the Fund has risen 25.4%, beating 93% of its peers that were handily beat by 10.5% and the S&P 500 by 7.3%. Jonathan is dedicated to the principles of Value investing.

Mackenzie Cundill US Class F 1 year Performance



Mackenzie Cundill US Class F since manager change



Source: Morningstar Direct, July 31, 2017

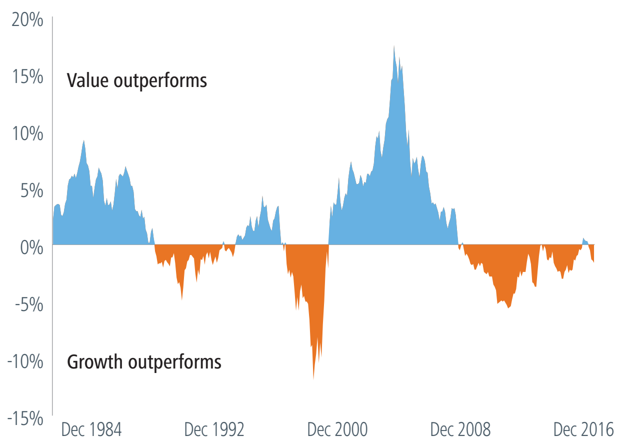
[1] Source: Bloomberg, July 31, 2017

Q&A with Portfolio Manager, Jonathan Norwood

Q. Why do you believe that now is the time to own Value stocks?

A. I have spent my career looking for patterns and recognizing that the market is mean reverting. That is, stocks can go substantially higher or fall much lower than their true intrinsic values for years, then return to their true value. We strongly believe that we are in the very early stages of a multi-year cycle back to Value. The last cycle from 2009, as defined by the Great Financial Crisis, was dominated by Growth, low volatility and high dividend yielding stocks given the backdrop of declining interest rates, low inflation and low GDP growth. This has clearly begun to reverse course and should be a very supportive environment for Value stocks.

US Value vs Growth*



Source: Morningstar Direct, Mackenzie Investments

*US Value represented by 5-year rolling returns for Russell 3000 Value, US Growth represented by 5-year rolling returns for Russell 3000 Growth

Most will agree that (over a long enough time period) almost everything runs in cycles: demographics, nature, economics, inflation, interest rates, commodity markets, real estate markets, capital markets, fashion trends, hairstyles, you name it. Technology may be one of the few things that exhibits linearity over time.

Some cycles may last longer than others, in which case they are termed “secular,” but they are a cycle nonetheless. The older we get, the more cycles we see and consequently the better prepared we should be (in theory) to recognize and capitalize on cycles as they re-occur. And they will. This is especially important to value investors, as it pertains to mean reversion.

We operate in a business that “what goes around, comes around.” Unless you can predict the future, hitting the cycle right (or at least not missing it entirely) is key to compounding wealth. The fact that you are a little early or a little late to the game should be of little consequence in the grand scheme of things; however, if you get in at the top and subsequently get out at the bottom, your investment results will be catastrophic. Unfortunately for some, there is a natural impulse to do that.

Similarly, if you buy a growth fund at the peak of the growth cycle, or a bond fund at the peak of an easing cycle, you will get hurt on a relative basis when Value outperforms. You could own the best growth fund on the planet and experience abysmal investment results when it is Value’s turn to shine.

Q. The US Fund has experienced some volatility this past spring. How do you view volatility in general?

A. Much of the volatility in net asset value has been associated with capital gains distributions. The Fund’s fiscal year ended March 31 and we rang the register on a couple of positions that had performed extremely well in a very short time period. From a performance perspective, March, April and May were weak months for Banks and Energy, two of the fund’s largest overweights. Volatility is not always a synonym for risk, however. To margin of safety investors, risk is defined in terms of permanent loss of capital, not daily fluctuations in net asset value. Predictable volatility is actually a useful thing and our Chief Investment Officer makes sure that we stay true to the deep Value style and exhibit predictable volatility. This makes the Cundill Funds a very powerful tool in portfolio construction, because they tend to have consistent, low correlation with the overall market. Our funds also tend to move in lock-step with interest rates and inflation. This makes them a great diversifier within a larger portfolio containing bonds, growth and income-oriented equities; which tend to go down when interest rates and inflation rise.

We understand that Cundill's actions and style of investing have to be consistent and predictable and so they always will be. We want people to know what they are buying. You will never see a momentum or high growth stock in our top ten holdings. We are much more at ease buying hard assets below their replacement costs than chasing the likes of Amazon and Facebook to the moon. We buy things like trucks, trains, banks, boats, helicopters and buildings. You also will not find pricey telecom, utilities or consumer staples stocks. As Value resumes its leadership in the market, we believe volatility could shift to these segments.

Q. Where are you finding value in US markets?

A. We are finding deep value in select US banks, challenged energy companies, struggling retailers, conventional media companies/broadcasters and out of favour health care stocks. We will investigate further into some of these areas below.

Financials remain fertile ground for Value stocks, which the market has not favoured since the financial crisis of 2008, but these banks have healed and are poised to deliver substantial shareholder value. I think what people are missing is that bank regulation has continued to roll forward since the credit crisis. Now, whether Dodd Frank gets repealed or regulations roll back, it will not get worse. That is constructive in and of itself. The glass is now half full. Mackenzie Cundill US Class owns banks and insurers that are trading near book value and historically have traded as high as three times book value and hit 2.2 times in the last peak in 2006. Balance sheets are rock solid, with capital ratios in line with even the best banks in Canada, but returns on equity and capital payouts are lighter and have significant room to improve given a very favourable backdrop of:

- Cost cutting initiatives
- Reduced capital requirements
- Rising interest rates
- Stable and potentially rising GDP growth
- Rising employment levels
- Strong consumer and business sentiment
- Deregulation

Investors see red on the street these days in terms of department stores, specialty apparel, auto **retailers** and food retailers, but we see value. There is a physiological barrier to buying brick and mortar retailers right now because the wholesale channel is being disrupted. We look for retailers that do not go head-to-head with Amazon or Wal-Mart, do not have double digit same-store-sales declines and own their own real estate. With respect to the latter, we believe that fast growing e-retailers will inevitably have to bridge the digital and physical world and will need great real estate locations to do that. If the retail stores cannot be managed profitably, real estate can be sold or reconfigured, leases transferred, inventories can be liquidated and receivables collected. Today, we see significant value in retailers such as Kroger, Dollar General, and CVS.

We also own some specialty retail positions in Hanesbrands, Limited Brands (think Victoria Secret) and Under Armour. These stocks have been severely punished, but have brands/businesses that we believe will prove channel agnostic in the long term.

Q. What do you think of energy stocks? Are they value plays?

A. Clearly there is value in this space and yet many people will not go near it. Drilling technology has thrown a few curve balls into the energy complex and will continue to do so, but the underlying fundamentals have remained cyclically predictable. In my view, you just have to buy low in the price cycle and have patience. We are finding tremendous value in **energy** and **energy services** companies.

Bristow Group provides one of the highest value, least commoditized services in the offshore oil and gas services industry – high specification helicopter services. It provides a mission critical service (air transportation to and from rigs) for which there is no replacement/substitute. If this business did not exist tomorrow, the offshore space would quickly grind to a halt. In recent years, it has also diversified into Search & Rescue (SAR) services, which is non-cyclical in nature.

Bristow is not a broken company, but rather cyclically challenged. It has been around for some 62 years and has survived multiple oil and gas downturns. The company has ample liquidity and in our view, will survive the downturn again. The company has a net asset value of $42.76 and is trading at just $7.37 (as of July 31, 2017). This represents a discount of >80%. The appraisal value of the fleet is determined by a third party valuator, not the company.

Chicago Bridge & Iron is a global engineering & construction firm focused on energy infrastructure. The company is cyclically challenged, but not broken or in secular decline. It has been hurt by poor timing/financing of a large acquisition, significant litigation overhang and project cost overruns. The stock price has declined >80% from its all-time high in 2014. We think the company's backlog of orders is robust and the stock will respond positively to a number of catalysts such as new contract wins, increased infrastructure spending and successful litigation outcome. We think the intrinsic value is upwards of $37.

Fund and Benchmark Performance as at: July 31, 2017	1 year	3 years	5 years	10 years
Mackenzie Cundill US Class Series F	20.3%	10.6%	17.3%	6.7%
S&P 500 TR Index (net CAD)	10.8%	15.9%	19.9%	9.4%

Conclusion

Do not give up on the US. There are pockets of the US market that are very expensive and pockets that are still affordable. We are obviously focusing on the latter. I keep a copy of Peter Cundill's book on my desk, as well as Ben Graham's, to remind myself that as Value investors, we really do not face anything new. Technology throws in a few odd wrinkles here and there, but the bottom line is that the fundamental impulses and the challenges that investors face, namely fear and greed, are fairly timeless in our line of work. We have improved technology today, much like you will find in golf, but the fundamentals of the game and our swing remain consistent. In short, we will continue to execute on our Value discipline and we believe that the wind will soon be at our back.

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