Mackenzie Cundill Canadian Balanced Fund – Series F

Q4-2018 COMMENTARY

Performance Summary

- For Q4 2018, the Fund returned -10.4% compared to the return for the blended benchmark of -5.8% which is comprised of 62.5% S&P/TSX Composite Total Return Index and 37.5% FTSE TMX Canada Universe Bond Index.
- The Fund underperformed the benchmark over the quarter due to security selection in the Energy, Financials, and Materials sectors.
- We would draw attention to the extreme attractiveness of the Cundill Canadian Balanced fund's valuation which currently trades at a 40% discount to the blended benchmark on a price to book value of 0.90X vs. its blended benchmark at 1.50X. We do not believe that the Q4 sell-off in Cundill Canadian Balanced was fundamental in nature. We did not have a material, adverse shift in individual company fundamentals that reduced our estimate of intrinsic values. Nor was there a material change in our risk management practices or portfolio construction. In fact, at the end of Q3 all the risk metrics looked normal.

Portfolio Activity

- During the quarter, we added positions in **Brookfield Asset Management, Parsley Energy Inc. and Renesas Electronics Corp.**
- In the fourth quarter the team initiated a position in **Brookfield Asset Management (BAM)**. Brookfield Asset Management manages funds on behalf of institutional investors that invests in alternative asset classes – infrastructure, real estate, and private equity. BAM's business generates a steady stream of management fees, with additional upside from performance incentives as well as capital appreciation on its co-investments with its investor clients. In recent years BAM has also created four publicly listed partnerships (Brookfield Property Partners, Brookfield Renewable Partners, Brookfield Infrastructure Partners, and Brookfield Business Partners) that raised additional capital for the company to invest, and assets in these publicly listed partnerships have grown to become a significant portion of BAM's value. We believe that shares of BAM trades at a discount to the combined value of their stakes in the listed partnerships and the value of their growing stream of asset management fees. Brookfield Property Partners recently acquired one of the largest US retail mall operator, and we believe the depressed sentiment towards retail has created an overhang on BAM as well. However, our view is that Brookfield Property Partners paid an attractive price to acquire the assets, the malls are top-tier in their location and quality, and the real estate has substantial redevelopment potential. There is also significant growth potential ahead for alternative asset funds, as major institutional investors continue to allocate more of their investments into these asset classes. We believe the discount on BAM will shrink considerably as sentiments towards Brookfield Property Partners improve and BAM's assets under management continues to grow.

Market Review, Outlook and Strategy

- 2018 was a tumultuous year of performance in global markets, with volatility dominating the first and fourth quarters. The year started with concerns over Trump's tariffs on aluminum and steel imports, U.S. - North Korea tensions and rising worries over China-U.S. trade as well as the fear of a Federal Reserve policy mistake. That culminated in panic out of risk-on assets in the fourth quarter.
- The disappearance of risk appetite and tax loss selling in markets during Q4 particularly of holdings in Cundill funds is akin to holding a beach ball under water. Once the selling pressure eases and shares begin to reflect fundamentals again, the beach ball pops right back above the water, as demonstrated by the significant outperformance of Cundill funds in the first weeks of the new year, recapturing a big portion of Q4 underperformance.
- The fourth quarter was characterized by investor worry, panic and capitulation. The panic engulfed many cyclical sectors including energy and financials which are overweights in our portfolios. The selling pressure was further exacerbated by technical, algorithmic and short selling especially in the energy space. This happened against a backdrop of trade war concerns, relatively weak economic data, and an inversion in the 2-5 year segment of the US government bonds yield curve. As a result, there was a sudden and dramatic disappearance of risk appetite in the marketplace. Deep value stocks, which trade at substantial discounts to intrinsic value because they tend to be in various stages of operational improvement, financial

deleveraging, business turnaround or restructuring, were indiscriminately discarded by the market as market risk appetite hit an "air pocket".

- Under such a scenario, stocks that Mackenzie Cundill team owns didn't do well in the short term, as "re-rating stories" take time and execution. At the time of writing, we can look back and see that the sell-off was way overdone as Cundill funds recaptured both absolute and relative performance in early January.
- Countries such as China, German and Italy, have decelerated growth recently. In China's case, the economy is shifting toward being more consumer-centric and consumer spending is still growing at high single digits. The Chinese government is now considering fiscal stimulus measures such as tax cuts to counter weaknesses in the economy related to trade war. In addition, the central bank there has been cutting the Required Reserve Ratio since mid-2018 to improve financial conditions. In Germany, we believe the weakness is mostly related to the delays in factory production caused by Worldwide Harmonised Light Vehicle Test Procedure (WLTP). This testing requirement has delayed auto production significantly but the issue is temporary. Once the testing procedures are caught up, vehicle production should normalize. In the case of Italy, the newly elected Italian government has finally struck a budget deal with Brussels to avoid EU sanctions after the months-long row.
- In the UK, at the time of writing, the Parliament has rejected the Brexit deal that Theresa May negotiated. However, Theresa May has won the confidence vote and remains as Prime Minister. At this juncture, May could try to tweak her deal to get it approved at a later date, she or the Parliament could ask for an extension of Article 50 beyond the original deadline of March 29th, they could annul Article 50 or even call a second referendum. However, the risk of a Brexit with no deal is highly unlikely as that will be detrimental to both the EU and UK. Our portfolio has a small exposure to the GBP at 0.8%. In addition, our UK holdings are global companies with extensive operations outside of their home country.

Cundill View

- We view the fourth quarter as a temporary setback and believe the markets will shake off the fears of 2018, driven mainly by two overriding concerns: 1) US Fed raising rates too quickly, and 2) China-US trade wars and tariffs, as evident from positive market behavior in the first week of January 2019 after Fed Chairman Powell convinced the market that the Fed is going to be patient with further hikes.
- Our view is that although global growth is slowing, there is no sign of recession on the horizon. Employment numbers and wage gains are pointing to continued healthy labour market and consumers. The parts of the yield curve that are meaningful indicators are still upward sloping and not indicative of impending recession. The current US Fed has indicated that it pays attention to signals from the equity markets. We find it difficult to see a Fed that will blindly hike rates to potentially cause a recession in the foreseeable future.
- In summary, we believe what we saw in Q4 was a "global growth scare". Although global growth is slowing down, recession risks remain low. As the costs of the trade war increase on both sides, we believe the US and China are incented to reach a deal where both sides can claim victory and provide businesses and consumers with more confidence. Such a deal should bring relief to the markets.

Catalysts for 2019

1. US-China trade negotiations - deadline March 1st, 2019
    a. Base case is that we see resolution that will provide certainty to the market
    b. Delay - will push certainty into future and add to volatility
2. Energy
    a. OPEC cut 1.2m boe/day
    b. OPEC+ March 1st meeting
    c. Expiry of Iran sanction waivers to eight countries - early May
3. Sentiment change
    a. Chinese government stimulus and further rate cuts
    b. Continued strong labour markets and strong banking sector earnings dismiss fear of recession
    c. Depressed valuations in our holdings getting re-rated to reflect underlying fundamentals

Bullish on Financials and Energy

- In **Financials**, after the sell-off in December, our major US bank holdings were trading at near 'recessionary' book value levels and we are not even in a recession, nor do we believe we are heading into a recession in the foreseeable future. This was a big disconnect we can only attribute to panic/fear. Our banks are in better financial condition than they were even before the 2008 financial crisis with great balance sheets that are actually over-capitalized which allow the banks to ramp up dividend payouts and buy back shares. As we write, the market is coming to its senses. Year to date (January 16th), shares of Bank of America are up 15.5%, Citigroup up 19.5%, Goldman Sachs up 18%, and Wells Fargo is up 6.2%.
- In early January, our bank holdings have reported earnings that have largely exceeded expectations and erased market fears of impending doom.
- Bank of America's Q4 Net Income is up 40% vs. year ago. Return on Equity is up 380 bps. Efficiency improved by 700 bps. Credit quality is stable. They see in the US strong indications of continued growth. During 2018, the company returned $25.5 bil in dividends and share buybacks to shareholders.
- Citigroup results showed continued momentum in 2018. EPS grew 25% vs. 2017. The bank returned $18.4 bil of capital to shareholders and bought back more than 200 mil shares during the year. Returns on Tangible Equity improved 286 bps to 10.9%. The company sees strong underlying fundamentals in the economy.
- Goldman Sachs Q4 revenues and earnings beat estimates. Their economists still see global growth of 3.5% in 2019. Wells Fargo disappointed with an extension of the asset cap operating period to the end of 2019. But credit quality remained strong and capital ratio remained high. They returned $8.8 bil to shareholders through dividends and share repurchases in Q4/18 alone, more than doubling their shareholder return in Q4/17.
- We expect the US banks to continue to return substantial capital to shareholders via higher dividends and share buybacks. Notably, their expense base is shrinking and they see positive momentum in many parts of their businesses. That should improve their positive operating leverage going forward. They commentary during this earnings season confirms our view that the fundamentals of the economy are sound.
- **Energy** stocks got hurt when oil prices cratered at the beginning of October 2018 from near $75 per barrel for WTI to around $45 by December 31st and Brent fell from about $85 per barrel to nearly $50 by December 28, both down around 40% in 3 months. Why? We believe Trump 'browbeat' the Saudis into pumping more oil into the market with the quid pro quo that he would increase sanctions on Iranian oil, preventing output. However, Trump provided enough waivers to buyers of Iranian oil that the markets ended in oversupply in the short term. This added to global growth scares but is entirely uncorrelated in our view to any growth concerns. The oversupply will be temporary in our opinion. OPEC has agreed to cut production by a substantial 1.2 million barrels per day and we have seen the market recognize this with WTI jumping up to $52 and Brent up to $61 by January 16, 2019. We evaluated every energy name in the portfolio, talked with management of our holdings and their competitors and customers in Oslo, Houston and Brazil. All of them indicated that business was looking good if not better in 2019 than 2018, which is completely not reflected in stock prices. With global crude demand growth in 2019 of ~1.2-1.4 mb/d as estimated by most analysts, The OPEC+ agreement sharply reduced the likelihood of an oversupplied market in 1H19. We expect supply and demand to be broadly in equilibrium over the year, an improvement over 2018. The waivers granted to eight countries (China, India, Greece, Italy, Taiwan, Japan, Turkey and South Korea) are not perpetual and are scheduled to expire by early May 2019. Supply from US shale is strong currently but in the medium to long run these assets are short life assets and require continuous investments to sustain and will likely face diminishing returns in the next few years. In our research and discussions with company management, we believe energy services in the offshore space are on a gradual upswing with better utilization and more contracting. These improvements once again are not reflecting in their share prices which have gone down instead of up.
- As for Canada, the announcement of a mandatory curtailment of crude oil and bitumen in the province of Alberta arrived on December 3rd. Since then, the reaction of the Western Canadian Select (WCS) crude oil benchmark has been spectacular. Western Canadian Select has gone from well under $20 to about $43 at the time of writing. We believe recently announced Alberta oil cuts have significantly de-risked the Canadian oil/gas space.
    - The government believes that Alberta is producing 190,000 bbl/day more than it can export (pipeline/rail); the initial cut is 325,000 bbl/day to achieve a goal of normalizing tank inventories in the province (~35mm barrels in storage);

- Mandatory curtailments for the industry are to be 8.7% (in January) at an operator level for oil and bitumen production output above 10 mbbl/d (excluding condensate)

- **Fixed Income Team Outlook:** Market sensitivity to higher US interest rates, and more generally monetary policy tightening, showed through strongly in the fourth quarter of 2018. The Federal Reserve's tightening path continued through the fourth quarter as the policy rate was increased a ninth time since late 2015, to 2.50%. Chairman Powell's slight increase in hawkishness as Q4 began, when combined with the slowing global growth projections, expectations of slowing growth in US corporate profits, and the by-then significant declines in many emerging market equities and bonds, caused a sharp revaluation of US equities and high yield debt.

- For the US economy, while there are no immediate signs of economic recession to begin in 2019, some areas of the domestic economy have begun to feel pressure from the higher interest rates and yields ushered in by the Federal Reserve policy hikes over the past two years. For example, as mortgage rates moved higher through the middle of 2018, applications for mortgages fell as affordability became more challenging for a greater number of households.

- Even though some leading indicators of growth, in-particular some of the well-observed sentiment surveys, have recently come off their highs, labor indicators for the US economy are expected to remain supportive of growth in 2019. Chiefly, low unemployment and higher wages should keep consumer sentiment somewhat buoyant in the face of the fractured US political environment, and uncertainty emanating from the US-Chine trade war. So, the underlying support that drives consumption, which the most significant component of US GDP, should have growth somewhere in the 2% range for 2019.

- The market volatility of Q4 caught the attention of the Fed. As 2019 began, the Fed signaled that it will pause additional rate hikes, effectively removing the hawkish bias embraced just three months ago. Future rate movements are now dependent on emerging data evidence as to inflation trends and labor market conditions. Thanks in part to the recent drop in many commodity prices, headline inflation rates are likely to be quite subdued until much later this year, when base effects may kick in to boost price indices. The bond market, which has generally lagged the Fed's dot plot on pricing in future rate hikes, began 2019 with no rate hikes priced-in. In serves to keep-in-mind that the Fed intends to keep reducing its balance sheet throughout 2019 by allowing $50 billion of maturing bonds to roll-off. This is effectively a form of policy tightening, just as the purchase of these bonds was a form of easing after the financial crisis.

- The Bank of Canada appears likely to follow or lag the Fed on potential monetary policy hikes this year. In general, the Bank of Canada faces a more rate-sensitive economy, given the greater amounts of household leverage in Canada as compared to the US.

- Corporate credit spreads widened swiftly in Q4 as the risk-off tone was exacerbated in the low liquidity days typical around year-ends. Valuations remain reasonable for this stage of the credit cycle, which may be prolonged by the Fed pausing its rate hikes for a while. Corporate fundamentals have only weakened modestly, and do not appear threatening, given continued growth in the US. Any truce in the trade war and a complacent Fed will likely ensure that profitability remains high and debts manageable. Nevertheless, we will be approaching this stage of the credit cycle with a degree of cautious optimism, and an expectation that additional market volatility will be a part of the valuation picture we need to discount.

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Fund and Benchmark Performance as at: December 31, 2018	1 year	3 years	5 years	10 years
Mackenzie Cundill Canadian Balanced Fund Series F	-8.9%	2.8%	1.4%	7.2%
Blended Index (62.5% S&P/TSX Composite Total Return Index and 37.5% FTSE TMX Canada Universe Bond Index)	-5.0	4.7%	4.0%	6.7%

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