Quarterly commentary

International Core Equity

2017 fourth quarter

Market review

Global equity investors enjoyed a strong finish to a strong year in the fourth quarter of 2017. Even more remarkable than the strength of the market's advance was the absence of volatility. Indeed, 2017 marked the first year on record in which the S&P 500 didn't experience a single monthly decline, finishing with a gross total return of 21.8%. More remarkably, the U.S. market was a relative laggard on the global stage. Most international markets fared even better, especially the emerging markets, fueled by synchronized global growth and a weaker U.S. dollar.

A multitude of themes bolstered the market advance, most notably strong corporate earnings, which surprised to the upside on balance. Market sentiment also enjoyed a further boost during the fourth quarter, thanks to the unexpectedly swift passage of the U.S. tax reform bill featuring substantial reductions in headline corporate tax rates. Both the quarter and the full year demonstrated a strong, pro-cyclical, "risk on" bias. Investor sentiment seemed particularly impressed by top-line growth improvement during the latest earnings reporting season, which saw aggregate earnings growth 6% and 8% for Europe and Japan, respectively. From a sector perspective, the strength was cyclical in nature led by technology and commodity-linked industries, while lower volatility defensive sectors lagged.

Emerging markets especially thrived in the quarter with the MSCI Emerging Markets Index posting a total return of 7.5% and concluded 2017 with an impressive yearly return of 37.8%. International markets posted a 4.3% return for the quarter, finishing with a 25.6% year to date total return.

While returns were robust and broad-based, the disparity by investment style was striking. On average, growth oriented benchmarks outpaced their value counterparts by 2% in the fourth quarter and over 10% for the full year, for the MSCI World Index. The differential was even more gaping in emerging markets, with growth ahead of value by nearly 19% for the year. Perhaps unsurprisingly, low volatility and high dividend benchmarks also lagged the conventional indexes by 4% to 6% for the year.

Improving economic conditions in international markets contributed to a weaker U.S. dollar, helping spur positive fund flows abroad, with a notable tilt toward cyclical sector and emerging markets. From a sector perspective, technology and consumer-oriented companies topped the league tables as investors remained willing to pay up for growth amid low volatility and stubbornly low bond yields. Basic materials companies also performed well for the year, underpinned by improving industrial metals prices, reflecting tightening supply and positive manufacturing and trade data out of China.

The U.S. dollar depreciated against most currency baskets in the quarter closing out the year meaningfully lower, most notably finishing 14% lower relative to euro and faltering negotiations on

NAFTA weighed on the Mexican peso and Canadian dollar.

In what has been a significant reversal since June of 2017, oil prices have roared higher with both West Texas Intermediate (WTI) and Brent closing out the quarter with an advancement of 16% giving the physical commodities a yearly gain after much volatility in the first half of the year. The Organization of the Petroleum Exporting Countries (OPEC) and non-OPEC members agreeing to extend production cuts through December 2018 while disruptions in Iran and Libya as well as the surfacing of a more balanced market, contributed to the gains.

Central banks moved further away from ultra-loosed monetary levels led by the Federal Reserve (Fed). The Fed approved the reversal of its historical stimulus measures while the European Central Bank (ECB) also announced the cutting of its massive bond-buying program. The Bank of England hiked its rate by 25 basis points (bps) while in Japan, Prime Minister Shinzo Abe and his coalition partners were in favor following a strong showing in snap election results while the likelihood of a softer Brexit as the UK leaves the European Union (EU), has risen.

Despite the more “hawkish” movements, global yields were largely mixed in the quarter with many remaining almost unchanged for the year. The lack of inflation coming through maintained its grasp on yields keeping them at depressed levels.

The MSCI Emerging Market Index was up 7.5% for the quarter. Japan rallied 8.6% and the MSCI Europe Index was up 2.26%.

Strategy review

The portfolio underperformed the index for the quarter.

Top contributors

Relative to the benchmark, stock selection in France contributed to outperformance, driven by an underweight position in Sanofi, which we do not own. Sanofi is a global and diversified healthcare company based in France. The company focuses on the field of healthcare with five growth platforms: diabetes solutions, human vaccines, innovative drugs, consumer health care, and emerging markets. The company has a portfolio of prescription drugs, vaccines, generics, and consumer health care products. Earnings visibility remains limited as diabetes is under pressure, and new competition is on the way. Pipeline progress continues at Sanofi, but we continue to find more attractive opportunities elsewhere.

Stock selection in Canada contributed positively to outperformance, driven by an overweight position in Dollarama Inc., Canada’s largest dollar store with almost 1,000 stores across the country. They have five times the stores of their nearest competitor. Their multi-price strategy and has just started to offer products in the $3.50 and $4.00 price range. During the month, the company reported earnings per share (EPS) of $1.16 vs. $1.04 consensus while EBITDA beat by 10%. Dollarama opened 17 stores in the quarter which is ahead of what is needed to meet the full year guidance.

Stock selection in the consumer discretionary sector contributed to performance, led by an overweight position in Kering SA. Among others, they own the Gucci brand, which has experienced a significant turnaround since mid-2016 with successful collections. Not only is the company benefitting from improved demand from the Chinese consumer, but also from other geographies which is resulting in product driven, market share gains

Relative to the benchmark, stock selection in the utilities sector contributed to outperformance, led by an underweight position in Centrica plc, which we do not own. Centrica is a vertically integrated UK utility. Centrica has significant presence in UK downstream through its British Gas brand. British Gas supplies electricity and gas to retail and business customers throughout the UK. During the period, the company guided down amid an unprecedented time for the energy sector in the UK with intense public and political debate over rising bills. Centrica is somewhat protected by the 5% yield, but it is clear that the company continues to face considerable headwinds. Therefore, we do not hold the stock in the portfolio.

Stock selection in the information technology sector contributed positively to performance, driven by an overweight position in Rohm Co., Ltd. Rohm manufactures custom linear integrated circuits and semiconductors. Product mix is 47% Integrated Circuit, 36% Discrete and 17% Modules/Other. Geographic mix is 28% Japan, 72% International. The company has made a concerted effort to shift sales mix toward more auto and industrial applications, which in 2014 comprised 38% of sales mix but should improve to 43% by the end of 2017 and steadily move higher into 2018. Given a high degree of overseas sales, the company is one of the bigger beneficiaries within Japan tech of a weakening yen.

Top detractors

Stock selection in the industrials sector detracted from performance, led by an overweight position in Vestas Wind Systems. Vestas is a Danish manufacturer of wind turbines. It is

Past performance is not a reliable indicator of future performance.

the global leader with a market share of over 16%. Vestas has a particularly strong competitive position with onshore turbines for developed markets, but also has a JV with Mitsubishi Heavy Industries for offshore turbines. The high-margin services business accounts for around 20% of sales. The company reported a 4% miss in sales and 14% miss in EBIT, however orders were 7% ahead of consensus and 23% year-over-year. The main drivers of pricing pressure are the shift to auctions for wind capacity and competitors pricing aggressively, which will be a drag on margins going forward. We no longer hold a position in Vestas.

Stock selection in Denmark detracted from performance, led by an overweight position in Genmab. Genmab is a Danish antibody company. Genmab's leading product is Daratumumab (HuMax-CD38), approved in 2015 and now marketed as Darzalex for multiple myeloma (MM). The drug is partnered with JNJ/Janssen and is rapidly changing the treatment paradigm for MM. During the period, the company announced soft 2018 guidance implying 40-50% increase in the 2018 cost base, suggesting a 12% cut to operating profit. However, upside surprise potential from blockbuster antibody Darzalex remains intact. We continue to hold the stock in the portfolio.

Stock selection in Japan detracted from performance, led by an overweight position in Furukawa Electric Co., Ltd. The company engages in the business development of transmission infrastructure and functional materials businesses. During the period, operating profit came in line with consensus, but management revised down 2H outlook for the communications solutions segment, which includes optical fiber. On the other hand, the outlook for electronics/automotive was revised up. The downward revision is a short-term negative as optical fiber S/D remains tight and Furukawa is expanding its capacity by two times. We continue to hold the stock in the portfolio.

Stock selection in Ireland detracted from performance, led by an overweight position in the globally diversified building materials company CRH. They manufacture cement, aggregates, and asphalt as well as distribute building materials. CRH's revenue and EBITDA breakdown is ~45% N. America, 35% W. Europe, 10% E. Europe, and 10% emerging markets. The company should benefit from an improving construction outlook in North America and an associated pickup in cement pricing and building products demand. Concerns regarding raw material costs increasing has put pressure on the stock during the period, however we remain positive on the company's fundamental changes. We continue to hold the stock in the portfolio.

Stock selection in the healthcare sector detracted from performance, led by an overweight position Evotec AG, German listed outsourced drug discovery company. Growth in research and development (R&D) outsourcing by biopharmaceutical clients, and the accretive acquisitions of Cyprotex in Dec 2016 and Aptuit in Sep 2017 should drive above-market revenue and EBITDA growth for the next 5+ years. During the period, the company reported earnings for the third quarter which exceeded consensus expectations. We continue to hold the stock in the portfolio.

Outlook & strategy

With improving economic data in most regions of the world, the backdrop for earnings from the cyclical sectors of the market remains good. Industrials, technology, and financials continue to see earnings forecasts move higher as growth prospects improve in the United States, Europe, and Asia. Energy and materials are also seeing earnings forecasts revised higher, however, commodity prices in many cases have begun to weaken (crude oil, natural gas, coking coal) resulting in lower share prices for companies.

Valuations and earnings trends for financials in Russia, Brazil, and some markets in Asia look attractive. In addition, cash flows at technology and consumer companies in North Asia and India are still underestimated by the consensus and we continue to find opportunities in these regions.

As we expected, Brexit related earnings forecasts are beginning to normalize. Sharp cuts following the Brexit referendum are giving way to earnings upgrades for many domestic UK companies as there is a growing realization it will not be the disaster it was originally forecast to be. We see opportunities in these companies along with some of the multi-nationals that will additionally benefit from any weakness in the British pound.

Regardless of the region, sector, or general market conditions, our bottom-up focus on sustainable earnings trends and valuations relative to expectations remains a constant across the portfolio, and helps rise above the fray of short-term "risk on/risk off" tendencies of many investors during bouts of volatility. As always, our analysts' search for underappreciated fundamental change at attractive valuations continues and, despite the macro noise, is highlighting profitable investment opportunities across sectors and regions.

The financial market outlook is based on current market conditions. There is no assurance that such events or projections will occur and actual conditions may be significantly different than that shown here. The potential for profit is accompanied by the possibility of loss.

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