Quarterly commentary

International Core Equity

2018 first quarter

Market review

The first quarter of 2018 provided fodder for bulls and bears alike. Most major equity market indices finished slightly in the red for the period, but with plenty of twists and disparity along the way.

Investor enthusiasm was on full display across much of the globe during January. Early February then brought an eye-opening, self-feeding uptick in volatility, revealing vulnerabilities of leveraged VIX trading and risk-hedging strategies in a swift technical correction in equity markets. Reassuringly, credit markets were largely unfazed, and corporate earnings delivered strongly, restoring some stability and confidence to markets, until March brought tough talk (and tweets) on tariffs, trade, immigration, and even the U.S. postal service. The latest privacy breach “mea culpa” by Facebook, and two recent autonomous vehicle fatalities further added to investor anxiety to end the quarter on a decidedly sour note.

On balance, the drawdowns to markets were modest, but many individual stocks saw sharp swings, particularly in the commodity-linked and technology sectors. Nonetheless, the final tallies for the quarter retained a pro-cyclical tilt, certainly atypical for a “down” market. Technology and consumer discretionary shares topped the quarterly league tables, while conventional defensive shares, particularly the dividend paying variety, lagged in sympathy with (slightly) higher interest rates. Similarly, emerging markets outperformed developed peers, and small-caps outpaced their larger brethren in most regions.

While the S&P 500 shed 1.20% in price to post a total return of -0.80% for the quarter, many European markets fared worse in local currency terms, offset by weakness in the U.S. dollar, leaving the MSCI Europe index with a small fractional loss. The strength of the Japanese yen, more than offset share price declines to finish slightly in positive territory. Emerging markets were a mixed bag, but relative strength in Latin America, China, and Taiwan contributed to a positive showing on balance. The combined MSCI All Country World Index finished with a -0.80% gross total return, effectively in-line with the U.S. market.

Strategy review

The portfolio underperformed the index for the quarter.

Top contributors

Stock selection in Australia contributed positively to outperformance, driven by an overweight position in Qantas Airways Limited. Qantas is an Australian airline and is the market leader in the domestic market, where it is essentially a duopoly with Virgin. Qantas also has a low-cost carrier (Jetstar) and the very successful Qantas Loyalty scheme. The fundamentals of Qantas's business are improving both on the Domestic side, where the competitive environment remains more disciplined and a healthier mining and resources segment is supporting volumes and on the International side, where capacity growth has moderated from the very high levels of previous years and pricing has improved.

Stock selection in the industrials sector contributed positively to outperformance, driven by an overweight position in Ryanair Holdings Plc. Ryanair is a European low-cost airline with 15.00% market share of intra-European air passengers. The company is the highest quality low cost operator with a significantly lower cost base than peers, partly because they have emphasized use of secondary airports where operating costs are less and turnarounds are shorter – only about 30.00 to 35.00% of capacity is in primary airports. Ryanair will continue to gain market share in the European low-cost segment and continue to aggressively expand capacity with a combination of new routes and more frequent flights.

Stock selection in Austria contributed to performance, led by an overweight position in Erste Group Bank, a retail and corporate bank providing a broad range of services in its core markets of Austria (headquarters), Czech Republic, Slovakia, Romania - its four largest markets - as well as Hungary, Croatia, and Bulgaria. The bank derives 66.00% of revenue from net interest income and most of the remainder from fee income. Economic improvement in Central and Eastern Europe (CEE) (2.00% to 5.00% real growth depending on the country) is driving an acceleration in loan growth and higher interest rates with net interest margins improving.

Stock selection in Germany contributed to outperformance, led by an overweight position in Hannover Ruck SE (Hannover Re). The company engages in the provision of reinsurance activities. It operates through the property and casualty reinsurance, and life and health reinsurance business segments. Hannover Re is the first insurer in the European insurance universe to receive approval from the regulator on its internal Solvency 2 model. During the period, the group reported a +12.70% rise in volumes and a +1.40% increase in pricing for its January 2018 renewals.

Stock selection in the United Kingdom contributed positively to performance, driven by an underweight position in British American Tobacco (BAT) plc. British American Tobacco is the second largest international cigarette company globally with 23.00% share (ex China). Relative to other tobacco companies, BAT has the most diversified geographic exposure with 65.00% of sales in emerging markets and just 24.00% of sales in Western Europe. BAT finished the year with 2.90% organic sales growth versus consensus estimates of +3.40%. We continue to prefer opportunities in this space elsewhere.

Top detractors

Stock selection in Japan detracted from performance, led by an overweight position in Fujitsu Limited, Japan's largest information technology (IT) services company. Their three business segments are technology solutions, ubiquitous product solutions, and device solutions. The company reported disappointing results and low-quality maintenance of guidance. The combination of which negatively impacted our thesis, and therefore we no longer hold the stock in the portfolio.

Stock selection in Canada detracted from performance, led by an overweight position in Brookfield Asset Management (BAM). Brookfield is a global alternative asset manager, operating in four key segments: renewable power, property, infrastructure, private equity, and asset management. It operates and manages hydroelectric power generating facilities, as well as a range of wind farms and commercial real estate. Much of the infrastructure universe struggled amidst a broader sector sell-off, however the fundamentals have not changed even though sentiment is clearly week. BAM's business model remains intact, providing ongoing fundamental changes, including sourcing capital, deploying globally into real assets, enhancing cash flows, and earning general partner fees.

Stock selection in the consumer staples sector detracted from performance, led by an overweight position in Alimentation Couche-Tard Inc. A strong operator with upside from achieved synergies and a solid balance sheet, Couche-Tard is a leading global convenience store operator with a network of nearly 15,000 stores, 10,000 of which are located in North America and Europe. During

Past performance is not a reliable indicator of future performance.

the period, the company reported weaker than expected earning and earnings before interest, tax, depreciation, and amortization (EBITDA) results of $0.54 (+1% year-over-year (y/y)) and US$720 million (+11% y/y) due to fuel margins on rising commodity prices. However, our thesis remains intact with management's ability to identify and integrate attractive acquisitions, a broader fresh food offering in-store, transferring best practices across the network of stores, and market share gains.

Stock selection in the Netherlands detracted from performance, led by an overweight position in ING Groep. ING is a retail and wholesale bank based in the Netherlands, with roots as a universal bank in the Benelux region. The company reported strong revenue, however operating costs were 6.00% ahead of consensus. The quality of the result was good with key revenue drivers next interest income (NII) and fees both 3.00% ahead of consensus. We continue to hold the stock in the portfolio.

Stock selection in Switzerland detracted from performance, led by an overweight position in Lonza Group. Based in Switzerland, Lonza Group is one of the world's leading custom contract manufacturers of biotech drugs, as well as a leading provider of chemical ingredients for antimicrobial, agrochemical, sanitation, nutrition, and personal care products. The company has underperformed after seeing negative earnings revisions following weaker management guidance. However, we continue to hold the stock as core earnings per share (EPS) growth remains attractive due to management's ability to achieve goals early and raise the performance bar longer-term regularly.

Outlook & strategy

Fourth quarter 2017 earnings, announced during 1Q 2018 showed relatively positive earnings trends in place in most sectors and regions. We continue to find interesting opportunities in information technology, financials, industrials, and energy. In general, new investments in these sectors have been funded by reducing exposures in consumer staples, healthcare, and telecommunications services.

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 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.

Sustained efforts by China to reduce polluting activities has resulted in tighter supply/demand balance in several areas in commodities. Steel, aluminum and higher quality iron ore have seen higher than expected prices drive free cash flow higher for many companies involved in these commodities. We have investments in several opportunities benefiting from this sustainable trend. We do not expect U.S. tariffs to change this trend.

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

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 United Kingdom companies. We see opportunities in these companies along with some of the multi-nationals that will additionally benefit from the weaker 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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