Market Commentary
Third Quarter 2018

BLACK CREEK
INVESTMENT MANAGEMENT INC.

Black Creek Global Balanced Fund

We are not having a good year relative to the markets, and a good friend and colleague reminds us that when you are underperforming there is a fine line between reasons and excuses from the client's point of view. In order to avoid semantics, we can point you to our commentaries from 2011 and 2014 and suggest that it's just "one of those times" in the market where we look very different from the indexes. We also find that people don't want to hear your views and opinions when you are underperforming but listen closely when you are doing well. At the risk of not having an audience now, here's our view.

What's doing well this year in equities? Information technology, consumer discretionary, health care (including pot stocks) and U.S. small-cap stocks (up until recently) are outperforming. By region, the U.S. market is doing well relative to the rest of the world. Investors are seeking both safety in the U.S. market and growth, multiples are expanding for stocks with growth potential, and current earnings don't matter much. Areas of the markets that are not doing so well this year are non-U.S. stocks, especially emerging market stocks (trade war concerns), and cyclical stocks in general. It's now late cycle for markets, and "sure growth" sells for a premium. The U.S. market valuation has a high premium to the rest of the world.

There are signs of a slowdown in global growth, the inflation rate is increasing in many countries, and the cyclical risks for China are becoming more evident. As we have discussed in previous commentaries, we are at an inflection point in monetary policies and long bond rates are moving up. The point at which equities will be impacted is unclear, but they will be impacted.

There continues to be more nationalization of privately owned groups by state-owned enterprises (SOEs) in China. These SOEs have good access to credit from state banks, whereas private companies increasingly do not. The SOEs are also guided by politics and national interests, investing heavily in sectors that are deemed to be vital to China's interests and without much regard for global capacity or returns on capital. This situation is at the heart of the trade war being waged by the U.S., but it is difficult to see how the situation will be resolved.

We would be remiss if we did not comment on a bubble taking place in our backyard. It's difficult to have a view of the Canadian market when you can't see through the thick cloud of pot stocks. Together, Canopy Growth, Aurora Cannabis, Aphria, Vivo Cannabis, Tilray, FSD Pharma and Namaste Technologies have a total market capitalization of US$36.9 billion and total sales of US$180 million. That's a ratio of 205 times. And of course, there's an ETF and equity index for pot stocks as well. It would be interesting to see how much marijuana a tulip bulb from Holland in the early 1600s would buy today. Buyer beware.

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Fund performance has lagged for the quarter and year-to-date. As always, we are focused on investing in winning businesses that are gaining market share and where our view of the business is different from other investors. Sometimes, this means our portfolio will act differently from our peers and indexes, but we do believe that valuations matter and we strive to add value for our clients over the long term. Fund performance over the long term has been attractive.

Equities

Equity performance in the fund has lagged in 2018. There are several dynamics at work that have led to this performance. Global equity markets in general have narrowed, with a smaller number of stocks driving overall market gains. We also have certain holdings that are not achieving our view of the true value of their underlying businesses. While some of these holdings are underperforming due to low investor expectations, we continue to revisit our investment theses to confirm validity.
For the quarter, top contributors to performance included FTI Consulting, Dialog Semiconductor, SES, Oracle and DistributionNOW. The top detractors were Varex Imaging, Aryzta, HeidelbergCement, Basilea Pharmaceutica and Nielsen Holdings. For the year to date, top contributors included FTI Consulting, SES, DistributionNOW, Ericsson and Nutrien. Notable detractors were Aryzta, L Brands, Ontex Group, HeidelbergCement and DIA.

New holdings in the quarter were BAE Systems and Carnival, while Accor, Aryzta and L Brands were sold.

BAE Systems is a global defence, aerospace and security company that is headquartered in the U.K. The company is among the largest defence contractors in the world. Beyond its well-established positions in air, land and maritime defence technology, the firm has a growing position in cyber security.

Carnival is the world's largest cruise company with a fleet of 102 ships visiting more than 700 ports around the world. Carnival's 10 leading brands offer a wide range of vacation experiences from value to luxury. This holding is well known to Black Creek. We have owned it previously, sold our holding due to valuation and now brought it back given a more attractive valuation opportunity.
Accor, a leading multinational hotel group, was sold for valuation reasons post a period of strong market performance. A portion of our thesis – Accor transitioning to an asset light platform – has also come to fruition with the sale of a majority interest in its owned assets to investors. We also have concerns around recent merger and acquisition activity spreading management's focus too thin.

Aryzta, the global leader in par-baked technology, has been a notable detractor this year and we often add to companies on weakness. However, we have decided we will not go beyond 10% of a company's free float and therefore could not take a meaningful position within our global portfolios. We believe the company's turnaround plan will take a significant amount of time (U-shaped vs. Vshaped) to execute but we will monitor their success. In the interim, we are opting for more attractive alternatives in our global opportunity set.

L Brands is an international company that sells lingerie, personal care and beauty products, apparel and accessories. Our outlook on L Brands changed after it provided a sales update in July 2018 on its Victoria's Secret brand. The company announced that its semi-annual sale was disappointing and it had to extend the sales promotion period and reduce prices further to clear inventory, as customers were becoming accustomed to promotions. This indicates that consumers' perception of the brand has changed. We decided to exit the position post this announcement but will continue to monitor the company for an improvement in both sales and profitability.

Fixed Income

Within fixed-income markets, it was more of the same this quarter with high-yield credit outperforming investment-grade credit, both of which outperformed government bonds. Within the high-yield market, bonds with the riskiest credit ratings (CCC rated) have continued to outperform bonds with higher credit ratings (B, BB rated). In a similar manner to equities, emerging market bonds have been the laggards in 2018.

From a performance perspective, the fixed-income portion of the fund was essentially flat for the quarter and up low single-digits year-to-date. Over both the quarter and year-to-date, the fund benefitted from holding high-yield corporate bonds and not holding European or Japanese government bonds.

During the quarter, bonds rated non-investment grade (high yield) outperformed those rated investment grade as economic activity has remained robust and high demand from yield-seeking investors has outstripped supply. In fact, U.S. high-yield bond spreads (difference between corporate bond yields and Treasury bond yields of the same maturity) have narrowed to levels not seen since 2007. However, it is important to note that outright yields in the sector remain above cycle lows. U.S. investment-grade credit spreads also declined (became more expensive) in the quarter but are not back to the lows recorded earlier this year. Within the portfolio, we continue to prefer earning higher yields by allocating to bonds issued by companies rated below investment grade, although we do remain cautious of the long-term returns in the lowest end of the credit spectrum and instead prefer bonds issued by companies with a more robust credit profile. The high-yield corporate bond allocation in the portfolio experienced positive returns over the quarter and year-to-date, delivering a significant portion of the value add for both periods as well.

In September, the U.S. Federal Reserve (Fed) increased interest rates another 0.25 percentage points to 2.25 percent on the back of continued strong economic data, its eighth such increase since it began in 2015. Given the strong economic backdrop, rate hikes are expected to continue into next year. Expectations of higher inflation and a rising rate environment have led to higher bond yields in the U.S. across the yield curve. However, short-term interest rates have risen faster than long-term rates, leading to a flatter yield curve. U.S. Treasuries look more attractive to investors because of higher yields, but mainly in the short end of the curve. As U.S. interest rates have risen, the government bond portion of the portfolio faced a negative return over the quarter.

Internationally, the fund does not hold any European or Japanese government debt given their near-zero yields provide little future return potential. We remain cautious on emerging market fixed income generally, which lagged this year given concerns around slower growth in China, tightening U.S. monetary policy and concerns about the potential impact of a deeper trade war between China and the U.S. There could certainly be future opportunities in emerging market credit as bond valuations become more attractive.

Within the context of the current interest rate environment, we remain focused on purchasing fixed-income securities issued by winning businesses with resilient cash flows, access to liquidity, and strong management teams. We will continue to be selective as opportunities present themselves amid increased volatility in the markets.

The key to successful, long-term investing is patience. We thank you for your patience and continued support.

Class F Returns (in %) as at September 30, 2018	**Year-to-date**	**1 year**	**3 year**	**5 year**	**10 year**
Black Creek Global Balanced Fund	-1.3	0.7	5.7	7.8	9.4

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