# Market Commentary
# Second Quarter 2018

CI Investments

## CI Canadian Small/Mid Cap Fund

The portfolio of the fund is divided among three sub-advisors: Picton Mahoney Asset Management, Manulife Asset Management, and QV Investors Inc. The comments below pertain to each sub-advisor's portion of the portfolio.

***Picton Mahoney Asset Management***

Markets have been generally "on the mend" following the volatility spike that marked the first quarter. After the experience of 2017, where there was very low implied (and realized) volatility in the marketplace, we remind investors that as we move into the late-cycle phase, volatility tends to be a feature, coupled with more violent sector rotation and a general need to be nimble and manage risks.

The inflation impulse has resurged, to a degree, providing the commodity-heavy S&P/TSX Small Cap Index solid performance during the period in review. That said, underlying economic growth globally seems to be exhibiting some meaningful divergences, as a robust U.S. economy keeps the U.S. Federal Reserve Board (Fed) stalwart on a path of higher interest rates. The Bank of Canada failed to hike rates at its most recent meeting, yet curiously sent a hawkish signal for the next meeting, despite continued frustration in NAFTA negotiations, now coupled with the imposing of U.S. tariffs. The sabre rattling of trade disputes is but one more risk testing the mettle of active managers and passive equity holders alike.

Security selection in consumer discretionary and health care added value relative to the benchmark, as well as underweight positioning in utilities and materials. Securities with top contribution to relative returns were Great Canadian Gaming and Kirkland Lake Gold. Detracting from performance was an underweight positioning in energy and selection effects in materials. The largest individual detractors reflect the energy underweight as the fund did not participate in the performance of index-weighted names like MEG Energy and Tamarack Valley Energy.

As noted above, the intent of the Fed to continue hiking interest rates is causing discomfort for many economies whose growth is far less robust. These growth divergences also hinge on a strengthening U.S. dollar, which poses its own risks, notably for emerging markets and economies sensitive to consumption of goods priced in U.S. dollars (i.e., commodity-centric economies), which could pose an acute risk for smaller Canadian issuers.



Overall, the rise of populism (in its various permutations globally) brings with it risks of heightened protectionism and a likely shift away from globalization, which has been a powerful underpinning to global growth for many years. As such, we continue to focus on portfolio construction, whereby risk management and active share (i.e., differentiating from the benchmark) should add value. We are of the view that the Canadian economy may not benefit as greatly in this late-cycle phase as it has in the past, and that the next global recession (when it comes) will likely expose some structural challenges in our economy.

***Manulife Asset Management***

In the second quarter, the Canadian small-capitalization equity market recovered as a result of compelling stock valuations, higher corporate earnings expectations, and a strong increase in oil prices. Although trade talks between the U.S. and Canada intensified and both countries announced plans to add tariffs to select products, equity markets advanced as a result of strong underlying company fundamentals. Energy was the top-performing sector in the S&P/TSX Small Cap Index, as West Texas Intermediate oil prices increased by 14% following robust global demand and tightening global supply. As a result of inflationary pressures and the potential for higher interest rates, the bond-like proxies of the market, including the utilities and telecommunication services sectors, were the worst-performing sectors in the market.

Over the quarter, underweight allocations in the health care and telecommunication services sectors contributed to the strategy's performance. Individual contributors to performance were within the resources industry, including a gold company and an energy sector company.

Overweight allocation to the utilities sector and underweight allocation to the energy sector detracted from the strategy's performance. The top individual detractors from performance were the portfolio's zero-weight allocation in an energy sector company and an overweight allocation in a base metals company.

Equity markets react to expectations, which can come in the form of everything from company-specific earnings growth to global macroeconomic conditions. For much of 2018, the global macroeconomic backdrop has been mired by trade rhetoric between the U.S. and its main trading partners, including China, Europe, and Canada. Overall market sentiment has been negatively impacted by the belief that these trade talks pose a significant risk to the economy. Whether these concerns will be realized in the form of slower growth is not yet known, but the expectations alone have caused the markets to trade in a range-bound pattern this year. As a result of this uncertainty, we do not see a catalyst for significant equity upside in the short term, nor do we expect notable downside either, owing to compelling valuations and strong company fundamentals.

Despite the macroeconomic environment, we believe fundamentals within the Canadian equity market are positive, with reasonable valuations and expectations for continued growth in earnings.

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We are optimistic on the outlook for late-cycle cyclicals and favour industrials sector stocks, energy producers, and information technology sector companies. Our overall view is cautiously optimistic. The strategy's cyclical positioning may shift to become more defensive if warranted, but we do not believe the equity markets are at that inflection point.

At the end of the quarter, the portfolio held sector overweight positions in industrials, information technology, and utilities, and sector underweight positions in materials (resulting from an underweight allocation to gold stocks), health care, and real estate.

***QV Investors Inc.***

Benchmark returns were led by the energy sector, which advanced nearly 15% during the period. Despite providing sound absolute returns, the strategy's energy holdings underperformed the benchmark sector, as energy service stocks have not benefited as much as producers. Many of these producers are low quality. Declines in the fund's financials holdings also contributed to underperformance on a relative basis. The strongest individual contributors to fund performance over the quarter were Macy's, Williams-Sonoma, and AltaGas. The largest negative contributors were New York Community Bancorp, Alleghany, and PrairieSky Royalty.

At quarter-end, Canadian holdings represented 69.0% of the portfolio and American holdings represented 23.6%. Cash comprised 7.4% of the portfolio. The fund consists of 34 investments, of which 23 are Canadian domiciled and 11 are U.S. based.

No new positions were initiated during the quarter.

The fund exited its position in Domtar, a producer of paper products. To offset declines in its legacy paper business, Domtar has been pursuing other fibre-based offerings in personal care. Despite these initiatives, organic growth has been slow. As higher global pulp prices benefited the shares over the quarter, the position was sold in favour of better risk/reward opportunities.

The fund also exited Ritchie Bros. Auctioneers, as the shares traded well above long-term average valuations. The sale improves the valuation and balance sheet characteristics of the portfolio.

Stocks exhibiting growth and momentum are outperforming meaningfully, often to the detriment of value investments. Corporate activity such as mergers and acquisitions continue to be a growth driver for many companies. This is classic late-cycle activity.

In an environment where lower-quality companies generating minimal revenues and earnings continue to outperform, we remain focused on businesses that are able to operate profitably throughout the cycle. The strategy continues to have stronger long-term profitability and lower

valuation risk than the benchmark, while maintaining reasonable financial leverage. This is important as companies with heightened leverage in a maturing cycle will often pose outsized risks when the economic environment changes.

The strategy provides a dividend yield of over 3%. In addition to providing a competitive return relative to fixed-income securities, this should provide downside support in a more difficult market. We believe continued growth in dividends supported by earnings growth will also help to offset potential negative implications from inflationary pressures and higher interest rates.

| Class F Returns (in %) as at June 30, 2018 | Year-to-date | 1 year | 3 year | 5 year | 10 year |
|---|---|---|---|---|---|
| CI Canadian Small/Mid Cap Fund | 2.2 | 8.7 | 6.3 | 9.1 | 6.6 |