Sun Life MFS International Opportunities Fund

FUND COMMENTARY | Q4 2021

Opinions and commentary provided by MFS Investment Management Canada Limited.

Market review

In some ways, the year ended the way it started: with a stark reminder the pandemic is not over. The Omicron variant has renewed levels of fear and uncertainty with unanswered questions about its severity and resistance to vaccines. Politicians are once again grappling with tough decisions whether to repeat lockdowns and social-distancing measures at some economic cost or remain open and live with the adverse health consequences of the virus.

Looking back at 2021 and the fourth quarter, financial markets were largely unperturbed by the massive surge in global COVID-19 infections. On a sector basis, in the fourth quarter, utilities, materials and consumer staples outperformed, while energy, communication services and real estate underperformed. During November, the Omicron variant was discovered, and the Fed took a more hawkish stance, both of which influenced growth investors to become more risk-averse.

While macro and headline drivers continued to impact the international equity markets, in 2021 corporate profits continued to recover at an impressive, historical rate. Gains in equity markets this year were attributed entirely to strong earnings growth, as the valuation (forward P/E ratio) of the growth index declined in 2021. In most markets, besides China, earnings came in better than expected. This dynamic contrasts with last year's market environment when strong multiple expansion, not earnings growth, drove the growth index higher.

Prospects for tighter financial conditions led to pullbacks in unprofitable tech stocks, many of which had been trading at elevated valuations. This group of long duration, highly valued/unprofitable stocks initially pulled back late in the first quarter, driven by the rise in real yields which occurred at that time. The group was pressured again in the fourth quarter as expectations for monetary policy shifted meaningfully from continued accommodation to a sooner-than-anticipated tightening cycle, in response to inflation coming in higher and potentially more sustained than prior expectations. The Fund's underweight to these more speculative companies contributed to relative performance. This market dynamic was in contrast to a 'growth at any price' or momentum style that proved to be a significant headwind for the Fund in 2020.

Another important dynamic in international equity markets in 2021 was weakness in emerging markets, in particular China. China was hit by softer economic data, regulatory clampdowns and the near collapse of Evergrande, the world's most indebted property company. Though the MSCI World Index (which consists of developed markets only) posted a gain of 20.8% in 2021, the MSCI Emerging Markets Index returned -3.4%. The Fund's underweight to emerging markets contributed to relative performance in 2021.

Policymakers added almost $9 trillion in policy stimulus this year to the $23 trillion announced in 2020, which has been an overarching driver of market returns and in no small part contributed to the current state of inflation. Inflation is close to hitting 40-year highs in the US (+6.8% in November 2021) and 30-year highs in Europe (Eurozone +4.9% in November 2021). The big debate in 2021 was whether inflation was transitory, as most central bankers initially believed, structural or part regulatory. Also debated was the likely policy response or mistep. Interestingly, the Federal Reserve removed the term 'transitory' from its most recent policy statement, doubled the pace of QE tapering to $30 billion and announced it will be buying $60 billion of bonds each month beginning January 2022. While the Fed hasn't started yet, we're ten months into an emerging markets led global tightening cycle. The Bank of England, as well as many other central banks, has already started raising interest rates as transitory appears more persistent.

Portfolio positioning

The Fund's focus on high-quality, above-average growth companies continues to drive portfolio positioning. The team seeks to invest in companies that can compound above-average growth at high returns. These companies typically are market leaders with durable business models that have experienced management teams and competitive advantages that should allow them to maintain higher returns and earnings growth than their peers. We seek to apply our buy criteria in a disciplined manner, irrespective of economic conditions. Combined with our long-term investment horizon, this typically results in very modest shifts in portfolio positioning from quarter to quarter.

The portfolio was overweight Consumer Staples and Materials. The team has long favored consumer staples companies that have strong brands, sustainable, above-average growth, and geographically diverse revenue sources. Should inflation persist, many of the Fund's consumer staples companies have pricing power. In particular, the Fund has an overweight to the alcoholic spirits industry which has generally been able to pass on price increases.

Within materials, two of the portfolio's largest active positions are industrial gas producers Linde and Air Liquide. These high-quality cyclicals generate returns above their cost of capital and generate significant free cash flow over a full cycle, driven in part by long-term contracts that have built-in price escalators. The Fund also holds specialty chemical suppliers Symrise and Sika. Lastly, the Fund owns Akzo Nobel, a global manufacturer of coatings and paint products.

As of December 31, 2021, the portfolio was most underweight information technology and communication services. Aside from software, the portfolio has an underweight to many of the industries within the sector such as electronic equipment instruments and components, tech hardware and communications equipment. While the sector offers many businesses with attractive characteristics in terms of growth and returns on capital, the team struggles with current valuations, which is the primary reason for the underweight. More than half of the Fund's sector underweight is in semiconductors, where Taiwan Semiconductor is the only investment. While many semiconductor companies do not look particularly expensive on forward earnings estimates, the team believes this is optically misleading since many of these companies are generating earnings well above normalized levels. On normalized earnings, the team believes many of these stocks look fully priced. The portfolio's next largest underweight is IT services. The Fund recently trimmed its exposure to IT services companies, both due to strong relative performance and due to concerns that this industry may face difficulty offsetting wage inflation pressure due to the tight labor market. The Fund's underweight to communication services is primarily the result of not owning many telecommunications companies that do not meet the teams minimum growth hurdles. Most of the Fund's communication services exposure is in the interactive media and services industry with companies such as Tencent and Naver.

Key transactions

During the fourth quarter, the Fund continued to build or initiate positions in high-quality businesses that the team believed had attractive risk/return profiles while trimming or eliminating companies that became more fully valued or were facing structural headwinds. Key trades during the fourth quarter included:

The team initiated a position in Nitto Denko, a Japanese company that produces display films used in smartphones, tablets and televisions, industrial tapes and transdermal tapes used in health care applications. With new products in display films and life sciences ramping up, the team thinks the quality of the business is gradually changing for the better, and the scope for future growth is likely underestimated for a business that has managed to consistently re-invent itself.

The team added to the Fund's cosmetics exposure through a new position in Korea's Amorepacific, whose core strengths are its unique brands and fast innovation. The company is in the early stages of revitalizing its business through channel restructuring, growing duty free and concentrating on key brands.

The Fund exited its position in Infosys at higher valuation following strong performance. The proceeds were used to fund a new position in Oracle Japan, which has lagged other IT services companies recently and thus trades at a more attractive valuation. The team believes Oracle Japan is well positioned to benefit as Japanese companies accelerate their investment in the cloud.

Market outlook

The macro environment is certainly changing. Following a decade of falling interest rates, we could be approaching a point of 'regime change.' Central bankers have started to reign in stimulus measures by tapering asset purchases and raising interest rates to offset inflationary pressures. This shift in monetary policy has huge implications for all asset classes. Part of the 'buy case' for equities has been predicated on their relative value compared to low-yielding bonds. For a while now, equities have not looked cheap in absolute terms.

Across most sectors, equity valuations look stretched on a variety of measures. Furthermore, risks are abundant, including the potential for continued inflationary pressure, fading stimulus, higher taxes, trade wars, central bank policy mistakes, new Covid variants and geopolitical risks. With company profit margins at all-time highs, it seems right to ask if this is as good as it gets. MFS believes investors should likely prepare for lower returns ahead as it seems unlikely the spectacular returns of the last decade will be repeated.

Longer term, MFS continues to believe that stock selection will be the key component of generating alpha and avoiding significant drawdowns. Historically, the Fund's relative performance has been driven mostly by stock selection. With so much uncertainty in the near term, the team remain focused on doing what they believe they do best: invest with a long-term horizon and use short-term market volatility as an opportunity to add and trim (and start and eliminate) positions. The Fund has a clear strategy of investing in companies with sustainable growth, returns and cash flow generation through the cycle, but with an added focus on downside risk management and assessing risk that others often seem willing to overlook.

Significant impacts on performance

CONTRIBUTORS

+ Linde Plc
  Holdings of industrial gas supplier Linde (United States) aided relative returns. The company's share price advanced due to volume growth across all geographic regions and end markets, combined with broad-based price attainment and continued progress on productivity initiatives

+ Schneider Electric SA
  An overweight position in electrical distribution equipment manufacturer Schneider Electric (France) contributed to relative performance. The stock price advanced as the company reported better-than-expected organic sales growth during the third quarter, driven by strong performance in its energy management segment.

+ Nestle SA
  An overweight position in global food company Nestle (Switzerland) bolstered relative returns. The stock price advanced as the company reported better-than-expected third-quarter financial results, driven by strong organic sales growth, and raised its full-year organic sales growth forecast.

Significant impacts on performance (continued)

DETRACTORS

- **Hitachi Ltd**
  An overweight position in electronics company Hitachi (Japan) hindered relative returns. Although the company reported quarterly revenue results ahead of expectations, the ongoing headwinds from global chip shortages weighed on the stock's performance. Management also reduced its fiscal year operating profit guidance, which further pressured the stock.
- **AIA Group Ltd**
  Overweighting shares of insurance company AIA Group (Hong Kong) weakened relative performance. The share price declined over the reporting period after the company reported in-line third-quarter financial results. A slowdown in insurance sales in China, in addition to COVID-19 disruptions, appeared to have weighed on investor sentiment.
- **Alibaba Group Holding Ltd**
  Holdings of online and mobile commerce company Alibaba Group Holding (China) detracted from relative performance. The stock price declined after the company delivered weaker-than-expected financial results. Core growth in the company's online shopping platform Taobao was softer than already-lowered expectations, due to decreased market share, and losses in its investment areas were materially greater than anticipated.

Fund performance

COMPOUND RETURNS %[1]	SINCE INCEPTION[2]	10 YEAR	5 YEAR	3 YEAR	1 YEAR	Q4
Sun Life MFS International Opportunities Fund - Series A	8.4	10.1	10.9	12.1	7.1	4.2
Sun Life MFS International Opportunities Fund - Series F	9.7	11.3	12.2	13.5	8.3	4.6
MSCI EAFE	8.5	10.4	8.2	10.6	10.3	2.4

[1]Returns for periods longer than one year are annualized. Data as of December 31, 2021.
[2]Partial calendar year. Returns are for the period from the fund's inception date of September 30, 2010 to December 31, 2010.

Effective June 1, 2020, Sun Life MFS International Growth Fund was renamed Sun Life MFS International Opportunities Fund.

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While Series A and Series F securities have the same reference portfolio, any difference in performance between these series is due primarily to differences in management fees and operating fees. The management fee for Series A securities also includes the trailing commission, while Series F securities does not. Series A securities of the fund are available for purchase to all investors, while Series F securities are only available to investors in an eligible fee-based or wrap program with their registered dealer. Investors in Series F securities may pay a separate fee-based account fee that is negotiated with and payable to their registered dealer.

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