Quarterly Portfolio Update

Pioneer Funds – U.S. Fundamental Growth
29 September 2017

EQUITY COMMENTARY

Market Review

U.S. equities posted their eighth consecutive quarter of positive returns, with the S&P 500 returning 4.5%. Growth continued to outperform value as investors rewarded secular growth over cyclical growth. The Russell 1000 Growth Index returned 5.9% vs. 3.1% for the Russell 1000 Value Index. Value, however, outperformed growth in the latter part of the quarter with the Russell 1000 Value Index returning 3.0% in September versus 1.3% for the Russell 1000 Growth Index. This was due to signs that the U.S. economy is strengthening, which is a positive for cyclical companies, many of which are in the value universe.

All sectors in the growth index posted positive results for the quarter, with the exception of the Consumer Staples sector (-3%). Telecommunications (+11%) and Information Technology (+9%) were among the best performing sectors for the quarter.

Portfolio Review

The Portfolio underperformed the 5.90% return for the Russell 1000 Growth Index for the third quarter of 2017.

The Portfolio's underperformance for the quarter was mainly due to three factors. Firstly, it did not own high growth stocks with high valuations such as Facebook, NVIDIA and Netflix. While the fundamentals of these companies remain strong, the stock valuations more than discount these fundamentals and are excessive in our view. Our decision not to own these stocks is consistent with the Portfolio's discipline with respect to limiting risk. Secondly, the Portfolio's defensive positioning in consumer stocks also hurt performance. Consumer stocks have struggled due to sluggish growth, intensified competition in some areas, and a shift in investor sentiment towards cyclical stocks at the expense of defensive stocks. Despite these headwinds, there are consumer stocks with wide moats around their businesses and secular growth prospects (off price apparel continues to increase as a percentage of overall apparel sales, for example) that are selling at attractive valuations. We continue to invest in these stocks and believe the risk/reward is favourable, especially in a market environment where stock valuations overall are high.

A final contributor to the underperformance in the quarter was the Portfolio's Healthcare holdings. Healthcare was the largest overweight versus the Russell 1000 Growth Index in the quarter given our view that demographic trends and continued product innovation are secular tailwinds supporting the sector. Though we are monitoring potential legislative changes to the Healthcare system, we think a significant change in the Healthcare landscape is unlikely given political gridlock in Washington, DC. With markets at all-time highs, we also believe it is particularly important to maintain our defensive positioning and the Healthcare sector, with valuations at reasonable levels, is an attractive place to invest in our opinion.

In terms of individual detractors, Allergan, a specialty pharmaceutical company, declined after transferring its patents on lead dry eye product Restasis to the St. Regis Mohawk tribe to fend off intellectual property challenges. While this novel approach may succeed, it re-focused investor attention on the Restasis patent issues. We have maintained our position in Allergan given its leadership position in aesthetic and dermatology products such as Botox and other categories as well its product pipeline, which should offset lost profit from Restasis when the patents expire. Another detractor in the quarter was leading medical device company Medtronic, which declined due to lower than expected second quarter results related to supply constraints on a sensor used in treating diabetes. We expect the supply issue to be resolved this year. Finally, consumer giant PepsiCo fell due to declining beverage sales in North America. We believe the company's exposure to the growing snack category positions it favourably versus competitors and are monitoring the longer-term beverage trends.

On the positive side, financial processing giant MasterCard rose after reporting strong quarterly results driven by continued solid growth globally with rising penetration of electronic payments. Raytheon, a leading defence company, increased after reporting strong quarterly results and a positive outlook given increased defence spending globally. Finally, PayPal, the leader in online digital payments, climbed after reporting solid quarterly results. We believe Paypal's partnership with MasterCard and Visa, which makes it easy for consumers to fund their PayPal accounts through their credit or debit cards, should drive further growth for PayPal. In addition, PayPal is investing in new technologies such as Venmo, a digital wallet that allow friends to share payments, and Braintree, a payment system that supports businesses such as UBER.

Trading Activity

The Portfolio added two new holdings and also exited two positions in the third quarter. We added Accenture and Charles Schwab. Accenture is a leading provider of management consulting, business process outsourcing and technology services. Accenture's deep experience across many industries and global footprint to serve clients throughout the world provides significant competitive advantages. Accenture generally has long-term client relationships that enable the company to generate stable and predictable financial results as well as high returns on growth capital.[1] Charles Schwab provides a broad range of financial services to individuals, institutions and advisors including asset management, brokerage, and banking businesses. Schwab has significant scale and cost advantages along with a strong brand and loyal customers that provide a wide competitive moat around its business. We believe Schwab has opportunities to drive growth through continued reinvestment in its scalable business model.

We sold both The Walt Disney Company and Nike. We exited our position in long time holding Disney due to secular changes in the media industry that have led to increased fragmentation and competition. The proliferation of online media and decline in viewership of traditional media such as Disney's broadcast and cable TV networks is putting downward pressure on Disney's returns on growth capital. In response to these changes, Disney may increase investments in technology and in media content in order to deliver an "over the top" on-line service that is increasingly popular with consumers. However, the returns on these investments are uncertain given intensified competition. We sold Nike due to increased competitive intensity and slowing growth in the global athletic footwear and apparel market particularly in the United States, which accounts for nearly half of its sales. With increased competition, there is likely to be reduced pricing power and downward pressure on profit margins and returns on growth capital.

Outlook

Though earnings growth has recovered this year in the U.S, and tax cuts and other pro-growth policies may sustain earnings growth through next year, we are cautious in our outlook for equities given high valuations. In addition, there are significant risks to the consensus view that growth will remain strong, including the potential for the Fed to raise interest rates more aggressively if inflation increases, possible negative repercussions from restrictive immigration and trade policies and geopolitical issues.

Consistent with our investment philosophy, the Portfolio remains conservatively positioned. As discussed previously, the Portfolio is overweight Healthcare relative to the benchmark (Russell 1000 Growth) as stocks are attractively valued in our opinion due to lingering concerns about the prospect of healthcare reform, which we do not believe will significantly alter the healthcare landscape if it occurs. The Portfolio has also recently gone to an overweight position in the Financial Services sector by adding to Marsh McLennan, a global leader in risk management that is benefitting from secular growth as companies seek to limit risk.

While growth stocks have performed well this year, much of the performance has come from a small set of highly valued growth stocks that we believe could be vulnerable should the market correct. Volatility has been exceptionally low over the last few months but this may change if geopolitical concerns escalate or inflationary pressure builds, leading to further tightening of monetary policy.

As always, our goal is to aim to generate long-term capital appreciation for our investors and we believe the best way to do that is to limit risk.

[1] Return on growth capital is the return a company generates on investments made to grow, rather than simply maintain, a business.

Important Information

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