EP 123 | Playing the plan: Mawer's Canadian equity portfolio

Andrew Johnson (00:00):

Hi everyone, in this episode we welcome back Mark Rutherford, portfolio manager on our Canadian equity strategy. We kicked things off today talking about the newly proposed tax on share buybacks here in Canada, how the portfolio has performed in 2022, and what changes he's thinking about as we move into 2023.

We also talk through a range of other topics—including energy, real estate, and building resilience through market turmoil. As always, we'd love to hear any feedback from you or questions you may have for future episodes. I hope you enjoy the conversation.

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Andrew Johnson (01:09):

Mark, it's good to see you. Welcome back.

Mark Rutherford (01:11):

Yeah, thanks. It's great to be back and catch up and talk Canadian equity.

Andrew Johnson (01:16):

Exactly. It wasn't that long ago that we had you on the podcast. I think it was about six months ago now, but the markets are moving pretty fast these days, so we thought it would be great to check back in with you to see how things are going.

I'm going to kick things off with a question, Mark, that we've been getting a lot lately on a proposed new tax here in Canada on companies doing share buybacks. So, for everyone unfamiliar with that, this is when a company buys its own stock back from its shareholders. There's several reasons why they may do that, but I've also heard a range of opinions on this tax in particular. Everything from, "It's not really a big issue," to "It's the end of the world," which is probably more of a reflection of me researching this on social media and the influence that that has on gauging this.

So can you cut through the noise for us? What's your view on this and will it have a meaningful impact on either the market and or the portfolio?

Mark Rutherford (02:06):

Yeah, so I think it's a topic we've seen more in the news, seen buyback tax in the U.S. as well as in Canada now. And I think ultimately if we step back and think about what the government may be trying to do, is really, one, there's the story that there's potentially a lot of cash. Companies that have done well through 2021 and even this year, especially oil companies, banks, some of the bigger companies in Canada are doing pretty well and are paying down a lot of debt. But there's also maybe the concern that they're hoarding cash on their balance sheets. And from a government perspective, this may be some marginal decrease in the incentive to return that to shareholders and more of a stick approach—instead of the alternative for companies maybe reinvesting it into opportunities that they see. So ultimately, because it's such a small percentage, I think it's not going to have a material impact, and so far we don't see companies really changing their capital allocation plans because of it.

It may be more of just a way to increase corporate taxes as government budgets are stretched as they bore a lot throughout the last few years. But I think maybe stepping back, one thing to think about more broadly as investors is just, why aren't companies putting that capital to work in the first place?

And I think a lot of these companies that we own throughout the portfolio—if they found good investment opportunities, especially here in Canada, they would love to invest that and earn attractive returns on that capital, but they're just not seeing massive opportunities to do so. So with that excess capital, to be efficient with it and not just have a bunch of capital on the balance sheet that's not being used, they are deciding to return that to shareholders, which we think is a reasonable choice given their alternatives.

But I do think another takeaway for us as investors is being mindful of what government policies are doing around the world, because governments often like to copy one another in terms of public policy. Especially if our neighbours to the south make a change, there may be ramifications here in Canada.

So, it's important to think about and just keep monitoring some of these macro factors as it can have an impact domestically.

Andrew Johnson (04:35):

Thanks for that. That was going to be one of my follow up questions, too. The other follow up question that I had was, are there any particular sectors that are more prone to this tax going forward in your mind?

Mark Rutherford (04:45):

Really, the biggest sectors have been buying back more aggressively probably include financials as well as energy, even materials companies that have done really well. And if you think about the growth opportunities for energy in Western Canada, it's very limited. So the oil sands companies aren't really doing any greenfield expansions of new projects just because really it's so difficult to permit them. And so they're really just focusing on existing assets and continuing to operate those over time. With the banks, Canada's really a mature market, so for a lot of the capital that these banks are generating on a quarterly basis, we see them deploying that either elsewhere, so BMO, TD, they both announced large acquisitions in the U.S., and other banks. The other alternative is return that capital.

Mark Rutherford (05:38):

So, those would be two of the sectors that are probably impacted the most from the buyback tax. But I think as an investor it's probably a better alternative than raising a dividend or income tax. This way, really, you're deferring that capital gains tax if you are a longer term shareholder, versus something like a dividend tax increase where you'd be recognizing it right away as a taxpayer or as an investor in your capital gains. Relative to the alternatives, I think it's not seeing just a massive impact overall.

Andrew Johnson (06:11):

That's good insight. I know it's been a real topical question in the last couple of weeks with it being in the news and I know clients are curious as well, so I'm sure they'll get some comfort from understanding it from your perspective.

I want to move from what may have an impact down the road to what has happened since the last time we spoke. So, how has the portfolio been performing, and more specifically, how have some of the businesses been faring throughout this year? In other words: a recap of high-level performance is helpful in this context, but what are you seeing with the fundamentals of the businesses themselves throughout the turmoil that we've experienced in 2022?

Mark Rutherford (06:49):

It's been quite a bit of volatility throughout the year. Markets were up to start the year, banks were performing strong, financials were strong, materials were strong. As inflation really started to accelerate throughout the year and rates really started to move up faster, sentiment quickly changed. And so that led to pretty big downdraft in the middle part of the year and even going into the third quarter. And so there we saw weakness and financials weakness in companies that were having difficult time passing through inflation. A lot of the consumer discretionary companies were getting hit on concerns that consumers may be stretched and may be pulling back. Real estate, with interest rates going up, has been a pretty big concern as a lot of real estate companies that have longer term leases may not be able to pass on some of their costs quickly. And so there's a margin squeeze there.

In addition, on real estate, it's typically an asset class that uses debt to finance all the assets. And so there's a concern that as the debt rolls over, over time you're going to have higher interest rate expense, lower free cash flow, and valuations may come down significantly in certain asset classes within real estate. And then looking at the last really month or two, seeing maybe some slight positives and some slowing inflation data. And that's really brought back some enthusiasm into the market and really the story or the thinking that the central banks may be a little bit closer to the end of raising interest rates. And people may be shifting [their] thinking how long interest rates stay at this level or thinking that we're a little bit closer to the end of the rate hike cycle.

So we've seen a pretty big rebound in financials, rebound in some of the technology names that were hit pretty hard that were more growth oriented, longer duration names.

Mark Rutherford (08:53):

And so as we wrap that all up, we're close to flat on the year, the down low single digit absolute terms, which is roughly in line with the index this year. Thinking about what are really the strong performers and really the top performers by far have been energy companies. So, that would be Canadian Natural Resources (CNQ), Suncor. They've really benefitted from high prices, and because they're really in manufacturing mode and they're not in growth mode, reinvesting a lot of the capital, and they have such a long-term reserve life on their assets, they're able to really manufacture a lot of cash flow and they haven't seen cost increases like we have in previous cycles. So that's led to much better free cash flow generation. And then they're doing the right thing with that cash flow in terms of paying down debt, returning it to shareholders.

The other area that I'd point out that we've seen quite a bit of strength in, especially on a relative basis, is consumer staples. So, these are some of the really boring (Be Boring. Make Money.TM) companies that we love. So that would be Loblaws, Dollarama. Some of these companies that we think are very prudent and they're just chugging away, executing, able to pass on inflationary pressures and do well regardless of the economic environment. And even some of the steady-Eddie industrials that we own. So CP rail, CN Rail, have performed very well. Finning [International] is doing well, with the businesses really strong in Western Canada, South America and the UK. All those combined really offset some of the weakness in technology, real estate, and even some of the gold material stocks that have been down this year.

Andrew Johnson (10:36):

So overall performing relatively well when you take into the full context of the global stock market. What's some of the reasons why Canada's done well, generally speaking?

Mark Rutherford (10:45):

A big part of that is mix—in terms of what the investible market is in Canada in terms of sectors. So you do have a big proportion of energy be over 10% of the index in Canada, especially once you include all the pipeline companies. Also materials. So, all the copper mining companies, gold companies have rebounded somewhat in the last quarter here, so they're holding in on a year-to-date basis. And then financials would be a very big proportion of the index in Canada. And with higher interest rates, while they've had bit of a headwind in terms of yield curves now inverted—and that's not great for their business as they're often borrowing short and lending longer term—but they have seen a pretty significant net interest margin expansion. And that's really earning more on the deposits then they're paying you and I on our deposits of the bank and they're earning that spread with higher short-term rates. So that's benefitted.

And then they haven't quite seen big loan losses materialize as the unemployment rate has stayed relatively low. So, people continue to pay off their bills. And loan growth actually has remained pretty robust. That's commercial loan growth, even mortgage loan growth, credit card loan growth. As we look across Canada through September, we've seen strong loan growth. So that's offset some of the inflationary pressures within the banks.

So when you combine really financials roughly flat, energy really strong, materials doing okay, that's really offset some of the weakness in smaller sectors like consumer discretionary and technology in Canada.

Andrew Johnson (12:26):

Certainly some strong fundamentals there showing up throughout the year. Obviously still some risks on the horizon. One of the jobs that you have as a portfolio manager is to take all the information that you glean from the holdings—and you just highlighted a few of those areas—and you compare that information to the current makeup of the portfolio as well as that broader opportunity set that you have in the Canadian stock market and you ultimately make judgments around positioning, adding new companies, removing companies from the portfolio.

There's been a few themes that I picked up on during the recent time period. Let's start with energy because you just mentioned it and you talked about it for a few minutes. What have you been doing with some of those energy stocks in the portfolio?

Mark Rutherford (13:05):

Earlier in the year, one of the things that we did, especially post the news with Russia and Ukraine, we saw oil well over $100 a barrel. At that point in time, we did trim back some of our energy exposure. One, just in terms of overall sizing of the portfolio was getting to be a very large weight in absolute terms.

Historically, if we look over time, thinking probabilistically when oil prices are way above what we view as really marginal cost for the industry, that's normally been a temporary phenomenon. Same thing on reverse in 2020 when oil was trading well below, really, our estimate of longer term marginal cost. That also tends to be a temporary phenomenon as the market globally for energy does a pretty good job at adjusting very quickly and responding to prices. So that was one of the changes that we made.

We did add some back later in the year as prices came down and we thought there's a little more balance and we still think there's pretty good return potential in those names. But keep in mind, one of the two risk parameters that we have from a structural point of view at Mawer is our 6% position limit on any individual security and then a 20% limit on any particular business model. And so, looking at that and just overall weightings, we don't want to make some big call one way or another that we think energy is going to continue to be $100 a barrel or bet on that scenario. So, as some of those companies like CNQ and Suncor have drifted way above a neutral weight in the portfolio, just brought them back a little bit to be more in line.

But good news is for now that even with the $75-$80 oil environment, these companies are still very attractive in our view longer term in terms of the cashflow that they can generate. So we don't need to see them grow much if anything at all to generate attractive returns. So that's really been our thinking. And then continuing just to review other names within energy that we think could make sense and waiting for price points that we'd like to see for the return potential to be there.

Andrew Johnson (15:17):

Commodity prices (generally speaking) but in particular, oil prices, have a history of being volatile and we've certainly seen that throughout this year. Sustained balanced certainly makes sense from that standpoint. Another theme that came up was real estate, you mentioned that earlier as well, and some of those related businesses, there's been some changes happening there in the portfolio as well. Can you recap that for us?

Mark Rutherford (15:38):

Really to recap our holdings, there's a lot of real estate in Canada, especially when you think about banks have a lot of exposure to real estate. Insurance companies have real estate in their investment portfolios. And then there's individual REITs that we can own as well. So two of the names in the portfolio are Choice Properties and Granite REIT. And Choice is really a Loblaw-anchored retail REIT and has really great assets across Canada, a long development pipeline and they're continuing to develop that and actually build quite a substantial industrial footprint in Ontario that we think is attractive longer term. And then Granite is a more pure-play industrial REIT with assets in Canada, the U.S., as well as Europe. And I think that the team there has done a very good job remaining prudent with low debt on the balance sheet. That's one area where we've lightened up on this year.

And I think really the core thinking there is higher rates, and really we focus on the spread in terms of what they can earn on their assets versus how much their debt service costs are and see that narrowing with this higher interest rate environment. The offset to that is that cash flows from some of the leases are inflation protected. Choice has some inflation protection in their leases and so does Granite [REIT], even on some of the assets in Europe that are tenanted by Agna International, the automaker. So, [we] think they're relatively protected, but just given valuation issues with interest rates going up, we've just lightened up there over time, but think they'll remain well positioned, particularly Granite. Lots of demand for industrial real estate over the long term with shift to e-commerce and the Ontario market in particular remains very undersupplied.

So continuing to own them, but just at lower weights relative to last year.

Andrew Johnson (17:35):

You just touched on this, but both Choice and Granite are spinoffs from other stocks, historically Magna as well as Loblaws respectively. And I assume one of the parts of the thesis is to determine how diversified they get away from their original business lines when they were a part of those businesses. Can you speak to that? Are they doing a good job of moving forward in their diversification?

Mark Rutherford (18:00):

So that's been a really big theme for Granite. Granite came out of Magna International and a big chunk of their revenue really came from leases that were purely associated with Magna. And so, as they've developed new assets and acquired new assets over time, they're doing a really good job steadily paying that down and reducing the tenant risk profile. I think for Choice it's a little bit different, where people view Loblaw as a very stable tenant over time that's actually still growing locations throughout Canada. Choice does not have really the same, I think, desire from the investor standpoint or from our standpoint to reduce the Loblaw exposure. I think those are great core assets to have.

Mark Rutherford (18:46):

I mean, if you have a Loblaw on a property, that drives a lot of other tenants to that same property. And then the relationship with Loblaw helps as they can often get first dibs on when Loblaw's going to develop a new store location and maybe they can go out and buy the land first before they'll work together to try to optimize portfolio. Over time, I think that's one of the things that we've liked and that from Granite's side, they'll continue to reduce. They have some big leases maturing on Magna in the next year or two here. So as those leases get renewed, we think there's decent chance that they could either keep those, or if they wanted and there's attractive buyers that you can sell them [to] at pretty attractive prices. So yeah, I think overall they've done a good job just reducing that risk over time.

Andrew Johnson (19:33):

Another theme that has come up in a lot of our discussions on the podcast so far this year and even the later part of last year is to ensure that there's resilience in the portfolio moving forward. And you could argue that this is always on our minds when we're putting together portfolios, but what adjustments have you and the team been making more recently that fit into that bucket of resilience?

Mark Rutherford (19:53):

Yeah, so I think it's something that we really focus on on a bottoms-up basis. And so Paul [Moroz] talks about building portfolios "brick by brick," and that's really what we try to do and look at every company on an individual basis and then stack them up and look at aggregate exposures and make sure we're not making a huge bet in any particular area of the market. [We] made a number of changes this year, particularly bringing down some of the longer duration stocks and that's led to exits of a few portfolio companies. So, Topicus would be one of them. That was a spin out of Constellation Software. [We] continue to like the business model, it generates a lot of free cash flow [and] I think they have quite a long runway to deploy that, but the valuation and return potential just got too stretched in our view. So I would love to own it again if we get the chance.

Shopify was another one that we've talked about earlier in the year that [we] decided to exit as a combination of factors led to higher competition, seeing potentially slowing growth, some deteriorating margins relative to historical levels. And then again, just trying to reduce that valuation risk in the portfolio. Another stock that we ended up exiting from was Boyd Group. Boyd is a collision body shop repair company, assets throughout Canada and the U.S. [They've] done a really good job managing the business historically and consolidating the industry. [We] think there's still quite a long runway for them to consolidate. But a few things were concerning us earlier this year, primarily being their ability to pass on costs as they're seeing margin pressure as insurance carriers are just very slow to give them rate increases on labour and in parts.

We don't know how long this inflationary environment's going to last, so if you continue on through 2023 and 2024 and they have a consistent lag effect with getting higher price points, that was a concern that it could be a drag on margins. And then also just with the valuation and how much we're paying for growth, that led us to exit that company from the portfolio.

So overall I'd say a lot of bringing down valuation risk where we thought things were stretched and playing a little bit more in the middle where I think we're getting reasonable returns at higher quality business models.

Mark Rutherford (22:30):

So, a company that we've added to recently would be CGI Group. They've done a good job steadily growing the business, announcing tuck-in acquisitions. And CGI—Andrew, you recall, but really two parts of their business—they have a consulting business and a systems integration business where they're helping companies and governments implement new software systems.

They also have, really, a business-process-outsourcing business. And that could be processing transactions for banks or governments. And they've really continued to chug along. Margins have remained healthy and they're actually seeing improvements in their billings and bookings throughout the year. So we thought there we're getting much more attractive return potential in a business that can continue to grow steadily over time.

Andrew Johnson (23:12):

This is a really great reminder, especially around the valuation risk, that sometimes we will exit businesses based solely on where they fall on the valuation or at least our estimate of fair value. And that doesn't mean that we won't own those businesses again in the future, barring nothing has changed fundamentally with the business.

Mark Rutherford (23:31):

Yeah, exactly. And sometimes, yeah, there's places that you can hide out where we don't think we're taking much valuation risk. Oftentimes, if the company doesn't have to be heroic to get an attractive return, then we'll rather be there than another spot in portfolio.

Andrew Johnson (23:47):

In other news relating to some of our holdings in particular, there are of course changes that happen within management teams on a fairly regular basis. This year, however, we've seen a few of the more prominent positions with some of our larger holdings and just some of the more prominent businesses here in Canada have some changes happen at the C-suite level.

So, CN Rail had a new CEO start earlier this year. We had Suncor CEO stepping down in the summer, Bank of Nova Scotia announcing a CEO change. All different circumstances around each of these. And I'm not looking to get any thoughts on these individuals themselves, but I'm more interested in understanding what the team does from a process standpoint when changes like these happen or you anticipate these changes happening. Can you take us through that and some of the discussion that happens on the team?

Mark Rutherford (24:39):

Sure, yeah, happy to. That's something that goes on regularly through the course of business, and so [we] try to think a lot about what this could mean for a company and our investment, ultimately.

Mark Rutherford (24:59):

I think one of the big things that we do if a CEO change or management team changes get announced, [is] we really end up talking to a lot of people and doing scuttlebutt and trying to get insights into where that person may differ from the prior person. And so, that's often, one, talking to the company. So, getting the story from current management on the team, [we] like to ask questions about what they see as a different person's strengths and weaknesses, strategic changes that they think that they could make or more likely to make. Talking to the board is another process item that we like to do regularly. Typically we do this on an annual basis where giving feedback to board members and hearing their thoughts on how the business is evolving.

So that's one great area that we like to do. Talking to people that have worked with the executive in the past is another great way that we can get insight into the person. And so most of the people that are becoming CEO or CFO of a larger enterprise have quite a track record that you can dig into. It's quite easy for us to look into where they worked, find people that a lot of the companies. Canada's a small country at the end of the day. And so yeah, we can quickly get into what the person's track record was, what are they like culturally, what are their values? And you're not going to get the exact answer, but it gives us a little bit of an indication of good-ish/bad-ish, are they [maybe more the] aggressive type? Are they more sales oriented? Every executive has their own strengths and weaknesses.

And so for us it's really identifying those and then thinking about does that line up with what the company needs. Through all those items, talking to sell-side even—a lot of these are contacts at sell-side institutions, so banks, sales contacts. They have great insight. They talk to investors from around the country, around the world, who have different stories and interactions with these people over time.

So we compile all that together and I think get a reasonable picture. And then I think the big step after that, we have our original assessment of what we think this means for the business. It's really looking for evidence and looking for the results that follow on. And oftentimes it doesn't show up immediately, but it may take several quarters or even several years to really impact a business.

Think about a company like CP Rail. You could argue that the culture there is really a function of the culture that Hunter Harrison brought over and that was almost 10 years ago. So, that's one where the culture lives on and it started a very long time ago and continues to drive the strong culture today with the current management team. So looking for that evidence is really the final step to corroborate what we're hearing.

Andrew Johnson (27:44):

Yeah, that was going to be my follow-up Mark—was it fair to characterize many of these changes as, from your standpoint, very much a-wait-and-see type of thing? Unless there was something that you saw with the previous management team, and I'm guessing if we're getting more of the same, then maybe that's a negative card that comes up for you?

Mark Rutherford (28:03):

For the most part, it's a wait and see. I think there's some exceptions to that. Historically, when Jim [Hall] and Vijay [Viswanathan] originally purchased CP Rail in the portfolio, that was when Hunter Harrison and the team came over to run it. And that was given long experience with Hunter and his track record running CN.

So, there are some exceptions where you give the person the benefit of a doubt right away, but for the most part, it's "okay, this is the story," and wait to see some further evidence for that story to match up with some facts.

Andrew Johnson (28:38):

All right, Mark, before we let you go, I'd like to get your thoughts on, obviously we just talked a lot about 2022. What's on your mind and the team's mind as you look forward to the end of this year and into 2023?

Mark Rutherford (28:52):

I think inflation still, from a macro perspective. I'll start there. I think inflation's still a really big focus area for us as it impacts companies as well as for the markets and its impact on just central bank policy. I think companies that can do well, regardless of whether we see inflation slowing quite a bit next year, or whether it stays elevated.

We see examples in the portfolio where companies are just giving unions right now price increases or wage rates are still coming up in the latter half of this year, which will still flow through to next year. So that is a concern, I think, on the cost side. And so it's thinking about companies where they can pass that through and we're paying reasonable prices for that and balancing the weights in the portfolio.

I think one of the big things, too, that we're thinking about is just the delayed impact of interest rates going up. As we saw central banks cut interest rates in 2020 aggressively to really, zero, [we're] still feeling the lag effect of that into 2022. And on a go-forward basis, we'll likely start to feel a lot more of the effect of higher interest rates this year into next year. And so [that] could be just more pressure on companies in terms of if they want to do new projects, they're going to have higher return targets. So something needs to adjust for them to get their targeted return.

So that would be a big theme for us—just thinking about companies where, okay, how much does the company rely on external financing? Can they grow organically regardless of market environment, or is it M&A funded growth? Thinking about companies that can grow organically is a nice thing.

On the banking side, one of the things we'll be watching is just loan loss provisions. Unemployment rate would have a big impact there. Also, just being open to different scenarios. We still own some real estate in the portfolio through Brookfield, through Granite and Choice that we talked about. And if rates do fall back down, we see inflation cooling off some of those higher growth names or names that used debt on the balance sheet, like the real estate companies, [which] could be set up really well to do well in 2023. So those are just some of the things that we're thinking about, staying resilient, and trying to stay balanced so we can adjust as the information comes out.

Andrew Johnson (31:17):

Well, best of luck navigating all of that and thanks Mark for all of that insight as well as all of the other things that we discussed today. I know I always come away with a better understanding of the portfolio after talking with you, and I'm sure our listeners do as well. That's why I'm sure that we'll have you on again at some point in the future. Until then, thanks and take care.

Mark Rutherford (31:36):

Thanks Andrew.