the art of boring™

EP17 | Playing the plan: Mawer's global balanced portfolio

00:24	Cam Webster	On this episode, we speak with Mawer CIO Paul Moroz about the Global Balanced strategy. We talk about building the portfolio brick by brick, our overall risk management approach, and highlight a few holdings, including discovering why a specialty chemical company's active ingredient in wrinkle cream is a competitive advantage.
01:02	Cam Webster	Today with us is Paul Moroz. He's our Chief Investment Officer and co-manager of Global Equity. We wanted to have him on the podcast today to speak about something that doesn't get as much airplay around Mawer these days, and maybe it should: our Global Balanced Portfolio. Paul, welcome to the podcast.
01:23	Paul Moroz	Thanks for having me once again!
01:26	Cam Webster	Paul, before we get into specifics of the portfolio itself, why don't we give a little background on why we actually offer a Global Balanced Portfolio to clients.
01:36	Paul Moroz	I think we have to go back a little bit further—even to when we started Global Equity. And the reason I say that, is the equity piece. A big part of Global Equity (when that came about in 2009), was we had all the building blocks to change the way we thought about constructing portfolios. The idea was that the world's really globalized. In the past ... "the old world" where the different stock markets and currencies were very much independent and you could allocate capital between countries—that sort of broke down and the world started being a lot more correlated.
02:19	Paul Moroz	So in 2009, we started our Global Equity Fund and Global Equity mandates that work together to put a portfolio that was stitched "brick by brick" so to speak; individually selected stocks. The purpose of that was to really try to build the most resilient portfolio possible so that different

themes and risks that work its way through the portfolio—if you ended up in that scenario—the portfolio was going to be okay. It would bounce back. That set up Global Equity; that same concept of the resilience. Not only diversified, but having the securities work together so that they're resilient—they can bounce back from tough scenarios.

03:08	**Cam Webster**	What I'm hearing in that is maybe a definition of resilience: there's a bounce back effect.
03:13	**Paul Moroz**	There's a bounce back. You get into the glue of some scenario that you can't necessarily predict. It may or may not happen. But when you do get into that scenario, the portfolio can bounce back. It continues to grow. What you don't want is that permanent impairment of capital. It's so important for clients to understand that we're working on. That's the scenario we don't want. We want things to be resilient. Of course we'll go through tough markets and tough economic times...but we need it to bounce back.
03:41	**Cam Webster**	You mentioned the start date of Global Equity is 2009. Has it had a test of resiliency?
03:46	**Paul Moroz**	Well, we've been in a very similar market regime since the start date. The short answer is, it hasn't been tested in that regard. Of course, all the other funds that we offer (and mandates)...you can go back and see how the securities performed, so we have a good sense of how we can do in a downturn. That's where I spend a lot of my time focused on with Global Equity and ultimately, Global Balanced—[for when] we will get tested eventually and making sure that it can bounce back.
04:20	**Cam Webster**	You said "brick by brick," but how do you go about building this Global Balanced Portfolio? Is there a bit of top down to it? What level of judgment is involved around the macro as opposed to the micro?
04:31	**Paul Moroz**	Well, remember, there are two components to Global Balanced: we have the equity sleeve, which typically represents about 60% of the portfolio, and then we have the fixed income sleeve, which is fixed income and cash component, which is, in total, 40%. Included in that is an allocation of

global bonds.
The thinking—and this is really important for people to understand—that fixed income sleeve? That's about protecting capital, preserving capital. It acts as a fire extinguisher if there's a fire.
Our game isn't to pick up pennies on the train track and trying to reach for yield and reach for credit with our fixed income portfolios.

05:15 **Paul Moroz**

We want that to be really safe if there is an event, a particular scenario that's not so hot. That's the first basic when you think about the construction of Global Balanced.
Along the lines of different scenarios ... what happened if we're in a scenario of a banking crisis? How do Canadian bonds and the Canadian dollar work [then]? That's one of the reasons we have a sleeve of global bonds in there—to help protect in that particular environment.
Now within the equity sleeve, the question is: how is that put together?

05:56 **Paul Moroz**

We use a similar approach to our other funds, only there's an expanded universe. We look at the quality of the securities across our platform and then we look at the return potential. We map that out on something we've called "The Matrix"—I think we may have spoken about this before on the podcast.
I think the overlay, and what we spend a lot of time thinking about, is the risk management. How do the individual securities fit together in terms of currency exposure? How do they fit together in terms of the different company business models and the different country risks? Even where the securities are at within their economic cycle.

06:37 **Paul Moroz**

It's those aspects that we want to not only diversify—call them "The Four C's"—but then think about what offsets do we have in the portfolio? And, if we end up in these different scenarios—interest rates rise, higher interest rates—is the portfolio still going to be diversified? What sort of offsets do we have? What securities are not performing well? And map out those scenarios.

07:09 **Cam Webster**

Your role as CIO: I would characterize it maybe as "Ultimate Risk Manager," or "Risk Awareness Officer." Let's get into talking about the current investment environment and what risks are out there. Do you use some kind of framework to rank risks?

07:27	**Paul Moroz**	For looking at risk across our organization at Mawer, there's four building blocks. The first is actually at a cultural level. I think listeners might be surprised how much focus we put on that—actually making sure that our team gets along well, is a high-functioning team, shares different ideas, and is candid with each other. Because if that candour and communication breaks down, we're not going to get those opposing ideas and debate out in the open. There's the risk that we miss something if we don't have enough humility.
08:02	**Cam Webster**	Can you give us an example?
08:03	**Paul Moroz**	Well, sure. Just recently our summer student Michael Song came over to my desk and he was debating the merits of a Brazilian company. A company that I had just met with when I was on my trip in Brazil. We were debating the merits of that. Now he had some—
08:21	**Cam Webster**	Wait a minute. It wasn't the company that chased you out of the store, was it?
08:23	**Paul Moroz**	No. No, it wasn't that company. It was a different company in Brazil. It was actually a travel agent company. He had a different perspective or view on how their model business model worked—a different interpretation. That's really important for him being a summer student to be able to just walk over to the CIO's desk, in our open office environment, and share those opposing thoughts—because he was right! There is a different interpretation of—in this case, a very specific aspect—the business model that served as a risk. My first point on how we think about risk: if our culture moves or adjusts such that we can't have those conversations...that's a big risk across our organization.
09:08	**Paul Moroz**	But let's move up the next level of risk management—how we select the securities. Are we following our investment process? I think that most people are aware we're interested in excellent companies that are run by able and honest managers and we don't pay too much.

What you might not recognize as a listener is how much we focus on quality assurance. I'm not sure if this has been released on your podcast...We have something called "the bathroom list."

09:42	**Cam Webster**	Oh my god. What possibly could be the bathroom list [laugh] related to investing? How do we do that?
09:47	**Paul Moroz**	Well, if you walk into a Starbucks and use the washroom, what you might see on the wall is a bathroom list. A list of when the toilets have been cleaned, when the sinks have been cleaned, what time they were cleaned, and who did the cleaning. We have a very similar quality control checklist for research. When's the last time that we've updated the model? When's the last time that we've interviewed the management team? Rebuilt the report? Talked to independent sources to understand the investment thesis? We really try to run our research department at Mawer like a factory to make the highest quality investment decisions for our clients.
10:27	**Paul Moroz**	That's just an example of a process for how we manage that element of risk. If we move one step up further, we have portfolio construction: are we diversified? This is important for the Global Balanced Fund because in any fund across Mawer, the maximum weight in a portfolio is 6%.
10:51	**Cam Webster**	Weight of what?
10:53	**Paul Moroz**	The weight of a security.
10:55	**Cam Webster**	Single holding.
10:56	**Paul Moroz**	A single holding.
10:57	**Cam Webster**	Gotcha, thanks.
10:58	**Paul Moroz**	If we own (and we do) Google Alphabet in the portfolio, the maximum exposure we could have is 6%. This ensures diversification. If you think that the equity exposure is 60% of that, then it's really 3.6% maximum exposure in the Global Balanced.

There's that element of looking across by stock, by industry, country exposure. Then we get to the final stage: looking at systemic risks. Is the portfolio going to be resilient in different scenarios? And we're seeing different scenarios—we're seeing scenarios right now where it could be the case that the Federal Reserve continues to increase interest rates and the U.S. dollar is very strong.

11:42 **Paul Moroz**

What happens then? What happens if there's a recession? How is the portfolio structured to deal with a recession? Are we going to be able to bounce back from that? What's the impact on emerging markets? If the U.S. dollar is very strong, do you see a continued deterioration in emerging market currencies such as Turkish Lira, such as the Brazilian Real, so on, so forth? How does the portfolio stand up in that environment?

The approach to risk management is not that we're trying to predict the future—I'm not getting on T.V. and calling where the price of gold is going to be. But what I do want to have happen is if we do land in that scenario, I want to be in a position where the portfolio can bounce back, and as we're sliding into it, we can kind of...lean away. We can roll off the risk as the cards get turned up.

12:31 **Cam Webster**

So at that top level right now, Paul—are there any scenarios that would have higher probability in your mind?

12:38 **Paul Moroz**

Well, I think the big one is, what's going on with the U.S. dollar and U.S. interest rates and the impact on emerging markets? You have an economic environment that might parallel what was going on in maybe 1997-1998, where liquidity is moving across the system. I think that's probably the biggest systemic risk we have for investors and across the economies—the move on U.S. dollar. That's certainly the indicator of risk—what's the U.S. dollar doing versus other emerging market economies—that's capturing a lot of risk.

We're shooting this podcast on a day where we just went risk-off. The Turkish Lira was down. The Brazilian Real down 2%. South African Rand down 2%. That is absolutely top of mind.

13:26 **Cam Webster**

The great fear out there right now is some kind of contagion—emerging markets takes all markets down.

13:32 **Paul Moroz**

Sometimes it shows up in the banking system because the banking system—if we take Turkey as an example—maybe we had companies that were borrowing U.S. dollars. And of course, as the Lira depreciates, then they have more debt and a higher interest rate, and so on. Sometimes it's more on the sovereign side. So in the case of Turkey, Turkey also has a fair amount of external foreign debt the government has borrowed. That becomes an issue.

Often when things break like this, you can have a recession. If we take Chile in 1982, the issue of what happened there is copper prices declined. You had a global recession because Volcker at the time was raising interest rates. You had a very similar phenomenon. That spread into a banking crisis. You had a number of bankruptcies that occurred in the severe recession. The transfer mechanism that you're speaking of can go a number of different routes. I think the issue is that this is difficult, if not impossible to predict. I actually don't know whether this is going to unfold into something like Chile in 1982 or Mexico in 1994. What we are trying to do is balance the odds in the Global Balanced Portfolio such that, well, if we do go further down this path, we're still going to be okay. If we don't [go down that path], well, we can still make money in emerging markets.

14:52 **Paul Moroz**

Emerging markets, by the way, (still from a perhaps long-term opportunity point of view) represents some of the best value. Keeping in mind, as Keynes would say, "in the long run, we're all dead." You have to put things in perspective.

Let's go back to ... diversification. When we talk about emerging markets exposure, we're looking at 8% exposure to emerging markets in the Global Equity Portfolio. Within Global Balanced, that's 60% of that. That's a manageable amount. Of course, there is building the portfolio brick by brick. There's elements of it that provide relief.

15:38 **Cam Webster**

From a risk management point of view, within the Global Equity sleeve, what have you been doing? What's been going on? Give us a primary exit that you feel is important to the portfolio?

15:49 **Paul Moroz**

A lot of the moves that we make are done probabilistically. As we see pieces of information come up, we shift. We adjust. As the Federal Reserve has begun to increase interest rates in the United States, recognizing where we are in the cycle, we began to decrease our position in BlackRock. BlackRock is an excellent company, very much a tax on the investment business across the United States, gaining share in passive investments. We've done fantastic on the investments; it's time to start to shift. And we have done that. We've decreased that position over time. Say, just for a timeframe sake, over the last three to six months.

16:33 **Paul Moroz**

And we've recycled capital back into companies that might benefit from interest rates going up. We've increased our position in AIA, which is largely a life insurance company based out of Hong Kong. They have reinvestment risk in their policies. So, as interest rates go up—assuming that it's a more gradual fashion that the market doesn't go discontinuous—they're going to benefit from reinvesting capital back into those higher rates, and they'll make money as you compare that to their claims, which stay static.

17:08 **Cam Webster**

Another really topical bucket of stocks are the FAANG stocks. How much exposure is there within the portfolio to those? ... Maybe on a day like today, where it's risk-off, those are the first ones to get sold. How are we building resiliency through exposure or not in specific names like that?

17:28 **Paul Moroz**

We do have a little bit of exposure to the FAANGs: we own Google (that's one of our larger positions). Google has a pretty strong network effect. What we also like about the company—what people, perhaps, underappreciate about Google—is the culture. They've had a lot of success developing different business options and those options might well be undervalued by the market longer-term. I mean they've had some fantastic success with YouTube and Android. A number of the things they're working on now could be quite big, so we still have some exposure there.

18:04 **Paul Moroz**

Where we've trimmed is Tencent, which is a large internet technology company in China, which has some fantastic platforms. I mean, Tencent for a lot of people is the internet in China.

18:20 **Cam Webster**

Yeah, absolutely.

18:21	Paul Moroz	But they make most of their money through the monetization of video games. So, it's still a fairly narrow business model. And they're making a lot of investments that are much longer-term in nature. The payoff could be 10 years, 20 years, 30 years down the road. What we look at in a rising interest rate environment—the so-called duration of an investment like that—is much longer. You don't get your money back for a very long period of time and thus, the investment is much more sensitive to a rise in interest rates. That was one of the reasons that we actually exited our position in Tencent. And the stock's actually a fair bit lower than when we exited the position.
19:03	Cam Webster	Even though we're long-term investors, it sounds like with Tencent there's a threshold of, "if I have to wait 20 years for the cash flow payoff on Tencent, then I'm willing to put capital elsewhere."
19:15	Paul Moroz	Sure! It was the going through the discounted cash flow model with Tencent and looking at the scenarios. I was in a meeting for—it must have been three hours—with our analyst in Singapore, working through the different scenarios and saying, "okay. Well, if they monetize WePay, what's that worth? When can they gain that cash? If they can hold onto 30% of the advertising market in China and it grows something similar to what we've experienced in a more developed country, how much money do they make? When's the timing of that cash flow? What's the probability of success? When we discount that back, is it worth holding the security?" At the time we thought, "You know what? We're just going to shift. We have other options."
19:59	Cam Webster	You started the conversation and you keyed in on "resiliency." Maybe we can talk about three of the top 10 names in the Global Equity Portfolio, and you give us the reason behind each: that's a "resilient" holding.
20:12	Paul Moroz	Where do you want to start? Maybe Wolters Kluwer?
20:15	Cam Webster	Sure. Let's go with Wolters Kluwer.
20:18	Paul Moroz	This is a terribly boring business. I don't think most people will recognize it. I mean they're involved...

20:23	Cam Webster	But it's The Art of Boring!
20:25	Paul Moroz	It is the Art of Boring! So, this is a publisher, really, turned data and information company. They're involved in the terribly attractive businesses of accounting, tax, and healthcare. They provide information. They used to—and still do—provide reference books for legal practitioners. One of the boring things they do is they provide health information on websites for doctors. Our president actually was out at his doctor getting checked-up and he's snooping over to this computer and is quizzing the doctor on what sort of program...and sure enough, it's Wolters Kluwer! Imagine that. Your doctor doesn't shut that off.
21:10	Paul Moroz	Your doctor doesn't say, "Well, we're in a recession now. I'm not going to subscribe to this information and we're just going to guess what you have." You know? This is a non-discretionary spend. We're trying to find investments, make investments like that—where the price we're for paying for it still makes sense, where it's pretty boring and will be pretty resilient. There's Wolters Kluwer.
21:32	Cam Webster	Okay...maybe a smaller cap name globally, but it is in the top 10 of the Global Equity Portfolio—Croda International. Why is that resilient? What do they do? What might be the risks?
21:44	Paul Moroz	Croda, a UK-based specialty chemicals company. They manufacture chemicals, have a direct sales force, and work with the customers to innovate. A lot of that business is into a consumer segment. They'll sell things such as an active ingredient that goes into anti-wrinkle cream.
22:06	Cam Webster	Ooh, good one.
22:07	Paul Moroz	They sell this to the cosmetic companies all around the world. It's something that cost a very small amount, but the value proposition is very important for your anti-wrinkle cream to work.
22:19	Cam Webster	There's anti-wrinkle cream and there's anti-wrinkle shirt fabric, isn't there, for Croda? They do that as well.

22:26	**Paul Moroz**	Yeah.
22:27	**Cam Webster**	Okay. That's Croda. How about the top holding, JPMorgan Chase? How is that resilient?
22:34	**Paul Moroz**	Well, JPMorgan is a leader in almost every division that they're in: very significant market share across mortgages, across their merchant credit card business; they're involved in ETFs; they are involved significantly in capital markets and fundraising. That's a company—especially given its heritage—that has really done a good job and dominated. I think Jamie Dimon, who runs the company, has talked a lot about "building a fortress," making their balance sheet a "fortress" to protect against downturns.
23:10	**Paul Moroz**	When they went through the financial crisis in 2008-2009, they were in a position to be able to allocate capital and one of the companies that came out very strong. They were able to bounce back and that's really the definition of resilience.
23:27	**Cam Webster**	I really like how we've concluded on three of the top 10 and explained to folks why we focus on resilience. Maybe we can close the conversation on asset mix. I know it's kind of an age old question in our industry: what mix is right in a balanced portfolio? Why is it 60-40, Paul?
23:52	**Paul Moroz**	When we've studied the asset mix in the past—and I think this is a good model to use, or mental model—if you had absolutely no knowledge about a particular subject and you want to diversify, how would you come to a decision? You'd probably divide that in equal parts. When we've back-tested this without knowing what the future would look like, or what changing historical returns...we believe that one of the most resilient models is just to diversify across the different asset classes. From that perspective, bonds and equities would get an equal weight. We've given equities slightly better than equal weight because historically equities have performed well.
24:34	**Paul Moroz**	They have a higher discount rate embedded into them and have generated a lot of returns. There's much more optionality in that asset

class than there is in bonds.
I think that's the reason why we've gravitated towards that structural asset mix and why that's a bit of embedded wisdom across the asset management industry.

24:56	**Cam Webster**	Very insightful commentary. I think we'll leave it at that as far as Global Balanced goes and shift to "One Mawer Thought." I've seen you in the hallway with a pannier and bike shoes on...what that's all about?
25:10	**Paul Moroz**	Those panniers are going to fit on a bike rack that I helped strengthen...I bought this bike rack, from somewhere on Amazon, set it up, and noticed that it looked a little bit weak. There's one particular rod—the way that it was constructed—I was concerned that while I'm pedaling through the mountains...it's just going to fall apart. I got my tent and all my gear—and I was worried about that. So I strengthened that by cutting some aluminum tube and spent some time grinding it down, drilling out this aluminum tube—
25:46	**Cam Webster**	You got a whole machine shop at home or what?
25:48	**Paul Moroz**	My dad has every tool known to man.
25:50	**Cam Webster**	Awesome!
25:51	**Paul Moroz**	If you need a tool, he'll have it. My point is I do all this engineering and create what I think is a wonderfully engineered addition to the bike rack, and my brother, who's an engineer, is looking at it, and he said, "Paul, you might want to be careful because that might have created a point of stress where there's an issue." I thought, well, maybe there's a point of stress in my bike rack...or not. But it's just a good model for looking at investments. Looking across the portfolio: where could a point of stress be? Right now, it seems like it's the U.S. Federal Reserve raising interest rates and we're starting to see that point of stress in emerging markets.
26:32	**Cam Webster**	Okay. We'll end with that! Thanks for being here, Paul. That's a great way to conclude it.
26:36	**Paul Moroz**	Great. Thanks, Cam