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EP34 | Playing the plan: Mawer's Canadian small cap portfolio

00:41	**Cam Webster**	Welcome to the podcast! We're here with Jeff Mo, our lead on Canadian small cap or as we refer to it, New Canada Fund. So, welcome Jeff.
00:51	**Jeff Mo**	Thanks Cam! Thanks for having me.
00:52	**Cam Webster**	I want to [look at things through] a six month lens.
00:56	**Jeff Mo**	Sure—so down and then up.
00:57	**Cam Webster**	Yes, but two different markets, right? So, how do we make sense of that? Let's talk about it on a six month basis. What informs your view on the Canadian economic side? Do you have a view there? What's going on in the economy that's impacting the portfolio?
01:13	**Jeff Mo**	As you know that's not the primary lens we look at our portfolio from, but certainly I'd say it was...perhaps not necessarily economic fundamentals that drove the portfolio on the last six months, but psychology around potential changes in the economic environment. For those that follow economic stats in Canada, Canadian GDP growth—still growing—was slowing. And this was happening throughout 2018, so Q2 and then Q3 was lower than Q2...and then Q4, I think, barely grew at all. Q1 is looking a bit better, but again, these stats often get revised later on. I think what really happened was there was this fear that, with interest rates rising, [and] different central banks—especially the U.S. Fed—pushing rates up in Q4...that unsettled the markets.
02:03	**Jeff Mo**	And so small caps...Canada, in both cases, being a little bit more peripheral from a global investor standpoint...I think that's why we saw a pretty bad, kind of down turn in Q4 in this portfolio.

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We are happy to say that we were able to protect our clients on the downside as our portfolios tend to do, but it's hard when it's a liquidity-driven, psychology-driven type of situation.

When Canadian investors aren't buying and you have American investors selling, you typically get a draw down in Canadian small caps being seen as a higher risk kind of asset class.

And then Q1—I guess the opposite, right? We saw that rebound.

02:42 **Cam Webster** Yeah, so you cued in a little bit on U.S. investors in the small cap space. Liquidity's obviously a consideration for small cap, but is that big issue in managing a portfolio? That you've got foreign investor flows?

02:56 **Jeff Mo** I would say less so from our standpoint because the New Canada Fund, like all the other Mawer mandates, has a turnover of about 15-20% per annum. We're looking at things over five, seven-year time horizons. What that does impact though, is your market-to-market.

In the short term, if you actually look at the stats, Canadian equities—not just small cap but large cap as well—the highest correlation in terms of other global asset classes is with emerging markets. And you would think, "oh that's kind of strange, why is Canada—a relatively developed nation, neighbours with the U.S.—why does their stock market trade like an emerging market country?" And the reason is natural resources. We have a pretty large resource-driven economy. If you look at our indices, depending if you are looking at the TSX Composite or the TSX SmallCap, anywhere from 35% to 50% of the index—depending on the time period—is in either mining or in oil and gas.

03:53 **Jeff Mo** And because China and to less extent India and their development has really caused resource prices to move—they are the marginal purchaser of a barrel of oil, a pound of copper, etc.—Canada being a big supplier of these resources, our currency as well as equities tend to trade in emerging market equity baskets.

That's kind of why I say: "U.S. investors," because those who follow the markets know that U.S. investors tend to move emerging markets. Canada, perversely, is a bit of an emerging market. So you see that effect when psychology changes.

04:26 **Cam Webster** Let's dig into that a little more. Would you say the oil price was a big factor in terms of the fourth quarter of 2018 and the first quarter of 2019? Or are we going to blame the Fed on that?

04:37 **Jeff Mo** [laughs] Well, oil prices definitely was a factor. Oil prices started cracking in Q3 already, so depending on where we're drawing our kind of arbitrary six-month time period here Cam, I'd say yes, for sure. Oil prices did impact Q4 and Q1 returns both the down and the up. Maybe slightly less than in some historical periods. For example, 2014-2015 oil prices were really impacting how Canadian equities were trading compared to U.S. equities.

05:04 **Cam Webster** Through the six-month period of the down and the up, what did you do about it?

05:08 **Jeff Mo** One thing that I'll tell you Cam—and I tell all our investors whenever I have a chance to converse with them—is it matters not that much for us. Our mentality very much is, we are sailing a ship for the long-term. When stormy patches come up, you just kind of go through it.

What I mean by that is, rule number one, always, is stick to your principles: buy wealth-creating companies, run by good management teams, bought at discounts to intrinsic value.

I'm sure our listeners have heard that ad nauseam but it's true!

05:41 **Cam Webster** A few times [laughs]. For new listeners, you'll hear it more.

05:44 **Jeff Mo** First principles. And why do we have that? It's because of emotion. It's times like these when clients and even your portfolio managers could get emotional. The difference potentially between a good investor and a bad investor is what you allow your emotions to do.

At Mawer—we're humans, we haven't somehow mechanized ourselves.

We're not borg or anything like that. We're affected when markets move. But if you stick to that process and you look at all the companies and investments [with a] 5, 7, 10, 15-year lens as owners not as traders, that's when you realize opportunities. And so, in the downturn, we were [actually] able to pick up some shares of companies that we thought became attractively valued because of that downturn.

06:29 **Jeff Mo** For example, Descartes Group—we added to our position there. I think it was in the mid to high 30s. Today, it trades about $50 a share, so that was obviously a good move. Colliers International as well, we picked up a few shares there.

To be fair, I don't think all of them have done that well. We did add to our position in NFI Group (formerly New Flyer), that's still sort of where it was at in Q4, unfortunately, despite the bounce. It's down a little bit more.

06:55 **Cam Webster** So, before we get to some other names, I want to focus on the emotion you mentioned. How do you deal with that? How do you recognize it in yourself, and how do you turn it into good things for the portfolio?

07:06 **Jeff Mo** It's tough, but I would say process, process, process. And as part of that, our culture helps a lot as well. We have a very flat hierarchy; we have language around how to talk to each other. So it's okay for people on the team to come and challenge "Jeff the portfolio manager," because I know they're challenging my ideas and not me as a person. I'm not emotionally crushed because someone disagrees with one of my thoughts.

And I think it's okay for someone to come up to me and say, "hey Jeff, I wonder if you're suggesting this trade idea because we lost money on the company before. and so now you want to buy more to sort of justify why you added to it higher up last time." That's a fair point! Was that emotion? Or is that following the process and looking at it long-term?

07:54 **Jeff Mo** So, I would say process is a way for you to have some type of quasi-objective view of the world. If you go through all your steps, you check all the boxes, you research all the pieces you need to research, you do your model, you look at the fair value range...and then you can compare that to what Mr. Market is telling you today.

And, on the flip-side, culture and that ability to challenge each other and to use common language, so we know that we're not attacking each other personally, but just calling out people on their ideas. I would say a combination of those two things is what allows us to minimize the impact of emotions in our investments, while recognizing that again—we're all humans. Emotions will creep in.

08:35 **Cam Webster** Great answer, thank you! So, what we touched on was—what in the portfolio is kind of meeting your expectations right now? Maybe you can [explain how we view that term]...

08:46 **Jeff Mo** We're not like the sell-side where we'll publish a quarterly model update and say, you know, "if revenues were up 3.5% that met our expectations." If it was only up 3.2%, then that somehow magically did not meet our expectations, and we're much more emotional about that.

So, we don't have set expectations on that granular of a level. But I would say, at a really high level, what do we mean by expectations? It's just: is the company continuing to execute on our investment thesis for it?

09:19 **Jeff Mo** For example, Boyd Group, it's now the largest weight in our portfolio. They are an autobody repair shop. In Canada, in Calgary especially, they own Boyd. In Ontario, for our listeners over there, Assured [Automotive] is their largest brand. In the States, Gerber. Regardless of where they are, they are the second largest autobody repair company in North America. And a company like them—they have the scale to go to an auto insurance company and sign what's called a "direct repair program." This gives them the ability to get higher volumes from insurance companies depending on the jurisdiction. Insurance companies cannot refer their clients to repair their cars after a collision to a specific shop, but they can provide a shortlist of recommended shops. And most of the time, after a traumatic accident, [people aren't] really looking to get 10 quotes. So they'll probably go to one of the ones recommended by the insurance company.

10:24 **Jeff Mo** What the insurance company gets, is, a more professional management of that repair. There are some stories out there of unsavoury repair shops that are repairing a lot more than what was actually damaged in the actual collision. And a company like Boyd, and some of the other bigger companies—they have very trusted relationships with these insurance companies. They're not going to do that. Insurance companies like it because they don't have to pay as much for repair, and Boyd likes it because they get more stable volume.

10:58 **Cam Webster** How is Boyd Management executing on that business model?

11:03 **Jeff Mo** Their strategy is to buy up either single or small chains of autobody repair shops and then bring those repair shops onto what they call their "WOW Operating Way." Just a much more disciplined way of running the autobody repair shop.

For example, one of the biggest costs for an insurance company is when you bring your car into the shop, you get a rental car as well. So, if you can fix the car in eight days rather than 10 days, the insurance company saves two-days worth of car rental cost. Boyd, with their processes, how they schedule jobs, and all the different things they've learned from running 500 to 600 repair shops—they can typically get the rental costs down compared to a single shop operator.

Boyd would buy these small stores, bring in their operating processes and bring in their insurance relationships, and they would be able to increase volumes as well as increase margins for these repair shops.

If you look at the last two quarters and Q3, they had same store sales growth of 4.9% in an industry that arguably is flat or even slightly declining, because of kind of auto collision avoidance technologies that are [improving]—

12:19 **Cam Webster** Okay, so the accident rate is actually going down, same store sales means they're grabbing more market share. What would be the major risk for Boyd? What could really go wrong?

12:27 **Jeff Mo** The biggest risk, I think, for them is a bad acquisition. They have, in the past, bought some companies that are maybe up to about 10% of their size.

They have to pay more, and if integration goes badly, they lose key talent, and that could hurt them.

Another risk that they actually did face once in the past, is, their customers are technically not you and I—individual car drivers. Their customers are really the insurance companies. And that's a pretty concentrated market in the States as well as in Canada. You don't have that many customers, and so customer concentration—their negotiating power might be hard. Ten years ago when Boyd was smaller, they did have an issue once where I believe Allstate—their largest insurance company partner at the time—decided that perhaps Boyd should get a little bit less for each repair. That hurt the company. But since then they've diversified a lot more and I believe they have a lot better negotiating power against Allstate and other insurance companies.

13:27 **Cam Webster** Anything on the holdings within the New Canada Fund that maybe have entered an accident zone or aren't meeting your expectations? That's what I'm trying to get at.

13:37 **Jeff Mo** I'll highlight NFI Group. We touched on that briefly. So that was one of the companies that we did add to in Q4 that so far hasn't panned out. NFI Group is the largest manufacturer of both transit and coach buses in North America. With New Flyer, with their dominate market position, they have done a very good job of [being] a leader in their market. And what that means typically, is engineering their buses better. They were the first to move into hybrids, hydrogen fuel, electric. They're working with a lot of their customers to build out an all-electric charging fleet, and how that would work for the new era.

So, it's good that they're on all the trends. Unfortunately though, when they have 40 to 50% market share in both of these markets, when those markets take a hiccup, you take a hiccup. New Flyer has seen that over the last two or three quarters as orders have slowed. As well, because orders are slowing a bit, their margins are coming down a little bit as well. Just less volume to cover overhead, as well a little bit more [of a] competitive market, even though in most of their markets there are only one or two other bidders for that kind of contract.

14:49	**Cam Webster**	So, what I'm hearing is not necessarily concern on execution of the business model itself but just—
14:54	**Jeff Mo**	Yeah, macroeconomy. Macroeconomic factors.
14:56	**Cam Webster**	Just the economy, okay. Are there any particular things about the economy throughout your portfolio you're particularly worried about or particularly excited about?
15:05	**Jeff Mo**	Let's start with worry, because where we usually start every day. We think that investing is a losers game, meaning it's much better not to lose in your portfolio than to win. And so, the biggest worry for us is the Canadian consumer. We've seen the stats, I'm sure anyone who reads economic news—the Canadian consumer is more leveraged than they've ever been based on certain ratios. Things like disposable income to GDP, or total amount of debt outstanding. I think where this really comes into play is two areas: housing, as well as just general kind of consumer-type investments. And we've seen it hit in our portfolio. For example, a company like Sleep Country, which I think hits upon both of these themes. On the one hand, a mattress. I think the average mattress they sell is $800 to $900. That's a pretty discretionary purchase. You don't just go out on a lark and drop $900 on a mattress [laughter]—
16:02	**Cam Webster**	Unless your back's killing you, you can't get out of bed, so your doctor says you need a new mattress—
16:06	**Jeff Mo**	But it's not quite the same as buying a pack of gum, is what I'm saying [laughs].
16:10	**Cam Webster**	Exactly.
16:11	**Jeff Mo**	And so, if finances are a little bit tight, or you're just a little bit more worried about the economy—you delay purchasing for a few quarters, right? And on the flip-side, the most common reason someone purchases a mattress is because they're moving. So, either you've bought a new house, or you went from renting to buying, or even if you got divorced, unfortunately. There's a reason for you to move. There's a reason for you to buy a new mattress. And

if the housing market, and housing transactions are slowing, less people are moving. That has really affected them.

When we look at stats like Vancouver especially, where year over year housing sales volumes are down 30-40% depending on the time period, and housing prices are down 25%, that is the third largest market in Canada. So that affects Sleep Country, especially given that Sleep Country started there. They have the highest market share in the Vancouver market.

17:05 **Cam Webster**

I won't sing the jingle. Everybody's singing it in their own head anyway. That's a great example of where your worries might lie.

Jeff, I know you were in Montreal recently on a research trip. Why don't we spend some time there. Why did you go? And what were some of the insights out of going?

17:21 **Jeff Mo**

Yeah, so this is something that we do frequently—go out on the road, invest with our eyes. In terms of Montreal, we have seven or eight holdings headquartered in Quebec, so we try to get there at least once a year just to see those teams and catch-up—see how the companies are doing. Another reason this particular time was, there was also a small cap conference [being] held there. About ten or so of our current portfolio holdings that aren't headquartered in Montreal—they were also presenting at that conference, so we had one-on-one meetings with the CEOs of many of these companies.

17:56 **Jeff Mo**

The takeaways from that trip are, well, the first one is just, get out there! I think it's very interesting even for us as long-term investors. If you haven't spoken with a company in six months or nine months, sometimes what is most top-of-mind for the CEOs of any of these companies can change.

For example, we learned that Logistec, which is a marine services business, their management team is pretty optimistic, pretty buoyant. They are seeing opportunities to make acquisitions and they're not worried or not afraid to take leverage up to about 5x debt to EBITDA. That comment—we were a little bit surprised by their debt tolerance, I guess, so that was new information for us, exactly.

18:41 **Jeff Mo**

Or, for example, New Look Eyewear. I guess they changed their name to New Look Vision Group now. That company has finished digesting their late 2017 acquisition of Iris Group, which is a large chain. I think we have them here in Alberta as well as in Ontario. Now [that] they've digested that large acquisition they're shifting strategy a bit. They're going to do single store or small chain roll-ups. And based on our discussions with that management team there—Antoine Amiel, the CEO. He's seeing much better valuations for buying a single store than buying a large chain like Iris. So, they just recently completed an acquisition in Ontario of a small chain. And they're looking to start to aggressively ramp up that side of the acquisition story. So, we think that could be value creative.

GDI Group—they're the largest janitorial services company in Canada. But they've kind of gone up market a bit. They bought a company called Ainsworth, which is the largest maintenance contractor in commercial buildings in Canada. So, if you need to change location of a light switch in a commercial building, or you need to fix your building automation system—you know, all those keys that everyone carries around with them. You call Ainsworth. And when they bought Ainsworth, the margins are very low they had some tough contracts they had to work through, and it looks like they've kind of gone through that. And now they're actually pretty aggressively cross-selling.

20:04 **Jeff Mo**

What I didn't realize is, GDI being a janitorial company—they actually spend or each building spends about four times as much money every year on janitorial services as they do on these kind of repair services for mechanical systems.

So, the janitorial side of the business was talking to people at the C-suite level in these companies. Whereas Ainsworth Mechanical side was not able to get to the C-suite. They were kind of talking to the regional manager or even the building manager. Now GDI has been able to bring Ainsworth into the C-suite and they're winning a lot of business because of that new relationship. That is something we wouldn't have known if we just sat here in Calgary.

20:46 **Cam Webster**

Instead of just looking at numbers you're face-to-face and hearing somebody explain that change in the sales model.

20:52	**Jeff Mo**	Yes. And we also toured some of the operations. The one that, I guess, that struck me the most was actually New Look Vision Group again. Antoine Amiel walked us through the factory there in Saint-Laurent which is near the airport in Montreal. I was really impressed with the passion of Antoine and the details he knew about the business. But even more so it gave me appreciation of New Look's competitive advantages. He was talking us through this one step in [the] manufacturing of glasses. This particular step was putting scratch resistant coating on the lens. Apparently, you need to adjust a chemical bath very precisely. It's a temperamental machine, it's a temperamental process. Typically you need to train and operator five to ten years before they can actually do that properly.
21:41	**Cam Webster**	Five to ten years just to put coating on a piece of plastic?!
21:44	**Jeff Mo**	Well it's preparing the chemical bath.
21:45	**Cam Webster**	Oh, oh, okay. Chemical bath, all right.
21:48	**Jeff Mo**	There you go, so it's chemistry!
21:49	**Cam Webster**	Sounds painful.
21:51	**Jeff Mo**	[Laughs] And he actually gave me a story about how even sometimes that operator with 10-years experience can't figure it out. One night he was saying—I can't remember when it was—[that] sometimes all the executives are coming in on Saturday at 9 p.m. or something, trying to figure out what's wrong with the chemical bath. All these guys in a suit and tie are standing around this machine with all these chemicals in it going, "why is the color coming out different for the chemical that what we're expecting?" But that's level of dedication that's required to manufacture glasses on a large scale. And in fact, New Look has the largest factory in Canada that makes glasses now because it's really, really hard to do. For most glasses that are worn by Canadians, the coating [that's] applied and the cutting process before that is done in the States because it's just really hard to do. So that gives New Look an advantage. You don't have to clear it through customs to get it to your customer.

22:44	Jeff Mo	And the other thing too, I guess maybe a little aside, is I was really impressed how much they cared about the environment. More and more this concept of ESG—Environmental, Social and Governance concerns—is becoming a bigger topic in investing, and for us as well. At Mawer we have an ESG checklist now for all our companies. For New Look, one of the steps in this factory is they'll take the lens and they'll cut it down to the right size to fit the frame that the lens is going into. All lenses are plastic and so when you cut it down, you get all this little plastic waste, basically. Very fine plastic dust. Usually that just runs through the water system and drains in the sewer system. And years ago it just kind of went into the municipal water system.
23:32	Cam Webster	Seriously?
23:32	Jeff Mo	That's what happened!
23:33	Cam Webster	All the cuttings just went whoosh.
23:35	Jeff Mo	All the cuttings, right. To be fair the city never complained about it—just went in. But New Look, I think it was about three or four years ago, decided: "we aren't being a good corporate citizen doing that." So at their expense, they put in a system to capture the waste at the factory before it went into the sewage system. And they recycle the waste and clean the water. So now they use a lot less water because they are recycling this water and reusing it in the manufacturing process, and they're no longer dumping plastic into the sewer. There was no customer pressure, there was no pressure from regulators at the city. They did it because they're a good corporate citizen. And I think that's the type of companies that we like to invest in. The part the really surprised me about this, is, New Look has never talked about this in their annual reports, their press releases...they just do it because they think it's the right thing.
24:23	Cam Webster	Right, and that was the subject that came out while you were on the—

24:26	**Jeff Mo**	That's right. He just mentioned it as an aside because we were walking by this recycling system.
24:30	**Cam Webster**	Thanks for the tour through New Canada Land. Thanks for spending time with us Jeff! We'll have you on again soon.
24:36	**Jeff Mo**	You're welcome Cam, thank you for having me.