the art of boring™

EP36 | Mawer Insight: Q&A with CIO

00:41	**David Fraser**	Welcome to a very special episode of The Art of Boring podcast. I'm your host, David Fraser. I'm an associate investment counsellor here at Mawer. Every year, we do a couple of events which we call the "Insight Events." We have a webcast and a live event where clients have the opportunity to ask our research team questions and get more information about what we do here. This year, we thought we'd add to the list of events and add a podcast. We have the questions that have come through most often, and who better to answer those questions than our chief investment officer, Paul Moroz? Not only is he chief investment officer, he is the co-manager of the global equity fund and global small cap funds. Paul, thanks for joining us.
01:21	**Paul Moroz**	Thanks for having me, David.
01:22	**David Fraser**	All right, so we'll dive right in. In the news right now, U.S. and China trade wars are going on that are affecting the markets. What's happening there, and what are we doing about it?
01:34	**Paul Moroz**	Well, most of the companies that we invest in—the starting point—just don't have the same level of exposure, fundamental exposure, that you might think about if you're just reading the newspapers and worrying about trade wars between the U.S. and China. So, I'd say for most of the actual companies at a main street level, they're unaffected by it. There are a few companies that might have a little bit more of a fundamental impact, and we're talking across our portfolios maybe a few percentage points in total. For example, we've been trimming our position in BMW because they have a fair amount of business in China, and to the extent that the Chinese economy is impacted by the trade wars, there

might be less BMWs sold in China, and that's a big part of their profits.

So it's really at the margin for us. I think it creates a lot more market volatility and a lot more news for selling newspapers. But I'm sleeping well at night and I think our clients should too.

02:48	**David Fraser**	What is it about our investment approach that we don't have as much exposure to some of these companies? What is it about our investment approach that means we aren't involved as much as other companies might be?
03:00	**Paul Moroz**	I think that our approach really emphasizes services and products that are instrumental to the running of the economy. They're almost infrastructure; they're the fabric of the economy. We have a position in, for example, Wolters Kluwer, which is a bit of a data publisher. One of the things that they do is they will provide your doctor with a web portal—information to help your doctor diagnose you. So if you're in for a check-up and your doctor's looking at something on a screen, there's a good chance they're using that information from Wolters Kluwer. Now, that is so fundamental to the practice whether there's a trade war or not in China. That service that's being provided is going to continue to be sold to medical practitioners, and for shareholders of Wolters Kluwer, that means that there's a continual recurring revenue stream coming in. The business model is one of the things that we research intensively to understand how our companies are exposed, how they make money, how they profit in different scenarios, and we emphasize those types of businesses that are just less impacted by external risks.
04:27	**David Fraser**	Yeah, and I think that's something that I point out to clients often. We're looking for robust companies, regardless of the macroeconomic environment. So it's good to point that out. Another question we had come in—which, feel free to take it in whichever direction you like—but basically, the question was around performance over the last, call it six months. In Q4 of 2018 we saw markets pull back, and then

there's been a strong performance year-to-date so far with those unsettled trade talks that we mentioned, a bit more volatility there.

What was the driver of that performance over the last six months, and where are we today in terms of valuations?

05:05	**Paul Moroz**	Starting with performance, what was driving it: I think in the fourth quarter of 2018 we started to be concerned about the trade war—or, the market was concerned about it, not necessarily us as a firm. We started to see some data come in suggesting that economies around the world were slowing. That certainly that was the case in China, [and] the case in Europe as well. And at the time, central banks around the world were still in a tightening mode. So the market was very concerned that economies were slowing and central banks were still tightening, and now you have this unknown risk around trade wars. The big reversal happened in January of the new year, where central banks effectively reversed their position and the Fed in the United States (the Federal Reserve), said that they were going to be on hold, and in Europe they basically paused and started actually loosening a little bit, and in China there was monetary stimulus. So, that acted as a pretty significant change in direction. And it instilled a lot of confidence in the markets, and I think that's part of the reason why you saw a pretty good rebound in the market psychology.
06:27	**David Fraser**	So if we're looking ahead—I don't want to put you on the spot and make you make a prediction—but what are the major things that are going to influence markets over the next 12 to 24 months, in your eyes?
06:37	**Paul Moroz**	Well it's so tough because market performance—it's really psychology. It's the psychology of people. If you're thinking about performance, we should really use the word "psychology." Imagine, as an example, that there's a stock that is owned—a company that is owned—by myself and you, David, right? There are two shares. I own one of them, you own one of them. In order for me to predict the performance of this stock...let's say that

you're the emotional one. I'm going to have to know whether you wake up in the morning and are feeling happy and excited and are thinking that you're going to pay a lot of money for my share in this fictitious company. Or, you might wake up and you might feel sad and depressed, and you might want to sell it to me at a low price!

I'm not sure of what sort of emotion I'm going to be dealing with, with you. And if you think about recognizing that if you can't predict the psychology of one person, then how can you do that for the entire market?

So that's really a long, honest way of saying well, I'm not sure what markets are going to do. They could be up, they could be down. What I can comment on is valuation. If, on average, if we invest in this basket of securities at this price level, what level of return do we think we're getting holding the securities for a very long period of time? That's valuation. And the most common answer that we get when we do all our modeling, is 6 or 7%. We rarely get 5% that comes out. We're not getting 8 or 9%. It's in that 6 to 7% range.

08:36	**Paul Moroz**	Now, remember, in theory, practice and theory are the same. In practice, they're different. So, again, that is long-term value. That's not performance or psychology—what the market's going to do over the next six months or 12 months.
08:51	**David Fraser**	So for the most part, I guess we've mentioned on this podcast before, in a lot of ways, we disregard that short-term noise. We go back to the latter part of your answer there, which is to look how resilient that company is over the long-term and focus on that.
09:05	**Paul Moroz**	Yes. The whole idea of our philosophy, and most fundamental investment philosophies, is, "get on the get-rich-slow train." It's systematically figuring out a way to win with time by collecting your dividends. This is very old-fashioned, it's boring, it tests your patience because of market psychology, and we'll go through tough times. We'll go through a recession and a bear market. Is it going to be next year, or five years from now? I don't know. But over time, the fundamentals will end up winning if we exercise patience.

09:39	**David Fraser**	So if we go back to your example of the two of us owning one company, half each, and I'm the emotional investor, some days I'm going to wake up happy, some days I'm going to wake up sad, but over a longer period of time my mood is going to average out through time and you're going to get a reasonable assessment of my perception of the world over time.
10:01	**Paul Moroz**	On average your mood doesn't matter! It's what the company does that matters over a long period of time. Let's say...David, do you want to be on a deserted island? We can own this company on a deserted island. What's going to matter in that case is, is there tourism on our island, where our company's making a lot of money? Or, is it the case that, no, this is a deserted island and there's no treasure [laughs] and the fundamentals of our fictitious company are really bad? That's what matters over a long enough period of time.
10:32	**David Fraser**	Okay, great [laughs]. We also had a question, if we drill in a little bit closer to home—so, looking at North America—the question was, when we're looking at the U.S. markets and Canadian markets over the next 12 months, how do you (again, putting your prediction hat on, I'm sorry!) but how do we see those two markets playing out, and what are the main drivers and the main impacts that'll impact markets there?
10:59	**Paul Moroz**	There are two big ones in Canada, at least. One of them is oil, depending on what happens with our political situation. Today, oil stocks are in the red, so that's certainly not an insignificant part of Canada—oil and resources. So, you can imagine a scenario where oil prices decline, resource prices decline, and that part of the Canadian economy and the cash flow that those related companies are generating will be down, so that is going to impact Canada a lot more than the United States. On a day like today, we're seeing the Canadian dollar depreciate against the U.S. dollar, so currency's going to be a big factor, too. The other big one would be housing. The housing market in Canada is very different. We've seen governments take measures to slow the housing market for a variety of reasons, but in the long-term, really, to provide a safer, more affordable housing market. The housing market across Canada

is not everything equal. So, Vancouver has been struggling recently more than, say, the greater Toronto area, which seems to have bottomed a little bit and is still doing okay. There's probably a little bit more immigration that's supporting that market. Calgary's very soft. So, Canada is not a homogeneous housing market.

12:34 **Paul Moroz** Overall, though, because of the measures that the government has undertaken, it seems like volumes are down in terms of housing sales—prices are down—and that means our Canadian banks, at least for that segment of their business, they're just not going to be lending as much money. Even if the credit environment holds together, even if people still have jobs and can pay their mortgage, even if that's all fine, they're not going to be growing earnings perhaps quite as quickly with this new housing environment.

That means your Canadian banks—which make up a pretty good chunk of the Canadian economy—they might not be doing as well as the United States, or companies in the United States. So that's another big factor that people should be aware of.

And maybe the last one is, there is a lot of technology companies in the United States that drive markets, and whether that is companies like Facebook, Amazon, Netflix, or Google; or even new companies like Uber—I guess Tesla's not super new—but these companies...they're making investments that are very far out into the future. And the stock price performance is going to be driven by, again, that psychology--that sentiment of how do people feel about prospects of Elon Musk's Tesla?

It's a psychology thing, and people might be very hopeful, or not. But that's another significant driver of where you could get a pretty significant under- or over-performance.

14:24 **David Fraser** So, on a similar note, if we're looking how Canada is affected by the U.S. and the correlation there, is it as strong as it's been in the past? If U.S. markets are doing well, can we expect Canadian markets to do well? Is that correlation still there?

14:37	**Paul Moroz**	Overall, globalization has increased. And whether you're looking at the Canadian and U.S. market, or a different market, there are more companies that are just closely related or correlated. And I think the psychology of markets are more closely correlated. But given some of the comments previously—whether it's housing, whether it's oil prices, whether it's the mood of technology—you could end up with very different results. In the case where there's a pretty significant downturn, I think investors should recognize that the U.S. dollar might still very well be the reserve currency of the world. And when investors get scared, they move their money to that reserve currency. At least in a downturn, correlation-wise, investing in the United States if there's a recession...I would expect that the U.S. might out-perform Canada just based on the pick-up from an appreciation of the U.S. dollar. I'm not saying that's going to happen for sure, but that's probably the way the odds are pointing.
15:46	**David Fraser**	And if I'm an investor—I'm just thinking if I'm a client listening to this—and I'm investing in Mawer funds, how does that foreign exchange impact my return on the funds that I'm invested in?
15:57	**Paul Moroz**	If you are investing Canadian dollars into, for example, one of our global funds, which would have significant U.S. exposure, if the Canadian dollar appreciates—let's say the Canadian housing market does really well, oil prices are well, resource prices are doing well—then the Canadian dollar will appreciate versus the U.S. dollar, versus, maybe, other foreign currencies, and that will dampen returns. So there'll be a negative effect. The other side of it would be if the Canadian dollar is doing really poorly and you've invested internationally, you're going to have a positive currency effect, and those returns are going to be more significant when they're converted back into Canadian dollars, which is where all our funds are marked.
16:50	**David Fraser**	Perfect. So, shifting gears a little bit. We had a question on India and China, and I guess I'd open it up. I know I've had client questions myself on

emerging markets, so, just wondering what opportunities or risks we're seeing in those areas at the moment.

17:09	**Paul Moroz**	Certainly within China, a lot of the Chinese economy relates to government policy, and the Chinese economy still does export a fair amount of goods to the United States, so going back to their economy and "main street" in China, they are impacted by trade wars. I think there are more opportunities, in my opinion, in India compared to China. I think culturally, India is more entrepreneurial. And I think it has a better business climate—particularly if the Modi administration is confirmed that they'll be in power for another term. I think they've been very pro-business and have implemented a few policies, which is going to support business and ultimately support capitalism and the stock market. So we do have exposure in India, whether that's through banking or ratings services. There are a number of companies that we own. I think that India has a bright future.
18:17	**David Fraser**	If we're taking a step outside of emerging markets and still continuing to look internationally, what are we seeing in developed markets, particularly Europe? What are you seeing in those parts of the world?
18:27	**Paul Moroz**	Europe isn't growing very quick, is the short answer. As I mentioned before, their central bank has basically gone back to stimulating. There are many people concerned that...from, at least, when you're looking at the economy, what's happening to Europe now is a little bit like what happened to Japan. Where you're just not going to see the same level of economic growth that you have in the past, and it's going to be very slow, and that means there might be less opportunity for businesses to create value. So that's the "headline" view. What does that mean for the companies that we invest in? There are still ways to get exposure to companies that can do well, create value, and that's what we've been doing with our European companies. You price them in a manner that reflects that slower growth, you collect those dividends, and you reinvest them into the best available opportunities.

19:35	**David Fraser**	So what you mean there, is, because we're expecting a lower growth rate, we're prepared to pay less for those companies, effectively?
19:41	**Paul Moroz**	Yeah, absolutely. I think listeners should recognize that we don't discriminate between high-growth and low-growth companies. We try to understand the growth prospects, and when we build a model to determine the value of that business, we take growth rates into consideration. So you could easily have a scenario where Europe as an economy does extremely poorly—it's marginal—but the securities that we purchase are purchased at a price that still makes economic sense and the stocks perform really well over a longer period of time.
20:25	**David Fraser**	And effectively, when we look at the world, we're agnostic as to where we invest, right? So we want to factor everything in you mentioned there, and in countries where there's more risk—we're prepared to pay less for those companies, and in countries where we think it's a little bit more stable and less risk we're prepared to maybe pay a little bit more in price for those companies.
20:46	**Paul Moroz**	Yeah, absolutely. We're adjusting based on the value we see in the stocks, the characteristics of the business—whether it's a good business model or not—and the quality that the people running our businesses bring in creating new value. And [whether] we are able to shift based on those factors and changing risk qualities.
21:11	**David Fraser**	Great. All right, shifting gears again. We had a question—and it's a question I get a lot from clients—is the question of active versus passive investing. So, if you're a listener and you don't know, we are an active investor. So Paul and his team are out there looking at good companies all over the world and trying to decide which ones will outperform and invest in those only. And then a more passive strategy, or ETFs, or what are called "exchange-traded funds," really they buy the benchmark in a lot of companies and the buying and selling is done by computers and it's all automated. So, Paul, just give them a sense of how we differ, first of all, from those more passive strategies.

21:57	**Paul Moroz**	Maybe an analogy would help with this, because investment management services are really investing money—people's hard-earned dollars—to achieve some sort of long-term goals, and most often that's retirement for an individual client. And I think that you could look at active versus passive in terms of...imagine that you are getting on a voyage, you're getting on a ship, and you're sailing across the ocean, and you have a choice. One choice is, you can get on a boat, where really there's no captain steering the boat. You're going to go the general direction the water's going to take you, but, that's less expensive. Your fare is a lot less. The other choice is that you can take a boat, there are the same risks, you don't know how long it's going to take you to get to the other side, you don't know whether it's going to be rough seas, it's going to be out of the control of whether there's a captain or not, but with this choice you do have a captain on the ship and the captain will be steering it and it might go a little left, it might go a little right. As a result, you might get there to the end location a little bit faster, or not. Or a little bit safer, or not. And so that's the choice that investors have. Do they want to invest in a passive fund where the fees are less, but you get the average journey? Or, do you want to pay a little bit money for that captain and, as well, the support that people like yourself, David, provide in terms of investment counselling?
23:45	**Paul Moroz**	So I think in terms of the market, there's a place in the market for both. In that, in some cases, passive does make a lot of sense. And I think—certainly for our business and our clients—we've demonstrated (at least this is my opinion), that we have created value, stronger returns, with less risk and provided very wise investment counselling along the way. That's the choice that any consumer client has in today's environment. And I think it's wonderful the way the market has evolved providing those two different options.
24:24	**David Fraser**	So, for us being an active manager—do you ever see us getting into the world of passive investing?

24:29	**Paul Moroz**	Our board has made a decision that we're going to stick to our knitting and focus on active management. We've done a good job in the past, and honestly, we see lots of opportunities. Because there are active managers who have been weeded out and removed from the market. And I think over the long-term, we're well-positioned to provide that differentiated, value-added service. One of the things that I don't think people maybe recognize the way the market is evolving—is that as there's a greater passive share, there are less captains on the sea making those decisions. And the funny thing is, when you see many companies that are IPOing, maybe it's Lyft, maybe it's Uber—
25:17	**David Fraser**	Sorry, an IPO?
25:19	**Paul Moroz**	Oh, an initial public offering—coming to the market and listing their shares and making those shares available to the public to purchase. You have a number of these new companies that aren't making money. And when you're at the 10-year point in a bull market, it's very easy to sell hope over reality. Some of these companies will work out fine. There will be another Google, absolutely. Many of them will not work out. And when you think about how these companies are getting absorbed—who ends up holding—it ends up being passive investors, because the active investors have more choice. Not to say that active investors don't make mistakes too, or might not hold them, but there's just that structural element of how the market's evolving, which worries me when you get to the end of the cycle in the bear market. So that's why, from my perspective, I have no problem being an active investor.
26:29	**David Fraser**	There is an argument out there—and I'd just be interested to hear if you would agree with it—is that passive investing, over time, if there's enough of it, with those ships out there with no captains on them, will increase volatility because it'll just be buying in without really thinking about it. And then again, on the flip side, selling out without really thinking about it too much. Would you agree with that?

26:53	**Paul Moroz**	There are different risks, the world is different. I think with respect to volatility, there are two risks, two big ones. One is with the investment counselling side and having people work with clients in providing advice. The one risk that passive investing and robo-investing has, is if you're doing it by yourself, and some people do that and that's fine, but if you get scared at the wrong time and you don't have someone to coach you and work through the emotional element of investing, you may make a decision at the wrong time. And that's where I don't think passive investing has proved itself out yet—or robo-investing for that matter. Now, the other element is that the liquidity of the market is changing, and by liquidity I mean the ability of the market to buy and sell shares to different players. With passive investing, as you've been through a bull market, large passive investment companies like Vanguard or BlackRock are a net buyer of securities, and often they sell securities to each other when they require this liquidity, when they want to create a transaction. The question becomes: how does the market react in a bear market when all the passive players are trying to sell to someone else, and the active investors have already selected—they're only interested in certain types of companies? In our case, strong companies that make money and have good people. That's a big question mark for what happens to the liquidity in that downturn. And the only way we're going to find out is [laughs] when we see that next recession, that next bear market.
28:55	**David Fraser**	We had another question which I thought was interesting. We talk a lot about buying into companies, why we purchase a company, and how we come about that decision. This question flipped that on its head and said, what are some of the decisions that go into how we trim or sell out of a company?
29:11	**Paul Moroz**	What we do is, really, we flip our investment philosophy around and we say, “if there is a deterioration in certain factors, we're going to trim or exit the position.” We have a quarterly process that we go through to understand how every position is evolving according to our criteria. So, if we have a case where the management team is deteriorating in some way—perhaps

there's a change of manager, or perhaps the management team does something with our client's capital that isn't very good, they make a big acquisition and they pay too much money— then that would be a factor in terms of us trimming or exiting the position.

Business models are not permanent in nature, and there can be new technologies or developments that make a business model less attractive. If there's an event, a new technology development that makes that business model less attractive, then we will sell or trim.

You know, I was thinking the other day, being based in Alberta, we're hearing a lot about new plant-based meat alternatives. I was thinking to myself, how would I feel if I owned a cattle ranch in Alberta? This is kind of an emerging technology. Now, it's just at the edge, it's just at the perimeter. But it would be something that, if I did own a cattle ranch as a business (we don't, in the portfolio), we'd be monitoring, and it might cause us to say, "the strength of the business model is weakening, and we might want to move away from that."

Then the final thing is valuation. So, if a stock becomes too expensive as we're measuring its value—and too expensive in statistical terms—then we will trim or exit the position. Stocks only make sense as an investment if the price makes sense. The economics do matter.

31:17	**David Fraser**	So as you point out, we have a couple of options. We can sell everything tomorrow or today, or we can, as we sometimes refer to it, "walk to the exit" on a company. What goes into deciding whether we want to exit quickly or slowly, and who has decision rights there?
31:34	**Paul Moroz**	I'll take the last part first. The portfolio manager of that particular fund has the decision rights, so there's someone that's charged with that accountability and responsibility and has that tiebreaker vote. In terms of whether we walk to the exit...what we're really doing is we're weighing the probabilities. And as a piece of information comes up, we're not sure whether this means the complete destruction of the business, or whether this is going to be the next Google. It's most likely somewhere in between.

We're moving a little bit left or a little bit right based on our assessment of the probabilities, and so I think that's a pretty important feature to understand. When we're making investment decisions, we don't have the answer, but we're trying to get the odds approximately right in a systematic fashion such that we can make value-adding decisions for our clients.

32:31	**David Fraser**	Perfect. I think that's great to know if you're an investor with us. So, we've gone through a lot of the questions that have been submitted. Is there anything that clients are missing that's on your radar that's out there that you think investors, clients, the markets, should be aware of?
32:46	**Paul Moroz**	I think one of the most important elements of investing is just managing your own psychology. I do this exercise for myself! I obviously invest in our funds, and there's always a question of...what happens if the recession comes? The bear market comes? What do I do? I like to think about things probabilistically and balance the risk of investing the capital and recognizing that we might come into a bear market, and that for some period of time, you might lose a little bit of money on paper. And I also like to balance the reinvestment risk. If I have all of my money sitting in a bank account and it's not invested in the market, what happens if the market goes up 5% or 10% over many years? I like to think an individual's best position is where those two risks kind of neutralize each other. Anyway, that's just my own personal thought about asset mix and how to think about that problem.
34:01	**David Fraser**	I think that's a great point and something that I'm often speaking with clients about, which is the time horizon. You talked about losing money on paper—if we have a long enough time horizon, if a client's on the phone with me panicking that markets are volatile, I say, "look, last time we spoke, we were investing for a time which is 20, 30 years away." And that speaks to what you mentioned earlier, which is me doing my job acting as a sounding board to ensure clients understand that we have to take on a little bit of risk to get a better return, and finding that happy medium, as you say, where they balance each other out.

So thanks very much for that, Paul! And especially thanks for everyone who submitted questions. We appreciate that, and hopefully we can have you back again to answer some more questions. It's great hearing it from the horse's mouth versus getting it vicariously through me, but we appreciate you answering those questions. Thanks, Paul.

34:55	**Paul Moroz**	Absolutely. Thanks, David.