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00:41 **David Fraser**

Hi everybody and welcome to The Art of Boring podcast. I'm David Fraser, an investment counsellor here at Mawer. And time certainly flies by—it's that time again. I've got Greg Peterson joining us for yet another quarterly update. Greg's our asset mix chair and the balanced and global balance fund lead manager. Greg, thanks for being here.

01:00 **Greg Peterson**

Hi David, thanks for having me.

01:01 **David Fraser**

As always, there's a lot to cover this quarter. Thankfully it was a positive quarter and overall, the majority of asset classes performed pretty well. The Dow Jones and S&P 500 and the Nasdaq—they all finished with record highs last Wednesday. This broadly seemed to reflect expectations that the investors out there are expecting central banks to keep monetary policy relatively loose. Greg, what were your major takeaways and the major drivers of performance this quarter?

01:27 **Greg Peterson**

I think you've covered them [laughter] to some extent. It was a good quarter. I think the second quarter was really a continuation of the first quarter. So, to me, not a lot has changed. The main driver would have been lower interest rates, changing expectations for central banks—especially the U.S. Federal Reserve.

Market expectations are for lower rates and expecting the Federal Reserve to cut rates—whether they do or not. And I think that's helped to drive equity markets higher. It's also helped to drive bond yields lower, which has helped bond prices to move up. So we've had good contributions from both bonds and stocks in the Balanced Fund over the quarter, and certainly over the year to date. It's been one of the strongest six-month periods that we've had for many years for both equities as well as balanced perspectives. So it was a good start.

02:07 **Greg Peterson**

I think adding to the expectations for lower interest rates is just the continuing speculation with respect to global trade and what's happening with the U.S. and China. I think the market's fairly optimistic that relations there start to thaw and perhaps improve. And I think that's helped the markets to come along somewhat as well.

Every three months is a fairly short period of time and I don't think things have changed a great deal over that period. The central topics of the last couple of quarters or few continue to be the same as what we've seen for a while.

02:34 **David Fraser**

And, I think as investors, we're relatively demanding. It seems that we want to have our cake and eat it too. We want that strong economy and we want central banks to lower interest rates. So we're pretty demanding in that regard.

On the topic of interest rates, the 10-year U.S. Treasury—that can continue to fall. It hit highs in Q3 of 2018: it was around 3.2% and now it's hovering around that 2% rate. Also, other things in that same vein to note—Austria launched a 100-year bond recently, with a 1.2% yield on that; and, looking further afield with interest rates—25% of global debt has a negative yield at the moment.

If we do continue to see these "lower for longer" interest rates, which some of those numbers tend to point to, what do you think that means for investors?

03:22 **Greg Peterson**

It means it's very difficult to earn income off fixed income investments, for one thing. That's similar [to] over the last five, six, seven years of very low interest rates. It's very hard to derive just a straight income. And what that does is forces investors to seek returns in other areas and tends to move money into higher risk investments, whether that's equities or other investments. So, it does tend to drive capital a little bit.

I think it shows how much willingness there is among investors to seek safety of capital. So, going into long-term bonds of very low yields, and also shows just how much capital and liquidity there is in the world that's needing to find a home. So, it helps to drive down interest rates.

I'm not sure that interest rates will remain this low for that long. So, one risk if you will, looking forward, is that the markets have priced in lower interest rates—both administered interest rates and then that's helped drive bond yields lower. There may be some surprise that perhaps they don't stay that low and perhaps the Federal Reserve doesn't need to lower interest rates through the course of this year—despite pressure from Donald Trump. And I'm sure that

Jerome Powell will look past that and they'll react to data as it comes out and just see how the economy fares through the course of the year.

But that is one risk: markets are priced in (lower interest rates and lower bond yields) and if that doesn't transpire, then perhaps causes a bit of a pause in equity markets for a period of time as they reprice those expectations.

04:33 **Greg Peterson**

So, I still think that interest rates and bond yields do gradually move up over the next 10 years. But I think it's a very long, slow process, and we may have periods of time like this where they go lower for a short period of time. But it would seem that we should be towards that secular trend of slightly higher rates. And it may be aided by, perhaps, some surprises in inflation in the next year or so. While most expected inflation is very subdued and numbers are relatively soft at the moment, we still have wage growth that's running stronger in North America, anyway. Historically, that has helped to lead to higher inflation. I'm not sure why that needs to change a great deal at the moment, it may just take longer. It's certainly more difficult to take inflation expectations higher. And so that's one thing that may delay that transition—but you could get a bit of a surprise there as well.

And I'm not saying that we're going to have some dramatic changes, it's just something that's likely [to be] gradual over a period of time. So, I'm not entirely buying the low rates forever. I think we are in a period where it is relatively low rates for a long time, but it doesn't mean that they have to stay exactly where they are.

05:33 **David Fraser**

And so if I'm an investor, I might be thinking: why do we hold fixed income? I often use a [phrase] I heard you say a long time ago [in] a lot of my client interactions: “well look, a bad time in the bond market is typically a lot better than a bad time in equity markets."

I think that summarizes why we still continue to hold some of the fixed income there—particularly in the balanced funds that you manage.

05:58 **Greg Peterson**

That's exactly right David. We don't propose to know that we know everything that's going to happen perfectly going forward, and bonds are a big part of our protection against that. Bonds provide the stability in a balanced portfolio and also the liquidity in the event that the equity markets do go through a rough time [so] that you have an area to draw from.

I would never propose to somebody who is properly suited for a balanced portfolio to sell off their bonds and fixed income and just go all equity because that's where the returns are. We don't know how things are going to work out in the next several years, so you always have that backup plan just to manage risk. Can't forget about the risk side of the equation despite 10 years of fantastic equity returns!

06:32 **David Fraser**

Absolutely. Thanks for that.

There is an argument out there with the skeptics of all this accommodative fiscal and monetary policy from central banks—do you think we need to go through some short-term pain to recalibrate markets and make them a bit more robust going forward? As you say, you pointed out we have had strong equity returns in the last 10 or so years, especially coming out of 2008. What's your thought on that?

06:56 **Greg Peterson**

Yeah, a little pain in the markets every now and then just helps people to realize what their risk tolerance truly is. So, as much as it's not pleasant to go through times where equity markets are correcting—if you take the most recent example in the fourth quarter of 2018, stock markets, the S&P 500, was down almost 20% at one point. There's a bit of short-term pain there just to realize, number one, why we have fixed income in the portfolio; and number two, why we [are] not stretching ourselves even further to take on more risk. So, a little bit of pain every now and then [is] not a bad thing despite our preference to avoid it.

And it does help to recalibrate markets. If you look at valuations in stock markets—one of our lead concerns for many years—valuations today, I would argue, are still better than they were a year ago despite being at record levels in stock markets. Because there are other things that help support valuation: lower interest rates being the key one, but also earnings growth has helped over that period of time to provide better relative value. That's where we are today.

07:48 **David Fraser**

Yes, and one thing I think about as I hear you speaking—and to remind Mawer clients of as well—is, as active investors, we need a bit of volatility in markets because oftentimes we follow companies as you say, with those good valuations or possibly high valuations. We follow that company for a long period of time, we like the business model, we like the management team, but that third pillar of our investment approach—the valuation—oftentimes can be on the high end of our expectations. And that volatility in the market...oftentimes it's indiscriminate selling where the market is selling the good companies with the bad companies, in our mind, at least. Those good companies get sold down and that's our opportunity to buy into those companies. So we need that volatility as active investors.

08:31	**Greg Peterson**	Yeah, exactly. It's always nice to buy something on sale.
08:34	**David Fraser**	As in really any market, you've got to look at companies with potential growth as well as protection on the downside, so a little bit more defensive. Are there some examples of companies that we hold in our portfolios that tell that story for you?
08:48	**Greg Peterson**	Yeah, there are many companies in the portfolios that help with that. And I think a lot of the businesses, while also trying to look for growth, provide a defensive position for us as well. So a few companies that we've been adding to, or have introduced in the portfolio in the last while, are companies like New Look Vision Group in Canada. They're an optical retailer, predominantly in eastern Canada, in Quebec and the Atlantic provinces. Fielmann, which is a German company operating in Europe. And Grand Vision, which is a Dutch company that also is a very large optical retailer in Europe. Optical retailing—if we're going to see, (and I can speak to somebody that's aging and having more difficulty with vision)—if I want to be able to read my notes, I need glasses. And it's not something you typically would, or you might put off for a while, but you can only put off for so long. So, optical reselling isn't as economically sensitive. People still need to have glasses. They need to replace them as their eyes change as they age. So you have a fairly strong recurring business.
09:40	**Greg Peterson**	With businesses like these three that I've named, they're fairly large. They have scale. They're able to source their supplies at a reasonable price. They have that pricing power with suppliers. They're able to pass that on through, perhaps,

lower prices to their consumers. And the optical retailing business itself is still fairly fragmented. So, there's a lot of small independent businesses that have a more difficult time competing with the large retailers. They also don't have the distribution and visibility these larger retailers have through the number of stores they have as well, and the ability to market.

So, that brand awareness; that market share that they have in their scale allows them a fairly strong competitive advantage in an area that may not be quite as economically sensitive. So they have good upside through continuing to grow their businesses. Then, I think, they also have defensive properties not being as tied to things like the economy; global trade may not influence them as much either.

10:29 **David Fraser**

They're really textbook examples of a business model that we like, aren't they? They're subscription-based, which means clients are coming back time and time again. And also as you mentioned, that macro environment isn't really going to impact whether you get new lenses or buy glasses. You just need them regardless of all of that noise that's out there. So that's the type of business model that we often look at.

Greg, I'll put you on the spot. I know it's a very tough thing to do, but looking ahead to Q3 and predicting things there—what are you keeping an eye out for?

10:58 **Greg Peterson**

There [are] a number of things we're watching, and beyond Q3. Very difficult to look into the short-term and know with any high probability what's likely to take place. I mean, if you did put me on the spot that way, David, I wouldn't be surprised to see things slow down in the third quarter. We've had a very strong first half of the year, so it'd just be natural to expect things to pause at this point and digest some of the information that we've had in the last little while.

I think risks in the very near term are probably poised to some disappointment. And the reason I say that, is that markets have already priced in expectations for rate cuts. We talked earlier that they may or may not happen. So that could be some disappointment for the markets. Markets have also priced in optimism around global trade, and again, U.S. and China relations in particular. We could see some step back from that—there's been quite an ebb and flow to those trade negotiations.

11:44 **Greg Peterson**

What we do try to focus on is the longer-term view—ensuring that we have portfolios positioned for that more secular outcome, rather than just looking through the next quarter or so—where we have a much better chance, if you will, of being right over the long-term. You would still watch monetary policy and interest rate; expectations on bond yields and where they move from here. More looking at the trend, as opposed to short-term fluctuation.

Earnings growth is the other key part to equity returns and expectations for equities as we go forward. So we'll continue to watch the growth rate for earnings for companies globally. And these will be influenced by some of these short-term measures. Global trade is already having some effect on business investment. If you're a business manager, it's difficult to reinvest in your company and grow if you're uncertain what that environment looks like going forward, or it may just cause you to pause for a period of time as well. So we will watch that.

Geopolitics can have an influence on those longer-term earnings expectations as well. If you look at what's taking place in the Middle East, that could influence oil markets in particular in the short-term. So, there [are] many things that we'll continue to watch. Investor psychology—how that translates into market valuations—will be another that plays in there as well.

12:51 **Greg Peterson**

So if we look at some of the markets around the world, Canada actually sets up reasonably well from a evaluations perspective. Our stock market, despite the really strong start to this year, over the last several years, hasn't kept up with other markets. So, we probably have an advantage from a valuation perspective. That doesn't provide a good timing point necessarily, but it does help to set up longer-term expectations that are perhaps a bit more positive from that side. Although, Canada continues to have some of the same concerns we've had for some time: [...] household debt levels are relatively high; our real estate market, at least in the two big markets, is still going through some transition—that creates a bit of uncertainty there as well; and while unemployment is relatively low, wage growth has started to pick up in the last little while, so that may actually support consumption going forward.

So, the Canadian economy seems to have started to reaccelerate just in the short-term, but we'll need to see a bit more evidence before we actually commit more to Canada as we go forward.

13:43	**Greg Peterson**	So, many things to worry about in the short-term. We don't let them worry us a great deal other than how they influence our longer-term view. We don't want to trade around those—your opportunity for error and detracting from value is much better if you trade on short-term news. We're much more worried about how this influences that longer-term picture and ensuring we have proper diversity built in our portfolios, and then also the allocation setup for both best opportunity long-term [while] also [being] somewhat on the defensive side.
14:08	**David Fraser**	Great! Well thanks for those insights. I guess today's no different than any other day. There [are] some headwinds out there, but some green shoots as well. Focus on the long-term. Greg, thanks for your insights and thanks for joining us.
14:18	**Greg Peterson**	Thanks very much, and have a great summer!