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EP55 | Mawer Market Update March 2020

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Rob Campbell: **00:38** We're recording this podcast at 4:00 p.m. Eastern on Thursday, March 12th. Quite remarkable day in the markets, the S&P 500 was down close to 10%, indices in Europe were down even more than that, 11%-12% on the day—and this despite a pretty rocky couple of weeks. Hard to imagine that the S&P 500 hit an all-time high just three or four weeks ago. I'm joined by our Chief Investment Officer, Paul Moroz, to provide a little bit of context on what's going on, and how we're responding at Mawer. So Paul, welcome to the podcast.

Paul Moroz: **01:11** Thanks Rob, pleasure to be here.

Rob Campbell: **01:13** Can we start there? What is going on?

Paul Moroz: **01:16** Well, you have countries globally that are recognizing that they need to contain this coronavirus [COVID-19]. What that means is that you're limiting, effectively, social interaction, and you're clamping down on demand. And you can imagine—if you put everyone in quarantine like Italy has done—you're not going out to the theatres, you're not going out spending money shopping. Your shop has shut down, and demand has been drastically reduced. So, it's a funny situation—in that we know humans are social. We know that you want to go out; you want to do things; you want to run your business. But it's this sort of...self-imposed program to contain and mitigate the virus. So, it's a funny thing in that once we work through this as humans (society), all those natural human tendencies are going to bounce backand you're going to see a return to demand.

Paul Moroz: **02:18** In the meantime, you have a real significant economic event. I was on the phone with a friend of mine. He's from Edmonton; he's building a house. He gave me an example of how this can back things up economically. He was ordering a light fixture for his house and right when the coronavirus broke out in China, he got a call that the lights would be delayed. Now, it could have been a problem that someone who is doing the pick-and-pack out in China at some warehouse was quarantined. The problem could have been that there was a worker problem such that some component that made up this lighting unit wasn't going to be available and that backed the whole thing up. Or maybe it was somewhere else in the supply chain. But from that example, you started to recognize that the supply chain was backing up.

03:10 Now, where that helped me out in understanding the micro and connecting that with the macro, is that my friend (whose name is Eric), said [that] as a consequence, "I'm not going to be paying for a couple more weeks until this product's in." So, all of a sudden you can see the situation we're in now, where, on a micro level, if your payment is deferred; if then, that warehouse in China or wherever it's coming from isn't ordering from someone else to replace their inventory, there gets to be a bit of a financing problem. It creates a crunch. And what this can create is a bit of a normal accident. You can imagine a car accident on the highway—if everyone's going very fast and then something breaks, you get a multi-car pileup. And I think this is what's happening. And the longer this goes on, the greater chance of a larger pile-up.

04:06 Although, we can recognize that this can turn around very quickly too. Yesterday, we saw the first instance of a broader recognition of this, perhaps, financing problem, in that a number of companies and larger asset managers said to their private companies to utilize their full lines of credit. And a number of companies spoke with their bank and are utilizing their full line of credit, because they are worried about increased working capital to get through this period of time. And whether that's the delay of payments, bad receivables, the fact that they might be paying their employees even though they're staying at home and maybe they can't even contribute to their role...the world is starting to prepare for a bit of a cash crunch. So that's part of the story.

Rob Campbell: **05:02** So there's a supply aspect, there's a demand aspect, and potentially a growing credit aspect to it as well. Can you speak a little bit to... clearly, and just today, [an] announcement from the Fed in terms of liquidity injections. Can you comment on the policymaker response to date? And the efficacy of that response to date?

Paul Moroz: 05:21 Well, I think that the central banks around the world are starting with the tools that they have. The starting point is tougher comparing this to 2008, in that you're starting with a very low-interest rate base or negative interest base in some cases. That's the bad news. The good news, at least they have the playbook for this. And so, very quickly the Fed cut 50 basis points to inject some liquidity. Today they are back on the quantitative easing, buying back bonds—and that's really to make sure that the system—the financial system—the plumbing, doesn't get gummed up. Because we're starting to see instances where maybe it's not going to function as well as at the core.

06:09 Your banks are in a lot better shape. So at the core, I think that's fine. In terms of policy—that's going to be required. I don't think it addresses the core problem of this self-inflicted reduced demand to contain the virus. And central banks or governments are going to have to find ways to get capital and to relieve people in a position where they don't have access. They're not getting the benefits of the current policy. Other places around the world say Hong Kong…[that] they're handing out money to individuals to get through. And I think it's possible that you see more fiscal programs like that around the peripheral of the economy.

Rob Campbell: 06:55 You mentioned the banks being in better shape than just over a decade ago and having a better playbook today, yet banks seem to be one of the hardest-hit parts of the market that are selling off. Can you comment on just what other parts of the market are being hit the most? And what are parts of the market that had been "relatively" unscathed?

Paul Moroz: 07:16 Well, I'm not sure there's a whole bunch that's been unscathed, saved some longer term government bonds in say, the United States and Canada. But maybe just commenting on banks first, where in many places around the world, they're just so much better off as the leverage is under control and regulations that went into place after the great financial crisis made it so that they just can't take as much risk. So, there's a double-edged sword: I think they're in a much better spot because they're not taking risks, but they're not acting as an absorber of risk during this time period.

07:53 One of the reasons they are getting hit is…what we've seen across time in Japan and in Europe as interest rates and long-term bond yields have come down, it has really pressured the net interest margins of banks. It's just tougher to make money. And that's going to hurt the U.S. banks. And I think that's the big part of what investors are thinking. So, in some ways they're less riskier, but there's this macro factor that's being priced into banks.

Paul Moroz: 08:26 Just to follow up on your question about well, "what's been hit the most..." I think this is where we get into energy. Because of course, the major surprise last weekend was when the Saudis came out with the announcement that they were increasing output of crude oil, effectively sparking a price war. And the energy sector has been decimated. In some places, the securities are down 50%, 60%, 70%. Currently, we have a cost of crude oil that's trading below the marginal cost, but part of that is because you have this demand for crude [that] has fallen off the map with containment. As government's cancel flights and trips around the world, you're just not consuming the fuel like you would in the past, which backs everything up the energy chain.

Rob Campbell: 09:16 Why have technology stocks—again, in relative terms—hung in better than other parts of the market?

Paul Moroz: 09:21 In this—and again, this is just kind of one scenario—one economic scenario that played out, where you had supply chains problems and a cash crunch problem...if your business model was based on physical stuff and shipping it from A to B where...maybe you're shipping it from China to somewhere else and then you have to finance that inventory, all that becomes more difficult under the current climate. Compare that to a lot of technology business models where the product or services—it's really virtual. There's no inventory; the business model doesn't require you to finance anything. And in fact, some technology companies—maybe if you're an online provider of information or maybe you're shipping goods, you're an Amazon—you might actually benefit a little bit from the increased services you provide over the internet.

10:16 So I think that's why you're seeing a little bit of a disparity. In China, what's amazing is their stock market is doing—even though the virus originated out of China, their stock market is doing wonderfully relative to the rest of the world. And part of that is some of their large technology companies that are managing through this.

Rob Campbell: 10:36 Can you speak to what we've been doing in response? How would you characterize the level of activity across the research platform over the last couple of weeks?

Paul Moroz: **10:46** Well, as we receive new information, we shift with it, but we're very lucky in that we're starting from a very solid footing. This investment philosophy of buying quality companies run by able and honest business people and reasonable valuation puts us at an excellent starting point. We have made a few adjustments in the coming weeks. Companies with more debt—we've tended to trim and reduce. Financial companies that are interest-rate sensitive such as banks we've tended to reduce. We've tended to increase those companies that are less impacted by backing up of the supply chain are less impacted by people taking the time to work from home rather than a work location. So, more internet-based businesses.

11:39 So it's been subtle shifts. We've also been cognizant of the scenario that just carries on and gets worse and you run into this cash crunch. We have reduced our credit risk in our fixed income fund; we have made sure that we have cash reserves in our equity funds just to manage the volatility. So those are some of the things we've done, and we feel that we're in pretty good shape.

Rob Campbell: **12:07** What about from a process perspective? What has your message been to the team over the past couple of weeks?

Paul Moroz: **12:13** My message to the team and both our staff, the organization, as well as our clients, is that the reduction in demand is very much imposed by ourselves to help contain this virus. And the core building block of economic activity is that people are social and people will continue to be social. We might do it a little bit differently after, but eventually, this will bounce back. It's not the zombie apocalypse. Even if we have to go through a longer, tougher period of time. So that's the first message.

And then the second message is that volatility is normal. We're not sure how long this is going to go on for, or exactly what the impact is going to be. Part of the message is we have to prepare for multiple scenarios where the portfolios are resilient. In a good scenario where this is a short-lived event, we want to be able to bounce back quickly. And at the same time, if this goes on for a prolonged period of time, we want to make sure that all our businesses or companies or investments survive, and when the economic climate does change, can then bounce back.

Paul Moroz: **13:17** The stock market is a reflection of people's collective feelings. People get scared or angry or happy or greedy, and that's projected out in the stock market. And that, as we know—people are emotional, they have feelings. We have to recognize that with that volatility and the feeling scared or happy or greedy or whatever it is—that's okay in this period of time. We just have to acknowledge that it's okay to feel scared and that the stock market is just reflecting that and that volatility is normal.

13:55 So that's what we're telling people. Acknowledge that, and remember why we're investing in the first place. And that is: we have this wonderful system where if you work and you save and you invest in productive assets, those companies or those investments will compound the interest payments and compound the earnings and dividends. And of course, there's going to be setbacks. But over long periods of time, there's this wonderful mathematical function of compounding these returns. And that's the long game. So the message is: don't forget the long game. This volatility is expected. Of course, we're going to run into situations. It's going to look a little bit different every time. This is certainly looking different, but it looks a lot the same as other situations in the past, as well.

Rob Campbell: **14:50** Certainly most of the clients that I work with have 10+ year's investment horizons, but you [also] mentioned some of the aspects of what it is to be human...certainly, some of the aspects of what it is to be human is to be curious and try to understand what's happening on a shorter term basis. Can you comment on how our investment strategies have been performing, generally speaking, through this environment?

Paul Moroz: **15:11** Well, we're very pleased with the performance on a relative basis. Across all of our strategies, including fixed income, year-to-date we're ahead versus the appropriate relative benchmark. So, the bad news is we're down, absolutely. The good news is that we're down less. We're adding relative value and holding up better in a down market, which has typically been the result of our investment philosophy in the past. Fortunately, we've received a little bit of benefit from some of the negatively correlated assets that we hold in, say, our balanced funds. By that, with the Canadian dollar being down, you're getting an offset with foreign currencies and you're getting an offset with sovereign bonds both in our Canadian Bond Fund and our Global Bond Fund.

Paul Moroz: **16:02** So, as of yesterday, as an example, our Global Balanced Fund was only down a percentage point year to date [Note: Paul misspoke; he was referring to Tuesday, March 10th performance, which was for Series A Net of fees, -0.76%. At the time of the recording, Thursday's market had not yet closed]. There'll be a hit today with the market, but even if on this extreme day it loses 4% or 5%, given what's going on and that those balanced year-to-date losses are only 6%, I mean, I think that's relatively a pretty spectacular result and demonstrates the resilience that we're trying to put together with our investment decisions.

Rob Campbell: **16:32** What about us as a business? Are we doing anything differently either as a research team or as a firm given the coronavirus outbreak?

Paul Moroz: **16:11** I guess there's two elements of it. There is, one, we're trying to communicate a lot more. That's the purpose of this podcast—we're trying to reach out to clients. And certainly, if you're a client [and] if you're listening and you want more information or ideas, please get in touch because you're at the heart of capital markets, of reinvesting intelligently. So we want to provide you as much information as possible and allow you to make the best decisions.

16:37 As a business we have employed various systems or methodologies to reduce business risk. What's nice is that we have offices in Toronto and Singapore as well as Calgary, so we're already, I guess, geographically diversified. Our people in Singapore and a number of our traders for some time have already been "self-quarantined," such that we just don't want any sort of issue where an entire office gets knocked down. So we have some systems like that. We, of course, have the computer systems to back things up. And our management committee has established a virus task force, so to speak, and has a number of different contingency plans should things continue to evolve to the negative.

Rob Campbell: **17:24** Paul, one last question before I let you get back to work. And it's a question I think that's often asked of CIOs: what keeps you up at night? And I just wonder how has that changed in the last couple of weeks?

Paul Moroz: **17:36** Well, I mean you can't control how other market participants price the investments that you own. And one of the things that's happened, is, if people are really scared and if they panic—that psychology is going to be reflected in the market. We have to make sure that we're in a position liquidity-wise where we can offer liquidity to clients and make sure that the financial system as a whole is running smoothly. So that's why we've worked so hard on different liquidity reports and providing offsetting investments such as bonds that can help support that liquidity function.

Paul Moroz: **18:18** And I've been very pleased in the last week that I feel we have a very good position. Even as something as simple as all our money market investments are invested in T-bills right now. It's ultra-liquid and ultra-safe. It's what I constantly worry about and it's something that we've managed and put ourselves in a very strong position—and our clients should know that. It's important for people to temper their emotions and recognize that while there's risks out there and there's dark clouds today and maybe on the horizon for a bit, there is a silver lining. Don't forget about the return potential and the opportunities that may very well come out of this environment. And that's important to keep a balanced perspective investment-wise.

Rob Campbell: **19:00** Well, thanks Paul. One of the longstanding tenets that we've had at the firm is that the middle of storm is not the right time to fix your ship. Rather, it should be properly fortified long before you set sail. Certainly, that feels like this type of environment, and thanks so much for your work that you do for our clients.

Paul Moroz: **19:16** Thanks, Rob.