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EP71 | Playing the plan: Mawer's global equity portfolio

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Andrew Johnson:	**00:40**	All right, welcome back to the podcast, Paul.
Paul Moroz:	**00:43**	Thanks, Andrew. Thanks for having me back.
Andrew Johnson:	**00:45**	Paul, the last time that you and I sat down—I think it was late January, early February—that was just prior to a very clear point of demarcation this year, with the sharp downturn that occurred shortly after that. And subsequent recovery—at least from a market perspective.
	01:04	I think at that time, we talked about the importance of building resiliency into a portfolio. You've joined the podcast a few times since then, and covered that topic further. But maybe from a Global Equity Fund perspective, how has that resiliency been demonstrated throughout 2020?
Paul Moroz:	**01:20**	When we were talking, we were in the midst of making sure that the portfolio was what we're calling "in two spots at the same time." That's really what we mean by resilience. So that you could end up in two, or multiple scenarios, and whichever scenario you end up in, you're going to be okay, it's going to end up bouncing back over time—even if it's a tough scenario.

Paul Moroz: 01:41 So literally, we were preparing for both a depression—something that I'll say the recent generation of investors has never seen—and as well, this idea that perhaps we get through this, or the stock market looks through this. And in particular that the earnings recession, the decline in earnings in corporations, would be more than offset by interest rates that were lower. In one of our blogs that we put out we said, historically, it's been sage advice not to fight the Fed. There's a reason. There's an opportunity cost to the cost of money, and lower rates from the Federal Reserve, lower bond yields… that usually translates into support for all assets.

02:34 Now looking back, in hindsight, it was that latter scenario that played out. We're not looking at the world where, in some cases, it's recovering. There [are] still stark differences between Wall Street and some larger companies, and Main Street. Some people are calling this a K-shaped recovery, because it really depends where your spot is in the economy as to how you're actually doing. We're in a spot where the market is rallying, particularly in some spots, and driving new market highs.

03:07 So, that's the recap. It's a really good example of how you have to approach financial markets, stock markets, with a very high degree of humility, and recognize that different scenarios can play out.

Andrew Johnson: 03:21 How would you characterize the role that risk management is playing right now? Clearly in the market, it's probably not being rewarded currently…

Paul Moroz: 03:31 Risk management is a cost of doing business [laugh]. It is not being rewarded. I don't think risk management has been rewarded for a long period of time. Particularly with respect to the notion of valuation, it's been a lot more difficult. There are spots in the market where there's some froth, and there's also spots where investors have to have a different lens on valuation, where some of the traditional approaches are different.

03:59 But in general, it has seemed like—and partly governments, and partly central banks, they're responsible—they've come out and have tried to support the economy with fiscal stimulus and monetary stimulus that's, at a scale, even more significant than 2008/2009. They've actually stepped in and taken the risk out of the market, they've taken that. They've said, "we're not going to let this collapse. You're not on your own, we're stepping in to help." As a result, risk management I don't think has been rewarded, because they have been fulfilling that function.

Andrew Johnson: **04:36** Can you give me an example of where you or the team have taken a different lens on, you mentioned, a different lens than you would traditionally view valuation, or the analysis of valuation?

Paul Moroz: **04:47** Well, I think one of my colleagues who works on the technology front, Justin Anderson, the way he explains it is, business models have changed such that more companies are investing through their income statement. In other words, they're not investing in property, plant, and equipment, they're not building a factory to expand their business, that would be a capital expenditure, and that would then be depreciated over time. So the cost is actually amortized over many years in the future.

What often happens is, a company is investing in acquiring more customers, it's rapidly growing, and that means that if you match that expense, if you actually capitalize it and match it to the life of the customer, you get a very different accounting number.

05:39 So, we have to try, as best we can, to appropriately match these costs, and understand, well, how long is that customer going to last for, how much does it cost to get that customer? And really peer into the true economics of the business. If you don't do that calculation, you can peer through valuation from a very simple lens of basic multiples. We hear the financial press talk about price-to-earnings ratios, and price-to-book ratios, which in and of themselves don't mean a whole bunch without the context of understanding how much cashflow the business is expected to generate, and when that cashflow actually lands.

The lens which we approach valuation, which has really helped us out, is through our discounted cashflow models, where we're just trying to figure out how much cashflow a business will generate. But, that's the one problem with valuation.

06:35 Another significant problem, I think—I don't even mean to look as a negative, it shouldn't be a problem, it's just a challenge—is businesses have evolved dramatically. And we have a very different investment climate that we would've 100 years ago. 100 years ago, you expand[ed] by building a factory, you need[ed] more capital to expand your business, and there's still a *cost* to expanding.

07:03 One of my favourite business examples? A used car business. Imagine you own your used car business. You expand by buying more used cars—that takes up capital. And then, when you sell that used car, there's of course the cost of the car that you purchased. There's a margin on it; there's still an incremental cost.

Paul Moroz: What's happening now with a lot of these technology businesses in the world, is well, first of all, when a new product is created, you have access to distribute that product to potentially millions, if not *billions* of people. Instant distribution. Never mind trying to attract a few people to your used car business. Never has business experienced this sort of instant distribution. That's made all possible because of the internet. So that's a major change—incorporating that power of distribution.

08:01 Then, the second piece: for so many of these…call them "virtual businesses," the marginal cost of selling to a new client is often approaching zero. Imagine you've created a video game, you're distributing it to many millions of people. If you add another client who then plays that video game, it really doesn't cost you anything. The inverse of that is the incremental margin is very high.

08:29 So how do you price or value these businesses in a capitalist world where there's the potential to distribute to billions of people, millions of people, and your incremental cost is very low? These are clearly different animals. That optionality is worth something. Valuation still matters. It's not worth an infinite amount, but it presents the entire investing community with a real dilemma in terms of how to value. What is the appropriate range of outcomes?

09:03 The truth is the range is very wide. We do the best we can to estimate and diversify, but we're dealing with a very wide range of outcomes in valuation. As the internet's developed, that's just a characteristic of the investment climate of what we live in. And for those reasons, and the accounting reasons, we have to be very careful when we approach valuation. And recognize there's a really large range of probabilities. That's a lot to unpack, and I appreciate the nature of that.

Andrew Johnson: **09:34** Yeah, absolutely. I want to pick up on the sentence that you just said, which is "a characteristic of the environment that we're operating in now." I think, (coming back to your earlier comments about central banks and monetary policy and how they're stepping in and stepping up), I think one thing that's been noted in response to the pandemic in particular has been the tools used from governments and central banks. Notably, the contrast between the fire power that we've seen from Europe and North America, what they've employed, versus what we've seen from Asia, for example, which has been modest in comparison.

10:10 What are your thoughts on why that might be the case? Of how they've come to those different decisions? And if any, what are the implications moving forward?

Paul Moroz: **10:19** Well, I think that there's probably differences in the currency regimes and difference in culture and the politics that have to be taken into consideration.

10:32 So every region, whether we're talking about the United States, or Canada, or Europe, is going to be a little bit different in terms of how they approach their monetary policy and the fire power, or the perceived fire power they have. Even consider a country like Germany, who historically underwent a period of hyperinflation, which has made a number of the finance people that are running the economy very concerned about using some of the tools that they have. At least historically that's been their position. That's one of the things that has shaped policy.

11:10 I think that governments and central banks are starting to also acclimatize to this post Bretton Woods world. It seems like every crisis, they reach a little bit further with both monetary and fiscal policy. That's partly maybe a change in, or acclimatization, that's gone on. People are becoming more comfortable with using those tools. And I think countries—this might impact some of the differences between different regions or countries—countries that have a greater reserve currency status might be tempted to employ their powers and flex their muscles a little bit harder. That's the United States. They might have a ways to go on this, because they're in a position that's envious in terms of having a reserve currency and being able to issue debt. And frankly, set the cost of money across the entire bond yield.

12:14 In this environment right now, central banks are choosing the cost of money not only overnight, but I think probably the majority of the yield curve. That's extremely powerful policy.

Andrew Johnson: **12:27** It is. And talking about flexing muscle, and maybe the state of reserve currencies going forward, I think one of the other topics we covered the last time we spoke was this continuing evolution of the power dynamics between the United States and China. I think our clients and our listeners are always curious about the connections to the investment portfolio that may have, but I think equally curious about, perhaps, the broader implications for the world going forward. Whether that's economically, socially, technology's certainly at the top of that list.

12:57 Can you speak to those dynamics, from either your or the team's perspective?

Paul Moroz: 13:01 Well, I think the most interesting dynamic has been what's going on with TikTok, where President Trump came out and effectively ordered the owner of TikTok to sell the application in the United States. If you're not familiar with the program, it's short little videos that is sort of an evolution of Facebook; an evolution to what YouTube is. But, they're short little videos that could eventually be used for advertising.

13:29 And I think that sort of…I don't know, to the extent that the owner of TikTok, which is ByteDance, whether it actually is a security risk or not. But it's resulting in a greater divide between China and the United States. To the extent that people have talked about almost a technological iron curtain.

This is of interest to us in terms of expansion, because ByteDance is a private company right now, [and] they're a competitor to Tencent, which we own in our international portfolio and in our emerging market portfolio. This is where politics can intersect with the microeconomics—to the extent that a Chinese company can't expand into North America because of the political climate. Or, to the extent that a North American company can't expand into Asia. That, of course, impacts the growth dynamics and future margins, and so on.

Andrew Johnson: 14:29 Speaking of politics…and you've mentioned President Trump there. Another curiosity, I think, that's very common among our clients and our listeners is the upcoming U.S. election. That happens every four years…

14:40 Can you just remind our listeners what outcome we're placing all of our clients' capital on?

Paul Moroz: 14:46 [Laughs] Which outcome? I really don't know which way this will go, as so many events in the world. I think we're always trying to position capital so that we're indifferent. That's the idea of resilience. So, whichever scenario we end up in, we're going to be okay.

15:05 We recognize that if the Democrats are successful that there's a chance that there could be a roll back on some of the tax breaks corporately. That could impact valuation. It seems like the current slate on the Democrat side is much more moderate than some of the previous choices, so that's probably going to be a little bit better for the stock market. There could be some surprises on healthcare, either way.

Paul Moroz:	**15:31**	For us, I think it's possible it creates volatility, but we're pretty confident in the wealth-creating nature of the companies we have. They're going to survive, and adapt, and continue on.
		Our goal is to bet on that wealth-creation effect and the people and make sure prices remain reasonable. And, focus on that core investment philosophy. It's back to playing the plan, I guess, Andrew.
Andrew Johnson:	**15:56**	Yeah, absolutely. Good plug for this episode.
	15:59	I'm jumping around here a little bit, but this comes from a recent conversation with a client. Generally speaking, how do you and the team think about mistakes? The other way I would phrase that is, how do you determine or classify a decision as a mistake? And what role, if any, does that play on the team?
Paul Moroz:	**16:18**	I mean, it's a really tricky concept. I think you have to back up first to talk a little bit about process and culture before we even get into classifying the mistakes themselves.
	16:31	The reason I say that is because when we think about risk management—and there's a few different levels, there [are] four different layers for us when we think about risk management—but the base, foundational level is actually culture and communication.
		It's really important for us that across our people that are engaged in investment research and making investment decisions, that there's a safe place to study mistakes and learn. That's actually extremely important. And it's important for leadership to lead by example and have the humility to recognize that we can, and do, and have, and will, make mistakes. That's just part of investing. The trick is to recognize that and then be humble and learn from those mistakes. Adjust to them.
	17:25	So, people should know that we have a process, a formal process. It occurs once a year, where we dedicate time to reflect upon what we've learned from our mistakes. In some cases, we go so far as to write what we call "exit reports." People are well familiar with an initiation report—why they've invested in a company. But what about the companies that don't work out well? In some cases where there [are] significant learnings, we'll actually study those businesses and what happened and what went wrong and how the decisions followed from there. So, process-wise, that's part of our DNA.

Paul Moroz: **18:06** Now your original question was, "how do you classify, how do you know whether you make a mistake, or when to look back on it?" It's a pretty difficult question because my counter-question would be, "over what time period would you consider that mistake?"

If you lost 100% of an investment, clearly that would be a mistake. But if, let's say, you didn't invest in a stock that, over the course of a year went up more than another stock in your portfolio, is that necessarily a mistake? What if you looked at that over two years, or over three years?

18:41 This is a really difficult thing to measure because there is no endgame to investing. It's not like we're in the Stanley Cup Playoffs and you look back at the game and the game's over and you can say, "okay, that play was clearly a mistake."

Unfortunately, the game carries on in investing. And in fact, something that looks like it wasn't a mistake because of positive feedback—usually through a stock market performance—can still go terribly wrong. If we're back to our NHL hockey analogies, if you make a mistake, it's possible that all the Stanley Cups you've won in the past get taken away from you. A stock can always go to zero, even if it goes up in the short term.

19:27 So how do you approach that? Well, I think you have to do a couple things. You have to weigh the different time periods, both recognize what's happening in the present, but taking a long-term perspective. And then, I think you have to consider different environments (or I call them "regimes") of recognizing that what we're perceiving as "not a mistake" *might* have been a mistake in an environment where there was, maybe, rising interest rates. Or so on and so forth. It's not an easy question that you pose. It's an excellent one, but it's a tough one.

Andrew Johnson: **20:03** I think that's really great perspective, Paul. Thanks for sharing your insights on that.

20:08 One thing as we get close to wrapping up today, we always like to take a look at a business or two in the portfolio—(today, we're talking about the [Mawer] Global Equity Fund in particular)—just to illustrate how we are playing the plan, like you said, and see our philosophy and our process in action.

20:22 One example that I wanted to ask you about today was Couche-Tard. My question was, out of all of the convenience store operators around the world, why Couche-Tard for the Global Equity Fund?

Paul Moroz: 20:33 My colleague Christian Deckart, if he was here, would immediately talk about the specific culture that Couche-Tard has created, and really, a culture around operating excellence.

20:44 So when we think about any company, it doesn't matter where it is, we're benchmarking it against its global peers—in terms of metrics that matter. Both the metrics for the industry, in the case of Couche-Tard, margins per gallon of gasoline which, in their most recent results, they were ahead of their comparable peers. As well as more generic metrics that demonstrate the efficiency of the business. For us, that's largely return on invested capital.

21:12 When you run through that exercise and see the results of the company and compare them, that's why it floats to the top within that industry. They're really excellent operators on a global scale. At the heart of what they're doing, *that's* the competitive advantage.

Andrew Johnson: 21:28 So when I think about operating a convenience store, and you mentioned that they're obviously excellent at this, that tells me a lot about the here and now, about the cashflow that they're receiving from their current operation. What about going forward? Is there upside to holding a convenience store operator? Or is it a more mature industry?

Paul Moroz: 21:45 Well, it is more mature. And it's probably a good example of something that the balancing factor's always price. How is an investment priced? We recognize that there [are] companies out there that have more significant growth prospects, but how much capital is going to be required to achieve those? Or, what is the price of that in the market?

22:07 That's why when we're putting the portfolios together, we try to come up with a very balanced approach and look at discounted cashflow models to understand...just compare these companies to each other that might be very different.

Paul Moroz:	**22:23**	If we compare it to an IT consultant company (we were talking about this before, [Accenture](#)), *that* business has probably much more significant organic growth prospects because they're helping organizations transform and manage IT across a whole host of solutions. They're growing at a much faster organic rate, and are acquiring small tuck-in acquisitions that enable them to expand into emerging fields, whether it's cybersecurity or so on. What you get with that business is better growth prospects, but you have to pay a higher price for the cashflow that's coming in right now, recognizing that it's going to be growing in the future.
	23:10	Again, how do we square that off? Our discounted cashflow models. Accenture's an interesting case, because we're pretty clear that (and I think the world's pretty clear that), there's going to be more technology in the future [laughs]. There's going to be more technology in business. Our approach with Accenture is thinking about the old Levi Strauss model: where sometimes you don't know which gold miner is actually going to strike it rich, but if you can sell jeans to everyone on the way out to the Klondike? You're going to do okay. That's the way I think about Accenture. On a risk-adjusted basis, you get to capture that technology theme over many years.
Andrew Johnson:	**23:50**	That's great. Well Paul, that's actually all of the topics that I was curious about today. I'll throw it back to you: is there anything else that you want to share with our listeners before we leave today?
Paul Moroz:	**23:59**	Just that I think that we remain in a very difficult market environment. There [are] still a lot of risks out there and we're doing as best we can a job to balance the two big risks of capital impairment with participating in the upside of these different businesses. We recognize that there's going to be different outcomes. Either one could make us look relatively better or worse off. But, our goal is to get clients to the end of their journey in a resilient fashion, no matter which way the world turns out.
	24:44	So, I think we've used the term resilience, I don't know, a dozen times. But that is the key feature of what we're trying to build into all the portfolios at Mawer.
Andrew Johnson:	**24:54**	That's great. It was great to talk to you today, and I really look forward to talking to you in the future.
Paul Moroz:	**24:59**	Absolutely. Thanks so much for having me.