



[00:00] Rob Campbell: Coming up on the Art of Boring, Paul Moroz returns for a timely conversation on markets, conflict, and managing risk when the list of things to worry about seems to only be getting longer. We start with the recent escalation in the Middle East and the market reaction so far, then widen the lens to AI, to software, hyperscaler CapEx, and private credit.

Along the way, Paul explains why second-order effects matter, and why in markets like these, the weighing machine can feel a little outnumbered by the voting machine. In the end, a useful reminder that while headlines can change quickly, good portfolio management is usually a series of smaller decisions made over time.

[00:59] Rob Campbell: Paul, welcome back.

[01:01] Paul Moroz: Hey Rob, thanks for having me.

[01:03] Rob Campbell: It's twice in quick succession. Last time you were on our podcast, which I think was hardly a month ago, you walked us through how in the vast arc of human civilization, over and over again, there was this tendency or a pattern for divergences in economics to influence politics, and in turn, to lead to conflict. We're recording this today, two and a half weeks into a sharp escalation in war in the Middle East.

Can we start there? What have been the most important impacts from your vantage point so far, and can you help us understand the market's reaction over the last couple of weeks?

[01:39] Paul Moroz: Maybe just transition from the earlier podcast or topic, these things are completely unpredictable, but not really, in context of human history. That's why, when we talked about adjusting the portfolio and more names and things like in this very different regime, adding things like gold, oil, and utilities, and just really diversifying - of course, we didn't know this would happen - but that seems to be the road that we're walking down.

What's happened? Well, the price of oil has spiked. You could expect that, and a big part of that is the logistics.

The Strait of Hormuz has closed, and I'm not sure if we've still felt the total impact of that, because of course, we don't know how long this is going to go on. If you think about how you actually invest in companies, it's all based on the timing of that cash flow. I was explaining to my youngest son about this conflict, and I said to him, the profit pools are shifting.

If oil companies make more money because of scarcity, well, their revenue is someone else's expense. You have to go through the value chain and figure that out, but the wild card is you don't know how long this is going to go on for.

Is this a one-week thing? Is it a two-week thing? Is it a month thing? Is there a term premium put on oil? Then there are all the complexities that attach to that.

To close off this opening, we still don't know how this is going to transpire. As a thought experiment, imagine that the sun collapsed. You have something like eight minutes while there's still sunlight.



I feel like it's the same thing with the Straits of Hormuz being closed. These last couple of weeks, you've still had products shipped, so you might only start to know the real full economics in the coming weeks.

[03:37] Rob Campbell: It does seem to be a pretty key question. Obviously, you've seen a ton of volatility in key commodities, like oil. Would I be wrong, Paul, in thinking that outside of that, market reactions have been fairly benign?

Not nothing, but perhaps a market that expects this to be resolved in relatively short order?

[03:57] Paul Moroz: I think that's right, and I think the market's taken it in stride. You can argue whether that's actually appropriate, whether the market's thinking long-term or whether the market's complacent at some of the longer-term risks and implications.

However, you still have had some effects. The yield curve has backed up around the world, and people are expecting more inflation. There has been some reaction at the margin to securities that have more of a discretionary nature.

Overall, it certainly hasn't been a panic situation.

[04:32] Rob Campbell: What's it been like at Mawer? I'm wondering if we can use this as an opportunity to get a real-time look at what risk management looks like in managing portfolios at Mawer, certainly the global equity portfolio, given that's the one that you manage.

What process-wise has this looked like within the team over the past two weeks?

[04:53] Paul Moroz: Well, the good news is we were running diversified portfolios. As I mentioned before, we were more diversified. As an example, we did add some oil and gas exposure.

What we have in there is Royal Dutch Shell, and as you can imagine, that has done well. In some cases across the platform, there's been, at the margin, some additions to energy producers, oil and gas.

There's been some cases where we've actually trimmed back exposure in different universes as it's run. One of the things that we've done in global equity is be thinking about the second-order risks as well. I can share this concrete example.

We had a small position in John Deere, which, of course, predominantly manufactures equipment for farmers. The other thing that is impacted in all of this is there might be 20% or 30% of fertilizer that comes through the Straits of Hormuz, as well. The same thing across the different types of fertilizer, prices have spiked.

Now, again, this may go on for a longer period of time or not, but second-order risks - you can think about what impact would that have on farmers making a decision of how much fertilizer to use, or what type, or what crop to plant, and how do they plan for capital allocations in the next year. As we went through this—remember, this is a complex question—and if I back up there, I mean, Rob, there's so much to talk about.

February was a pretty rough month in terms of news and things that were going on. One of the things that was going on was this, I'll call it, bits versus atoms trade. Software companies really got hit. There was the risk of AI disintermediating a whole bunch of things. The other side of that trade was real hard, tangible things. Companies that made stuff, just like tractors.



The specific case is John Deere, the stock price, got ramped up pretty hard because of that theme. We're trying to balance both the psychology of the market as well as the real risks that are adjusting. As a case study, we're in our models and trying to understand: how much is this worth? What's the range?

This is a very complex question for even a simple manufacturing company because we don't know precisely the exact margin that John Deere is going to make in the future. Management says they're going to make an operating margin or a target margin of about 20%.

We also know that they're probably going to sell more equipment in the future because things have been depressed. You can imagine if we went back to the really low interest rate times, probably it was easier for farmers to borrow money at a low rate and buy equipment. After we went through that interest rate adjustment, we've slumped a little bit in terms of the cycle.

We have to model varying outputs or ideas on both growth rates and the timing of the recovery, as well as margins, as well as the discount rate -just as an example of three inputs we use in our Monte Carlo simulation. When we run through that math, we were getting a fair value range of John Deere of anywhere between \$350 and \$400 a share to about \$650, call it 90% of the curve, probability-wise.

Now, I'm giving viewers the whole backup. All that happened before we get this extra risk of what happens if we have an extended war, an extended period of time where maybe fertilizer prices are high, or even that prices are high enough that farmers make a decision.

[08:55] Rob Campbell: If I'm hearing you right, this is not a process that just started two and a half weeks ago. Thinking of individual securities in the portfolio, this risk management has been taking place for a long period of time. Yes, there's been an additional maybe second-order impact that's happened today, but there are other risks in the background that have played out with this particular security.

More recently, just with the bump up in price, there's been an ability to make a shift with all of it. I guess with that in mind, that's another thing that I've been thinking about too is, for good reason, there's clear focus on the Middle East at the moment, but that's not to suggest that other risks weren't bubbling around in the background. You mentioned a bit on the bits versus atoms, but there are several other pretty important ones too that are worth mentioning.

[09:41] Paul Moroz: What we saw in February was really quite extraordinary. I've been doing this for 20 plus years, and one of the things that happened late February is, there is a report that came out by a research firm called [Centrini](#). It wasn't really an exact research report, but more of a thought experiment about how the future could play with AI.

Now, many of the listeners will have read it already and saw the market reaction, and you should read it. But what is fascinating about it is for just a thought piece that got people thinking about disruption, which as I believe the author later stated, this was just one scenario. It moved markets tremendously.

It wiped hundreds of billions of dollars off the market caps of companies. It was just a pause for thought on how sensitive markets are to this disruption, and how much voting there is in the market, and the feedback with prices and reality. The truth is, we're not going to know for many, many years exactly how this pans out.

We just won't. It'll evolve, and there'll be lots of different competitors, and there'll be responses, and there'll be acquisitions. People will try different things.



I mean, it's going to be an evolutionary process. In February, there was something similar happening with a debate on the CapEx of the quote-unquote hyperscalers, those building the compute for their customers like Microsoft, or Google, or Meta, Amazon.

The debate was really around the level of CapEx and the returns that would come from it. And what you saw, same type of thing where just as the CapEx numbers of these large companies came out, and they were quite big, the market took that as a big negative. That impacted short-term stock performance.

The question remains: in the long term, this is still a substantial investment opportunity, but there's that puzzle around, as this evolves, what's the return on capital of building out the compute and providing that to your customers through perhaps your unique distribution?

Google, Microsoft, and Amazon all have unique characteristics to their distribution and their business models, which is so important. Microsoft now focuses on corporations where security, privacy of data, and identification on who's on the network—everything's bundled together. It's really different than, say, what Alphabet is doing. We don't know exactly how this will play out.

On the other side, there's the concern, will we end up in a world where the AI companies, the LLMs, is it going to be one player? Is it going to be three or five players? Is it going to be a total commodity or a differentiated product? You're getting all these different debates about the competitive advantage.

As the market mood swings, one of the things that's happened is that there's a lot more programmatic or thematic trading of baskets. That'll just ripple through the entire market. I am less certain of price moves in securities being marked to market actually representing fair value than probably any time in my career.

I think we have to think about the weighing versus the voting and thinking about the bands of outcomes as very wide.

[13:28] Rob Campbell: You're saying that because of the way that market structure and trading has evolved, the Centrini report comes out, someone gets scared, they press a big button saying sell all software exposure. Indiscriminately, this entire bucket just moves down under a wave of selling pressure. But of course, not all those individual companies are the same. You mentioned Microsoft and Google.

[13:50] Paul Moroz: For sure. Or buying pressure. So, the other side of that was the atoms across the board.

[13:55] Rob Campbell: Mid-March now, understanding sort of the initial wave of momentum around that, have we started to see any differences between those where the concerns might be overblown and those where it was like, no, this was exactly the reason why you should sell these things?

[14:11] Paul Moroz: Well, some, but I mean, you don't have enough evidence to really sort this out. There's the deductive logic. We can say, all else equal, we'd rather have a software business that is backed somehow by proprietary data versus a software business that's based on data that's just publicly available to anyone.

Or, we'd rather have a business where they've monetized it in a way that privacy and security actually serve as a barrier or switching cost to another sort of software. Or all else equal, we'd rather have a business, we've looked at businesses before that have a regulatory angle to it. You just can't vibe code competing software because there's a whole regulatory requirement that you have to plug in.

That's the deductive logic of the work that we focus on. Right now we're in this space where the inductive evidence really hasn't played out to shift these companies one way or the other, and I think a lot of them are



getting hit indiscriminately.

What I mean by that is if you look at the results, I think that economics, right now at this moment, are all fine. The market is looking forward to the future. If we just build on this, if we take this second or third order risk, a greater concern of the market has now been around private credit lending to software companies.

And so, this has backed up and it's hit perhaps banks and private equity companies. Right now, probably the economics in most places are fine. Valuation and leverage is a different question.

But that's just another place where the market is starting to say, hey, this may not be right. So again, we don't know exactly how this will turn out. We're just going to be in this period of time, not unlike the advent of the internet, where there's that same sort of concern over what's going to be disrupted or what's going to be invented.

And we have to sort of speculate and you're going to have to manage all those competing risks with a lot of care, judgment, and an honest assessment on how the world is evolving. I'm really just trying to give viewers a sense for what's going on with a lot of these big risks. There was a lot in February.

[16:29] Rob Campbell: Correct me if I'm not thinking about this right, but if we've seen this shift from businesses that have traditionally required very little capital—in other words, can generate tremendous returns on that capital—towards a part of the market that's maybe a bit more capital intensive. For that part, your incremental returns aren't infinite; they require that capital to generate those returns.

And you also mentioned earlier just war, conflict, the inflationary aspects, the impact on discount rates, and margins being squeezed in certain businesses. Does all this result in a lower expected return when you do your discounted cash flow model and kind of across the board from equities?

[17:08] Paul Moroz: That's a really big question because there are a lot of different moving pieces. It depends on the company and it depends on the outcome. Incrementally, there are a lot of businesses that were traditionally capital light that are spending a lot more money.

Microsoft, Facebook, Google. Inevitably, the capital intensity of those businesses has increased. But I don't view that as in and of itself a negative. I think the question is, well, what's the return that you could get on that capital?

That's the real question. What's your incremental return once you bundle that new product and service with all the other competitive advantages that you have?

And there are, of course, different strategies with this, right? Apple has decided they're like, "We are not really investing in this. We're just going to collect the payment, put Gemini in our system from Alphabet, just like we did with Safari."

They're running this exact same playbook, and they are emphasizing their distribution advantage. They have a distribution advantage because of their ecosystem and iPhones in everyone's hand. Other companies like Microsoft and Amazon, they are not going to earn 100% incremental returns on their investment, but they might get 15% or 20% return on invested capital.

And they may find a way to, and they are, bundling that with their relationships with the LLMs. For example, with Amazon, they have an investment in Anthropic. And to the best that we understand is they have a revenue share agreement with them. That investment in compute and that capital heavy piece, they're utilizing their distribution, and there's going to be a capital light revenue stream that comes on top of that.



Certainly, they're going to spend CapEx over the next few years, but these guys are capitalists. Can they generate a very high return? Yes.

That's the picture that you want to remember too, is you actually want to find investment projects that will earn a high return and improve society and have long runways. That's how you really make a lot of money in the stock market. There are other spots, still to your question, if we shift it to war, conflict, and higher input prices, this is where we start to get into this stagflation scenario.

You could have scenarios where consumers have less money to spend and discount rates are higher, and there are going to be some securities where maybe the return expectations should be lower.

Going back to what we were talking about with John Deere, thinking about what happens if interest rates are higher. If you're a farmer and you have to borrow money at a higher rate, you're spending more on fertilizer, and you're buying less equipment, maybe your discount rate is higher in the first place. What should that do to the intrinsic value range of the stock price?

It has to shift and move. And in some cases, and maybe Rob, it's that some of the commodity producers still are undervalued in this environment because there's going to be a correction or reversion to the mean when in reality, we're just in a different investment regime. So it's very complex.

Back to the idea about thinking probabilistically, building a portfolio. It's not about one stock pick. It's about lots of diversified securities, how they're woven together, about intelligent judgment and thinking probabilistically.

This is the world we're in.

[20:49] Rob Campbell: Can we end there on the topic of the portfolio? And you've been in the seat for about not quite nine months at this point, re-assuming the leadership of the global equity strategy. Where are you even really pleased with the strategy over that period so far?

And I'm going to bet that increased diversification is part of the answer. And conversely, where are you a little bit more disappointed?

[21:12] Paul Moroz: The way I look at it, a portfolio is really a series of very small decisions that over time add up. We didn't have a large position in John Deere. We had a diversified position.

But as you start to make those intelligent decisions probabilistically, you don't get all of them right, maybe you get 55% or 60% of them right. But buying stock at 400 and trimming it at 600 based on fundamentals and economics, and you do that enough in a diversified fashion across the portfolio, and it starts to add up over time.

The challenge that I had coming in, it's stock versus flow. The stock was the portfolio I had to work with in a radically different environment. And there were a series of decisions that we made to diversify and align with the platform. We're now sort of in sync and in rhythm with the market to focus on flow.

All these little decisions as the stocks move just back to the core. Can we improve the valuation? Can we upgrade the quality of the management teams? Can we improve the risk metrics of the portfolio where it sits in the fair value range? All those little things. It's coming together. It just takes time.

[22:31] Rob Campbell: And as long term investors, yeah, it's certainly these little 1% or even one basis point moves and decisions that over time really do try to compound both for the companies that we invest in and the management teams and their decisions, but obviously for the decisions that we make as well.



The job of a portfolio manager is never easy. I imagine it's particularly not easy today.

Appreciate you coming on and sharing your latest thoughts.

[22:56] Paul Moroz: Just so people remember, and there are a lot of business people that will listen to this. We're measuring this voting of a portfolio day by day, company by company, and calling that voting performance. And for anyone out there that's actually built a real business, I mean, it takes years and years.

Even a couple years is like a very small period of time. So, remember the long game of what it is we're actually investing in. Sometimes it's very easy to lose sight of that when the market's moving one way or the other.

[23:30] Rob Campbell: Well said. Thank you.

[23:32] Paul Moroz: Thank you, Rob.

[23:34] Rob Campbell: Hi, everyone. Rob here again. To subscribe to the Art of Boring podcast, go to mawer.com.

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