MAWER
newsletter

Third Quarter 2017

# Market overview

Monetary policy “normalization” returned as a major theme this quarter. As indicators for the global economy continued to show signs of strength, central bankers in many major economies—e.g., U.S., Canada, China and Europe—have signaled that the end of a very loose monetary era is nigh. Markets may be facing an important inflection point.

For Canadian investors, this monetary environment has landed close to home, with not one but two rate increases in the past three months. Canada has been leading the pack among those countries that are tightening their monetary policies, resulting in the Canadian dollar strengthening appreciably versus a basket of major currencies. For example, the Canadian Dollar (CAD) reached a high of 82 cents to the USD in this period. One consequence to this surge has been to investments held in foreign currencies—i.e., a higher CAD has muted what would have otherwise been strong returns.
As ever, we view the increase in the CAD as a temporary headwind—sometimes currency works for you, sometimes against you—and the long-term case for investing globally remains compelling.

Overall, world equity markets performed strongly, with the MSCI ACWI Index gaining 4.4% in local currencies (1.3% in CAD). In Canada, the S&P/TSX Index was helped by recovering commodity prices and a strong domestic economy and rose 3.7%. Meanwhile, rising rates in Canada and globally contributed to negative returns in fixed income. The FTSE TMX Canada Bond Universe Index fell 1.8% and the Citi World Government Bond Index dipped 2.0% (CAD). Together, this meant that Balanced returns were marginally negative for the quarter; the Mawer Balanced Fund (Series A) fell -0.3%, but remained positive for the year at +5.6%.

**Big picture issues and observations:**

- **Central Bank expectations**
  The Bank of Canada doubled the overnight rate to 1.00% via two moves during the quarter. Elsewhere, the bias has been to raise rates and remove quantitative measures gradually. How quickly central banks tighten will depend on supportive data points, especially measures of growth, labour market employment, and inflation. The path forward may not be linear; for instance, if inflation fails to pick up more meaningfully, central banks may be forced to slow down.

- **Promises to policy**
  Investors have appeared concerned with U.S. tax reform, Brexit, and NAFTA negotiations. So far, NAFTA appears to be progressing toward a revision more than a repeal; in the UK, Brexit negotiations remain a long-term process with much to be determined, although the probability of a “hard” Brexit is high; and in the U.S., President Trump continues to face headwinds in implementing his policy agenda. U.S. tax reform is the legislative piece investors seem to care most about, yet markets remain skeptical about Trump’s ability to see it passed this year.

- **Global growth**
  Global growth figures have been promising in recent quarters. According to JP Morgan, Q2 global real GDP growth came in at 3.8% which is the strongest quarter since mid-2010. Q3 will likely come in slightly lower but still a very healthy rate. Supporting this thesis is the latest round of purchasing manager index (PMI) data with most countries firmly in expansionary territory and the U.S coming in particularly strong.

- **Political results**
  Angela Merkel won her fourth term as Chancellor of Germany, although her party conceded some important ground to the far-right. The Catalonian region of Spain voted overwhelmingly in favour of becoming an independent region/country. These results seem to suggest that nationalist and populist sentiment continue to brew in Europe, although neither events really point to an existential threat. Markets digested this news without much impact.

- **North Korea**
  A lot of news this quarter centered on the ongoing crisis with North Korea. Crises like these rarely impact markets unless they spiral into truly negative territory, such as a large-scale war or attack.

# How did we do?

*(All performance is for Series A Funds, net of fees and expressed in Canadian dollars for the period of July 1 – September 30, 2017)*

### Mawer Canadian Equity Fund: 2.2%

Rising, globally synchronized growth was a boon for the more cyclical sectors within the Canadian equity market as Energy, Materials, Consumer Discretionary, and Financials led the way. Particularly, a rising interest rate environment helps to bolster profitability at banks and insurance companies. Our portfolio's top three holdings are banks (**RBC, TD, Bank of Nova Scotia**) and we have long taken a favourable view of the industry in Canada as it is fairly concentrated, has high barriers to entry to foreign institutions, competition among the incumbents seems rational, and regulatory oversight has been sensible.

However, not all financials fared as well during the quarter. Rising rates had an impact on private equity investment firm **Onex**. Onex identifies businesses to acquire, makes improvements, and then sells these businesses a few years later at what it hopes are attractive gains on invested capital. For Onex, interest rate tightening could be a headwind as it may negatively impact their asset values and their ability to raise third-party capital should their clients shift away from alternative asset classes. The stock reacted negatively during the quarter, but Onex has a demonstrated track record of wealth creation for shareholders and it remains in the portfolio, though we have trimmed our exposure modestly in light of these concerns.

### Mawer New Canada Fund: –1.7%

The strength of the CAD versus the greenback had an impact on our Canadian small cap strategy. Many of the companies we own, though headquartered in Canada, have operations and customers in the U.S. These foreign revenue streams become less valuable in CAD when the loonie rises, thereby impacting stock prices. Two prominent examples in the portfolio are **New Flyer** and **Boyd Group**, both of which had modestly negative returns during the quarter. New Flyer is the leading bus manufacturer in the U.S. and Canada, both in size and in terms of innovation, and Boyd is one of the largest operators of collision repair shops in North America. **Winpak**, however, a plastics-based packaging materials manufacturer—and one of our larger holdings that also has revenue heavily weighted in the U.S.—is gaining market share with major U.S. protein processors. Its management team has a strong track record, both operationally and in terms of capital allocation, and it remains an important portfolio holding.

Just under 50% of our portfolio's revenue exposure is tied to the U.S. and this represents a greater proportion than the benchmark. Perhaps one reason for this is that our focus on wealth-creating companies run by excellent management teams leads us to those businesses that can credibly compete not just in Canada, but also in the U.S. market.

### Mawer U.S. Equity Fund: –1.1%

Though the S&P 500 Index delivered a robust 4.5% (USD) during the quarter, this was essentially offset by the currency effect. That said, our holdings in credit card companies **Mastercard** and **Visa**, financial data provider **S&P Global**, and insurance brokers **Marsh & McLennan** and **Willis Towers Watson** continued to profit from their dominant industry positions, strong demand growth for their services, and strong margins.

The portfolio did run into a few hiccups during the quarter within health care. One example is **MEDNAX**, a company that acquires private physician practices and manages the business, allowing doctors to focus on being doctors. We had been trimming our weight over the past year due to concerns regarding cost inflation and pressure on revenue, as is common across much of the health care sector. However, the deterioration has been more rapid than we anticipated and management seems intent on sticking to their growth-by-acquisition strategy which is facing increased competition from other buyers. This was always a below-average sized position in the portfolio in recognition of these risks, but we ultimately exited the name as we think these pressures are likely to persist.

### Mawer International Equity Fund: 1.2%

While masked somewhat by the strong CAD, international equity returns continued to advance in local currency terms. Companies that are meeting or exceeding lofty expectations are being rewarded as investors believe their future cash flows will more than compensate for potentially higher discount rates. The top four contributors to our Fund's returns are the top four holdings in the portfolio: certification and testing company **Intertek**, Chinese internet giant **Tencent**, insurance broker **Aon**, and Japanese drug store chain operator **Tsuruha**. Each have created meaningful wealth for shareholders over the last few years, and continued to do so in the third quarter. The market has rewarded them for executing on their strategy and our investment theses continue to play out.

However, equity valuations are leaving little room for error and it has not been uncommon for those that fail to deliver on expectations to be harshly punished. Advertising agency **WPP** is one example. Its stock gapped lower on a disappointing earnings announcement in which the company cited decreased advertising spending by its customers, particularly within the consumer products segment. The big question: is this a cyclical, more temporary lull or is it a more permanent structural transformation in the way companies deploy their advertising budgets? We believe WPP is still a great company, but acknowledge the possibility of a structural change in the industry that presents heightened risks to its business model. We ultimately concluded that our position needed to be further reduced even at the resulting market price.

### Mawer Global Small Cap Fund: 0.0%

The active share of our Global Small Cap strategy has typically hovered around 99%, indicating our portfolio is substantially different from the benchmark. In other words, factors specific to individual securities really tend to drive how our Fund performs, both in the short-term and over the long-term. During the quarter, IT hardware and software resellers **Softcat** and **Bechtle** performed well. These companies are examples of distribution businesses that we believe are potentially less prone to disintermediation given the significant value they provide to their customers. Our research suggests, that their independent and useful advice understanding of their customers' existing infrastructure and budget are all highly valued and result in customer stickiness: the potential benefits customers face when switching from a capable, trusted operator are asymmetric as IT disruptions can be very costly.

Other companies fared less well during the quarter. **Safestyle**, an assembler of made-to-measure residential replacement windows in the UK, suffered as the company warned that its profits would fall below expectations. However, our thesis is based on Safestyle continuing to build its position as leader in an industry where 50% of the market is comprised of smaller operators. Despite the headwinds, it appears that Safestyle will continue to gain share and build on its scale advantage. While we're disappointed that the stock reacted so sharply, our thesis remains largely intact.

### Mawer Global Equity Fund: –0.2%

In investing, uncertainty is ever-present. And to paraphrase Peter Bernstein, the only rational thing to do when faced with such uncertainty is to diversify and to focus on those things we can control. As investors, we have little control over investment outcomes: over the quarter, our companies generally performed well from the perspective of their fundamentals, even if their stock prices did not keep up to those in the benchmark in aggregate. However, we *can* better control how well we adhere to our investment process, the depth and attention we devote to our analysis, the quality of our management interviews, the way we hire and coach our investors, and our firm's culture. We can also control the way we react to uncertainty, which is by openly acknowledging how much is unknowable, by clearly distinguishing facts from opinions, and by thinking probabilistically as opposed to in absolutes.

Lately, we have felt that the investment landscape is being pushed out to the extremes: on one end of the spectrum, there are stable, predictable businesses whose valuations seem to reflect their fundamentals, while on the other there are those speculative businesses that could perform spectacularly or go bust. As valuations in the market climb ever higher, many of the stocks we own are beginning to trade toward the higher end of what we perceive to be their fair value ranges. This doesn't mean that they can't continue to climb—future discount rates certainly fall into that "unknowable" category—only that the probabilities seem to have shifted.

As investors, we are therefore faced with a choice: accept a higher probability of lower expected returns, or move further out on the risk spectrum and hope to capture higher returns. At Mawer, we look for wealth-creating companies run by good management teams that trade at discount to what we perceive to be their intrinsic value. Amphenol (see sidebar on page 4), a company introduced to the portfolio during the quarter, is an example of the type of company we like to own: a terrific business with a great management team. But we acknowledge that this is a company that appears much closer to being fairly/fully valued than being undervalued—all while being intimately aware of just how little we can be sure of with any degree of certainty.

### Mawer Emerging Markets Equity Fund[1]

China represents approximately 30% of the emerging markets index, and its economy seems to be performing strongly. Despite this, our assessment is that this high rate of economic growth continues to be driven by the "old economy" model reliant on heavy industry, rising property prices, fiscal stimulus, and increasing debt levels. While we believe that China's future growth drivers will be the "new economy"—consumption, technology, financial services, etc.—the transition is not occurring quickly.

Our emerging markets portfolio holds eight Chinese companies, representing approximately 22% of the portfolio—well below the index and we are notably absent

[1] Due to regulatory requirements, performance information may not be published until the Fund has completed a financial year.

in some of the more cyclical sectors such as banks and property developers. Outside of **Tencent** and **Alibaba**, two technology companies that performed well over the quarter, the rest of our Chinese holdings had much less impressive returns. One example is **Midea**, a well-managed manufacturer of household appliances. The domestic industry is dominated by a limited number of competitors that have developed strong servicing networks and market shares that are incredibly difficult to replicate. Midea should benefit from the expected shift to a more consumption-based economy in China. We don't expect this shift to occur overnight and as long-term investors, we have the patience to see our investment thesis through.

## Mawer Canadian Bond Fund: -2.0%

The Bank of Canada's actions during the quarter, along with market expectations building of further hikes, put upward pressure on the Government of Canada yield curve. Short-term maturities increased more than long-term maturities, resulting in a flattening of the yield curve. All sectors of the Canadian bond market delivered negative returns with corporate bonds faring relatively better than government bonds. The spread cushion on corporate bonds offered some protection but it was not enough to push their overall return into positive territory.

The future evolution of interest rates is an important consideration but one that has proven to be notoriously difficult to forecast. In Canada, a case can be made for both higher and lower interest rates. An argument for lower interest rates is that inflation is still well below the Bank of Canada's target level. On the flipside, the Canadian economy has exceeded expectations in recent quarters and an increase in global interest rates may warrant further increases from the Bank of Canada. Without a systematic and repeatable edge, our approach to manage this uncertainty is to diversify the portfolio by term, sector, coupon type, structure, and by issuer in an attempt to ensure resiliency.

While shifts higher in the yield curve will likely negatively impact the bond portfolio in the short-term, over the long-term the effects might be surprisingly positive. This might seem counter-intuitive. The performance of a bond fund is driven by the level and slope of the yield curve over time. The pace at which yields rise relative to the time it takes to recover lost performance is another important factor. While there is short-term pain, maintaining a long-term horizon means getting to reinvest at a higher yield—which, over time, will eventually outweigh the negative short-term impact.

### Connecting with Amphenol

The International Energy Agency estimates that the worldwide electrical vehicle count was 2 million in 2016, or just 0.2% of all light-duty vehicles. This number is expected to grow rapidly. As an example, Volvo announced it will be moving its engines entirely to electric and/or hybrid starting in 2019. And China is drafting a policy to require that 8% of car sales be battery electric or plug-in hybrid vehicles starting in 2019. Clearly, this is a very large and rapidly progressing trend.

How can we take advantage of this trend from an investment perspective? And it's not just cars: it's the electronification of... everything!

One tactic could be to predict who will win the race in many of these exciting new technologies, a path that will likely include spectacular winners and many more companies that utterly destroy shareholder value. We don't feel that we have an edge in isolating the winners from the losers at this point, but there are other ways to participate in technological progress.

Amphenol is a major producer of electronic and fiber optic connectors, as well as interconnect systems such as coaxial cables. These are connectors that take data or power from one input to another with the aim of minimizing power loss or the weakening of signal as much as possible.

The connector business is an example of what we refer to as a keystone business model; the product or service is critical but does not represent a major part of the purchaser's overall cost structure. Consider automobiles: connectors are a small portion of a car's overall cost, but they are critical to the car's effectiveness. Keystone products also introduce some customer stickiness as switching to a different provider introduces risk for generally marginal benefit.

End markets for Amphenol's products include not only the automobile industry, but also IT/data centres, mobile devices, and industrial processes. Furthermore, Amphenol benefits from a strong management team with a demonstrated track record of steady organic growth, accretive acquisitions, and steady margin improvement.

The investment thesis isn't without risks. Many of Amphenol's end markets are cyclical in nature. Competition also seems to be rising within this reasonably fragmented industry which could temper margins. And the quality of the business hasn't gone completely unnoticed: markets are generally efficient after all. But we believe Amphenol is a resilient business that is exposed to a truly electrifying trend, and we govern these risks—particularly around valuation—by managing its position size within the portfolio.

## Mawer Global Bond Fund: -2.2%

An appreciating CAD and rising interest rates globally were headwinds to the global bond strategy, particularly since the Fund is specifically designed to provide reserve currency diversification to balanced portfolios. Two of these reserve currencies—the U.S. dollar and the Japanese yen—represent just over half of the Fund and each shed approximately 4%

[1] Due to regulatory requirements, performance information may not be published until the Fund has completed a financial year.

versus the CAD over the period. Reserve currencies have typically underperformed the CAD during periods of rising, globally synchronized growth.

**Mawer Balanced Fund: –0.3%**
**Mawer Global Balanced Fund: –0.7%**

The strength of the CAD took some lustre off of foreign equity returns when translated into CAD, and it had an impact on domestic companies with significant foreign revenue exposure (given that these foreign revenue streams become less valuable in CAD when the loonie rises). The increase in bond yields also hurt fixed income returns. Relative to our benchmarks, stock selection was the primary driver of underperformance during the quarter, with little by way of common threads among our balanced funds' underlying strategies. As bottom-up investors, this is not surprising and we expect stock-specific factors to be the predominant driver of our funds' returns, both over the short and the long-term. From an asset mix perspective, our slight preference for equities over bonds added a modest amount of value.

# Looking ahead

As noted, it appears that markets are reaching an inflection point with monetary policy. If this is truly the case, then it is an important shift from previous years, when markets were frequently overwhelmed by the impact of unconventional central bank policies. The fact that central bankers are even entertaining this path means there is enough health in underlying economies (a good thing). However, the rising interest rate environment does create a headwind for bonds while increasing the potential for a re-pricing event for equities. These are risks in which investors should be mindful.

**What are some of the main positives in the investment landscape?**

- The credit cycle appears to still be in expansion mode for most major economies. As credit cycles underpin growth, that credit is still available and flowing in most parts of the world is good news. Balance sheets are still, on par, better than they were before the great financial crisis. Growth figures have also been decent.

- Interest rates may be increasing but the path forward still looks gradual. For the most part, central bankers look to be cautious in this process. Further, the lower inflation numbers we see, the more it is likely that this process is gradual; all else equal, a slower normalization path for interest rates is probably more supportive for both equity and bonds.

- Confidence is good among businesses. This is a necessary component to decent future growth.

- China is—so far—balancing its need to grow with its need to shore up its financial house. While China may not seem that important to the Canadian investor, the size of its economy, and the extent of its debt challenges, means that its economic health matters globally. A financial crisis in China is one of the few events that could trigger a broader investment crisis, while even just the matter of China slowing down can impact commodity prices (reverberating down the line to economies like Canada's). It is therefore positive that China has so far managed to navigate a difficult transition period in its economy.

**What are some of the main negatives?**

- Valuations. Within both equities and bonds valuations leave little margin for error. In particular, current valuations in equities increase the risk that we see some re-pricing. Meanwhile, the interest rate environment is a potential ongoing headwind for bonds.

- Unknown policy outcomes. There are some significant policy frameworks being negotiated at present in both tax and trade which could have an impact on markets. The outcomes of these talks won't necessarily be negative, as there is some potential that good policies could be enacted by politicians, but they do carry some risks. This is especially true as we see what happens in the UK and with NAFTA. Moreover, themes of populism and nationalism still could provoke problematic legislative agendas going forward.

- The Canadian housing market. While regulatory measures to provide protection from exuberant conditions have been introduced in a few major markets, housing affordability could take a significant step back if interest rates rise quickly and banks move prime rates in lock step and/or faster than the Bank of Canada.

Given the environment, we would caution investors over exuberant long-term return expectations. While equity indices have performed well and global economic indicators have been more positive of late, valuations and the changing monetary environment (increasing rates, unwinding quantitative easing measures) are headwinds at this point. Our base case is that risks are gradually building in the system—in what has been a long cycle that could go on for longer yet. Our approach is to ensure we have resiliency in portfolios. That means bonds will continue to be a component of balanced portfolios—while they may face headwinds, bonds should offer protection in an equity market pullback. Moreover, the outlook for bonds is more positive in the event the economy weakens again or normalization takes a slower path. Within equities, we continue to search the globe for companies that meet our investment criteria. Our inventory of potential investments for which we have completed our intensive analysis has grown and any near-term volatility may prove opportunistic in helping to improve portfolios built for resilient, long-term returns.

## Total Net Returns (Series A)*

| For periods ending September 30, 2017 | 3-Mo | YTD | 1 yr | 3 yr | 5 yr | 10 yr |
|---|---|---|---|---|---|---|
| Equity Funds | | | | | | |
| **Mawer International Equity Fund** | **1.2** | **16.1** | **9.6** | **12.0** | **14.2** | **6.1** |
| International Equity Benchmark** | 2.2 | 13.0 | 13.8 | 9.2 | 13.8 | 3.7 |
| **Mawer U.S. Equity Fund** | **-1.1** | **6.1** | **9.0** | **14.4** | **18.6** | **9.5** |
| S&P 500 Index | 0.6 | 6.5 | 12.9 | 15.0 | 19.8 | 9.9 |
| **Mawer Global Equity Fund** | **-0.2** | **9.8** | **8.2** | **12.3** | **16.2** | **–** |
| Global Equity Benchmark** | 1.3 | 9.3 | 12.9 | 12.0 | 16.5 | – |
| **Mawer Global Small Cap Fund** | **0.0** | **11.4** | **7.9** | **14.0** | **20.6** | **–** |
| Global Small Cap Benchmark** | 2.2 | 9.3 | 13.5 | 13.6 | 16.5 | – |
| **Mawer Emerging Markets Equity Fund*** ** | **–** | **–** | **–** | **–** | **–** | **–** |
| MSCI Emerging Markets Index | – | – | – | – | – | – |
| **Mawer Canadian Equity Fund** | **2.2** | **5.0** | **10.2** | **8.0** | **13.1** | **7.5** |
| S&P/TSX Composite Index | 3.7 | 4.4 | 9.2 | 4.5 | 8.1 | 4.1 |
| **Mawer New Canada Fund** | **-1.7** | **-2.3** | **2.5** | **4.5** | **15.9** | **10.7** |
| New Canada Benchmark** | 2.4 | -1.9 | 1.2 | 2.1 | 4.1 | 3.0 |
| Balanced Funds | | | | | | |
| **Mawer Global Balanced Fund** | **-0.7** | **6.1** | **3.7** | **8.3** | **–** | **–** |
| Global Balanced Benchmark ** | 0.0 | 5.5 | 5.4 | 8.0 | – | – |
| **Mawer Balanced Fund** | **-0.3** | **5.6** | **4.3** | **7.9** | **10.9** | **7.2** |
| Balanced Benchmark ** | 0.7 | 4.3 | 5.1 | 6.6 | 8.7 | 5.7 |
| **Mawer Tax Effective Balanced Fund** | **-0.3** | **5.5** | **4.4** | **7.9** | **10.9** | **7.1** |
| Internal Tax Effective Balanced Benchmark ** | 0.7 | 4.3 | 5.1 | 6.6 | 8.7 | 5.6 |
| Income Funds | | | | | | |
| **Mawer Global Bond Fund** | **-2.2** | **-1.3** | **-5.6** | **–** | **–** | **–** |
| Citi World Government Bond Index | -2.0 | -0.8 | -7.4 | – | – | – |
| **Mawer Canadian Bond Fund** | **-2.0** | **-0.3** | **-4.1** | **2.0** | **1.8** | **4.0** |
| FTSE TMX Canada Universe Bond Index | -1.8 | 0.5 | -3.0 | 2.8 | 2.7 | 4.7 |
| **Mawer Canadian Money Market Fund** | **0.0** | **0.0** | **0.0** | **0.1** | **0.2** | **0.5** |
| FTSE TMX 91 Day T-Bill Index | 0.1 | 0.3 | 0.5 | 0.6 | 0.7 | 1.1 |

* Mawer Funds are managed by Mawer Investment Management Ltd. Mawer Fund returns are calculated after management fees and operating expenses have been deducted. In comparison, Index returns do not incur management fees or operating expenses.

** Refer to http://www.mawer.com/our-funds/performance/ for Benchmark History.

*** This information is not available because the Fund has not yet completed a Financial year.

Index returns are supplied by a third party – we believe the data to be accurate, however, cannot guarantee its accuracy. Index returns sourced from Citigroup, FTSE Russell, TD Securities, FactSet and BMO Capital Markets.

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Performance returns for the Mawer Mutual Funds and benchmarks are calculated by Mawer Investment Management Ltd. These returns are historical simple returns for the 3 month, YTD and 1 year periods, and annualized compounded total returns for periods after 1 year. They include changes in unit value and reinvestment of all distributions and do not take into account sales, redemption, distribution or optional charges or income taxes payable by any securityholder that would have reduced returns.

MAWER
Calgary • Toronto • Singapore

t 403 262 4673
800 889 6248
e info@mawer.com
w mawer.com