EP97 | Playing the plan: Mawer's Canadian equity portfolio

Disclaimer: 00:25 This podcast is for informational purposes only. Information relating to investment approaches or individual investments should not be construed as advice or endorsement. Any views expressed in this podcast are based upon the information available at the time and are subject to change.

Andrew Johnson: 00:39 Welcome back on the podcast, everyone. Today we have Mark Rutherford. Mark is an analyst on our Canadian large cap portfolio. You've been on the podcast a few times, Mark. Welcome back.

Mark Rutherford: 00:50 Yeah, great to be back. Thanks for having me, Andrew.

Andrew Johnson: 00:52 Mark, I was thinking prior to the pandemic, you and I would actually bump into each other in the hallway and end up spending ten minutes or so talking about the portfolio among other things. We obviously haven't been able to do that for some time, and it's been a while since you've been on the podcast, so I've got a long list of questions and topics that I want to throw your way. Are you up for it?

Mark Rutherford: 01:12 Yeah, let's dive in. Let's do it.

Andrew Johnson: 01:13 All right. Well, let's start with a topic that is on the minds of many of our listeners: we've seen a much higher rate of inflation than what we've been accustomed to for decades at this point. Clients, investors are trying to understand what it means for both companies and stocks. What's been the impact in the portfolio? And quite frankly, is there anything that can be done about it?

Mark Rutherford: 01:34 Yeah, I think it's a topic that we've talked about quite a bit in Canadian equity, as well as across the entire Research team here. Maybe just a recap what's happened: post vaccines coming out and just massive amounts of government stimulus, we've seen this slow gradual reopening varies quite a bit depending on what industry you're in or where companies may be located in the world.

But as you mentioned, and as we're continuing to work remote, companies are making a bunch of adjustments, consumers are making adjustments not only in how they consume, but which channels they consume through.

02:16 So a little bit of a pullback in September and the majority of investors probably have been a little bit spoiled with solid returns since the COVID sell-off. What are you saying to those clients who have been rattled by the recent volatility in September?

Mark Rutherford: **02:10** The labour force has a number of big adjustments going on—whether that's people switching industries, retiring, maybe moving to different parts of the world. So all these changes are causing just big shifts that companies are starting and really trying to adapt to. I think for the [Mawer] Canadian Equity Fund, what we think about first-off is, if we start with taking it back to the investment philosophy, and if we are finding wealth-creating companies that are providing a lot of value to clients that are selling differentiated services that have competitive advantages and they're run by really good management teams, that's the best starting point that we can have.

02:50 And that is ultimately one of the greatest factors that really can provide resiliency regardless of whether this is a short-term inflationary bout or if it's longer term in nature, which is a bit of the key question.

Outside of the philosophy, once we start from there, we say, okay, every company in the portfolio has this wealth-creating characteristic. Then we can also look at it—and we're really going through the portfolio piece by piece and company by company—to understand, okay, are we seeing any evidence that this company is being negatively impacted and maybe in a way that we didn't suspect because of some of the changes that are going on?

3:29 So on the positive side there's a number of companies in the portfolio that we have seen either benefit from, or really carry on with business as usual, regardless of higher price levels throughout the economy.

Mark Rutherford: 03:42 Distributors would be one broad category that comes to mind. So in the [Mawer] Canadian Equity Fund, we have equipment distributors that would be Toromont and Finning. Those actually—not only are they really passing through the costs of the equipment to the customers, a lot of those customers and markets are doing really well, whether it's construction, mining, infrastructure. Richelieu Hardware would be another distributor that we own where they're really passing through their products and the product prices quickly to the customer because the true value-add to their customer is supply availability of a wide variety of products, not necessarily just being the lowest cost provider. Loblaw would also be another distributor that comes to mind, where they quickly readjust food prices as food can be quite volatile even in normal times. And that quick adjustment allows them to benefit from higher inflation as they collect the same margin, but on a higher dollar value of revenue.

Mark Rutherford: 04:43 Another just broad category that I'd highlight would just be companies that are benefitting from investments in the supply chain. So, some companies are really realizing that either because of channel shifts either to online or just because they want to build more resiliency in their supply chain, that they need to maybe invest in more distribution centers, they need to have more inventory located closer to the customer. So companies like Granite REIT, CP Rail, Choice Properties as well has a large industrial footprint. And then big category would be outsourcing. So companies like CGI Group as well as TELUS International can benefit. And then lastly, if we do have this sustained higher rate environment, financials broadly as well which is a big portion of the Canadian index and we have a large exposure there in the [Mawer] Canadian Equity Fund.

Andrew Johnson: 05:38 When I think about the ability to pass on price increases, it really comes down to the bargaining power that the company has over its customers. Contrast what you just described with some of the companies that we own versus a company like Stella-Jones, for example, who presumably would have a lower number of end customers and might not be able to pass on those prices. And of course, they work in the pressure treated lumber industry and it had its own moment in the sun in terms of inflationary pressures earlier this year and probably continues a little bit to this day. Can you speak about how they've handled it over the last little while?

Mark Rutherford: 06:12 Yeah, so Stella-Jones would be another one where, because there was such high demand for lumber, lumber products—and they're really, one, a processor as well as a distributor—they were able to quickly use their network and be a trusted supplier for any of their customers in a time of need and that led to really massive profits over the last few quarters. Some of what may be normalizing a little bit more recently, but having really a network for them that is reliable was really valuable to their customers when they were seeing shortages across the industry.

06:50 So they were a company, in particular in their lumber business, that has been able to benefit from shortages of lumber prices. And I think one thing that we saw there in that industry was there was very large supply of trees. So, even though there was massive increase in demand, the people that really collected the profit from that surge in demand was more so the bottleneck and the supply chain companies like Stella-Jones—the processors that were converting logs into various products for customers.

Andrew Johnson: 07:21 Let's stick with the theme of inflation because one of the contributing factors in all of this has been the rising price of oil. And I guess this is a bit of a two-parter for you. So, what has that meant from an industry standpoint? Have we seen more investment from the companies themselves? Have we seen job creation for example? And what has it meant from a portfolio perspective? Has it compelled you to look at new investment opportunities?

Mark Rutherford: 07:45 Yeah, so energy has been another industry that just has gone through what seems like dramatic change over the last really two years. Going back even before COVID, we were really in a situation with excess capital and that's really excess drilling from shale producers in the U.S.—a lot of them were issuing equity frequently tapping the debt markets and growing production very rapidly. And that really switched during COVID; really the capital markets shut off for many of these companies. And quickly companies have realized that we may be forced to live within cashflow potentially for longer periods of time. So what we're seeing now—and we're looking for evidence to see if this changes—but most companies are still below pre-COVID CapEx levels in terms of drilling and exploration. And most of them are really projecting just modest increases in production going forward because investors have said, "You know what? We want to see the cashflow. We want you to maybe grow a little bit, but we don't want you to grow as fast as possible with debt."

08:50 And that wall of cashflow—we're starting to see it. Suncor last week raised their dividend 100% back to pre-COVID levels. And then the other big theme that energy companies are really grappling with is ESG, and the notion that it may be harder to attract capital longer term because of ESG factors. So if you think about how that flows through, well, if it's harder to attract capital, the rate of return that investors may require to invest in oil company is going to be higher. And if every company looks at projects at the bottom-up level, they're going to require a higher oil price to drill to get that return to satisfy the end investor.

Mark Rutherford: 09:32 So we're seeing a number of just...factors, not only concern about what happened with OPEC in 2020, but these ESG factors and the ability to tap the capital markets as factors that are limiting near-term production growth, which has been a really big positive for the Canadian producers that we own in the portfolio. So, Canadian Natural Resources has really benefitted from this, and Suncor as well in their upstream business. If you look at the cash flow they're generating now as well as downstream actually, the product demand has really come back to pre-COVID levels. So they're really benefitting from this discipline.

Mark Rutherford: 10:10 The question that really remains outstanding is OPEC. So that probably will continue to be a question for a long period of time. If we're above $80 oil and OPEC and Russia really constrain supply, they're running the risk a little bit that U.S. producers and North American producers really ramp up production again and create this supply overhang in the market.

10:30 So, that's the balance that they're running. And just to put maybe some context, I pulled up the numbers before this call: peak upstream CapEx in the industry was $890 billion in 2014— and that's per year. If you look at what it was for the four to five years before COVID, it was roughly $500 billion a year. That dropped to just under $400 billion in 2020. And we're just trending back really to the $500 billion level.

So you can argue we've really underinvested in that resource while demand is coming back quite strong. So [it] appears to be a favourable environment right now.

Andrew Johnson: 11:09 Yeah, and you mentioned in response to OPEC's decision making, you're really talking about the shale producers in the U.S. in particular that would be able to ramp things up quite rapidly.

Mark Rutherford: 11:19 Exactly. So, some of the drillers in the Permian, and even there's some areas in Western Canada where there's short cycle production that could ramp up quickly— especially as we get improved pipeline access in Canada.

Andrew Johnson: 11:32 You mentioned ESG as one of the factors that go into the investment decision-making for not just us, but any other investor looking at energy, oil and gas in particular. I was curious about ESG factors just generally speaking, so why don't we just go in that direction right now? And I think many of our listeners know that assessing the risk and the opportunities that come with ESG are an explicit part of the investment process here at Mawer. How do you and the team think about ESG and the Canadian portfolio in particular?

Mark Rutherford: **12:00** Yeah, it's been a really big area of focus—increasingly so over the last few years. At the very highest level what we think about it as our goal is producing the highest risk-adjusted returns as we can for clients. Now, looking at the ESG factors that we would incorporate into that process that could impact those risk-adjusted returns, we will take a deep look at environmental risks, social risks—whether that's labour cost inflation, the ability to attract and retain labour—or good governance within the company level in terms of management incentives or at the board level as well. So, that's something that we incorporate into every company update that we do. And it's a really big area of focus because it's important and it can help risk-adjusted returns over the long term.

Andrew Johnson: **12:48** I assume just like any other part of our process, you need to dig in sometimes and corroborate things and ask questions. How is that handled from an ESG perspective? How do you engage with companies in that regard?

Mark Rutherford: **13:01** There's a number of tools that we use when we're trying to assess and go into that process. One, it's going to company filings, looking at actual risk factors that they disclose—could be environmental liabilities on the balance sheet—factoring those liabilities into a discount cash flow model. Could be just talking to the company and asking how they think about some of these risks and what they're doing to address them.

A recent example would be talking with Agnico Eagle and what they're doing to really address some of the challenges working in remote locations. One thing that they do—and they've adopted as a strategy—is really to employ local labour as much as possible. So if they're in remote territories working with an Indigenous workforce, they're going to really try to utilize that workforce as much as they can. And they're realizing there are some very long-term benefits.

13:51 Maybe it's challenging at the start where they have to train a bunch of new people and teach people how to mine, but longer term, you get the community on-side with projects and I think there's longer term benefits to the community as well from bringing wages and economic growth. And in terms of procurement, that's another area where we've seen both pipeline companies Lundin Mining as well as Agnico, really try to focus on Indigenous procurement. Hydro One is also doing this quite a bit. So they've got explicit targets set out where they can really boost that partnership in the local regions that they're operating in.

Mark Rutherford: **14:31** So that's just one area where we'll talk to the company and ask for specific examples of what they're doing to mitigate some of these risks that could impact, really, the license to operate. And that's kind of the question that we have sometimes internally is, what could remove this company's license to operate?

14:48 Thinking about Loblaw that we just talked about a little bit, [we] recently engaged with them on attractive wages. They mentioned that they're working to try to provide competitive wages so that labour isn't an issue for them. As well, they're doing a lot of work on just fair-trade sourcing, so, making sure the products that they have in the stores are aligned with consumer needs. Outside of talking to the company, looking at financial statements in terms of disclosures, there's online sources we can use. So, we could look at Glassdoor, Indeed, Facebook, Twitter—see what companies are saying, former employees are saying about these companies, and really try to corroborate that story. So, just like we would on the business model and the strategy to corroborate that that's what management says it is, we would do that for ESG factors as well.

Andrew Johnson: **15:33** Makes sense. Thanks for shedding a little bit of light on that. I'm going to shift gears a little bit because I've been curious just given we're seeing things open up more, for example, both [in] business and personal travel we're seeing an increase. Prior to the pandemic, a big part of the investment process involved what we call "getting out there" and you mentioned it previously, how you're just constantly looking for evidence—this would be one of those approaches to looking for that evidence. So, visiting the operations of the companies, meeting with the management teams. Are you and the team looking to, I guess, get back out there now that things are opening up a little but?

Mark Rutherford: **16:06** Yeah, I think it's one of the things that we definitely missed about the last year and a half—just getting out there, talking to more people in person, seeing operations. So, a few members of the team have started to travel again. Vijay recently did a trip to the Toronto area, met with a few companies in person, looked at the bare streets of downtown Toronto [laughs] and really thought about what the implications are for real estate in downtown Toronto, so we had some good conversations about that. And really I think it's just investing through your eyes, looking at what's happening and observing in different areas. It's also just talking to companies in person. You can get the feel a little bit more of whether people are optimistic, whether there's lots of energy and excitement—just side comments that maybe sell-side analysts or management team members might make.

Mark Rutherford: **16:51** But we have thought about the actual process of traveling as well. And flying, say, to Toronto, walking 30 minutes to a meeting, doing a 45 minute/one hour meeting, walking back to the hotel, flying back to Calgary, is not the most efficient use of time. So we've thought that going forward we think we will see that travel shift a little bit towards just more site visits or seeing things that are much harder to see or learn about over the phone. We could see just more experiential visits in the future, and so that's just one thing that we've talked about internally.

Andrew Johnson: **17:25** Yeah, and I think our CIO, Paul Moroz, recently on a trip to New York made a similar observation where the central business district of the area seems to be fewer people still there, whereas some of the neighbourhood communities [we're] starting to see it come back alive somewhat from a community standpoint.

17:40 Another big part of the investment process is looking at different ways to make improvements to it. So I was also curious about what types of things you've been trying out lately to help in that regard.

Mark Rutherford: **17:52** This actually comes back even a little bit to the inflation supply chain question that we talked about earlier. So, one thing that we're doing right now in the [Mawer] Canadian Equity Fund is really thinking about fire drills. So, looking really at each company on a one-by-one basis and thinking about different scenarios and what would happen to that company in this scenario. So, it could be higher interest rates, could be wage inflation, could be supply chain issues from importing goods from China. And really thinking about, okay, how is this company going to benefit or could it be hurt? And then as we roll all that up asking, okay, are we exposed to something that's a really big risk across the portfolio? And then as we do that, I think we feel very good right now that we do have a fairly balanced mix of companies that can not only cope with just a wide variety of macroeconomic changes, but also internal changes too.

Mark Rutherford: **18:49** One thing that we've talked about for companies that we don't own in the portfolio right now, is what would be the catalyst for us to want to own that company? Is there just one thing that's holding us back? Maybe it's valuation. Another situation more recently could be management change. So, if we saw a management change, we thought, you know what? That could drive a bigger position weight in the portfolio.

19:11 So, it's really both [a] combination of external factors, as well as running fire drills on internal factors—what would it take for us to be more positive on this business—and maybe make that company a higher weight in a portfolio. So, I think that process has been helpful. That was something that Vijay introduced earlier this year.

Andrew Johnson:	**19:29**	So certainly just another layer of preparation that goes into the portfolio.
Mark Rutherford:	**19:34**	Exactly.
Andrew Johnson:	**19:35**	When I record these episodes with various portfolio managers and analysts on our various asset classes…these episodes—we spotlight things in a way that could perhaps give the impression that we have these silos of teams that are only focused on one asset class, and some of our listeners may not know just how integrated our Research team is. Can you talk about the benefits that come from sharing ideas across the entire team?
Mark Rutherford:	**19:58**	Yeah, I think that's one of the biggest strengths in the research platform here—is that we're doing our own individual work, but we systematically try to get together to share those learnings. We may have similar business models in different regions around the world, and getting that different perspective is often very helpful so we're not looking at the world with blinders on. In terms of the process that's in place, 1) our M42 research database helps a lot with that.
	20:27	That's kind of step number one. I can see everyone's notes, I get alerts in email when companies that I want to track outside the [Mawer] Canadian Equity Fund when anyone puts a note into M42 on that company. As a team we're doing weekly risk meetings. On Tuesday, everyone gets together and it's a short 30 minute meeting, but that allows people to just flag different risks that they're seeing at the company level or macro level.
	20:54	Also, just [in] our regular weekly meeting we get together and share updates on what people are working on, as well as key learnings. And then getting questions from clients is also sometimes helpful in terms of what's a really big focus area of concern for clients.
Mark Rutherford	**21:09**	So that's all, really: sharing learnings and gathering information; [it] really provides a strength that we can leverage and will continue to improve upon over time.
Andrew Johnson:	**21:19**	Are there ever any instances where you come across a holding in another portfolio and you say, "Hey, actually that might fit well into our portfolio. Maybe we should take a look at it."

Mark Rutherford: **21:28** Yeah, I think probably the most prominent examples for the [Mawer] Canadian Equity Fund are really just crossover with the [Mawer] New Canada Fund. So, we talk with Jeff and Samir and Dominic very often about [Mawer] New Canada Fund companies and that's led to a number of companies where we say, "You know what? This company's a little bit larger. Maybe it's more transitioning to become a mid-cap or we think the potential is really high, and so you know what? We can also own this in the [Mawer] Canadian Equity Fund."

21:54 And that's been very beneficial—just that continued overlap. So Softchoice, a value-added reseller selling IT services to small-, medium-sized businesses was a recent IPO that we participated in alongside with [the Mawer Canadian small cap team] and some of the relationships that they had developed in previous years. And we've had other shared companies that we work on together.

22:18 So [Topicus.com Inc.] would be another one (a spin out from Constellation Software), where we can share perspectives and share learnings. There are some other crossover names as well, so Converge Technology Solutions, as well as Richelieu Hardware still owned by the [Mawer] Canadian Equity Fund.

I think we continue to really leverage the learnings from the [Mawer Canadian small cap team]. And it really benefits clients, I think, at the end of the day. So, [we] continue to push on that and just continue to interact as we want to see everyone do well here.

Andrew Johnson: **22:50** You mentioned Jeff Mo—just a few months ago I spoke with him on the podcast here about small caps in Canada and in particular. the uptick that we've seen in IPOs. And I tossed some stats around during that episode, but generally speaking, this is being noted as one of the busiest years for IPOs—especially tech in Canada since the early 2000s. So 20 years or more. Does that mean anything for you and the team for Canadian large caps?

Mark Rutherford: **23:15** It definitely is 1) [A] sign of confidence in the markets and investor sentiment. [So, just] a checkpoint on where that is. It's also maybe a cautionary point to say, "Okay, things are hot, particularly in certain areas of the market, more than others." But I think it's positive for Canada overall. One of the things that we talked about at our team retreat last year was just the growing theme of technology in Canada. And I think that's just a longer term beneficiary for all Canadians and thinking about how our economy is going to diversify over long periods of time. And we're not going to see too many new Canadian Natural Resources spring up. The new companies that spring up and grow are going to be likely more service driven, maybe more technology driven, and [the] nice thing about those companies is some of them do have really great runway to grow both in Canada and internationally.

24:08 I think in terms of just direct impacts on the [Mawer] Canadian Equity Fund, 1) for investment banks—so, bank of Montreal, Royal Bank, Bank of Nova Scotia in particular—those all greatly benefit from the capital raising. So that's one particular area within Canadian banks that's really benefitted from increased number of IPOs over the last year or so. TSX and the TMX Group would be another big beneficiary from just an increased IPO. I was looking at some of the numbers and I think there's been 125 IPOs on the TSX so far in 2021—just year to date. And that compares to 114 for all of 2020 and 106 for all of 2019. Additional listing fees, as well as longer term if those companies issue additional capital, is a direct benefit to TMX group. So, that's just another positive for one of the companies in the portfolio.

Andrew Johnson: **25:07** You make a really good point on the Canadian market and where it stands in terms of how it's diversified. You mentioned you're not going to get another Canadian Natural Resources or Suncor anytime soon. We're not likely to see new telecoms for example, or grocery stores or the banks, as you just mentioned. So it is going to take (if we are going to see a change in diversification within [the] Canadian economy but also the stock market)...we're going to need it from technology and services like you mentioned. So, excellent point there.

25:35 And just before we wrap up, this may seem unrelated to the [Mawer] Canadian equity portfolio, but given the recent headlines out of China—and I'm talking in particular about the news around property developers—I know there's been a number of headlines coming out of China recently, but with the property market, it's a significant part of China's economy, and China's economy is very clearly a significant part of the global economy. When there's a potential for a large domino like that to fall, what does it mean for you and the team here in Canada?

Mark Rutherford: **26:05** Yeah, it's definitely a concern when you read of news of a company as big as Evergrande with that much debt outstanding having issues and not being able to potentially repay their debt. Then you start to think, okay, well, how many other companies are similar to that? And then when you look at, as you mentioned, how big real estate is as a portion of China's economy, it could have some broad global implications—not just domestically in China.

I think this really falls into a macroeconomic risk or an "N" market risk for some of the companies maybe within Canada. So, first off, just process-wise, what did we do when the news started to bubble up of Evergrande? I think first thing we tried to do is just really gauge, okay, who owns Evergrande debt?

26:51 So, some of the debt is publicly traded. We quickly worked to try to understand, okay, who owns this debt? [It's] often owned by big banks and insurance companies, [which] often have large exposure, so we really wanted to look through financials exposure in the portfolio and understand did any of them have material exposure to Evergrande. [We] also looked at contagion risk—do companies that we don't own in Canada in the financial sector own a large percentage of Evergrande debt? Luckily, we didn't see any material ownership or exposure to Evergrande. So that was really a good first check. Then I think the next step from there is thinking about just "N" market risks for us in the [Mawer] Canadian Equity Fund. So, are companies exposed or have significant exposure to Asia and domestic demand within China? One company that comes to mind that has some exposure would be Manulife Asia. They have a business that's selling more insurance and wealth products within Hong Kong and other countries in Asia. But if there's a broader China slowdown, that could certainly impact sales of those products.

27:55 And then I think just more broadly if China's policy—and there's a broader cooling of the real estate sector in China—really the factor there that would impact (really) the entire world could be just disinflation or a cooling of the inflation that we've seen so far, which actually could be a good thing.

Mark Rutherford: **28:13** So, a number of puts and takes, but I think really just trying to go through that process, trying to understand it, and then coming back [at] the end of the day and saying, "Okay, you know what? These companies remain wealth-creating business models, don't see material impacts," and we'll continue to update our assessment as new information comes up. Just because we don't see any impact today, that may change in a month and we'll adjust accordingly as the odds change.

Andrew Johnson: 28:38 Yeah, and we often refer to it as a complex adaptive market, so things happening in other parts of the world, not always, but sometimes can have an impact on Canada or various other asset classes, which, again, speaks to the importance of an integrated team and sharing those ideas and risks from across the team and the portfolios.

So like I said, Mark, we had a lot of stuff I wanted to talk to you about this episode. We covered inflation, we covered interest rates, we covered China, we learned about fire drills. That should cover us until next time we have you back, so, thanks so much for joining me today.

Mark Rutherford: 29:11 Great to catch up, Andrew. Look forward to next time.