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EP58 | Q&A with CIO: The top questions being asked right now

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Rob Campbell:	00:38	Paul, thanks so much for making time for us again on the podcast this week. How are you doing?
Paul Moroz:	00:42	I'm doing well. How are you doing, Rob?
Rob Campbell:	00:44	I'm doing pretty well. What we thought we would do this week Paul, is, as you can probably imagine, our client-facing teams have gotten a lot of questions from our clients and partners in the industry. And what we've done is we've basically surveyed our teams to understand what are the more common questions that clients have been asking; what's top of mind. And we've selected those that have come up most often and thought we'd just pass them by you to get your views. Does that sound okay?
Paul Moroz:	01:10	Yeah that sounds great.
Rob Campbell:	01:11	Perfect! So I'll get right into it. First one is about this idea that we know that markets go through cycles. We know that volatility is a normal part of financial markets. What, in your view, is the same in this downturn, and what's maybe different about the current environment versus down cycles?

Paul Moroz: **01:30** There's a few big things that I think are different. The first one is that this is self imposed. So, humans have decided that we need to contain this virus and as a result, we are not socializing (we're social distancing). And consequently, we've shut down large swathes of the global economy at the same time. And it's particularly hard on those elements of the economy that are more physical rather than virtual. Restaurants versus internet. So that's one big one. The second big point would be, that, the government and central bank response has been swift. Central banks have immediately stepped up and gone to the 2008-2009 financial crisis playbook: they've cut rates to zero, they've engaged in quantitative easing or buying back bonds to support fixed income markets. And in addition, governments have said: "we're literally going to create these fiscal stimulus programs where we're writing people cheques."

02:35 And I think that's something where we're just in unknown territory towards how successful that is—if that's too much or too little—there's probably going to have to be an adjustment. So, those are some of the differences.

Well, what's the same? Well, human emotions are the same. Humans get scared when stocks go down. We question: are we going to have enough money for retirement? There's a lot of emotion and volatility—all that's the same. There's also an element of debt and leverage that gets unwound. As an economic cycle carries on, investors reach for risk as they are trying to reach for return, and that unwinds. So, you kind of get to a point where that's retrenching, and investors are moving towards safer investments. And that's very much a similar playbook to any other financial crisis.

Rob Campbell: **03:29** Another one that I thought might be different is just that...we're all at home. This is may be different than what we went through in past downturns. How does that impact the human emotion behavioural aspect of things? And I guess I'm struck by a recent podcast that I listened to with Michael Mauboussin, who talked about just...human stress. One of the great outlets there is just to socialize and to talk to people. How is that impacting decision-making today?

Paul Moroz: **03:55** I think it's tough to measure, partly because in some cases people are still getting a lot of socialization, just in a different form. I mean, people are being forced to use programs such as Zoom or Microsoft Teams or they're FaceTiming more. And so in some ways, they're getting a lot of social interaction. But you're right, I think that there's stress that's put on people and we don't quite know the consequences on that, but in some cases it might very much be weighing on people's emotions.

Rob Campbell: **04:30** And maybe that's a segue to another question that's top of mind for clients—and I know we've spoken about this a little bit in particular in our last podcast, but maybe if you can summarize and to add anything that's new—what are we, as a research team, doing differently in the way that we're managing portfolios, just given the environment, given the volatility?

Paul Moroz: **04:50** To summarize, we're doing a lot of things the same. First of all, that's sticking to our core investment philosophy. On the equity side, invest in wealth-creating companies, don't pay too much, make sure they're run by able and honest people. But what are we doing differently? We're emphasizing those companies that have stronger balance sheets. We're ensuring that we have more liquidity in all the portfolios. We are emphasizing those businesses that are more essential, more at the core. So, in the event that this goes on for a longer period of time, the portfolios are going to be resilient. They're going to be able to bounce back from this. Those are the three main ones that we're emphasizing during this particular regime.

Rob Campbell: **05:34** Can you just go a little bit deeper on the liquidity piece? Because this is another question that's come up with clients as well. I'm struck by this idea that yes, we are long-term investors and we want management teams that are thinking long-term but it may be the case for many businesses that thinking long-term just means surviving through the near term. And so, can you speak to the work that you and the team have been going through to really go company by company and assess the liquidity available and the survivability of some of those businesses?

Paul Moroz: **06:04** We are doing exactly that; we've done that over the last couple of weeks. And on an individual company basis, or issuer basis, we're looking at how much cash that company has, and what is the timing of their debt payments—if they have debt? And then we're looking at, well, how much room do they have with their credit facilities—how much flexibility do they have there? And then we're looking at, well, what happens if there's changes to the company's working capital? Is it possible that that increases during these times of stress in the market? And if so, can the company have the resources to manage it? So we're doing that company by company, and again, emphasizing those companies that are in a stronger position.

Paul Moroz: **06:52** As an example, Microsoft, which is in a couple of the portfolios—even after subtracting their short-term debt, their long-term debt, their leases, their lease liability, if you roll that out into the future, Microsoft still has close to $50 billion in net cash. There's a question, "will Microsoft's stock price go up or down with the stock market and the prospects of the company?" Of course. There's going to be volatility. If we get into a more significant bear market, the stock price might come off, but it's going to survive. And so we're doing that analysis at each and every company level.

Rob Campbell: **07:27** I presume Microsoft, though, is not a surprise. I mean, we must have known coming into this that Microsoft's balance sheet was in pretty good shape. Have there been surprises as you've gone company by company in looking at these factors?

Paul Moroz: **07:40** There's been surprises in that...it's possible that the business model may have changed. Instructionally, a business model that created wealth in the past, might not be so viable with the same level of debt. In other words, the debt level in the past to support the business. Imagine a catering business where you're catering to education facilities and hospitals and large businesses. If you're sending everyone home, and you're canceling contracts and then servicing the debt, even if it was reasonable under the old structure, that might not be so reasonable if this goes on for 6 months or 12 months or 18 months, and so on. So, I think it's those surprises. It's not the first-order risk of, "what's on the balance sheet?" It's: how has the business model changed? How much debt do the companies have in relation to this potential new normal? And how long will the new normal go on for?

Rob Campbell: **08:40** Great, thanks for that. And then maybe, just to finish on liquidity—of course, we've been talking about the liquidity of individual companies. How have you evaluated the liquidity of our portfolios overall? And I guess I'm thinking more about the ability to trade and that [aspect] in the current environment? Has that changed?

Paul Moroz:	**08:55**	Well, several weeks ago as we saw how this was evolving, we anticipated that it was possible that there could be more of a credit crunch and almost…"a dash for cash." And we made sure across all the portfolios that we had adequate cash in each of the funds to support [inaudible 00:09:17] liquidity. What you'll probably see at the end of March if you're looking at any of the statements—the average cash levels may have increased a little bit and might be a little bit ahead of where they would normally be during a normal market regime. That's one element. I think that listeners should know that we take liquidity very seriously. Even though something like this only happens once every 10 or 15 years, we run a quarterly process with our compliance team where we look at the liquidity of securities and we're managing that…if we get into a situation where there's too many illiquid securities, we are actively reducing those in the portfolios.
	09:59	And under mutual funds' laws and regulations in Canada, there's a 10% limit. And we're managed well below that. It's a shout-out to our compliance team for implementing a very robust process. So, it's not just now that we're thinking about this problem of liquidity, we've been managing this throughout the entire cycle preparing for an event like this.
Rob Campbell:	**10:22**	And it's not just the compliance process, but also the semi-annual risk report that Jim goes through. There's a liquidity element to that as well, so, thinking about it at multiple levels. That's great. Another thing that clients have picked up on, is your comments—maybe it's the way that you worded this, is that they picked up on—[about] this idea of trying to position portfolios to be in two spots at the same time. I think people understand that on the surface, but can you maybe just give some more colour around how exactly you're doing that, and maybe from your perspective, specific to our global equity strategy?
Paul Moroz:	**10:56**	I think one of the best examples is…some of the positions we've built up that might seem like a natural contradiction. We have built up our position in Microsoft and our position in Amazon. Both those companies…many investors, many individuals would consider "growth" companies. They are more popular, and on traditional valuation metrics, they are more expensive. But they also have huge tailwinds in their businesses. More cloud business, more online business. The explosion in the use of Microsoft Teams has just been phenomenal. And that's something where, even though we're in a negative state across society, I mean, it's just a huge change management exercise that's going to have many more paying users across the Microsoft ecosystem. So, that's kind of the growth side of it. And these are undoubtedly going to be much bigger and stronger coming out of the cycle. So that's kind of geared for growth.

Paul Moroz: **12:01** But [at the same time], we also have companies we're adding to that were maybe less loved: pharma companies. So, Johnson & Johnson, and Roche, and Novartis. And these companies have been less-loved by the market—they trade at lower multiples. We've been buying stock on 13 or 14 times forward-looking earnings. We think a lot of the earnings that the companies have are going to be largely intact because the services they're providing are essential. They have very strong balance sheets, and they pay out pretty high dividends—3% to 4%. So, in the event that we're in a tough situation, they're very defensible—their price-to-earnings multiple has already contracted a fair amount—you're going to collect your dividend. So that's kind of the defensive scenario.

12:51 So we're expecting a situation where there could be a quick recovery and there could be a longer recovery. And that's just an example of how we're thinking about that portfolio: so that in either scenario, we're going to do relatively okay. We're going to bounce back.

Rob Campbell: **13:06** Can I maybe just challenge you on that? I mean, there is an interpretation of a business like Microsoft and Amazon as being also more defensive. So, maybe just to expand that: would you say that on net, portfolios have moved to be more defensive overall?

Paul Moroz: **13:21** Our portfolios have moved to be...I'll call it more resilient. You can take that as defensive. Or more robust, or stronger. Microsoft has a strong business: they're growing. They're going to be bigger and their balance sheet is clean. So, I think across the board, we have naturally allocated capital, again, to those businesses with greater long-term prospects; to management teams that are allocating capital well. And those companies that, maybe, at the margin aren't doing as well—we've shifted capital. So, for example, pretty much across the board, we've reduced our exposure to the banking sector. So, that sector or that industry...it's probably not as defensive as the way that you're suggesting it, Rob. But I think it is possible they're going to struggle over the next several years, they might not be able to buy back stock or pay out dividends, they're going to have to work through greater credit problems...

14:18 And it's possible that even if the government helps out with loans, that a lot of these credit problems are kicked down the road. So, it might not be the most defensive business right about now. Although, valuations are an offset to that. So that's just an example on the other side.

Rob Campbell: 14:35 Paul, shifting gears...ESG. Certainly heard about portfolios that we own or companies that we own, rather, maybe shifting some of their production facilities to help produce some of the materials needed in the fight against the virus. But how has the team looked our investments through an ESG lens in the past few weeks and months? And is it d e've been doing in the past?

Paul Moroz: 14:58 Well, first of all, I think within ESG, Rob, you're really talking about the "S." The social. Which is the human element. How are you treating your employees and other stakeholders and the entire value chain? It's a question about: are people being human to each other? Are companies being human? So, I think that's the core of the issue. And how are we evaluating it...honestly, it's too early to tell. I think, in general, most companies recognize that they're playing the long game. This is an opportunity to step up and contribute in a positive fashion. They recognize that in a lot of places, the government is going to help companies and individuals out. It's not the time to try to extract an economic benefit. And so, in general, I think the response from companies has been quite good from an ESG perspective, an S perspective. But I think it's too early for us to really get significant feedback from the companies because we're only a few weeks into this, and our process really hasn't changed as a result.

16:02 I think maybe just...seeing the results of what the companies are doing has made me realize that we really are in a different era for...I call it, "collective capitalism." Or more corporate responsibility (versus prior times). I'm reading a wonderful book right now, called The Power Broker, that details the life and career of Robert Moses at the beginning of the [20th] century as he came to political power in New York. And...it really is in large part, a commentary on that "robber baron" era of capitalism. And it's just interesting reading at this point in time, because it's so different than what's going on now, where, I think for the most part, corporations are really trying to help people out and humans are trying to help other humans out as well.

Rob Campbell: 16:53 The other insight I had, or thought that I had around that, was, it's companies that are more financially sound and have stronger business models that are probably in a better position to be able to do these things in the first place. In other words, they're not the companies—to borrow from Vijay's comments from last week's podcast—they're not the ones having to burn the furniture to heat the house. Is that fair?

Paul Moroz:	**17:14**	That's right. And they're giving back and helping out. And frankly, this crisis…because it has hit physical more so than virtual, it's really created a divided line, where, some organizations and people are tougher or not as well-off. And so, I think, if you're listening at home and if you're someone in that spot where, as a company or as an individual, you do have the resources and ability to help out and inject some positive energy into the economy…well, I would do that. Because the economy runs on trust and hope and positive energy. And if you have a few extra bucks to tip your delivery person, or leave a friendly note to kind of create some positive energy…do that.
Rob Campbell:	**18:02**	Another question that we've gotten a lot, and I would say more on the individual side of our business, is just about…what should I do? Should I move to cash? Or, if I've got cash on the sidelines, is now the right time to get into the market? Understanding that individual circumstances are going to differ situation to situation—what sort of high-level comments do you have to both sides of that?
Paul Moroz:	**18:25**	That's my "paradox of omniscience," Rob. And it's a paradox because, well, I'll explain it. If you knew everything about the world and if you knew how the world was going to turn out, the game of capital allocation would be very easy. Because you would just select the highest performing stock and invest all your capital in that one stock over the next 10 years or 20 years. Because you'd know! Now, on the other hand, if you believe you knew nothing, you'd take a very different approach. You'd probably—if you knew nothing about the world—you'd buy equally a little bit of every asset out there. So, you'd be diversified across space or place, and you would also diversify across time, because you'd have no idea of whether now is the right time or not. Now, it's a bit of a paradox because I think that in that scenario, to assume that you have no knowledge is actually, well…you're actually assuming some sort of knowledge in that case, [so] that's the paradox.
	19:23	But the reality is we're probably somewhere in the middle. Where…usually, when there's a recession and when stock prices come off and when there's fear in the market, it's more of a good-ish time to invest. But we still might be very early; we don't know. Maybe the market goes down another 50%, maybe it's going to correct and move upward over the next couple of months. So, I think a balanced approach is to stay diversified then kind of average in. If you have capital sitting on the sidelines, you might want to average in over the next 12 months.

Rob Campbell: 19:58 Thanks for that. And maybe to tee up next week's conversation with Greg Peterson, lead manager of our balanced funds...he may have some thoughts from an asset mix perspective and how he's thinking about that. So, that's another one that folks can probably tune into.

Paul, another question that we've got from clients—and I'm wondering if you can put your board member hat on for this one, because I can see you are wearing a hat right now—how is Mawer? Are we financially secure? What sort of flows have we seen? How are we doing, and are we in a good place?

Paul Moroz: 20:28 Mawer—the company's in an excellent place. The company has net cash on its balance sheet, so, as an organization, super strong. People should know that. And more importantly—and this gets into the structures—our funds are all held with custodians. And the securities in those custodians are segregated, which protects clients in the event of any bad situation. So, it's not like an institution can fail: the securities are actually separate in either the segregated account or the mutual fund trust. That's an important technical point to know. And in terms of flows, I mean, while we've prepared and created a lot of liquidity and prepared for a very bad situation, we haven't seen significant outflows over the last two weeks. The outflows have been, well, less than a half a percent of assets. So it's been quite minor.

21:19 One of the offsets we have investing internationally with pretty significant foreign currency exposure, is, as the price of oil has come off and as the Canadian dollar has weakened, that serves as a bit of a natural offset and provides a little bit of cushioning. A weakening of the Canadian dollar against other currencies provides an offset when you're translating that foreign exchange.

Rob Campbell: 21:42 And then a final question, it's a real softball for you, but probably the one that we [laughs] as a client team have gotten the most: how do you see this all playing out?

Paul Moroz: 21:51 Is that a softball question? Or is that a difficult question? I'm not the Oracle of Delphi! Here's probably what's going to happen: bear markets usually go on longer than the human mind thinks they will. And there will be probably some more times where people get scared and security prices go down. Probably. Don't know for sure. And at some point, and we don't know when—maybe it's when you hit some of the peak ratios, maybe it's when some of the companies are opening their businesses and coming back to work—we're going to get into a recovery phase, and the stock market, in anticipation of that, will turn around and lead that.

So, I don't know how that's going to play out, whether it's a six month event or a two year event, but what I do suspect over a longer period of time—over 10 years, and 20 years—that the stock market is going to be at a much higher level than it is now.

22:43 There will be businesses that are creating wealth. There will be new businesses that we're talking about, that we're excited about. And they'll be paying dividends and expanding their services to help people and companies. I'm absolutely sure of that—that longer term perspective. And that's what we're really focused on: compounding wealth over the long term.

Rob Campbell: **23:01** Great. And I know one of my messages in conversations with clients lately is that, yeah, I think we do believe that over the long-term, your assumptions about the rates of return that you could expect from various asset classes are likely to hold true. You're likely to earn more in equities than you will in bonds than you will in cash; uncertain over a one-year or three-year horizon whether those relationships hold. So, just like we've been doing with our portfolio companies and understanding the liquidity requirements there—really encouraging clients to understand their liquidity needs in the short- to medium-term.

Paul Moroz: **23:33** That's well put, Rob.

Rob Campbell: **23:35** Perfect. Well, Paul, thanks again for your time. Thanks again to you and the team for all the work that you're doing for our clients, and we're likely to hear again from you soon.

Paul Moroz: **23:43** Thanks, Rob, and thanks for having me.