Mawer Canadian Equity Fund, Series A

Q2 2023 | Performance Commentary

Market Overview

Canadian equity markets were modestly positive overall with most of the 1.1% gain attributable to strong performance from Shopify. Returns for Shopify are consistent with the return of risk appetite in high-growth technology stocks despite significantly higher interest rates. Shopify also announced the sale of their logistics business which appears to have moderated concerns of the capital intensity to build out a fulfillment network. On the other hand, the decision also diminishes a large potential source of revenue. Additionally, cost cutting measures were disclosed including significant headcount reductions.

Providing a modicum of relief for central banks globally, inflation continued to decelerate in the quarter, though core inflation which strips out more volatile food and energy prices remained stubbornly sticky. After pausing for two meetings, the Bank of Canada opted to hike the overnight rate by 25 basis points at its most recent meeting in June, citing the view that monetary policy was not yet restrictive enough to return inflation back to their 2% target.

After a brief steepening following the U.S. regional banking crisis, the yield curve in Canada reversed course and resumed inverting to end the quarter. What the markets appear to be signaling is that with every rate increase by central banks, the risk of a policy error grows. Despite this tug-of-war between central banks and market participants, it's hard to imagine central bank resolve to tame inflation abating until after there are clear, sustained real economic indicators that the fight has been won.

Corporate profits remain broadly resilient and consensus expectations are generally positive, while a potential recession remains one of the most widely anticipated on record.

Performance Commentary

The portfolio underperformed the benchmark in the quarter with the primary source of relative return coming from the lack of exposure to Shopify.

Caterpillar equipment dealer **Finning International** posted expanded operating margins and return on capital thanks to strong demand and a near-record order backlog. **Dollarama** reported excellent same store sales growth benefiting from the introduction of a $4+ price point last summer, immigration, and consumers trading down. Throughout the remainder of the year, management expects lower freight costs will help them maintain their target margin profile. CGI also reported strong organic growth, with sales to large clients, such as governments looking to modernize their systems, being a notable area of outperformance.

Lastly, management at financial market exchange and data provider **TMX Group** continued executing by investing in Trayport (TMX's commodity trading platform), growing recurring revenue data subscriptions, and building out capabilities to better cross-sell their existing client base.

While corporate profits were generally strong across the portfolio, there were a few exceptions. Producer and retailer of crop nutrients and supplies **Nutrien** reported weaker results due to lower volumes and sales prices while also lowering guidance for 2023. Dairy processor **Saputo's** stock performance was challenged as it continues to restructure the U.S. business by rationalizing plants and investing in automation. Commodity price volatility remains the key challenge in the U.S. while the Canadian segment continued to execute. **Enghouse Systems** headline results missed expectations while outsourced digital customer service provider **Telus International** saw sales beyond those to Telus Corporation decline in the quarter, both annually and sequentially, although guidance assumed resumed growth.

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Looking Ahead

The combination of historically inverted yield curves, strong year-to-date gains in equity prices, benign credit spreads, and well-anchored longer-term breakeven inflation expectations are all consistent with the consensus outlook for a soft landing; put differently, that central banks will be successful in their fight against inflation without causing too much harm to the economy. The widely anticipated recession, should it ever arrive, is expected to be mild.

The risks lie on both sides of this consensus: either that the impact of recent monetary policy impairs demand more substantially than expected (a hard landing), or that inflation persists longer than projected, emboldening policymakers to hike even further than currently expected. Both would likely be negative for equities.

Yield curve inversion has historically been a reliable predictor of recessions, and the transmission mechanism is worth understanding. Inversions tend to hurt the balance sheets and business models of banks, who borrow short to lend long. Higher short-term borrowing costs result in lower bank profitability, and the banks typically adjust by cutting back on lending which has a ripple effect across the economy. We've seen some indications of these ripples globally—the notable regional bank failures in the U.S., and UK Gilt crisis, etc.—but they haven't materialized, particularly in Canada, to the extent one might have anticipated given the degree of curve inversion. It's possible that any reduction in liquidity from the banks is being offset by other sources, e.g., excess consumer pandemic savings, private credit markets, and government fiscal policy. Nevertheless, it would be very unusual by historical standards to have the degree of yield curve inversion seen in many major economies today without an associated recession.

To prepare against the risks, we've leaned into our bottom-up approach. Our investment philosophy naturally leads us to businesses with more stable demand given the criticality of the products and services they provide to their customers, and we always have an eye on our companies' balance sheets as lower debt provides resilience in times of crisis. Our forensic accounting checklist is designed to ensure that we avoid getting caught up in narrative, and instead methodically comb through financial statements for clues with respect to changes in business or management quality. In the current environment, and especially as COVID-19 supply shocks have encouraged many companies to build up their inventories, companies with excess inventory levels may face gross margin pressures in the coming quarters should demand abate from its current trend. As such, in addition to continuing to understand how companies are coping with inflation, we're looking closely at cash conversion and days of inventory, especially when coupled with valuation levels that, year-to-date, have outpaced earnings.

Yes, "boring" work. But ultimately an approach that should prepare the portfolio to be resilient for the multitude of scenarios that may play out going forward.

Performance Summary[1] (%)
As of June 30, 2023:

	YTD	3 Mo.	1 Yr.	3 Yrs.	5 Yrs.	10 Yrs.	Since Inception[2]
FUND	3.8	(0.2)	8.3	10.9	6.2	8.6	9.0
BENCHMARK	5.7	1.1	10.4	12.4	7.6	8.4	8.3

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Calendar Year, as of December 31:

	2022	2021	2020	2019	2018	2017	2016	2015	2014	2013
FUND	(5.6)	23.7	2.7	20.7	(9.8)	8.7	15.8	(0.3)	15.8	25.4
BENCHMARK	(5.8)	25.1	5.6	22.9	(8.9)	9.1	21.1	(8.3)	10.6	13.0

[1]Performance figures are net of management fees and operating expenses. Periods greater than one year are annualized. Performance figures are in Canadian dollar terms.
[2]Mawer Canadian Equity Fund Series A Inception: June 3, 1991

Selections from Mawer's Art of Boring blog and podcast:

Rising Debt and its Potential Consequences: Canada's New Normal?
We need to understand where we are in the debt super cycle to inform our investment decision making.

Artificial Intelligence: The Return of The Centaurs
Recent AI breakthroughs are underscoring the power of the centaur model—humans + machines—creating something more potent than either model operating independently.

Inflation's one-two punch
It's inflation's second punch that can deliver a blow that investors may not be expecting.

Disclaimer

Opinions and Forecasts:
This report includes certain statements that are "forward looking information" or "forward looking statements" (collectively, "forward looking information") within the meaning of applicable securities legislation. All statements, other than statements of historical fact, included in this report that address activities, events or developments that the portfolio advisor, Mawer Investment Management Ltd., expects or anticipates will or may occur in the future, including such things as anticipated financial performance, beliefs, plans, goals, objectives, assumptions, information and statements about possible future events, conditions, results of operations, are forward looking information. The words "may", "could", "would", "should", "believe", "plan", "anticipate", "expect", "intend", "forecast", "objective", "will" and similar expressions are intended to identify forward looking information. Undue reliance should not be placed on forward looking information. Forward looking information is subject to various risks described in the Simplified Prospectus, uncertainties, and assumptions about the Fund, capital markets and economic factors, which could cause actual results to vary and in some instances to differ materially from those anticipated by the portfolio advisor and expressed in this report. Material risk factors include, but are not limited to, general economic, political and market factors in North America and internationally, interest and foreign exchange rates, global equity and capital markets, business competition, technological change, changes in government regulations, unexpected judicial or regulatory proceedings, and catastrophic events. The foregoing list of risk factors is not exhaustive.

All opinions contained in forward looking information are subject to change without notice and are provided in good faith and are based on the estimates and opinions of the portfolio advisor at the time the information is presented. The portfolio advisor has no specific intention of updating any forward looking information whether as a result of new information, future events or otherwise, except as required by securities legislation. Certain information about specific holdings in the Fund, including any opinion, is based upon various sources believed to be reliable, but cannot be guaranteed to be current, accurate or complete and is subject to change without notice.

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Benchmarks:

FUND	BENCHMARK
Mawer Canadian Equity Fund	S&P/TSX Composite Index

Performance Disclosure and Requirements:

Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the fund facts and the prospectus before investing. The indicated rates of return are the historical annual compounded total returns including 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. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. Mawer Funds are managed by Mawer Investment Management Ltd.

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