Mawer Global Small Cap Fund, Series A

Q2 2023 | Performance Commentary

Market Overview

Global equity markets delivered positive—albeit tame—returns buoyed by stocks in the U.S. and Asia, which kept the MSCI ACWI Small Cap return afloat, while equities in Europe and Japan slightly leaned the other way as returns were negatively impacted by their local currencies weakening against the Canadian dollar. Most notably, the yen weakened against other major trading partners as Japan remains one of the few regions with dovish interest rate policy and yield curve control policy to anchor government bond yields, while interest rates moved higher in most other countries. Finally, China's much talked about re-opening has been more fizzle than sizzle, affecting the performance of the emerging market complex.

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. Despite the deceleration in price growth overall, many central banks including the Bank of England, Bank of Canada, European Central Bank, and Reserve Bank of Australia raised rates at their most recent meetings, and while the Federal Reserve paused in June, Chairman Powell continued to jawbone markets into expecting several more hikes before 2023 is through.

After a brief steepening in Canadian and U.S. yield curves in April following the U.S. regional banking crisis, yield curves 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 and sustained economic indicators that the fight has been won.

Market dynamics remain mixed if not somewhat confused as 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 modestly underperformed its benchmark this quarter.

The notion of a variant perception resides inherently in our investment process; we focus on what the market may be missing or weighing differently than us with respect to a company's fundamentals. We believe fundamentals should drive long-term performance as market prices follow wealth creation over time.

We initiated on a number of companies in which we believe we have the aforementioned variant perception—notably, manufacturers of generic pharmaceuticals Dermapharm and Hikma—were amongst top performers this quarter. A portion of Dermapharm's business is related to COVID vaccines, which faced headwinds as sales volumes declined, something the market seemed to focus on while overlooking its core wealth-creating segment (i.e., branded pharmaceutical products). Now, this overhang is clearing up as recent results suggest the company is successfully growing revenue in its core segment; and the market is finally noticing and correspondingly rewarding the stock price. Similarly, we believe the market focused too much on margin pressure faced by Hikma's oral generics segment due to heightened competition. This dynamic is now turning around as an improving pricing environment led Hikma to increase its guidance for the year ahead. Brazilian professional service firm GPS reported strong earnings growth, bolstered by its scale and technology platform, making it the top performing holding of the portfolio this quarter following our initial investment earlier this year. Finally, value-added reseller SoftwareOne, a company we initiated a position in last quarter, received a preliminary bid from a private equity firm to take the company private at a valuation significantly higher than its market price at the time of offer.

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Partially offsetting these positives, market research firm Ipsos and Nordics car dealer Bilia faced headwinds as they reported slightly lower spending from their end consumers in their respective markets. Similarly, IT consultant Knowit's management highlighted that some clients are delaying their projects. We believe these headwinds are temporary in nature. We also will note that all three holdings also have what we believe to be engaged owners; a term we use to encapsulate the management team's technical alignment (i.e., skin in the game) along with their rationality, business acumen, long-term commitment to the company, and integrity. This is a component we have been emphasizing more over the last few years in our process, as we believe companies with engaged owners tend to focus more on the long-term, stick around during challenging periods, and are relatively more aware of risks inherent in the business.

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—such as the notable regional bank failures in the U.S.—but they haven't materialized 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. The end of the zero interest rates cycle should bode well for our approach as companies that make good use of their capital (one of our key investment criteria) should be rewarded. In terms of business model, our investment philosophy naturally leads us to companies with more stable demand given the criticality of the products and services they provide to their customers. Further, we always have an eye on our companies' balance sheets as lower levels of 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.

Global Small Cap Fund

Q2 2023 | Performance Commentary

Yes, "boring" work. But ultimately, we aim to employ 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	6.0	1.0	12.9	2.5	4.1	11.1	10.2
BENCHMARK	5.5	1.3	15.9	9.8	4.7	9.8	6.8

Calendar Year, as of December 31:

	2022	2021	2020	2019	2018	2017	2016	2015	2014	2013
FUND	(17.7)	4.8	14.8	24.4	(2.6)	20.8	(0.7)	29.1	12.1	47.0
BENCHMARK	(12.8)	15.1	14.3	18.4	(6.7)	15.7	8.3	18.3	9.1	33.7

[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 Global Small Cap Fund Series A Inception: October 2, 2007

Selections from Mawer's Art of Boring Blog and Podcast:

[The Case for Non-Predictive Decision Making]
How do investors figure out what a company is worth? (Especially in a higher inflationary and interest rate environment?)

[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.

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Benchmarks:

FUND	BENCHMARK
Mawer Global Small Cap Fund	Oct 2007: Russell Global Small Cap Oct 2016: MSCI ACWI Small Cap (net) Total Return index

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