MAWER
newsletter

Second Quarter 2017

Market overview

Investment headlines in the second quarter of 2017 were once again full of politics, with developments in Europe, the U.K. and the U.S. dominating discussion. One might say the quarter was not so good for the populists: Trump found himself embroiled in scandal, British Prime Minister Theresa May managed to lose her conservative party's majority by calling a snap election, and Marine Le Pen was soundly defeated in France's Presidential contest by Emmanuel Macron. Political uncertainty notwithstanding, it was a solid quarter overall for investment performance: most major equity and bond markets posted positive returns.

Two big, competing, and intersecting themes for the quarter were inflation expectations and the monetary environment. Inflation expectations came down in Q2, driven in particular by market participants re-examining the likelihood of Trump's proposed policies being enacted. This had the result of pushing bond yields lower. Meanwhile, investors received indications that global monetary conditions were on a tightening path. In the final days of June, in particular, investors reacted to indications from the Bank of England, the Bank of Canada, and the European Central Bank that special measures implemented since 2015 would likely be unwound. This trimmed some of the gains bonds had garnered, pushing yields higher again. The net result was nonetheless a positive overall quarter for bonds.

The Mawer Balanced Fund (A Series, Net) rose 2.3% in the quarter and has increased 5.9% YTD. The positive returns were primarily driven by strong security selection, as well as the contribution of international currencies like the euro and the pound versus the Canadian dollar.

One notable area of weakness was the Canadian market. Canadian equity markets were impacted by concerns over energy and commodity markets as well as housing market risks. This resulted in muted returns for the Canadian Equity and New Canada Funds relative to 2016. While the Canadian dollar rose at the end of the quarter—on the back of comments from the Bank of Canada of a potential 0.25% interest rate increase as early as this summer—the currency was mostly weak over this time period.

Big picture issues and observations:

- Expectations of "reflation" subsided in the U.S. Inflation expectations appear to have come down, as market participants re-examine the policy solutions that will be enacted under the Trump presidency, and as economic data has pointed to more muted levels of inflation. The environment has been positive for bonds while still supportive of equities.
- The Federal Reserve announced a 0.25% rate hike, bringing the benchmark rate in the U.S. to 1 – 1.25%. The Fed also provided more details on shrinking its $4.5 trillion balance sheet. Both moves amount to monetary tightening. Between these moves—and lower overall inflation expectations—the yield curve in the U.S. has flattened somewhat. How much further the Fed can push short-term interest rates will depend, in part, on future inflation expectations.
- Trump's firing of FBI director James Comey resulted in a major political scandal and an investigation of the White House. While the risk of impeachment appears low, the investigation and Trump's lower ratings potentially weaken the President's ability to see legislation passed. Nonetheless, investors still appear to expect more deregulation and a U.S. corporate tax cut.
- France elected Emmanuel Macron as President, who was then able to secure a parliamentary majority. Macron is a centrist, Europhile, and globalist. Some of his proposed reforms could improve France's labour force. Importantly, the election of Macron was a rejection of the more populist agenda of Marine Le Pen.
- British PM Theresa May embarrassed herself in a snap election, forcing her party to make a deal with the Northern Ireland Democratic Unionist Party. This may have changed her negotiating position ahead of Brexit negotiations which, if it means a softer Brexit, could turn out to be a good thing for global markets.
- China continued to balance its need to clean up its financial house with positioning itself as the new

- world leader. China stepped up after the U.S. backed out of the Paris Climate Agreement. China has been investing heavily into infrastructure in Asia and has been busy making trade deals. The MSCI also opted to include mainland China shares in the index.

  Yet China still has much work to do to clean up its financial industry. This quarter, China's banking regulator cracked down on "entrusted investments"—funds that Chinese banks farm out to external asset managers. Moody's also downgraded China from Aa3 to A1, warning of Beijing's financial strength and rising liabilities.

- Canadian industries gave a collective sigh of relief as Trump has appeared more docile on trade disputes than some had anticipated. Although there have been some lumber and dairy disputes, it now appears that NAFTA will be renegotiated and not simply tossed out.

- Key economic indicators show decent economic growth in Europe. Does this mean Europe is economically out of the woods? Not yet. The sale of the sixth largest lender in Spain (for €1.00), as well as the €17 billion bailout of two Italian banks, highlight that there continue to be bad debts within the credit system of the EU.

How did we do?

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

All of our equity funds beat their benchmarks during the second quarter.

As long-term investors, we are reminded of one of the parables included in legendary investor Benjamin Graham's influential text, *The Intelligent Investor:*

> *Imagine that in some private business you own a small share that cost you $1,000. One of your partners, named Mr. Market, is very obliging indeed. Every day he tells you what he thinks your interest is worth and furthermore offers either to buy you out or to sell you an additional interest on that basis. Sometimes his idea of value appears plausible and justified by business developments and prospects as you know them. Often, on the other hand, Mr. Market lets his enthusiasm or his fears run away with him, and the value he proposes seems to you a little short of silly. If you are a prudent investor or a sensible businessman, will you let Mr. Market's daily communication determine your view of the value of a $1,000 interest in the enterprise?*[1]

At Mawer, we aim to take long-term positions in wealth-creating companies run by good management teams. We perform our own evaluation of what we believe constitutes a fair range for the intrinsic value of each company, and then compare this to the price Mr. Market tells us it's worth to determine whether to buy or sell. And while we have gone through many periods over the years where Mr. Market has taken a rather different view of many of the companies we own, in most cases the fundamentals of these businesses don't change month-to-month, quarter-to-quarter, or even year-over-year. The price Mr. Market thinks our interest is worth, however, does fluctuate often.

So far, compared to the second half of last year, 2017 has been characterized by a number of reversals where Mr. Market seems to have changed his mind about many of the companies we own across our portfolios. The nature of those reversals, and how they influenced our Funds' performance, are discussed below.

Mawer Canadian Equity Fund: 0.6%

In a reversal of the trend experienced throughout much of 2016, companies involved in resource extraction—both energy and mining—have been weak so far this year due to falling commodity prices. Given these industries' prominence in Canada, the S&P/TSX Index experienced a negative return during the quarter. We are significantly underweight energy and don't currently own any precious metals mining companies in the portfolio. As price-takers, competitive advantages are hard to come by and there is a track record of capital indiscipline within both industries.

Instead, within the materials sector, our largest weight is CCL, a label printing company (as an example, it prints drug labels for the pharmaceutical industry). CCL's management have succeeded in generating wealth for shareholders over the past few years, are good operators, and have grown the business nicely through smart strategic acquisitions at fair prices. Mr. Market has rewarded CCL for its strong execution, and the company was added to the TSX 60 in June. While CCL remains an important position, we have been trimming our stake into strength in order to manage its size within the portfolio.

Mawer New Canada Fund: –3.2%

Canadian small-cap stocks fared worse than their larger-cap peers. Our strategy suffered negative returns, but outpaced the benchmark primarily due to strong stock selection. In particular, companies like

[1] Graham, Benjamin. *The Intelligent Investor—Revised Edition.* Copyright 1973 by Benjamin Graham. New material: copyright 2003 by Jason Zweig. HarperCollins Publishers Inc. New York, New York.

New Flyer, Solium Capital, and Sleep Country posted excellent results reflective of positive developments for their respective businesses. As an example, Sleep Country, Canada's leading mattress retailer, continues to execute well against a weak competitive backdrop highlighted by the fact that Sears Canada, its largest competitor, filed for bankruptcy protection. We view this as a positive development for Sleep Country and added to our position on the announcement.

Despite strong stock selection overall, there was a well-publicized exception within the portfolio. After having held Home Capital the previous 15 years, a period in which the company consistently generated wealth for shareholders, a combination of regulatory enforcement, management changes, and, most crucially, acute funding risk caused a hefty reversal in Home Capital's stock price. We exited the name when those funding risks became apparent as we ultimately lost confidence in the viability of the company's business model. At Mawer, we define risk as the permanent impairment of capital, and in this case, the capital we had allocated to Home Capital was permanently impaired. We regret that we did not move faster and are disappointed with the outcome: it stings. But we are comforted by the fact that Home Capital did not command an overbearing position size within the portfolio; despite a negative reversal in the stock, a well-diversified portfolio provided a great deal of ballast.

Mawer International Equity Fund: 6.3%

Equity returns outside of Canada during the quarter were much rosier as the momentum from stellar returns in the first quarter continued. 2017 has seen a reversal in top market performers: whereas lower-quality, more cyclical stocks and sectors performed well late last year in an environment of rising inflation expectations, Mr. Market seems to have reversed his opinion of many of our highest-quality ideas. Tsuruha and Halma are good examples. While the market penalized Japanese drug store chain operator Tsuruha last year for what appeared to be greater pricing pressure in its dispensing business, our view was that a rise in pricing pressure would simply accelerate a consolidation in the drugstore industry. We believed that Tsuruha was well-placed to benefit from the consolidation trend given its strong operational and acquisitive track record. That thesis has remained intact, and the market has subsequently rewarded Tsuruha for the synergies it has been able to extract from its acquired assets.

Halma is engaged in the provision of sensor and detection technologies related to health and safety (e.g., automatic door sensors) and Mr. Market had taken a dour view of its published results toward the end of last year, specifically questioning some recent acquisitions. We have been shareholders of Halma for many years and have a great degree of confidence in its management team's ability to allocate capital given a long track record of wealth-creating decisions for shareholders. While this trust isn't set in stone, our opinion of the company's management did not change materially as a result of the recent hiccups, and we have been rewarded so far this year as the stock has bounced back.

Mawer Global Small Cap Fund: 5.9%

Another reversal experienced this year has been a geographical change in leadership. U.S. equities led most major markets in 2016 (Canada was a notable exception) and our global small cap strategy had lagged its benchmark, in part due to our relative underweight to the U.S. in favour of Europe and the U.K. However, U.S. equities have taken a back seat to other regions in 2017; optimism related to fiscal reform in the U.S. has dissipated somewhat while economic growth and sentiment in Europe have improved. The fact that we happen to own more stocks in the better-performing European and U.K. markets than in the U.S. this year has been of benefit to our clients.

However, the strategy's geographic make-up is the result of our stock selection process, and not a starting point. Currency fluctuations, diverging economic growth trajectories, and investor sentiment can all have material impacts in the short-term. But as long-term investors, the proceeds of our decision to initiate a position in a stock are realized over the entire holding period of that stock, which tends to be measured over multiple years. And over the long-term, our view is that the benefits of focusing on wealth-creating businesses run by excellent management teams, if purchased at a reasonable price, far outweigh any short-term fluctuations associated with a company's country of domicile.

Mawer U.S. Equity Fund: 2.4%

While the U.S. has ceased to be a top performer in 2017, and while the Canadian dollar appreciated meaningfully vs. the greenback, U.S. equities still delivered solid returns in Canadian dollar terms. Our Fund benefitted from favourable stock selection in the second quarter, with information technology being an area of strength. Alphabet (Google), our largest holding, reported a 22% increase in revenues and a 33% increase in earnings before tax during the quarter…fairly mouth-watering numbers for a company with a market capitalization in excess of $600 billion.

Questions around the sustainability of the outsized gains in technology abound. We'd note that while we do have exposure to some of the companies that stand to benefit substantially from a potential new golden era in technology (e.g., Alphabet and Amazon), many

of our largest holdings within the sector lie outside of the crosshairs of those prophesizing a new tech bubble. Visa and Mastercard provide electronic payment technologies to facilitate transactions. Ansys provides engineering software that allows their customers, such as car manufacturers, to simulate new and improved products instead of testing prototypes thereby increasing speed to market and lowering costs. And in a world of increasing interconnectedness and automation, Amphenol produces electronic and fiber optic connectors and cables.

Equity valuations are a topic of frequent conversation within the team, and not just in the technology sector. Our U.S. equity strategy remains focused on ensuring the odds remain in our clients' favour by assembling a resilient portfolio that isn't overly dependent on any single outcome.

Mawer Global Equity Fund: 3.9%

Within our global equity strategy, we benefitted from strong stock selection within financials—a reversal of what we experienced in the second half of 2016. Broadly speaking, the pace of stock price appreciation for banks and insurance companies took a breather after a rampant end to 2016 as optimism around fiscal policy implementation in the U.S. cooled. The North American banks we own (JP Morgan, Wells Fargo, RBC and TD) posted generally unimpressive returns. However, this was more than offset by strong security selection within the capital markets segment. Asset manager BlackRock benefitted from rising equity markets and strong inflows which outweighed fee pressures. Financial information company S&P Global was rewarded for posting excellent results, bouncing back after a disappointing end of 2016. And insurance broker Aon was rewarded as our thesis continues to play out amid organic growth, margin expansion, and cost savings.

Mawer Emerging Markets Equity Fund***

After languishing behind developed markets for a good portion of the current decade, emerging markets equities have reversed course over the last year or two and have outperformed. Our Emerging Markets Equity Fund posted strong results in the second quarter that outpaced its benchmark, the first full quarter since we launched the strategy at the end of January. Among the many countries in which we invest, India was a bright spot. A common theme among our Indian holdings is that of "long growth runways," and two of our financials holdings, LIC Housing Finance and HDFC Bank, illustrate this point nicely.

There were 280 million households in India in 2016, but only approximately 200 million permanent-structure houses available. Given the current population growth of 1.3% annually, continuing nuclearisation (i.e. smaller households), and rising per-capita incomes, there could be additional demand for houses of approximately 10.5 million per year. Furthermore, these numbers omit the desire to upgrade; for example, India's latest census in 2011 suggests that 53% of total households didn't have a toilet. Additionally, India's mortgage penetration is only 9% of GDP compared to 18% in China, 20% in Thailand, 56% in Singapore, and 68% in the U.S.

Given this backdrop, we believe that LIC Housing Finance and HDFC Bank are well-placed to capitalize on this tremendous growth runway. Both have good management teams and a solid track record of operation and asset-quality discipline, having largely avoided the Indian infrastructure lending boom and bust of the past few years that weakened many of their competitors.

In emerging markets, the divergences between higher quality and lower quality business are often larger than those we come across in the developed world. We think this provides us an opportunity: by applying the same philosophy and process we use across our other equity strategies to emerging markets, we can hopefully take advantage of the growth potential available while ensuring that our companies still have strong competitive moats and management teams that are responsible stewards of a company's capital base.

Mawer Canadian Bond Fund: 0.6%

The fixed income landscape, both in Canada and globally, experienced a sharp reversal in the last few days of the quarter. Government bond yields had been drifting lower in 2017 as inflation expectations gradually tempered after spiking higher at the end of 2016. However, fixed income and currency markets were meaningfully impacted at the end of June as investors refocused their attention on central banks' more hawkish views on monetary policy accommodation, including the Bank of Canada.

As a result, Canadian Government bond yields out to ten years in term ended the quarter generally higher than where they began. However, from a total return perspective, this was offset by lower yields in the very longest-dated maturities, which allowed the Canadian bond market to deliver a positive return overall. From a relative perspective, the Mawer Canadian Bond Fund underperformed its benchmark, largely due to where the portfolio was positioned along the yield curve within specific sectors of the market. For example, the duration of provincial holdings is lower than that of the benchmark; as longer-term yields decreased, provincial holdings lagged. Additionally, the majority of corporate bond exposure is in issues with term-to-maturities less than 10 years given our view that it's very difficult from a risk management perspective to assess whether those entities' competitive advantages will be upheld over such

a long time frame. And given the strength that long-term corporate bonds experienced over the quarter, the Fund could not keep up with the broader market.

Mawer Global Bond Fund: -0.3%

Canadian dollar strength over the period versus the U.S. dollar and the Japanese yen put pressure on fixed income returns from those markets in Canadian-dollar terms. However, the loonie couldn't keep pace with currency gains experienced in other markets, most notably the euro. The Fund's relative underweight to euro-denominated bonds meant that we did not participate as keenly in those gains, even though we did benefit from holding bonds with lower interest rate sensitivity within the region.

Mawer Global Balanced Fund: 2.7%
Mawer Balanced Fund: 2.3%

Our Balanced Funds benefitted from both strong stock selection across our equity funds, as described above, and from favourable asset allocation. A preference for equities over bonds and a preference for foreign over domestic equities all contributed to our performance.

Looking ahead

Current economic conditions appear—broadly speaking—conducive to healthy corporate profitability. All else equal, this should be positive for equities. However, the offsets to this more favourable environment are (1) current equity valuations and (2) the potential for rising interest rates. Indeed, we saw a prelude of the headwinds that bonds and equities may face as interest rates rise at this quarter's end. Add to this the prospect of changing policies and bumps along the road would not be surprising. Our approach through this environment is the same as it ever was—build portfolios that can be resilient to a wide set of possible outcomes.

Issue—Normalizing monetary conditions

As noted, many of the world's central banks appear to be ready to tighten monetary policy. It is unknown at this point how this will unfold and a number of scenarios are possible. Many participants expect central banks to pull back stimulus by raising interest rates and reducing the size of their balance sheets, but in a sensible way that the markets can absorb. The expectation appears to be for some near-term volatility in currency and equity markets, as investors adjust their expectations on specific central bank moves, but overall a manageable scenario; one in which rate increases would be justified by economic conditions and therefore could be supportive of continued positive investment performance.

Of course, there is some possibility that central banks move too quickly and the economy isn't actually strong enough to handle the withdrawal of stimulus—this would be a policy mistake. This would likely prompt a flattening of the yield curve with safe-haven countries seeing their long-term government yields rally and economic growth potentially slowing. In this scenario we believe portfolio positioning should emphasize high quality businesses proven to be resilient in slowing economic conditions, and bonds that serve as the shock absorber in a balanced portfolio.

In addition, there is the possibility that rates rise and the economy really can handle it. This would likely be good news for equities with cyclical stocks and emerging markets leading gains while corporate credit spreads narrow with improved balance sheets. In this scenario, a well-structured bond portfolio benefits from reinvestment at higher rates. Our equity funds may lag our benchmarks but absolute returns are likely strong. Eventually, accumulated rate hikes will start to slow the economy and force valuations down, but potentially by then central banks will have built up enough of a cushion to be in a position to ease conditions once more.

Issue—Equity valuations
As we approach 10 years of positive equity returns, one of the largest potential risks to long-term equity returns is valuation. For valuations to make sense at these levels, expectations around growth and profitably will have to come through. Without this support, and should interest rates rise, there is a potential for valuations to pull back. There is a decent probability this happens in the short to medium-term. Then again, if interest rates are able to adjust in line with improving returns on capital, then valuations can continue to rise over time.

Issue—A Canadian housing downturn

Canada is on the world financial radar thanks in large part to hot real estate markets in Vancouver and Toronto. Given the continued gains in the housing market and the fact that housing markets move through cycles, it would not be a surprise to see the Canadian housing market eventually correct. The extent of the impact of a downturn in the Canadian housing market will depend greatly on the magnitude of the correction. That said, there are structural backstops in the Canadian lending market that provide mitigations to a disaster scenario. Further, the Canadian banks, which would be among the most directly impacted by a downturn, appear to have decent provisioning and quality underwriting practices. Should a pullback occur, our main exposure would be through the banks which we believe to be positioned to weather a fall in property values, even though it would be painful.

Ultimately, a downturn in housing would reverberate through nearly every aspect of the Canadian economy which means that many of the positions in our Canadian bond and equity mandates would be impacted. We have been careful to reduce some of our direct exposures to this risk and to invest in companies that would be resilient through a more difficult scenario.

Asset mix considerations

Within our asset mix strategies, we have reallocated capital to where we are seeing better opportunities (from U.S. equities to international and Canadian equities) and enter the third quarter with a slightly overweight allocation to equities. We are conscious of the risks that are present in the system, namely higher equity and bond valuations and the potential for central bank policy error. Ultimately, our approach continues to be that of building resilient portfolios by paying close attention to the fair value range of the stocks we buy (given equities have been rising for an extended period of time) and maintaining the appropriate level of diversification. This should allow for portfolios that can weather various scenarios and be positioned to grow over the long-term.

Total Net Returns (Series A)*

For periods ending June 30, 2017	3-Mo	YTD	1 yr	3 yr	5 yr	10 yr
Equity Funds						
Mawer International Equity Fund	**6.3**	**14.7**	**13.4**	**10.8**	**15.0**	**5.7**
International Equity Benchmark**	3.0	10.5	19.9	8.0	14.0	3.0
Mawer U.S. Equity Fund	**2.4**	**7.2**	**15.1**	**16.2**	**19.7**	**9.4**
S&P 500 Index	0.4	5.9	17.9	17.1	20.3	9.3
Mawer Global Equity Fund	**3.9**	**10.0**	**13.5**	**12.9**	**17.3**	**–**
Global Equity Benchmark**	1.5	8.0	18.3	12.5	16.9	–
Mawer Global Small Cap Fund	**5.9**	**11.4**	**18.6**	**13.8**	**22.0**	**–**
Global Small Cap Benchmark**	1.3	6.9	21.8	12.0	16.7	–
Mawer Emerging Markets Equity Fund* **	**–**	**–**	**–**	**–**	**–**	**–**
MSCI Emerging Markets Index	–	–	–	–	–	–
Mawer Canadian Equity Fund	**0.6**	**2.7**	**14.4**	**7.3**	**13.6**	**7.4**
S&P/TSX Composite Index	–1.6	0.7	11.0	3.1	8.7	3.9
Mawer New Canada Fund	**–3.2**	**–0.7**	**10.2**	**5.4**	**18.0**	**10.7**
New Canada Benchmark**	–5.5	–4.1	5.2	–1.8	5.6	2.2
Balanced Funds						
Mawer Global Balanced Fund	**2.7**	**6.9**	**7.4**	**9.0**	**–**	**–**
Global Balanced Benchmark **	1.2	5.5	9.8	8.7	–	–
Mawer Balanced Fund	**2.3**	**5.9**	**8.4**	**8.3**	**11.7**	**7.2**
Balanced Benchmark **	0.3	3.5	9.0	6.4	9.3	5.6
Mawer Tax Effective Balanced Fund	**2.3**	**5.9**	**8.5**	**8.3**	**11.7**	**7.1**
Internal Tax Effective Balanced Benchmark **	0.3	3.5	9.0	6.4	9.3	5.5
Income Funds						
Mawer Global Bond Fund	**–0.3**	**1.0**	**–2.3**	**–**	**–**	**–**
Citi World Government Bond Index	0.2	1.2	–4.1	–	–	–
Mawer Canadian Bond Fund	**0.6**	**1.8**	**–1.2**	**3.0**	**2.5**	**4.4**
FTSE TMX Canada Universe Bond Index	1.1	2.4	0.0	3.8	3.3	5.1
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	0.2	0.5	0.6	0.8	1.2

* 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.

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