MAWER quarterly

Third Quarter 2018

Market overview

Global economic signals presented a mixed picture in the third quarter of 2018. The U.S. economy forged ahead posting 4.2% real GDP growth, China implemented policies to broaden domestic demand, the U.S. and China announced retaliatory tariffs, NAFTA trade talks dragged out (only to be resolved on the last day of the quarter), and the U.K. continued to prepare for Brexit.

One of the most prominent risks during the third quarter was the rise in U.S. interest rates (with rising rates globally being the key valuation risk for portfolios) which, along with central banks reducing stimulus, added to a tightening of liquidity conditions. Investors reacted by selling off emerging markets currencies in part due to the rising debt service costs for foreign governments and corporations with U.S. dollar denominated debt. Notably during the quarter, Venezuela devalued the bolivar by 96%, and relative to the U.S. dollar, the Argentinian peso dropped 30%, the Turkish lira declined 24%, the Brazilian real dropped 4% and the South African rand declined 3%. The yield on the U.S. 10-year Treasury continued to test what appears to be a psychologically important 3% level with inflation data supporting continued increases in the Fed funds rate.

With this backdrop, U.S. equities as measured by the S&P 500 Index set new highs over the third quarter, appreciating 7.7% (USD) while the resource-oriented sectors in Canada suffered and the S&P/TSX Composite dropped 0.6% generally as a result. The stronger Canadian dollar did temper an otherwise steady period for overall investment performance. In Canadian dollar terms, the MSCI All-Country World Index (ACWI) gained 2.5%, the S&P 500 Index gained 5.8%, the MSCI ACWI ex-USA fell 1.0%, the MSCI Emerging Markets Index dropped 2.8% and the FTSE Canada Universe Bond Index posted a 1.0% drop.

Overall, the warning lights seem to have shifted from an organized grid of synchronized greens, with the mixed data and trade-related concerns forcing some lights to change from green to yellow this quarter, introducing more uncertainty around the global economic growth picture.

How did we do?

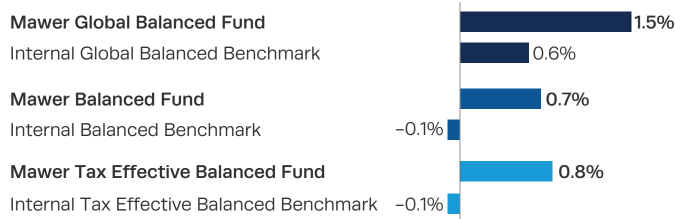
All performance is for Series A Funds, net of fees and expressed in Canadian dollars for the period of July 1 – September 30, 2018.

Mawer Global Balanced Fund: 1.5%
Mawer Balanced Fund: 0.7%

One of the three core tenets of our investment philosophy is that we look to invest in companies run by excellent management teams.

So what is an "excellent" management team? First and foremost, we're looking for effective allocators of capital: able and honest stewards who have a track record of investing in wealth-creating opportunities while expanding their companies' competitive moats. We like to see consistency in what they say and what they do. Great managers tend to navigate effectively through challenging times, but often provide surprises on the upside as well. And the alternative—bungling wealth-destroyers—is decidedly less appealing.

As discussed below, the past quarter—and the resulting effect on the performance of our various funds—serves to illustrate how the decisions made by various management teams have had an impact on our experience as shareholders.



In the end, our balanced funds posted fairly unspectacular (some might say "boring") returns over the period, though they both outpaced their benchmarks. The Mawer Balanced Fund benefitted from the outperformance of its Canadian equity and small cap components. The Mawer Global Balanced Fund's relative return was primarily driven by strong stock selection and an underweight allocation to global bonds.

Mawer New Canada Fund: 6.7%

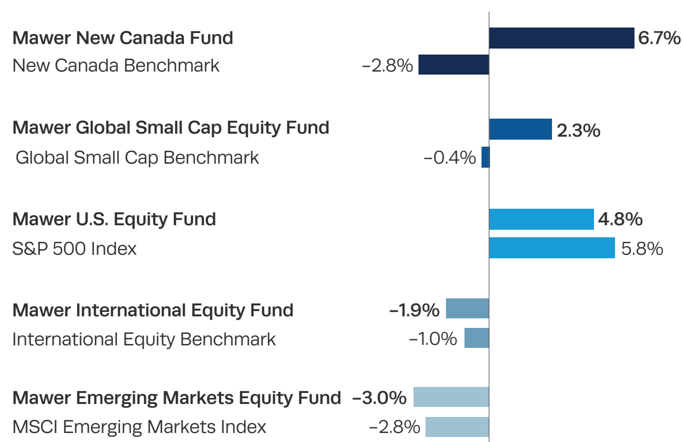
In a quarter in which the broader S&P/TSX Small Cap Index fell 2.8%, 41 of the 53 companies in our Canadian small-cap portfolio enjoyed positive returns and the Fund materially outpaced its benchmark. While the drivers of the Fund's return were broad-based, two stocks deserve further mention.

Earlier this year, quick-service restaurant franchiser MTY Group closed its acquisition of Imvescor Restaurant Group and management have already been able to realize significant synergies. The stock has gained 40% since the beginning of May. As of the end of the quarter, MTY is the largest holding in the portfolio as we believe management will continue to deliver on its long track record of solid performance.

The largest contributor to the Fund's return came from EnerCare, a home services company that rents water heaters, HVAC equipment, and provides sub-metering services to apartment buildings. For some time, we have felt that the market has been underappreciating the strength of execution that EnerCare's management team has been delivering. It turns out we weren't alone: during the quarter, Brookfield Infrastructure announced its intention to acquire the company at a 53% premium.

Mawer Global Small Cap Fund: 2.3%

Our global small cap portfolio also benefitted from M&A activity during the quarter which helped it to beat its benchmark. Jardine Lloyd Thompson (JLT), a U.K.-based insurance broker and employee benefits consultant, received a takeover bid by one of our U.S. and global equity portfolio holdings, Marsh & McLennan (MMC). The proposed purchase price represented a 33% premium over the prior day's close. At the time, JLT was our second largest weight in the portfolio, and therefore the resulting price action had a materially favourable impact on the Fund's performance. Other stocks that contributed to the Fund's outperformance, and that may be familiar to readers of past editions of the Quarterly, included IT-resellers Bechtle, Japanese drug store chain Kusuri



no Aoki, and human resources outsourcing services provider Insperity.

As both JLT and MMC shareholders, we have worked together across asset class teams to better understand the range of potential outcomes. We're obviously happy as JLT shareholders, but we're fairly optimistic as MMC shareholders, too. We consider the current management team's track record at MMC to be very solid and there's overlap between the two companies; as an example, JLT has a loss-making U.S. business that we think MMC should be able to absorb and eventually turn profitable. Ultimately, success will come down to management's ability to extract synergies from the acquisition.

Mawer U.S. Equity Fund: 4.8%

As referenced in the global small cap fund commentary above, synergies as a result of a Jardine Lloyd Thompson and Marsh & McLennan merger are, of course, not guaranteed. Integration issues associated with M&A activity can cut both ways. While our U.S. equity portfolio posted strong returns over the quarter, it lagged its benchmark return of 5.8% as one of the largest detractors, Dentsply Sirona, has struggled with a recent acquisition. The company was formed in 2016 as a merger of equals between Dentsply and Sirona, both of which are names familiar to dentists. Sirona's legacy business was geared towards dental equipment such as imaging systems, whereas Dentsply has been more focused on dental consumables such as anesthetics and prosthetics. The company reported disappointing earnings during a quarter marred by market share losses, inventory write-offs, and heavy restructuring costs. While we're disappointed with the pace of progress, we continue to view Dentsply Sirona as a defensive company with strong return potential; we believe the market may have overreacted but acknowledge that management will need to do a better job and continue to watch their progress closely.

Mawer International Equity Fund: –1.9%

Business conditions are constantly evolving and, as investors, we look to evaluate how management teams respond to changes in their competitive environments. Lately, challenges emanating from emerging markets have presented opportunities to judge how the leaders of our portfolio companies are coping with such changes.

Earlier this year, the Indian government announced a re-capitalization of its state-owned banks which had the effect of increasing the competitive intensity of mortgage lending in the country. This has put downward pressure on two of the Indian mortgage lenders in our portfolio, LIC Housing Finance and HDFC Bank. Part of our initial investment thesis in both companies was that they had historically taken a prudent approach to assessing risk, which had cushioned them from past credit cycles and allowed them to capture market share when their more risk-seeking competitors were reeling (hence the need for the re-capitalization). However, while HDFC seems to have maintained its lending discipline, we have seen some evidence that in response to this latest lift in competitive intensity, management at LIC has incrementally increased the business' risk profile by lending more to property developers. While residential mortgages still account for the vast majority of its loan portfolio, we have not interpreted this decision by management favourably and have therefore reduced our position.

LIC Housing and HDFC Bank weren't the only Indian names in the portfolio to suffer poor returns during the quarter. InterGlobe Aviation, a discount airline, fell as the company had difficulty passing on higher oil prices and as its long-standing CEO abruptly announced his departure. We had a high opinion of the CEO as he had presided over a period of impressive and profitable growth, building IndiGo into the market leading discount airline in India. We don't expect any major changes in strategy but acknowledge that the loss of a capable operator during a period in which there may be rising pressures on the company's cost structure isn't a positive development.

In the end, weakness in these Indian holdings caused the portfolio to lag its benchmark over the quarter.

Knock, knock...

An example of a resilient holding that we recently added to our portfolio is Assa Abloy, a Swedish company that is a global leader in door opening solutions (e.g., locks, security doors).

What are the "key" aspects of its business model that makes it resilient? Think of a hotel. If a door lock stops working, recession or not, it will quickly get replaced and chances are the hotel owner will use the same brand of lock that is used in the rest of the hotel. So, while sales from new builds may not be recession proof, the ongoing replacement business makes Assa Abloy quite resilient.

But we need more than resiliency to make an investment worthwhile, and with Assa Abloy we see many opportunities for its business to grow. Despite being the dominant global player in its field, the lock market in some regions can still be quite fragmented. This provides an opportunity for Assa Abloy to grow by acquisitions within those markets.

Another trend that should help Assa Abloy's growth is the switch to electro-mechanical locks. While traditional locks can last a very long time, electro-mechanical locks need more frequent replacement, sell for a higher price, and, globally, only account for 5% of locks (so lots of room to grow!).

Combine this with a fair valuation (we always hope we can buy companies at very attractive valuations but in this case, a fair valuation is acceptable given the high quality of the company) and this makes a good case for inclusion within the portfolio.

In fact, we liked this business model so much that we found similar companies in different parts of the world to add to our portfolios: Allegion in the U.S. and Dormakaba in Switzerland.

Mawer Emerging Markets Equity Fund: –3.0%

India wasn't the only emerging market that experienced negative returns over the quarter. While headlines focused on flash points in Turkey and Argentina, these two countries only represent a very small proportion of the universe of investible securities in emerging markets. In fact, the Fund had no direct exposure to either of those two markets.

Instead, the Fund's investments in Asia were much more influential in terms of its performance, which performed roughly in-line with its benchmark in delivering modestly negative returns. Chinese equities have been under pressure due to elevated trade rhetoric. As a result, the Fund's underweight exposure to China had a positive impact on relative returns, but the uncertainty weighed on individual holdings such as appliance manufacturer Midea.

Another Chinese stock that had a difficult quarter was JD.com. The company's core Chinese e-commerce business is performing well, but management is

increasingly investing into new business areas which has weighed on profitability. Unrelatedly, the company's founder was also accused of sexual assault, which added a new risk to the company given that he maintains a tight grip on decision-making in his dual role as Chairman and CEO. We reduced our position in response to the increasing risks around management.

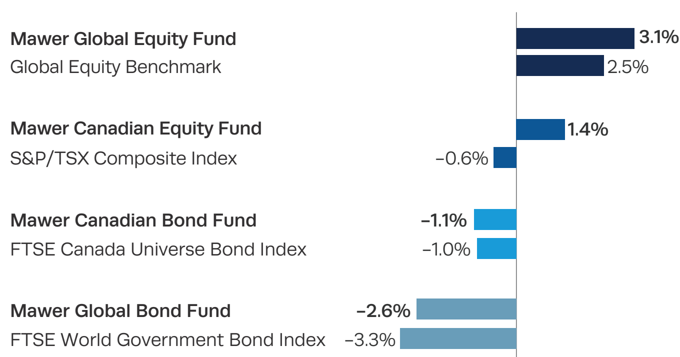
Mawer Global Equity Fund: 3.1%

There were more instances of welcome news in our global equity portfolio, which outpaced its benchmark return of 2.5% during the quarter. One of the best performing stocks in the portfolio was Taiwan Semiconductor Manufacturing Company (TSMC). Over the years, the playbook at TSMC has been to invest heavily in R&D to become the dominant player in semiconductor manufacturing, and especially in more advanced technologies where they currently have an 80% market share globally. As the company has gained scale, management hasn't rested on its laurels and continues to re-invest to stay at the leading edge of the technological spectrum. During the quarter, there was more evidence that this strategy is paying off: one of their competitors announced that they would be discontinuing the development of one of their more advanced chip programs, effectively waving the white flag and conceding that they can no longer compete with TSMC's scale and technological sophistication. The competitive advantages that TSMC has built appear pretty formidable and are the result of many years of prudent capital allocation.

Mawer Canadian Equity Fund: 1.4%

Ultimately, the discussion around management often hits home in Canada. The resource-oriented sectors had a tough quarter, with energy and mining companies suffering negative returns. We don't tend to hold investments in these sectors in as high a proportion as the benchmark, in large part because it isn't easy to generate a return on capital greater than your cost of capital when you have little influence on the price at which you sell your product. This underweight helped our Fund outperform the broader market over the quarter.

But quality of management is another important factor that shouldn't be overlooked. For whatever reason, it has been difficult—thought not impossible!—to find management teams in the resource sectors that consistently invest in wealth-creating opportunities and, crucially, who have the discipline to return cash to shareholders or strengthen their balance sheets if those opportunities don't currently exist.



One company that performed well over the quarter (and over our holding period) and whose management team we think very highly of, is Toromont. As the exclusive distributor of Caterpillar equipment in much of Eastern Canada, Toromont certainly has ties to resource extraction. It made an opportunistic and transformative acquisition of rival Hewitt last year to bolster its position in Quebec, an acquisition it would not have been able to make if its balance sheet had not been in a solid position, which is a credit to management. Based on our last conversation with them, we continue to be impressed by the way they think about capital allocation, risk, corporate culture, and how they're going about the integration—they're not afraid to adopt a longer time frame if it means doing it right.

The concept of a good management team seems simple enough, but it isn't easy to get it right as the distinction between skill and luck is blurry. Ultimately, we think the effort is worthwhile and feel that our clients' money is in better stead if we invest alongside capable and honest management teams.

Mawer Canadian Bond Fund: -1.1%

The Mawer Canadian Bond Fund's absolute return was negative, and the Fund slightly underperformed its benchmark. Over the period, the Canadian sovereign yield curve shifted higher, with yields on short and mid-term securities increasing more than long-term securities. The rising sovereign yield curve was the primary driver of the Fund's negative performance in the past quarter. The Fund's exposure to government bonds detracted the greatest from absolute performance as federal and provincial bonds were the most negatively impacted.

In July, the Bank of Canada increased the overnight rate to 1.50% and is expected to make another increase before year end. Three factors contributing to these expectations include: a solid Canadian economy, alleviation of trade uncertainty, and higher commodity prices. In Canada, the current environment consists of

low yields, a flat sovereign yield curve, and potentially increasing interest rates. The Fund has increased its average coupon and diversified its term structure, which may strengthen portfolio resiliency. This was implemented by reallocating weight from mid-term securities to longer-term securities in the provincial and federal sectors.

Mawer Global Bond Fund: -2.6%

The Canadian dollar strengthened against most major currencies during the quarter. Likely reasons for the Canadian dollar strength include supportive economic data, reduced trade uncertainty, and higher energy prices. The Fund's negative absolute return was primarily driven by the stronger Canadian dollar and to a lesser extent rising sovereign yield curves. Bond positions denominated in Japanese yen, euro, and the U.S. dollar contributed the most to the Fund's negative absolute return.

From a relative perspective, the Fund outperformed its benchmark. The largest driver was the underweight and outperformance in euro denominated bonds. In local currency terms, the Fund's euro denominated holdings benefited from a lower relative duration and the decision to avoid Italian government bonds. The Italian government announced plans to increase its fiscal deficit near the EU's limit which hurt investor confidence. The Fund also benefitted strongly from the lack of duration exposure to Japan's sovereign yield curve, which shifted higher and steepened as the Bank of Japan reduced its purchases of long-dated bonds.

Looking ahead

One analogy we have been using lately is that of a kettle. After you turn it on, it soon begins to make noise providing signals the water is about to boil. We certainly have a mix of indicators that may be considered noise in the markets at this point—a U.S./China trade war, rising interest rates, pressure on emerging markets economies, and Brexit plans. One or all of them may push the markets to boil, but we are not inclined to try to predict the precise moment. We do recognize the growing risks and position portfolios to cushion any downside. As a result, our recent asset mix changes lowered both U.S. and international equities to position the balanced asset mix back to a 60% equity/40% cash and fixed income level.

Thus far, the potential impact of the "noises" we mentioned above are unclear. The U.S./China trade war could lead to slower global growth, or it could present opportunities for some companies to improve their competitive positions. How the Brexit negotiations might be resolved likewise remains unknown. As an example of our approach, we might not be able to predict the results a specific trade policy might have, but we can hold companies we feel can adjust and pivot to new competitive situations or are less-exposed to trade between the affected countries.

A changing competitive landscape is a primary reason we have an investment philosophy that selects enduring businesses run by astute management teams. However, what you pay for an investment is a key driver of long-term performance. Our view is that the largest risk to equity valuations currently is the rising rate environment. This is because higher interest rates mean market participants are discounting future cash flows at a higher rate, hence lowering the intrinsic value of stocks and the corresponding price they are willing to pay for them. One way stocks could hold their value as rates increase is by delivering offsetting higher cash flows. Higher interest rates can also hurt stock prices by making corporate debt more expensive which suggests a less-indebted business could be better positioned to ride out the rise in rates. Our research team has been adjusting for higher discount rates and moving portfolios to more defensive business models with conservative levels of debt. We have reduced emerging markets weights and invested in businesses that are arguably essential in some way—such as Assa Abloy, one of the world's leaders in door locks (see sidebar on page 3).

While the rising rate environment is a risk, it is also a reflection of the strength of the global economy. So, while we are spending time this quarter talking about noises in the kettle, there are also positives that could extend the rise in markets. The U.S. leads the way with high business and consumer confidence, strong corporate earnings (thanks largely to lower corporate tax rates) and a near two-decade low in unemployment. Globally, industrial production statistics continue to read expansionary and interest rates in the developed world remain at low absolute levels. Taken together, these can add up to continued growth in equity markets.

The world constantly evolves, and we set about building your portfolio to benefit from this evolution over the long-term. Where there is noise suggesting we are getting closer to a boiling point, we have moved to retain resiliency. This way, we stay the course with a balanced, diversified portfolio that can withstand shocks but still benefit if markets continue to rise.

Total net returns (Series A)

For periods ending September 30, 2018

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Equity Funds	3–Mo	YTD	1–Yr	3–Yr	5–Yr	10–Yr	Since Inception*
Mawer International Equity Fund	**–1.9**	**1.3**	**7.0**	**9.3**	**11.4**	**9.6**	**8.2**
International Equity Benchmark*	–1.0	0.0	5.2	7.7	9.2	7.4	5.4
Mawer U.S. Equity Fund	**4.8**	**14.6**	**22.0**	**14.5**	**17.5**	**12.2**	**8.2**
S&P 500 Index	5.8	14.1	21.9	15.9	19.3	14.2	9.9
Mawer Global Equity Fund	**3.1**	**9.1**	**16.8**	**12.2**	**14.8**	**–**	**13.5**
Global Equity Benchmark*	2.5	7.1	13.5	11.8	14.2	–	12.3
Mawer Global Small Cap Fund	**2.3**	**6.5**	**15.5**	**11.4**	**16.2**	**17.4**	**13.2**
Global Small Cap Benchmark*	–0.4	6.1	12.3	12.9	13.4	11.8	7.8
Mawer Emerging Markets Equity Fund	**–3.0**	**–5.6**	**2.4**	**–**	**–**	**–**	**6.9**
MSCI Emerging Markets Index	–2.8	–4.8	2.5	–	–	–	11.1
Mawer Canadian Equity Fund	**1.4**	**1.9**	**5.5**	**8.7**	**10.2**	**9.8**	**9.5**
S&P/TSX Composite Index	–0.6	1.4	5.9	9.7	7.8	6.3	8.4
Mawer New Canada Fund	**6.7**	**4.0**	**10.6**	**10.1**	**11.5**	**14.5**	**13.7**
New Canada Benchmark*	–2.8	–4.4	0.1	10.1	4.2	6.6	7.6

Balanced Funds	3–Mo	YTD	1–Yr	3–Yr	5–Yr	10–Yr	Since Inception*
Mawer Global Balanced Fund	**1.5**	**5.5**	**10.4**	**7.6**	**10.0**	**–**	**9.8**
Internal Global Balanced Benchmark*	0.6	4.3	8.7	7.5	9.6	–	9.6
Mawer Balanced Fund	**0.7**	**3.6**	**8.0**	**7.2**	**9.4**	**9.0**	**8.5**
Internal Balanced Benchmark*	–0.1	2.4	6.4	7.3	8.0	7.3	7.9
Mawer Tax Effective Balanced Fund	**0.8**	**3.6**	**7.9**	**7.1**	**9.4**	**9.0**	**8.0**
Internal Tax Effective Balanced Benchmark*	–0.1	2.4	6.4	7.3	8.0	7.2	8.0

Income Funds	3–Mo	YTD	1–Yr	3–Yr	5–Yr	10–Yr	Since Inception*
Mawer Global Bond Fund	**–2.6**	**0.5**	**0.7**	**–1.3**	**–**	**–**	**0.8**
FTSE World Government Bond Index	–3.3	0.5	1.8	0.4	–	–	3.2
Mawer Canadian Bond Fund	**–1.1**	**–0.9**	**0.6**	**0.7**	**2.4**	**3.6**	**5.7**
FTSE Canada Universe Bond Index	–1.0	–0.4	1.7	1.6	3.3	4.4	6.9
Mawer Canadian Money Market Fund	**0.2**	**0.4**	**0.5**	**0.2**	**0.2**	**0.3**	**3.3**
FTSE Canada 91 Day TBill Index	0.3	0.9	1.2	0.7	0.8	0.8	1.0

* Refer to www.mawer.com/funds/performance/ for Fund Inception Dates and Benchmark History.

Mawer Mutual Funds are managed by Mawer Investment Management Ltd. Mawer Mutual Fund returns are reported in Canadian dollars and calculated after management fees and operating expenses have been deducted. In comparison, index returns do not incur management fees or operating expenses.

Index returns are supplied by a third party—we believe the data to be accurate, however, cannot guarantee its accuracy. Index returns are sourced from FTSE Russell, FactSet and BMO Capital Markets.

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.

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