MAWER
quarterly

Third Quarter 2019

Market overview

Managing through uncertainty is what we do and Q3 of 2019 has proven rife with unpredictability. But this is to be expected in an environment of experimental monetary policy, negative yields/low discount rates, elevated debt levels, inverted yield curves, trade wars, and slowing global economic growth.

There were many volatile days of news headlines during the third quarter driving markets—and this seems to have become the norm. Whether it's the loss of 5 million barrels of oil per day from the drone attack on Saudi oil infrastructure; news around Brexit with UK Prime Minister Boris Johnson losing his working majority and then the British Supreme Court ruling he unlawfully shut down parliament; or Democrats announcing an impeachment inquiry into Trump following reports he pressured Ukraine to investigate his political opponent; there seemed to be an endless barrage of bad news. Despite this, the Canadian bond market performed well and many large cap developed equity markets were positive.

While sifting through the noise, a few major factors we are paying close attention to are overall slowing global growth, slowing corporate earnings, and the potential implications from a prolonged trade war between the U.S. and China. But all of these issues presented mixed signals over Q3—in other words, it wasn't all bad news. Moreover, central bank monetary policies and the sheer amount of negative-yielding bonds globally are helping to keep the discount rate on equities low (while the Bank of Canada was able to stand pat, the Fed cut rates twice during the quarter while other central banks around the world also eased monetary policies).

Regarding slowing global growth, the Purchasing Managers' Index (PMI) is an index of the prevailing direction of economic trends in the manufacturing and service sectors. It signals whether market conditions are expanding, contracting, or staying the same. The Eurozone flash composite PMI for September fell to 50.4, a 6.5 year low, and in Germany, the flash composite PMI for September fell to 49.1 which is the first time in 6 years it has been below 50 (sign the country may be heading into a recession). In both cases, this was driven mainly by the manufacturing sector. And in the U.S., the September ISM Manufacturing PMI came in at 47.8 which is a 10-year low. This could be evidence that global trade tensions are finally having a meaningful impact on the U.S. itself. Although manufacturing accounts for just 11% of the U.S. economy, the concern is how this weakness may flow through to the labour market and consumer health.

Despite the prevailing downward trend of global manufacturing PMIs, there were offsetting positives. The Non-Manufacturing PMI (i.e., Services) was far more resilient. Services are driven by a healthy consumer—employment in the U.S. remained strong, wages rose, debt servicing continued to be manageable thanks to low interest rates, and overall consumer confidence was high.

And while slowing corporate earnings growth has also been a concern, this continued to be offset by the low cost to issue debt. In fact, Nestlé, became the first corporation to have a bond trade with a negative yield (i.e., zero cost debt!). The low cost of debt can translate into many positives: companies investing in projects, executing on acquisitions, buying back shares, or raising dividends. This low cost of debt should result in a lower weighted average cost of capital and ultimately into a lower discount rate on future cash flows.

Looking to the trade conflict between the U.S. and China, tensions have remained elevated with the discourse's tone changing from one day to the next. For context around the power the trade war commentary has to affect markets, the U.S. and China make up about 40% of the global economy. When the U.S. and China export or import less it has a broad impact on other countries. A good example of this is Germany, a primarily export-focused country. As previously mentioned, the German manufacturing PMI has been under pressure in large part due to the actions and rhetoric concerning the trade war.

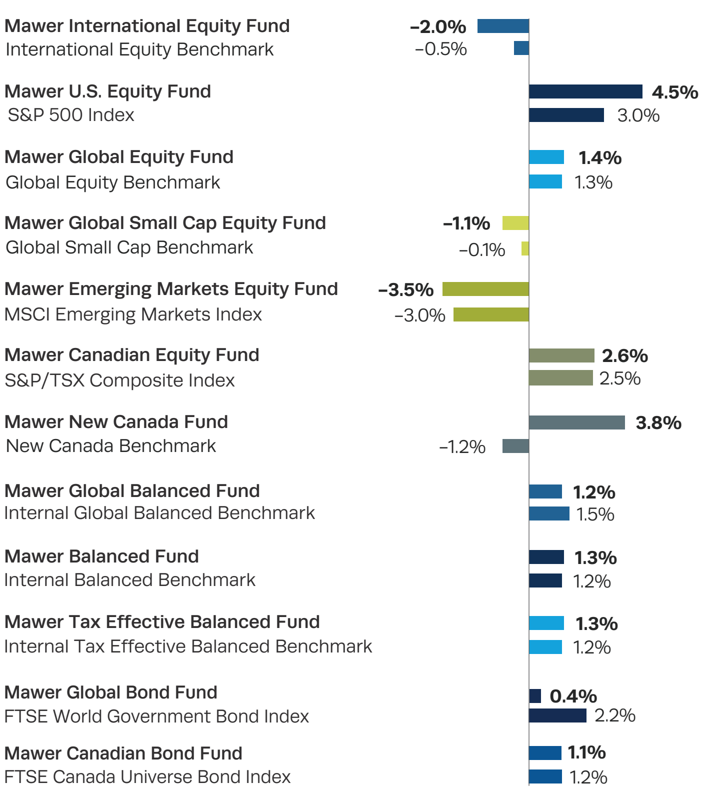
But once again, the news isn't all negative. Offsets for the trade war include the interest rate cuts in the U.S. and proactive Chinese fiscal policy. And some of our holdings that have a track record of managing through difficult times are navigating the trade war conflict and performed well through the uncertainty. For example, Nike, a company heavily exposed to China, reported earnings which the market reacted positively to (revenue +7%).

How did we do?

Performance has been presented for the A-Series Mawer Mutual Funds in Canadian dollars and calculated net of fees for the period of July 1 – September 30, 2019.

Chart A

(Q3 2019 – Series A, Net of Fees)



The overall performance of the Mawer Funds certainly reflects the mixed signals and offsetting themes we mentioned above. As denoted in Chart A, two of our seven equity funds outperformed, two underperformed, and three were roughly flat with their respective benchmarks. Our balanced funds delivered low but positive returns roughly in-line with their benchmarks. Our Bond funds similarly had modest returns, with the Canadian Bond Fund performing largely in line and the Global Bond Fund unable to keep up with its benchmark—primarily due to its significantly lower duration than the FTSE World Government Bond Index in an environment of falling global bond yields. While the returns across our funds over the quarter were pretty range-bound, we should note that most are significantly above where they began the year.

While one single catalyst cannot explain performance outcomes for the third quarter, we can speak to the theme of "reversals" that played out, perhaps due mainly to the vagaries of the market rather than any fundamental changes, and both contributing to positive and negative results.

Many of our holdings that had been showing signs of slowing earnings growth bounced back during the quarter as sentiment and/or recent results have improved. Examples of this include Japanese drug store operator Tsuhura, convenience store chain Seven & I, and Belgium's AB InBev. Similarly, the market took a shine to the reversal of momentum among a number of our small-cap holdings: Richelieu Hardware, commercial real estate services and software company, Altus Group, and Sleep Country.

Conversely, many of our recent outperformers over the last few quarters took a bit of a breather in Q3, perhaps as a result of too much exuberance having been priced in. Examples include specialty chemicals and materials developers, Sika, commercial steam system provider, Spirax-Sarco, and IT advisor and reseller Bechtle.

Furthermore, there were security-specific issues impacting a few of our portfolio companies over the quarter. In both of our Canadian equity funds, our underperformance in the materials sector wasn't just due to the lack of precious metals mining companies. Stella-Jones experienced an unexpected departure of its long-standing CEO, whereas commercial label producer, CCL, experienced a very weak quarter as slowing global growth and consumer spending is compressing its margins. Abroad, kidney dialysis company Fresenius Medical Care is facing pressure from payers (mainly national insurers) which prevented it from passing on all of its cost increases through higher prices. And CARE Ratings, one of the three main credit rating agencies in India, is a business model largely built on reputation, and trust seems to be eroding due to recent defaults on bonds that were highly rated by the company. In all examples listed above, we have reduced our positions.

Yet, there are many great companies in our portfolios that continue to be rewarded. Brookfield Asset Management has been a strong long-term performer and the past quarter was no exception. The company's management team has a keen ability to acquire lower valued assets and transform them into dependable sources of cash flow, and the company certainly benefits from a lower rate environment. In the U.S., both Microsoft and Verisk Analytics continue to impress. The mission critical nature of both companies' products and high switching costs have resulted in consistent returns that have been rewarded by the market.

Looking ahead

While it remains unknown as to how trade wars will play out or how much global growth will continue to slow, these issues highlight the importance of adhering to a long-standing investment philosophy focused on quality, competitively-advantaged companies bought at the right price. Both aspects—quality and valuation—are important. Companies with strong recurring revenues should benefit from a continued low rate environment while providing a measure of defensiveness should the macroeconomic environment deteriorate. Purchasing such securities at a discount to their intrinsic value should offer greater upside in a bullish scenario and better downside protection should markets correct. We aim to get the balance right, and to build resilient, well-diversified portfolios of such securities from the bottom-up. While not a formula for avoiding short-term, negative returns, we believe this approach should minimize the probability of permanent impairment of capital while leading to long-term compounding of wealth.

In addition, many of our portfolios minimize direct risk by having substantial exposure to external markets. The New Canada Fund and Canadian Equity Fund are heavily exposed to the U.S. (approximately 43% and 22%, respectively) and our Global Small Cap, Global and International Equity Funds are broadly diversified by country and currency exposure. These offsets can help stabilize the portfolios if potential risks in one area become a reality.

Our CIO, Paul Moroz, recently recounted a relevant parable to investing which seems particularly apt of late. His son was playing goal in hockey for the first time. As Paul watched, his son consistently threw himself with gusto over to the left of the net and then with equal verve over to the right throughout the entire game…and was scored on each time. Afterward, Paul said to his son: "don't move to such extremes. You'll have a much better chance of stopping the puck if you stay in the middle of the net."

Our investment philosophy and process are designed to address uncertain situations; it's why our portfolios have natural contradictions (offsets). We follow a disciplined approach so that we don't get drawn to the edges of our investment philosophy.

Total net returns (Series A)

For periods ending September 30, 2019

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Equity funds	3-Mo	YTD	1-Yr	3-Yr	5-Yr	10-Yr	Since Inception*
Mawer International Equity Fund	**-2.0**	**7.9**	**2.2**	**6.2**	**9.0**	**9.2**	**8.0**
International Equity Benchmark*	-0.5	8.1	1.2	6.6	6.7	7.1	5.3
Mawer U.S. Equity Fund	**4.5**	**21.0**	**15.7**	**15.4**	**16.1**	**15.1**	**8.5**
S&P 500 Index	3.0	16.9	6.8	13.7	14.7	15.6	9.8
Mawer Global Equity Fund	**1.4**	**14.4**	**9.4**	**11.4**	**12.6**	**–**	**13.1**
Global Equity Benchmark*	1.3	12.6	3.8	10.0	10.6	–	11.4
Mawer Global Small Cap Fund	**-1.1**	**14.0**	**4.3**	**9.1**	**12.3**	**15.8**	**12.4**
Global Small Cap Benchmark*	0.1	10.1	-3.2	7.3	9.8	10.6	6.8
Mawer Emerging Markets Equity Fund	**-3.5**	**5.3**	**4.7**	**–**	**–**	**–**	**6.1**
MSCI Emerging Markets Index	-3.0	2.6	0.4	–	–	–	6.9
Mawer Canadian Equity Fund	**2.6**	**17.5**	**3.9**	**6.5**	**6.6**	**10.2**	**9.3**
S&P/TSX Composite Index	2.5	19.1	7.1	7.4	5.3	7.0	8.3
Mawer New Canada Fund	**3.8**	**20.8**	**4.3**	**5.7**	**5.6**	**14.0**	**13.4**
New Canada Benchmark*	-1.2	9.1	-6.6	-1.8	-0.1	4.8	7.2
Balanced funds							
Mawer Global Balanced Fund	**1.2**	**10.5**	**8.4**	**7.5**	**8.8**	**–**	**9.6**
Internal Global Balanced Benchmark*	1.5	9.9	6.7	6.9	7.9	–	9.1
Mawer Balanced Fund	**1.3**	**11.8**	**7.6**	**6.6**	**7.9**	**9.2**	**8.4**
Internal Balanced Benchmark*	1.2	10.7	5.2	5.6	6.3	7.3	7.8
Mawer Tax Effective Balanced Fund	**1.3**	**11.8**	**7.7**	**6.6**	**7.8**	**9.2**	**8.0**
Internal Tax Effective Balanced Benchmark*	1.2	10.7	5.2	5.6	6.3	7.2	7.9
Income funds							
Mawer Global Bond Fund	**0.4**	**-1.2**	**5.2**	**0.0**	**–**	**–**	**1.8**
FTSE World Government Bond Index	2.2	3.0	10.8	1.4	–	–	4.9
Mawer Canadian Bond Fund	**1.1**	**7.5**	**9.3**	**1.8**	**3.2**	**3.7**	**5.9**
FTSE Canada Universe Bond Index	1.2	7.8	9.7	2.7	3.9	4.4	7.0
Mawer Canadian Money Market Fund	**0.3**	**0.8**	**1.1**	**0.5**	**0.3**	**0.3**	**3.2**
FTSE Canada 91 Day TBill Index	0.4	1.2	1.7	1.1	0.9	0.9	4.0

* 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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