Paul Moroz

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Mawer Investment Management Ltd.
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How did you decide to pursue a career in value investing? How did going to business school in Calgary transition into where you are today?

The short answer is that I fell into it; I did it before I even knew it was value investing. Even to this day, I wouldn't consider what I do to be value investing; all investors are looking for value.

My beginning was in starting my own business in high school. In Cochrane, there was a new golf course that opened up and there were only a few jobs for caddies. Myself and all my friends lined up for the interviews, but they only picked a couple of people and they didn't pick me. I did get a job delivering pizza. But, my business model rested on borrowing my parents' Jeep, which they quickly realized they didn't want to have used for that purpose. Then, my friend told me about this "Spring Clean-Up" gig that people were doing. You would air-rake, power-rake, and fertilize lawns. He knew someone that was charging $100 a shot for a couple of hours of work. This was Easter weekend, and over the course of the weekend we put together a business plan and I borrowed roughly a hundred dollars from my sister and my mom. Then we had our first company. That was a fascinating experience because, before I learned what investing was, I had invested in trying to understand a company, a business plan, a value proposition, and competition. I learned about the ins-and-outs of collecting cash, and I was doing marketing by delivering flyers. I was a businessman before I was an investor. So, looking at the investment part: we brought another partner in when we were doing "Spring Clean-Up." Then, we sold the business in university to one of our friends.

> "Before I learned what investing was, I had already invested in trying to understand a company, a business plan, competition"

The other thing that kickstarted my career was investing in the stock market. I did not know what I was doing. Late in high school, I took money from my friends and we started investing. We ended up incorporating a company early in university. We didn't hire a lawyer; I wrote the articles of incorporation myself. We made a lot of mistakes and ended up actually making a lot of money. I won't say that it was a smooth ride.

And one more, I would have been about 17, so still in high school, when I had this idea to speculate on currency. This was during the Asian crisis. Growing up in Calgary, my dad worked on the oil patch and I had this idea that a lot could be explained by reversion to the mean because I had seen it with oil prices. I became fascinated in the Bulgarian lift, a currency that depreciated something like 1/1000th of what it was formerly. Currencies at that time were being ripped apart as the economic problems spread. I remember printing out this large economic report and shopping this idea around to friends, and I raised about a thousand dollars. I had a very simple idea: if we invest a thousand dollars and then reversion to the mean happens, there's our first million. I was quickly squashed when I walked down to the Cochrane Bank of Montreal branch and asked if I could have one thousand dollars' worth of Bulgarian lift. As you can imagine, the bank teller looked down at me and thought something like, "No. We don't have that. Who are you? Why are you even here?" So, I returned everyone's money, but the idea of investing was planted in my mind very early. I was very fortunate because I got a lot of opportunities to explore what I call the "service area": making mistakes with small amounts of money to build up confidence and experience. To this day, for anyone that's interested in investing, my advice would be to go ahead and do it with small amounts of money just to learn. That's how I got started and it worked.

How did your experience founding companies and learning about competition inform your experience in business school and ultimately help make you as successful an investor as you are?

Part of it was that going to the University of Calgary allowed me to break into the industry while in university and get a few different perspectives from both the buy side and the sell side. I worked at a brokerage firm part-time during the day. I was sitting at a trading desk entering tickets and it was a very small part to play but it was neat because I got to see how blocks of stock were traded and how things worked. I was in on the game. That was a significant experience, even more so than university.

One of the best choices I made in university was to enroll in a co-op program. That was how I landed at a sell-side firm as a research associate. I got to experience the 5:30am-6:30pm days at work and how the sell side worked, including the conflicts of interest. I remember one day during the time when I was building oil and gas models, one of the senior analysts walked into my office and said, "Paul, I'd like you to pick up coverage on this junior oil and gas company." When I asked him why, he said that it was because our investment bankers would like us to. That's when the lightbulb went off and I realized how the whole system worked. And not to say that this part of the industry isn't important or doesn't add value, but I realized that we had to be aware of the conflicts of interest and recognize that not everyone is putting the client first. Not everyone is thinking the way that you are as an investor about making the most money as safely as possible.

> "We try to understand the culture and decision-making processes [management] engages in with that company's capital. This gives us insight into things that haven't yet occurred"

Out of school, I landed at a firm now called AIMCO, which is the investing arm of the Alberta government. That was an extremely interesting experience because it provided me with insight into how a large organization self-organizes. There were things I agreed with, and there were ideas I thought about where I realized my philosophy did not align. At that time, I was reading a lot: Warren Buffet's letters, Phil Fischer's book, Ben Graham's stuff, and I realized the philosophy was a bit different. I decided to move to Calgary and join Mawer because it had a very similar philosophy to the one I was reading about and developing at that time.

How do you predict that statistics and mathematics-based investing, including artificial intelligence, will change the investment industry dynamics in the next 10-20 years? Where do you see value investors, or actively managed funds in general, fitting in?

The first comment I have is that these trends aren't new; there are already some amazing quantitative funds out there. It gets taken to the next level, but it's still based on similar algorithms. I'm not sure it cuts into where some people, using the right part of their brain, can operate within the stock market. When we think about investing, a lot of it is related to "softer" issues. We talk to management teams and try to understand how people think about a business and understand the culture and decision-making processes they engage in with that company's capital. This gives us insight into things that haven't yet occurred. I think that's going to be around for a long period of time.

If anything, the way that the intellectual capital has been allocated is more towards those sorts of things you mentioned that are more quantitative. Now, it's probably easier to get a job in investing straight out of school than to get a job at, say, Google, Microsoft or Amazon. It's just different. I think intellectual capital goes through cycles too. What might be happening is that there is a lot of people getting trained up in the old-fashioned parts of investing and understanding the business and management teams and being that link in the economy to allocate capital towards organizations and entrepreneurs that need it.

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From our perspective at Mawer, we try to think of "an" solution. We see where some of this quantitative work can help us, and we have people working in what we call our "lab" to help us make less behavioural errors when we make decisions. That's how we see it evolving; the people that do this are going to have at their disposal a couple of different types of tools.

You mentioned the importance of investors evaluating management teams. Do you view incorporating the quantitative insights from your "lab" helps reduce the risk of being influenced by behavioural biases when evaluating the people running business as well?

I think it's important to be able to "dribble with both hands." Understanding a manager's vision, what they've done in the past, their integrity, and what the odds are of them being able to execute on those promises is important. So is looking at the base rates and the statistics and the valuation. The quantitative and qualitative can act as checks against each other. A similar line of thinking is how you look at the world in terms of knowledge.

Much of the world runs on inductive information. This is things that we've seen and knowledge we've gained from experience. But, there is also a deductive portion: you need to be able to ask, "Does this make sense?" I think that is very important. You must do both.

> "It's important to be able to dribble with both hands; qualitative and quantitative information can act as checks against each other"

What was the incentive and rationale behind starting the Mawer Global Small Cap Fund in October 2007?

At that point in the firm's history, we had a very good track record in both managing publicly-traded securities internationally. We were well placed in terms of being able to do something for our clients that not many other firms in Canada could do because not many had that international track record. We also had a very good track record in investing in small cap securities. So, the idea was, "Why not take our common investment philosophy – good management teams built of honest people, don't pay too much" – and extend that expertise in a market that can probably add value to clients because it's less efficient, being small cap, and it can diversify their portfolios. It seemed like a win-win for everyone. The logic from that time has since played out very well.

Do you feel like a lot of Canadian managers should have a fund that incorporates international equities to give clients the option to diversify?

I think you should do something if you have the expertise and doing so fits into your core competencies. I was just discussing with a colleague whether Mawer should expand into alternative investments. My thinking then was, "Well, maybe. But it's outside of our expertise. Someone who has done that for many years has probably developed a lot more expertise and may be in a better place to do that." Firms in Canada that focused on Canadian equities and never had that experience or international background were in a different place. Mawer was in a place where we had a British member of our team who had experience investing internationally. We were in a position to build on that.

Ben Graham talked about three types of risks: business, leverage, and valuation. How do you think about each of these risks when investing globally today? Do you emphasize any of these types of risk more than others?

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Business models have evolved, partly because of the development of the internet and how it has connected and globalized the world. As a result, there are more business models that I would call "winner takes all." As a result of these "winner takes all" businesses - imagine Google, Facebook - network effects can spread across a country or the entire globe. In a lot of cases, the business plan is "build first, land-grab, and then monetize later." That's fine, if it works. The problem as an investor is that all these investments are "backend-loaded." They're trying to grow very quickly, you don't know necessarily what the profitability is going to be. Some of them are going to do tremendously well. There is going to be a tail of the distribution where the investment returns are multiples. There are going to be companies that aren't successful in the winner takes all game. Inevitably, as humans are optimistic, we've projected all this growth. Then eventually the margin will come along, and you must question whether this optimism follows through. How business models have changed is a key concern with investing today versus previously when it had been much more about building a factory and concerns were more directly related to questions about supply and who else was building a factory. The analysis and the business world continue to evolve.

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Leverage is an interesting one. We have gone through a period where it seems like there's a lot of debt all over the world because of this monetary stimulus central banks have been providing since 2008/2009 when there is a significant financial crisis. And this has profound consequences both for how companies allocate capital as a result of that. I think there's more leverage and a greater tolerance for leverage because interest rates are lower at the consumer, government and corporate level. You can look at these two ways. If you think about the absolute level of debt that some companies are taking on, that has increased, and it can be a little bit scary. If a company gets into the glue, and if you compared the current interest rate costs then maybe you can justify that. Maybe you should have a little bit more debt to be able to lower your cost of capital and be able to compete in acquiring things, or expanding your business, or even buying back stock. So, with that leverage question, is this just a cyclical phenomenon? Are you going to get caught as an investor investing in a company with too much leverage, or are you going to be left behind because your management team isn't being fiscally responsible enough and they're not doing enough to optimize their balance sheet?

In a winner-take-all market you described, how do you identify whether growing companies have the sustainability and franchise value?

Well some of this fall back to our investment philosophy. The first criteria for us is does the company create wealth and earn a return on its capital greater than its cost of capital. Does it do so by a competitive advantage. Sometimes you just don't know. I was asked before about the cannabis industry in Canada and that is an example for me where I'm not sure. It's totally shaken out and which firm is going to be here to last to have a competitive advantage. So, I'm not saying to people that you shouldn't invest, or you can't make money. There's lots of different ways to make money in the market and lots of bright successful investors. But I think whatever your investment discipline is, you must fall back to that and at least be consistent to yourself and your clients in executing that. You can't be everything to everyone and there are some things where you're just going to have to say sorry because it's outside of what we can do. And that's OK.

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Going back to Ben Graham's three risks: business, leverage and valuation. The funny thing about valuation is that it is a slow risk quite often in the market, versus other risks that are fast. If you go wrong with leverage, you default. That's a fast risk. Valuation can be a slow risk. Think about fund flows and how the market system works. You might have a company that's overvalued or undervalued, and it doesn't necessarily correct just because you have discovered it (unless you have a lot of capital and you push up the price yourself). That's just a nuance of valuation and how it works.

When investing in Emerging Markets, how do you think about the liquidity risks there?

I would classify, in many cases, emerging markets in the same category as small cap stocks where it's an overflow asset class. When there's lots of liquidity in the system, when interest rates are low, and people feel confident; that liquidity can spill over into emerging markets. It's like the tide going out versus the tide coming in. When liquidity across the system reverses the opposite occurs. And so, we went through a period at the beginning of this year where I think you had a lot of liquidity pull out of emerging market stocks due to a strong U.S. dollar.

> "The puzzle is recognizing places where there's better value and improve your odds of investment success, versus situations where the liquidity, and the change in stock market perception as a result the liquidity, starts to impact the fundamentals"

The puzzle is recognizing places where there's better value and your odds of investment success have improved, versus situations where the liquidity, and the change in stock market perception as a result the liquidity, starts to impact the fundamentals. And where that might happen is a place like Indonesia which doesn't have a very deep domestic corporate debt market. They rely a lot on borrowing U.S. dollars.
So, if liquidity is flowing out of stocks, that means liquidity is flowing out of the currency (Rupee) and it is depreciating relative to the US dollar. If a company has a lot of US dollar debt, then suddenly that market psychology, or whatever the Fed is doing and the consequent market psychology, is literally impacting the fundamentals of the company and impacts your analysis. It's not independent. That's something that you have to watch out for. Never mind just the risks of emerging markets, but the second order risks that might occur and the result of liquidity.

Value investors tend not to practice "Timing the Market". What is your view on observing certain characteristics that may be indicative of business cycles, such as Ray Dalio's debt cycle analysis and Howard Marks' euphoria (over-confidence in the market), and how does understanding current market environments influence decision making at Mawer?

I don't think you can time the market, but I think you can weigh it. I think that's our job as investors and business analysts, weighing the quality of companies and the value. Often if a stock starts to move – whether it's up or down (and there are some

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other factors going into that) – it might have an impact on how you should be weighing it. Think about the December PMI (Purchasing Managers Index) number that came out of China, which I think was 49.4. Because it was below 50, it indicated a contraction, and this is usually a leading indicator that that the economy isn't doing so well.

> "Well I don't think you can time the market, but I think you can weigh it"

That is information that's more macro in nature, but you add that up with where we are in the stock market cycle, and perhaps where interest rates have moved up, and use that as an input into your fundamental analysis – you may weigh your decisions with regard to a stock and its fundamental a little differently. I'm not sure if that is timing the market. It is more like taking in that information and it's Bayesian analysis – just shifting the odds. You don't know the market is going to correct, but what you can say is that some fundamental data moved and that is going to play out. For example, if you are BMW in Germany, you're probably going to sell less cars in China. That's going to impact earnings and so it has an impact.
It must be a significant connection because otherwise you don't know. I think about breaking the market down to this thought experiment where there are two people on an island. There are two shares of a company and one owns one share and one owns the other share. How would you know what the other person is thinking about the value of that share, and whether they want to sell it, and whether that's going to drive the market value of this company on our imaginary island. It's an impossible game because you're trying to read the psychology of one other person. And then you increase the complexity of that thought experiment and try to guess what millions of people are going to decide to do with their stocks. It's impossible. That's the contribution of what Ben Graham did with value investing – there are some fundamental things that you can follow that makes all that guesswork irrelevant.

At last year's Value Investing conference, Mohnish Pabrai commented that high-quality small cap stocks, in the Indian market especially, often do a poor job of marketing themselves. Do you agree with Pabrai, and do you think that EM small caps in general are currently fertile grounds for the quality and valuations that Mawer finds attractive?

I think there's always opportunities with small cap stocks because there's less competition and market inefficiency. I find a fertile ground in the Indian market partly because of the culture of many Indian executives and entrepreneurs. It's very entrepreneurial. There are lots of opportunities in India, so I've made it a mandate to go to there often and I've been to India every year for the last three years.

> "Always opportunities with small cap stocks because there's less competition and market inefficiency"

I'd also note there's something structural that makes it more attractive for investors to do the work. India is what I'd call a promoter market, seems to be always a promoter or a family that owns a large block of stock, more so than the other markets and sometimes their holdings are significant. Some may own 70 percent the company which means on a free float adjustment there's not a lot to be owned. Depending on the size of your capital group, let's say a trillion dollars, you can't put a lot of money there. But there is the scaling effect that increases your probability there's an inefficiency and that you can find a good business with an excellent entrepreneur running it, where the valuation makes sense.

And India by the way is such a wild West market. It is extremely volatile, it hasn't developed as much as the Western world in terms of fundamental analyses. There's

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leakage in terms of news and rumors and stocks are just more volatile. So, if you're focused on your discipline there's a greater chance that you can use that volatility to your advantage.

Some things that Mawer look for in management include: alignment and governance, culture strategy, capital allocation, execution, and risk management. How do you quantify these attributes in management?

Some of them are more difficult but you can get clues. So, for the alignment, you can see how much stock managers own and have skin in the game themselves, and the second tier of management. What does their compensation program look like? Is it a percentage of revenue where they're just motivated to expand this company as much as possible without giving regard to their cost of capital?

A culture is more difficult, but I think that's where this concept of mosaic theory comes into play. Simply, if you talk to ten independent people and there's more people that are in favor of the management team's culture for good quality reasons, that probably leads you to the right direction. Something as simple as asking about employee turnover. That's something that is quantifiable. And if you have lots of people that are leaving your organization, well that says something about culture. It doesn't give you the answer, but it gives you a clue.

How do you balance management optimism and promises with external perspectives?

One important concept we rely on is integrity. When you do fundamental research and dig into public documents over 10 years, you start to line up whether the management team is doing what they said they would do. You can have that track record.

> “Management doesn't know how fast they're going to grow revenue next year. However, you can ask something that's more in their control”

The other one is differentiating in terms of learning about what they might forecast, and whether that's something they can't possibly know. Management doesn't know how fast they're going to grow revenue next year. However, you can ask questions that get you down to a scientific level, such as whether they are planning on increasing prices. That's something that's more in your control. How much are you increasing prices by for this product and when will that price increase realize? Your questions are geared to be much more scientific. And then you can compare that with the historic base rate in this industry.

Do you have a common question you like to ask to all management team you meet?

One of my colleagues and I like to ask, imagine that the company is bankrupt. And you're running through a whole story where you're taking your box out of your office and it's your last day. Tell me what went wrong. What led you to this path. It is a creative question that kind of tips the way someone thinks about the problem and what's really on that person's mind about the risks.

In 2015, the Global Small Cap Fund sold off its position in Slater & Gordon, a stock it's held since 2008, following several concerning announcements. This is an example of when the conditions that led Mawer to invest changed and S&G no longer met Mawer's definition of a high-quality company. How should investors manage their conviction and be able to shift quickly when necessary?

You must outline ahead of time what factors are going to be negative or positive for the investment. With Slater and Gordon, which was a publicly traded law firm in Australia, we recognized that they had an acquisition model where they took on acquisitions too large and given the structure of their working capital that could be a significant strain. One day they announced an acquisition, a much larger one in the U.K., and we saw that, not only did the leverage go up substantially, the asset itself had some question marks around it. You think again, in a business perspective, of the complications of managing something new overseas which was large. This wasn't a small project by any stretch. Those were one of trigger points that made us go back to what we'd outlined as risk factors in our original analysis.

> "Don't hold on to your own ideas too tightly. Recognize that it's not your idea, it's just an idea"

Going back to this Bayesian analysis, it's powerful to think about new cards, new information, that come up and every time they come up, think about shifting a little bit. If you've trained yourself or you're in an investment organization where you don't hold on to your own ideas too tightly, recognize that it's not your idea, it's just an idea. There is something to be said by when information does come up in an evidence-based way against your investment thesis. Once those shifts occur against your thesis, you can change your betting by selling a bit of stock.

How do you quantify these shifts in risks that reduce the odds in your favor and how do they influence your decision?

A lot of our valuation processes have focus on Monte Carlo analysis and thinking about the probabilistic play. You have a distribution that shifts to the extent of the risk. It's an inexact science but that framework helps you to think whether the risk is a three standard deviation or one standard deviation in magnitude. If it's a half a standard deviation, maybe you're only selling a small part of your position. If you're at a three standard deviation, that's your evidence then you have to shift differently. You bet differently if you have a royal flush as opposed to a pair of threes.

Is 15-year DCF model still used at Mawer, along with the Monte Carlo simulations? Do you apply any other valuation methods (aside from multiples)?

We do still apply discounted cash flow model analysis, Monte Carlo analysis, and other scenario analyses. I think that's the most robust approach. They do not give you the answer to understanding the business, however, when you're forced to think through the assumptions and look at different scenarios, that keep you agile when it comes to recognizing that a company might end up in a different scenario.

> "Always bring in different methods of valuation and try to get in contact, but don't get hung up or anchored off of one method"

We look at more traditional approaches as well. There's a running joke in a team that we don't talk much about the ratio known as price to book divided by ROE which, if you do the math, it's just price to earnings ratio. And the reason that's become a joke is because it's become so distorted in so many different ways that it's very difficult to say whether one is undervalued or overvalued based on 15x or 13x PE multiple. It depends on the accounting, business model, the growth, and higher or lower return on invested capital. There are many factors that go into it.

Always bring in different methods of valuation and try to get in contact, but don't get hung up or anchored to one method. Valuation for us is one tool that we use to

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help improve the odds of investment success. But it doesn't give us the answer. It doesn't give us concrete proof that we are indeed finding an undervalued security.

Mawer's "be boring, make money" slogan illustrates the firm's long-term focus and bottom-up, fundamental approach to security selection. Can you describe a holding that you think exemplifies this philosophy, and why you feel its competitive advantage is sustainable?

Let's talk about S&P Global. The business has two parts, half in the ratings business and the other half in a data business. They have a platform called Capital IQ which competes against Bloomberg. They also have a platform called Platts which provides commodity information. We mainly focus on their ratings business because there is a significant pull towards that business, not only because the brand that the three players have, but it's embedded into prospectus that require you to get bonds rated. Not only that you must get rated, but you also need an investment rating by one of the big rating agencies. So that business model is preferable because you are guaranteed some sort of business. It's very different from some businesses where you're knocking on the door hoping to earn the next sale. An example as simple as deciding where you're going to go for dinner next week or lunch. The decision point isn't such that you have very limited options. For ratings, however, there's only three, and you must do it. That's how I know that the business will exist for a very long period.

If a business isn't going to be around, you have less confidence that the moat is going to be there, and you have a regress problem. I'm unsure if anything's forever but the more confidence you have in the business model and the qualitative aspect, the more it will support your valuation. If you're uncertain whether the company is going to be around at all, don't spend a lot of time modeling it out or trying to figure out the numbers.

Mawer small-cap fund has significant portions invested in Softcat Plc. What is your analysis of Softcat's sustainable competitive advantages and what are the biggest risks associated with your investment thesis in Softcat? How does it cope with the big players in the market, such as Amazon Web Services, that offer a comprehensive set of Information Technology solutions?

Softcat is a value-added distributor, in both hardware and software. But the true value proposition is that they are advisors. Imagine there's all these different products. Not only do they sell them, they also provide advice. They don't charge for that, it is embedded within their margin. There is absolutely a role for that type of work.

The competitive advantage comes twofold. One is they buy a lot of product and service and pass them on to their customers. Scale wise, they get a larger discount than smaller players. That's something very concrete. Another that may not be as concrete, but it's extremely important, is they have a cultural advantage. They have one of the strongest cultures or teams I have ever seen. Their CEO and CFO sit in the middle of their organization right in the sales pit with everyone else. They only hire people out of universities and they have a whole training program because they don't want people with bad habits. When you have a customer, and that's your first sale, you stick with that customer. And they have well-aligned incentive programs to show appreciation of their employees. I'm even told that they have one of their managers, as part of their culture, turns into a DJ on some Fridays, which makes the culture very distinct. It's a unique sales and service culture.

As far as AWS goes, they sell some of the AWS products. So, they facilitate some players in the cloud business, and we've landed that they are more of an opportunity than a threat because you still need that advice, that consultant model, to help customers decide.

Now that we have an idea of what motivates you to invest in a company, can you describe your sell discipline?

One of the things we build out is a matrix where we plot all our companies by quality and potential. We do this in a disciplined manner, and when we find that a company slides one way or the other, we now have a frame of reference for not only against selling the company but probabilistically adjusting our thinking about other companies in our portfolio. We do that quarterly, and ad hoc, depending on the situation.

Your portfolio is very diversified geographically. How do you go about screening for opportunities at a global scale?

It's changed over time. We have a robust database of over 5,000 companies, so there's a lot about the world that we already know as a team. Within our understanding, we can monitor price movements or changes in their perceived valuations. Part of it is also when we are out being creative and literally go out to a country. Go through every company on the exchange and do a qualitative screening first in understanding each business, asking whether it can be around and continue to make money. And then look at their return on invested capital and ask is there an accounting reason why investors are missing this. Then we start to narrow it down. That helps us to create a list, and we talk to the management when we visit the country.