the art of boring™

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Disclaimer (00:25):

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David Fraser (00:40):

Welcome to The Art of Boring Podcast. 2022's in the books and we're here today for the Q4 Quarterly Update. Asset Mix Chair Greg Peterson's here to share his thoughts on what's come and gone in 2022, as well as what may lie ahead. Greg, thanks for being here again.

Greg Peterson (00:58):

Happy New Year, David, and to all of our listeners. I'm very happy to have a new year present and 2022 behind us, for a number of reasons.

David Fraser (01:06):

Let's start with an overview. How did things unfold in 2022 and, in particular, the last quarter of the year?

Greg Peterson (01:12):

As many of our listeners would already know and have heard from us before, there's really a few major themes in 2022 that impacted markets. One was widespread inflation. That's the biggest theme of last year and it will continue to be a bit of a theme this year as well. Higher interest rates, dovetailing in with widespread inflation, geopolitical concerns, the war with Russia and Ukraine. And then, just as we got into the second half of 2022, there was concerns around slowing global growth.

So, those were the four major themes. And I think one of the things moving below that too, is just a lot of currency movement through the year that we're not familiar with seeing as well. Those were the major themes [and] those major themes took markets lower, as everybody knows. So, for the calendar year, equity markets were lower, as well as bond markets, for last year.

Greg Peterson (01:57):

For our [Mawer Balanced strategy] investors, this wasn't a great year. Unfortunately, we go through these periods of time probably every 10 to 15 years. Last time we would've experienced a decline in values like this was 2008, with the [Global Financial Crisis]. Somewhat different back then: the financial crisis of course [was] caused by the housing bubble in the United States, as well as a lot of debt creation and high debt level issues that existed that time. There was a lot of excess, and it was largely a story of equity markets in 2008. Equity markets were down very sharply in that year; bond markets were positive.

For 2022, really, as I've already said, the story was weaker equity markets, as well as weaker bond markets. So, not helping out Balanced investors from that perspective.

David Fraser (02:41):

And how did we do in comparison? Everything was down, but our strategies in particular?

Greg Peterson (02:47):

So, our strategies were challenged in 2022. This is one thing I think is also different for our Balanced investors: historically, when markets are weak, Mawer's investment performance is somewhat better than the markets. So, directionally, we tend to go the same direction, but our relative performance is better than the markets themselves.

In 2022 our Balanced strategy was behind its benchmark for the year. So not only did we have weaker markets, but we also under-performed in that environment. That's not something that anybody would be terribly familiar with happening from our strategies. There were some strategies within the Balanced portfolio that performed well. So, Canadian equity and U.S. equity in particular were ahead for the calendar year for 2022, whereas, our small cap and international strategies were behind for the calendar year.

Really, what led to much of this under-performance last year in those other strategies and then for Balanced in particular, was the speed and degree to which inflation rose, and interest rates rose, at the beginning of the year. So, pretty much all of that relative performance can be chalked up to January, and perhaps January and February of 2022. That's when we first got behind.

And then, we really spent the year clawing our way back and improving performance over the course of the year. And particularly in Q4, Balanced strategies were ahead of our benchmark. So, we did close the gap somewhat towards the end of the year.

But one of the reasons I mentioned—the speed and degree of bond yields and inflation, well, inflation leading bond yields higher at the beginning of the year—is it really had an impact on high quality companies, as well as growth strategies. So, high quality companies, as we've probably mentioned on this [podcast] before, tend to attract a bit of a premium price in the market. So, a business that's very resilient, that's very well managed—investors are typically willing to pay a little bit more for those companies because they can hold them long term and not have to worry.

Greg Peterson (04:30):

And that premium valuation does make them a bit more sensitive to interest rates, and particularly how interest rates affect discount rates. So, stock prices are present value of future cash flows for business, and those future cash flows and calculated present value are affected by discount rates. And that being the higher the discount rate, the lower the present value, and the present value equating to stock price.

So, it does have an impact on quality companies. And growth companies, or long duration businesses where you're paying more, or more of the stock price is reflecting future value of the business (so, you're paying for the growth in their cash flows over time, and that stock price is representing less of current cash flows).

Those growth companies are also more exposed to interest rates and discount rates, so we're impacted more. This is not something that's happened for a very long time, where high quality businesses have underperformed the general market, and that's really the lion share would attribute to our relative performance in 2022.

David Fraser (05:26):

Were there any internal factors that led to that performance? Or is it all external? Did we make any changes? Have we changed our investment philosophy or are we sticking to our game plan, and market conditions just changed through time?

Greg Peterson (05:40):

Our game plan stays the same—so, as you've likely heard on many of the podcasts, [which] is to continue playing the plan. And that's one of the most important things for us too, is not to stray, start to bias decision-making based on short-term factors or cyclical factors that are taking place in the market. There's a great deal of emphasis placed on discipline, in sticking to our investment philosophy and process. So internally, things have not changed that way.

We always learn from the past. One of the things I think we would've learned is that despite the fact that we have been reducing those longer duration securities—or more expensive securities, quite frankly—within the portfolio for the last two or three years, going into last year and in hindsight it would've been nice to have a little less.

So perhaps we could have done a bit more to the security level with respect to shortening duration of the equity portfolio.

That was a theme prior to 2022. It was the theme throughout the year as well, just making the portfolios less interest rate sensitive. Again, I'd go back to the speed and degree of the change last year that was unexpected by most. So in hindsight, from a security selection, perhaps that way.

And then from an asset allocation perspective, and this relates our Balanced strategies as well, is we did reduce equity within the portfolios and reduce some of that risk throughout the course of the year. It would always be nice to go back with perfect foresight and make some changes, but we could have reduced maybe a little bit quicker from that perspective, too.

Again, this really happened within the first quarter for the most part last year, so it happened relatively quickly.

Greg Peterson (07:07):

But those would be some of our learnings. I think it would be really careful on the asset allocation side of things to say that for the market timing going forward, you can't time markets in the short term. So, despite the fact that it'd be lovely to go back and reduce equity faster, that would equate to a bit of market timing; it would've taken pretty good foresight to do so.

So, I don't think that that changes. We do make our decisions based off of the secular view and the much longer-term picture.

David Fraser (07:31):

So, you mentioned discount rates have gone up, which means valuations—typically a product of future cash flows—have gone down. Where are we historically when we think about valuations and what you're seeing out there today?

Greg Peterson (07:44):

Well, with markets coming down, valuations are better than they were. And that's the easy observation. In terms of where they are historically, depends on the market that you're looking at. So, I would say overall, valuations are closer to fair. In the United States, that might be on the high end of fair value. So, still not cheap by historical standards.

Canadian market's probably fairly valued here, or closer to it as well. Europe would also be in that camp. So, Europe's being impacted more from the war with Russia and Ukraine, as well as the concern over energy prices in Europe, and how that may impact European continent consumers and business costs there as well. So, that's likely brought European values down a bit cheaper as well.

It is really difficult to define it by market. So you can look at the entire market, but then you have to look at the portion of the market you're playing within as well. And so, I would still say that the high-quality businesses in Europe, they're cheap, but again, closer to fair value.

So, historically we're not at the point where we're jumping up and down and saying, "we got to get out there and get all the cash invested because things are dirt cheap." Not quite at that point. But at the same time, things are more balanced than they've been for a while, too.

So, pretty happy to see markets in a relatively balanced position. And that might mean that going forward things make a little bit more sense than they have for the past year.

David Fraser (08:56):

On the back of that, there's a lot of talk about recession. We've seen that big sell-off in markets last year. What is the actual definition of a recession, and what are we looking out for to see if that's occurred?

Greg Peterson (09:07):

Recessions are interesting. They're often publicly defined as two consecutive quarters of negative economic growth, or negative GDP growth. That's the common way to look at that. The National Bureau of Economic Research in the United States actually declares when they've been in the recession. It's usually either you've been in the recession for a long period of time by the time they declare it, or you're already passed it by the time they figure it out.

But they are saying that there's more things that go into it. So, it is a decline in economic activity. They do look at a number of things, such as GDP growth. They also look at labour markets, industrial production, and so forth. So, there's quite a number of different factors that go into it, but it's essentially a decline in economic activity over a period of time.

David Fraser (09:47):

And one of the things that's leading to that is inflation, which is causing interest rates to go higher. I know I've asked you this in the past as well, but it's just such a big determinant of where markets go at the moment. So, what's happening with inflation? And in particular, we're seeing a reopening in China there. Is that having much of an impact? Or does it have a potential, going forward?

Greg Peterson (10:07):

We have seen a moderation in inflation more recently. So, it's not that it's come down significantly, but it has eased and that's likely helped with the fourth quarter or the end of last year. Markets were much better behaved. We did get a nice relief rally in October and November, so equity markets bumped up. Bond markets were positive in Q4 as well.

I would attribute some of that to easing in inflation expectations, and then that takes the market guessing where interest rates go through 2023 as well. So, we have seen things soften somewhat from the inflation perspective. Doesn't mean it's gone away.

And the one thing I'll point out too is, even if we had inflation back to 2%, or the rate that central banks tend to target, it doesn't mean that our prices are coming down. So, inflation is a change in prices and prices have gone higher, they're likely to stay higher as we go forward. I don't think we're going to deflation, or negative inflation, anytime soon. But we have seen that moderation, and I think that's an important point.

And there's a few things that have contributed to that. Much of the easing of inflation numbers has come from goods or products. Goods inflation has slowed quite nicely, and there's a few things that have contributed to this. So, one is energy prices, food commodity prices have softened over the last few months. That's helped contribute.

A lot of the supply bottlenecks that we talked about through COVID-19, and then last year, have also eased and opened up. China's reopening, or removing their COVID-19 restrictions, is just one more step to helping ease a lot of those supply concerns as well. It probably won't contribute to a softening of inflation right away because you can't just put the “open” sign on the door and away you go and China's off and running again. It will take at least several months for that to work through, particularly, as they've more recently had a spike in COVID-19 cases. That has slowed things down there somewhat. But China reopening will gradually benefit. The benefit for us initially should be further easing of supply chain issues.

Greg Peterson (11:58):

As we go into 2023, inflation is going to be still watched very closely. One of the differences this year—now it's not going to be a surprise. We know the inflation issue, we know inflation's running relatively high, [and] we should continue to see inflation moderate as we go forward. I was talking about inflation being on the product side of things—inflation has really now shifted to services.

This also makes sense with the reopening of the last year and a half or longer. People are now spending money on travel, dining out, education, and so forth. All the things that contribute on the services side, where inflation is running a little bit hotter, and this ties fairly closely to the jobs markets.

So, jobs markets or employment in North America is still very good. The labour market's very solid. Unemployment rates in the U.S. are around 3.5% and in Canada it's about 5%. Historically, that's very low for both. And services tend to be tied much more closely to the health of the labour market and wage growth.

And so, you'll see central banks really working on the labour market. Not trying to get people out of work necessarily, but unfortunately, the labour market health does go hand in hand with services inflation. They're going to want to see some break in that as we go through this year before they start to ease interest rates.

So, it will still be a topic as we go forward, unfortunately.

David Fraser (13:10):

So, it sounds like that demand-side of things with consumers still willing to get out there and spend, that hasn't changed too much by the sounds of it?

Greg Peterson (13:19):

No, consumers always love to spend. That's what keeps the world going around. That's what keeps developed markets in particular moving as consumption [as you know] tends to drive two-thirds to 70% of U.S. and Canadian economies. So, it's very important.

David Fraser (13:34):

I guess that will be a big focus of policy makers around the world—to watch those labour markets and watch the demand side of things.

On the company side of things, with the inflation we've seen, how are companies faring? Are they able to pass on the inflation to consumers or are their profit margins being squeezed?

Greg Peterson (13:51):

So far earnings [have] been fairly resilient. This is another contributor I think to the strength in Q4, was the fact that earnings weren't dropping perhaps as quickly as markets had feared or were concerned [about]. So, it’s been relatively resilient.

Greg Peterson (14:04):

I would say that you are starting to see some pressure on profit margins from higher input costs, higher wage inflation as well. It's starting to put some pressure on profit margins for businesses, generally speaking. And this is an area I think is maybe positive or optimistic for us, is that going forward it's more emphasis put back on the quality of earnings again.

So, those high-quality businesses that [we were] sort of knocking at the beginning of this podcast because of the expense have an opportunity here, where they generally have very strong competitive advantages that either allow them to pass through their higher costs through pricing.

So, companies like LVMH, the luxury goods producer, tends to not be very price sensitive to their consumers, because it's largely the wealthier part of the market that they're passing their costs through to. So, LVMH continues to perform well. Or as businesses, where their competitive advantages allows them to manage the cost side of their business much more carefully. So, able to protect their profit margins better than companies in general. And that tends to allow quality businesses to perform better than the broader market, at least from a profitability perspective.

So, we're starting to see some pressures that way for sure, but I think there's an opportunity for us going forward because of that.

David Fraser (15:12):

So, a lot's happened in 2022, not all of it great. Have we made any asset mix moves recently, as we think about the portfolios going forward?

Greg Peterson (15:21):

We haven't made any specific asset mix changes in the fourth quarter. What we did do is we allowed equity weights to drift higher within the portfolio.

So, there's at least a couple of levers that we have with asset mix: one is to actually go through and make changes, sell something, buy something else, just between asset classes. The other is to manage the drift in the portfolio. I always find that this is just as important, so we've allowed equity to move higher over the course of the quarter, but still staying relatively close to our neutral asset mix weights. So, that hasn't changed.

But that would be the biggest change in the quarter. No deliberate moves, but just trying to manage the drift within our portfolios.

David Fraser (15:57):

And what's the Balanced strategies' weight in Europe in particular? I bring it up because I'm wondering if you see it at least favourably, given the prolonged Russian invasion and what you mentioned earlier with the impact that's resulted on oil and energy?

Greg Peterson (16:11):

For the Balanced Fund, Europe represents about 15.5% of the overall portfolio, and the Global Balanced Fund, it's a little bit higher—it's just a little over 20% invested in Europe. But there's a couple things I think I would point out on this.

One is the Russian invasion of Ukraine is a known, so that's factored into markets and priced in currently. So, unless there's a major change in either direction, it will either be positive or would be more negative for European equities. But if things stay relatively status quo, then that's not likely to be much of an impact as we go through 2023.

The other point for Europe is that when you look at the portfolio, revenues for those companies aren't necessarily coming from the domestic European market. They are global companies for the most part, and so much of that revenue is derived from other parts of the world and impacted by either global growth generally or regional growth in areas like the United States that have a big impact in those businesses.

So, our European weight is certainly considered in terms of our exposures within the portfolios, but relatively comfortable with where we're at there. And I think, given that European valuations are relatively lower as we look longer term and [there are expectations] that one day we [will] get past the Russian invasion, that provides a longer-term benefit to our investors as well.

David Fraser (17:22):

With all of this, as rates have continued to rise, what's been the recent correlation between stocks and bonds? In the past, they move in opposite directions. How did things unfold in 2022, and what do we expect going forward?

Greg Peterson (17:36):

[In] 2022, the protection of bonds and the correlation between stocks and bonds did not work for Balanced investors very well. So, that's been one of the few times in history where bonds haven't provided the protection that we'd expect in a Balanced portfolio.

That started to normalize as we've come through the end of the year. The relationship between stocks and bonds has improved in that bonds are providing more of that risk mitigation factor that we expect from bonds. And I'd expect that we likely see that come through 2023.

I don't think we're having another inflation shock, another interest rate shock, to the extent that we had in 2022, but we should start to see that improve. We've heard lots of the demise of the 60-40 portfolio, 60% equity, 40% bonds. I don't think that that's changed.

So, I think what's happened is we've had a very quick reset [which] didn't make for a great year, but that reset allows it to work as we go forward and bonds provide more of that risk mitigation in a Balanced portfolio again.

David Fraser (18:29):

You weigh all of this up from an asset mix perspective, but you also work with individual clients. And with interest rates having gone up, the question persists for them as well. GICs are more appealing than have been really in the past decade, with higher return potential. What are you saying to clients as they weigh up GICs versus holding bonds?

Greg Peterson (18:50):

Yeah, higher interest rates is offering options. So, for many years there's been no alternative to stock markets. There haven't been options for providing income. And one of the other things I meant to mention about bonds is, with higher interest rates and higher bond yields, now we do have an income component. The bonds again, as well, helping to provide more income for Balanced investors and certainly for more conservative investors.

GICs are an alternative. So, there's always trade-offs in investing and that's just one of the things that people have to look at. We have good yields on bonds again and we have good yields on cash in the short term as well. So, that's providing some alternative, particularly for shorter term or liquid requirements.

So, if people have spending requirements coming up, it's always good to have some cash or emergency cash. Now, you're actually earning something on it; you're not feeling as bad about holding cash in a bank account and not getting anything.

GICs are similar. So, GICs have some advantages in that they have better interest rates today as well. A trade-off there often is liquidity or penalties for redeeming early. So, this is where liquidity requirements need to really be weighed in terms of probability of needing funds in the short term. Bonds offer that liquidity.

When we look at things from a total portfolio, which is how we look at things for a Balanced portfolio, is that bonds provide price adjustment as well. And so, when we're talking about the historical correlation between stocks and bonds, because we have price movement on bonds, we would expect that as stock prices are dropping, bond prices should move a little bit higher.

That's that traditional correlation or relationship between stocks and bonds. And that's something you would not get from GICs. So, you don't get that immediate price adjustment or that risk mitigation in terms of the overall portfolio.

David Fraser (20:23):

So, as we think about interest rates going forward, are we still in a fluid environment? Or are we expecting higher rates to continue? I mean, is it as easy as saying policymakers might reverse a decision based on new data coming to hand? Or are you expecting rates to get back to a more pre-2008 level and remain there for some time?

Greg Peterson (20:43):

It's always a fluid environment, David [laughs]. It's one thing about investing in stocks and bonds—things are never static. And interest rates are much the same. Central banks have been very clear that they intend to hold interest rates high until they have a higher degree of confidence that inflation is moderating. And so, this is where they're going to look to labour markets for signs of that. So, I suspect that we have higher interest rates for a longer period of time.

Greg Peterson (21:06):

I mean, keep in mind that interest rates have gone higher, but historically speaking, we're not at a high level of interest rates. So, we're not back to where we were in the '80s or even the early '90s. We're still quite a ways from that.

So, historically speaking, rates are still fairly modest, but they're a lot higher than they've been for quite a few years.

So, I would expect that interest rates stay high or where they are and probably move a little bit higher as we move into 2023. Not the same shock or degree to what we experienced last year, but modestly higher. Markets expect this, [and] anything that markets expect are already reflected in prices in the markets. So, I don't think that changes things from that perspective.

And if we get to the point where inflation is getting back closer to what central banks are comfortable with, and if we see changes in economic growth, then interest rates are likely to be reflected in that too. So, markets have speculated a couple times in 2022 about whether central banks start to reduce interest rates because of a slowing economy. That's caused stock markets to bump up a couple of times.

We'll go through that again this year too. And eventually, markets always being forward-looking, we'll look to the prospect for lower interest rates at some point in the future. But we have to get to the point where central banks are comfortable that inflation is under control. But they will adjust and they will respond to change in economic conditions as well.

David Fraser (22:20):

So, interest rates was one of the things moving markets in 2022. Are we expecting that to be a major impact on what we see in 2023? Or is there anything else you're anticipating that might be moving markets?

Greg Peterson (22:34):

I think inflation and interest rates have already been factored in, and impact on markets has already been experienced. Interest rates and monetary policy are always central to stock market valuations and where we're at. So, that never goes away anytime, good or bad.

I think the focus is more around earnings and economic growth as we go forward. So, the growth story becomes perhaps a bit more important in addition to improvements in geopolitics. So, we'll start to see an ebb and flow to economic growth and activity based on different regions. Not all regions in the world are going to expand at the same rate, at the same time. So, that does provide some opportunity within the portfolios, and it also helps to speak to the diversity of the portfolios too, because it's very difficult to determine or time what market is likely to recover faster or run better.

And in times of higher uncertainty like this, for us, it's best just to stay very flat, stay well-diversified, keep your policy rates relatively close to neutral, and then you have proper risk diversification, but also coverage for opportunities and growth as we go forward.

David Fraser (23:33):

So, there's opportunities, there's been a lot of talk, though, about recession and the doom and gloom side of things, which we've covered a bit here. But as you look ahead and you think about what markets might do, what is something like the performance we saw in October of 2020—it was a very strong month, and all of those negative headlines were still swirling around at that time—what does that do, as you think ahead, in the face of all of this negative publicity?

Greg Peterson (23:59):

Yeah, it speaks to the inability to time markets. So, despite all those headlines in October of last year, markets were very strong in October and again in November. It also speaks to the fact that the markets are always looking forward, so it's hard to tell how far markets are looking forward. Eventually, we'll get to the point where the recession story is actually behind us, even though we might be just getting into the recession—if that does happen and play out that way.

So, it's impossible to time. It's best to stay invested, make sure you understand your portfolio exposures, and remain well-diversified. That is the best course of action.

The other point that we've made in this recording [and] in the past too, is, despite whether we're going into good times or bad times, it's always important to understand your liquidity needs. So, if you have spending needs in any given year, always make sure that you have liquidity built into your portfolio to account for that.

For the rest of that, ensure that the strong quality businesses that we invest in work their way out over time and perform over time. So, we're quite comfortable as we look at longer periods of time. Much of this focus is always around relatively short periods of time, and six months to a year is a relatively short period of time in the world of investing. And so, that's why we focus on the needs for short-term liquidity, and then allow the long-term investment portfolio to work its way through.

David Fraser (25:11):

Well, thanks Greg. That's probably a great place to leave it. Lots of great takeaways and insights. And here's hoping to a better 2023 than we saw last year. Thanks for being here today and sharing your thoughts with me and the listeners.

Greg Peterson (25:23):

Yes, thanks very much. And happy 2023 to everybody and I hope you have a great year.