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EP 141 | Canadian Equities: Inflation, Interest Rates, and Decision Making

[00:00:00] Andrew Johnson: Hi everyone, Andrew here. Coming up in this episode, I got to sit down and chat with Mark Rutherford, who co-manages our Canadian large cap strategy. We cover a few timely and relevant topics today, like interest rates and inflation, and how pervasive those are throughout the economy and markets.

We also cover what we think are some timeless elements of investing, like looking for strong business models run by excellent management teams, thinking about and putting in the effort to improve our decision making, and adjusting to new information. And of course, I pick his brain on a few of the holdings in the portfolio. Enjoy.

[00:00:34] Disclaimer: This podcast is for informational purposes only. Information relating to investment approaches or individual investments should not be construed as advice or endorsement. Any views expressed in this podcast are based upon the information available at the time and are subject to change.

[00:00:49] Andrew Johnson: Welcome back to the podcast everyone. Today we're joined by Mark Rutherford, who's the co-manager on our Canadian Large Cap portfolio here at Mawer. Mark, welcome back to the podcast.

[00:01:02] Mark Rutherford: Thanks, great to be back Andrew.

[00:01:03] Andrew Johnson: It's good to have you back. Why don't we jump right in and why don't we start with a little update on what's happening out there in the markets from your vantage point.

[00:01:12] Mark Rutherford: Earlier in the year there was lots of expectations for interest rate cuts later in the year and [for] inflation to come back down quickly. And that hasn't been the case at all. Rates are actually still potentially going up. The employment situation has stayed relatively healthy in Canada and in the U.S. That's been a benefit. But inflation has been very slow to come down. And then we've had a lot of volatility as well in oil and gas markets. In particular, more recently, interest rates—especially longer term interest rates—have been rising quite rapidly. Close to 5% (the 10-year treasury yield in the U.S.)

Lots of volatility that we're really managing through and focusing on those companies that we think will survive and thrive through the cycle whether it becomes a more serious downturn, or slower downturn and soft landing scenario.

[00:02:04] Andrew Johnson: That's a good recap; good state of play right there. And you know, the last time that we talked on the podcast was December of last year, so 2022. We talked about a few different things at that time, one general area that you were keeping a close eye on—obviously, as you just mentioned, was the level and direction of both inflation and interest rates [being] very much intertwined.

We're over three quarters of the way through 2023, so what have been some of those impacts that you alluded to or observations that you've had on those two things when it comes to the portfolio?

[00:02:36] Mark Rutherford: From a portfolio perspective, there's been a number of impacts. I think one of the things we talked about last time was the knock-on effects of high inflation, and that was a lot of employees at companies, labour unions, were going to be likely asking for big pay increases across the board. So, we're seeing that across a number of companies, whether it's railroads—Finning [International] in the U.S.; a lot of news about the autoworkers and their negotiations.

So, across the board that continues to play out within companies and sectors that are really big and important to the Canadian market. The interest rate move has had a really big impact on banks as well. It's created more competition for deposits. So, instead of us earning 25 basis points or basically zero in our saving and chequing accounts, now there are really attractive alternatives in shorter term government (basically risk¬-free) securities that individuals and institutions can shift into. And so that's creating more competition for deposits and that's a pressure.

[00:03:41] Mark Rutherford: You're seeing it more acute[ly] in the U.S. in terms of funding cost pressures, but then it also hits the loan demand—as it's getting much more expensive for companies to take out loans or for individuals to take out loans, whether it's to buy a home, finance a vehicle. So, that is really hitting the banks on two sides: both the funding cost side as well as the loan demand.

And it also hits them on the capital market side, where [it becomes] harder to do transactions, companies are maybe less willing to IPO in this environment.

The other big component in Canada that I'd note is the real estate markets that we've talked about. And there, it's really thinking about rents versus rates. And interest rates are going up and the interest expense on a lot of these assets are going up a lot higher than the rents are.

[00:04:28] Mark Rutherford: One exception to that would be more in the multi-family space because of immigration and lack of supply in Canada. You have more positive fundamentals for rent growth, but you also have a big proportion of Canadian cities that have rent controls in them. And that's a risk even in Alberta here where [there are] fewer rent controls relative to Toronto, Montreal, Vancouver. There's a risk that it's a politically popular thing to do, so, that is impacting cash flow growth at real estate companies as well as valuations.

Typically, it's a fairly levered business model. So really, you can think about it as your cash flow yield on the asset and that spread relative to your cost of financing really drives how much value you can create. And that is hurt with higher rates.

[00:05:21] Mark Rutherford: And then lastly, from just a broad perspective, I'd note valuation. Valuations across the board with rates moving higher…there's just a higher opportunity cost for that capital. And so, especially for longer duration growth companies where you don't see most of the cash flow for [five or 10 years] and you're paying out for that long-dated return, that's a hit to the valuation.

On the positive side, there are some businesses which we can get to later, which is P&C insurance, so, property and casualty insurance. Some of those companies, really, they have two core earning streams: it's interest income and the investment income, and it's also underwriting profit. As those portfolios of the premiums that they're collecting from customers are reinvested, they're often in shorter term bond portfolios and they can get reinvested at higher rates as those bonds mature. So, it's a little bit more positive for the P&C players, relative to the banks.

[00:06:23] Andrew Johnson: [That's] really good context. You know, just coming back to your comments on housing, I guess it permeates the Canadian economy to such a large degree and clearly has, you know, impacts that are felt from the individual level all the way up to the banks.

Now, having said all of that Mark, I'm always really curious about the investment process as we've discussed before and all that goes into, in particular, making good decisions. I mean, at the end of the day, that's what [your MO] is here. You just touched on some of the macro issues that impact a portfolio—and of course there are a myriad of other things that affect an individual stock or a company. So, when you step back and you think about the process, what are some things that help you in your role in trying to make good decisions?

[00:07:09] Mark Rutherford: We're always trying to improve the process consistently here. And one of the things that's been a big push in the Canadian Equity Strategy as well as the broader Research team is really, decision tracking. If we really want to get better at making repeatable, value-added decisions over time, let's increase what we're doing on tracking and analyzing our decisions. I think there's a lot of benefits from that.

One, you're realizing: actually, once you start to track, how many decisions that you're making. And oftentimes, a decision to not act is also a decision. So, we're thinking about, okay, if we discuss a portfolio trade idea or a new company that we're looking at to go into the portfolio or maybe eliminate a company from the portfolio, and we decide not to do that, we should also track that. And then over time, we can build a baseline and assess by person, by team, what are the common themes that we can maybe draw from that.

[00:08:07] Mark Rutherford: So, it's early days—hopefully if we keep building on that over time, that can lead to just broader learnings for the team. And then along with that, one of the things that I've been doing, some others on the Research team are doing it as well, is just working with journalling. And so, I'll write down just my thoughts on the week, specifically around trade ideas. And then hopefully we can look back over the end of the year and try to assess, okay, maybe we should have acted more often on some of these ideas; [or], it's really the big decisions that matter most and that add the most value, versus smaller ads and trims of the portfolio.

It's a really good assessment tool for us and can allow us to learn from each other. So, that's been a big push for the Canadian equity strategy as well as the broader Research team.

[00:08:52] Andrew Johnson: Interesting. Thanks for sharing that. You know, another thing that I'm always fascinated with—and I would think that your journalling comes into this—[is] how you incorporate new information into your decision. So, in other words (as you alluded to), you're not really just making a decision and then walking away, you need to monitor it. You need to adjust to new information on a pretty frequent basis. So, what are some examples of that?

[00:09:15] Mark Rutherford: I think that's one of the really big things that we've just observed over time in the markets—that the odds are always shifting for companies and for businesses. If you looked at the top companies, say, in the S&P 500 in 1993, 30 years ago, and you said, "what are those top 10 names?" and then, "would those top 10 be the same companies in 2023?" Well, most of the top companies today didn't even exist back in 1993. So, the odds were shifting quite a bit. So, a pure buy-and-hold strategy may be tough to survive over time. [You] could name a number of business models that were really good and made a lot of money at one point in time—whether it's the buggy whip manufacturer, or could be [the] radio business, TV—you name it. There's a lot of companies that, because of technology changes, [were really impacted]. One in the last few years, it's a little bit more recent in the Canadian equity strategy, would've been Cineplex.

[00:10:12] Mark Rutherford: So, we'd owned that business for a number of years, and started to become a little bit more worried about really, Netflix, and technology risk changing. Ultimately, they started to allocate capital into other areas outside of the core movie business and the odds were just deteriorating over time. We made the decision to exit that business. I think we started to sell Cineplex back in 2017, so that was just a decision where [we were] constantly reassess[ing] the odds because we know the odds are changing over time.

And one other thing I'd highlight, Andrew, with adjusting to new information—while, yes, we would look at some of the companies [where we might be] investing in new areas and new growth businesses, we also have to recognize they may be different in different points of time. So, if we go back maybe five years ago, we would've had over 10% of the portfolio in Rogers, Shaw, Telus, and Bell, and one thing that's really changed over the past few years and really over the past decade has been those telecom companies have really exercised quite a bit of pricing power.

[00:11:15] Mark Rutherford: And so relative to maybe 2008 or 2007, the last really big recession prior to COVID-19, they still had some pretty big growth engines in them, whether that's home, internet, mobile penetration and even mobile pricing longer term. Whereas when we look at those same companies today, they don't have quite the same pricing power that they had, and they don't have the same growth in terms of penetration that they once had. That, in addition to balance sheet stress, has actually led us to really reduce that exposure. It's below 2% of the portfolio now, and we do not own Bell. That was recently exited from the portfolio. And really, that's just a concern about how much pricing power there is. They have a lot of debt on the balance sheet and really outspending their cash flow.

[00:12:02] Mark Rutherford: We want our companies to really live within cash flow and as we've seen the cards adjust, that has really become less favourable for the telecom companies. And the last point is that we're seeing a much more public regulator that's coming out with regulation that's a lot more adamant that prices come down or remain stable, which would be a big shift from five or 10 years ago.

So, that would be another really big shift in the portfolio that happens slowly over time but then over five years, has a pretty big impact on overall exposure. That's one that I would point out with the telecom companies. That's been a big shift over the last five years.

[00:12:42] Andrew Johnson: When you think more broadly, is that a feature of a business? You know, in your case you used Cineplex as the example. So, they're faced with an existential threat of sorts with technology change (Netflix, as you mentioned), is that something similar that occurs with other businesses out there? [That] when they're faced with a threat like that and they still have excess capital to deploy, you start seeing them go into other areas that are not in their core domain?

[00:13:13] Mark Rutherford: Yeah, I think that's a common theme that we have observed. So, maybe more recently, an example in the energy sector, you saw a lot of big, multinational oil and gas companies look to invest in renewable projects versus really focusing on their core competency—to be oil and gas producers and refiners. It becomes a little bit harder to do over time. Your other option would be to just return the cash flow to shareholders and maybe focus on being the best oil producer you can be at the lowest possible cost. That's really more a strategy that Canadian Natural Resources has taken. And we're seeing it with telecom companies in Canada—some of the cash flow that they're reinvesting from the core telecom business from wireless services and home internet, now they're redeploying that into new verticals.

[00:13:53] Mark Rutherford: There's a chance that can work out very attractively over time and provide a new growth leg for the company. Maybe 'optionality' would be the kind of the positive spin on it…

[00:14:08] Andrew Johnson: That's certainly what management teams are going tell us too, right?

[00:14:12] Mark Rutherford: Exactly. And it's also a bigger risk because it's less proven. Specifically, with Telus as one example that has been more of a longer term question. As to how that will evolve over time and how these businesses will scale up. That redeployment of cashflow is very critical.

[00:14:31] Andrew Johnson: Just coming back to the energy topic there, energy strikes me as another interesting area for stock pickers like yourself these days, especially when you think of it in the context of the conversation around the energy transition in the face of what has been rising oil demand over the last couple of years. How are you dealing with that when you're assessing these companies?

[00:14:53] Mark Rutherford: We're trying to really be open to multiple scenarios longer term. If you looked at oil demand in 2019, it was roughly 97 million barrels a day. I think for this year it's estimated to be roughly a 102 million barrels a day of oil demand. And that's with pretty big headwinds from work from home, increased electrification across geographies…

And so, while yes, there are these headwinds and companies are working to get way more efficient and electrify, there's also risks that the electrification journey may be a lot slower than anticipated. A lot of the utilities [companies] that we speak with have a hard time seeing the pace of electrification that policy makers are maybe shooting for. So, while yes, we maybe could switch and everyone can buy an electric vehicle in five or 10 years, the grid may not be able to handle that. Or the cost to upgrade the grid may be so high that it becomes prohibitive. [If] the general population wants to focus more on affordability, that becomes a much bigger issue.

[00:16:03] Mark Rutherford: So, we're remaining open to these different scenarios. One of the biggest correlations with energy consumption is wealth per capita. And as you have rising wealth in emerging economies around the world, that is likely to drive further increase in energy consumption.

There's puts and takes across the board, so we're trying to stay balanced with not totally saying, "okay, this is clearly going away tomorrow," because it appears that it's sticking around for a lot longer than people may have expected or be talking about.

[00:16:34] Andrew Johnson: I think this is going to be a large part of the general conversation when we're speaking about the economy, energy, and markets going forward for some time. Just keeping on this commodity theme, this year we decided to also remove our exposure to gold producers in the portfolio. What played into that decision in this context?

[00:16:53] Mark Rutherford: Agnico [Eagle] was one that we had purchased in the Canadian Equity Strategy and they had a fairly good setup: really high quality assets, relatively low cost base, and clean balance sheet—no debt, high margins. And the ability with high gold prices to return a lot of that cash flow to shareholders, buy back stock pay special dividends, similar to what we've seen from, the energy producers. And, really that thesis of, okay, they're managing the business better, they're not just chasing growth for growth's sake… that really shifted with Agnico with the acquisition of Kirkland [Lake Gold]. And our assessment was "not wealth creating." And then the Yamana deal, as well.

[00:17:33] Mark Rutherford: And so, just seeing that change of returning back to trying to grow, which is hard to do, and then in addition, it also actually filters back to what we were talking about—rising rates—the cost to hold gold in a portfolio is much higher now. You're going to earn a much higher return from the cash flow of government securities than holding gold. So, just higher opportunity cost also can create pressure on gold price. So [we were] cognizant of that, but really, it was just a change in capital location that, in our assessment, was not favourable.

[00:18:09] Andrew Johnson: Okay, let's keep going on the energy theme and energy-related companies, and in particular, utilities and pipelines. Earlier this year we added AltaGas to the portfolio, and then very recently we decided to also exit Enbridge. I might be reading too much into that perceived switch, but walk us through those two decisions.

[00:18:31] Mark Rutherford: I'll start with AltaGas. What is AltaGas? It's a combination. Roughly 60% of the earnings are utilities in the U.S. so, Washington D.C., Virginia, Maryland, Michigan. And these are really natural gas utilities that earn regulated returns. And they have a lot of growth, actually, just from replacing and upgrading the existing system and population growth. And that gives them a fairly attractive base earnings cash flow, but also growth. And it's long-term growth that you really have to do to keep gas flowing in these geographies.

The other 40% of the business is really a gas processing and natural gas liquids export business, where they're exporting propane and other chemicals [and] natural gas liquids to Japan and Korea primarily. So, a business that's growing.

[00:19:27] Mark Rutherford: They have opportunities where they can reinvest and grow that processing business and really grow with the export business, as certain natural gas liquids such as propane are really trapped in Western Canada, and there's not enough pipeline capacity to export these easily to the Gulf Coast where there's more processing facilities. So, it provides AltaGas with a really cheap source of input.

And Western Canada, where AltaGas has an export facility, is a shorter distance to export markets such as Japan and Korea so it creates a really attractive price for customers. We really like that business relative to other options [for] the portfolio. We thought the valuation was very attractive and they also had a new CEO with Vern Yu, coming on board. He's formerly the CFO at Enbridge and we think very highly of him. He understands the needs for the business, maintaining the balance sheet strength, and slowly growing.

[00:20:32] Mark Rutherford: They think that they have a long runway of capital that they can redeploy to grow and that they can live within cash flow and provide just a steady "Be boring. Make Money.™" company that is defensive with growth. So we like those attributes for AltaGas.

On the Enbridge side, one of the challenges for Enbridge is it's gotten so big over a number of years with acquisitions [that] they're now really outspending cash flow and do not have the same level of growth that they used to have, as it's just really become harder for them to build big pipelines—and pipelines that really move the needle relative to the size of the business today. The primary concern with Enbridge has just been outspending cash flow and the lack of growth opportunities. Or, if you do grow, you have to really acquire the growth. They actually recently announced a large acquisition where they raised $4 billion of equity to finance it.

[00:21:25] Mark Rutherford: They're having to purchase that growth. And they actually bought assets that are similar to what AltaGas already owns, so where there are natural gas utilities in the U.S. That was the primary reason for the switch. We like the balance sheet, like the growth profile better with AltaGas and we like the valuation better as well.

[00:21:45] Andrew Johnson: Excellent. Yeah, I know we talked a little bit about that internally here in some of the meetings, so I appreciate the insight that we can share with our listeners. I had one more company that I wanted to talk about, and that's Dollarama.

Over the last year or so that stock has risen fairly steadily. What are you seeing at the company level that is coming through in the stock price? And the context here is that when you look south of the border to some of the similar business models down there, their stock prices have been trending in the opposite direction.

[00:22:14] Mark Rutherford: I think one of the challenges with this business is really your pricing power. And if you're in a dollar store, if you will, the question is always, "okay, in a high inflationary environment, can you pass on price increases when you get labour inflation or goods inflation?" And one thing that Dollarama really focuses on is the price gap for their products. And that, for the customer, is really important because that gives the customer a big value proposition if they can get a similar product—maybe it's not the exact same brand, but it's almost a virtual copy of the product—at Dollarama. That's a big value proposition if they're saving money.

Dollarama recently decided to launch the $5 price point within their stores. And so that, in combination with a continual readjustment of the SKUs that they have in inventory—they do a refresh every single year on what they're holding to make sure that the value proposition is there, and they can maintain their margin profile.

[00:23:11] Mark Rutherford: Those two factors have really helped them. I think one, gain some market share from some of the competitors as people trade down to Dollarama. And then two, just maintain the margin profile. And I think that margin profile has been harder to maintain for some of the U.S. competitors just given maybe they had already taken the pricing, or there's also a lot more competitors down in the U.S. You have Dollar Tree, Dollar General, you have Walmart, Amazon, and some smaller players.

And so, a combination of factors of, I think, their scale and the competitiveness in Canada, as well as just management execution on when to introduce new price points and really ensuring that value is there for the customer so that they know they are really saving money when they come into Dollarama.

[00:23:57] Andrew Johnson: Mm-hmm. So, some of Porter's Five Forces really coming into play here when you're comparing and contrasting those two geographies and business models.

Alright, I've taken too much of your time, Mark—we'll wrap it up there. As always, I appreciate your time as well as your insight, and I'm sure our listeners do too. I'm already looking forward to the next time we get to chat, so thanks again.

[00:24:18] Mark Rutherford: Great, thanks Andrew.