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EP 128 | Post-Mortem: Learnings from 2022

Rob Campbell (00:00):

Coming up on today's podcast, I'm joined by our CIO, Paul Moroz, to talk through one of the most important cultural rituals at Mawer: the annual post-mortem. Simply put, a chance for everyone on our team to reflect openly and share insights, mistakes, learnings, looking back over the past year.

As you might imagine, 2022 was a year that provided many opportunities for humility and lessons learned. Paul and I talked through some of the more predictable learnings as it pertains to interest rates, but you might be surprised at how many of the team's learnings were in the realms of psychology, emotions and behaviour, with clear tie-ins to better decision making, both in investing and beyond.

And hey, before we dive in, a quick favour to ask of all of you: we'd love your feedback. If you've got specific topics you'd like us to cover on upcoming episodes or anything else you'd like to share with us, email us at podcast@mawer.com. We'd love to hear from you.

Disclaimer (01:14):

Rob Campbell (01:30):

Well Paul, we're here to talk about the post-mortem process. And I know we've done this in the past, but for listeners who haven't tuned into these in past years, can you provide a reminder as to what the post-mortem process is and why we do it?

Paul Moroz (01:42):

Our post-mortem process occurs every year in the new year, and our team takes time to go back and look over what they've learned over the year, over the last several years, and then ultimately what mistakes that they think they've made. And this year in particular, we asked people to frame those learnings and that review process in terms of the decisions that they made.

And we are blessed with this tremendous resource—our Lab team has put together all sorts of data and science around the decisions. We look at stock trades by tranche going back years and years and years, so that all facilitates and helps the learning process.

Rob Campbell (02:31):

This is an annual process; presumably we're looking back at decisions made over the past year recognizing that it could be decisions made seven years ago that just played out in this particular year. Can you talk just a little bit about how when asking people to share their learnings, you balance that shorter term/longer term aspects of the process?

Paul Moroz (02:51):

It's tough because the stock market or financial markets provide their lessons over very long cycle times. And that's why this last year was so important for us as a learning organization because financial markets haven't had a period where there is inflation, war, and higher interest rates in a very [long time]. You can read about in history books, but last year it arrived. And people were able to adjust their learnings. What you'll see Rob, [is] over time you'll learn one way—you'll get these bull market learnings—and then there'll be another influence of results where you're taking sometimes a contradictory learning.

I think what's ultimately important is that you realize how little you know about the world, that you actually can't predict things very well, that your knowledge is very fragile, and it's a large dose of humility that's shot into your decision making.

And that's important because over time as you make investment decisions, you want to make sure that you don't have an overconfidence bias and do something that goes wrong just because you were overconfident.

Rob Campbell (04:09):

There was a member of our Canadian small cap team who said, "Is there a predictable cycle to our learnings?" A lot of these this year sound like the exact opposite of the ones that we gave at the end of 2021.

I think your point, if I'm hearing it right, is you might never know whether you're learning the right things because they're cycle-dependent, but it's the process of just going through that and exposing yourself to the humility, that's what's most important. Am I getting that right?

Paul Moroz (04:32):

That's absolutely right.

Rob Campbell (04:33):

Okay. I can imagine that last year was one rich with learnings just given the market context. Can we start with just some learnings that came from asset classes or members of asset class teams at Mawer where the performance streams last year were more challenging? Can you start there as to what they took away, or what was important with respect to the performance of their portfolios?

Paul Moroz (04:54):

One of the first big events that occurred was this interest rate hike cycle as a result of inflation and the resulting—we call it duration, but really—interest rate sensitivity. How sensitive asset classes are to a change in the discount rate.

This became an extremely important factor, and the way to think about it is that new information was coming up. We have lots of tools to measure this academically. Different asset classes would take this information in and of course make their decisions and incorporate that into the portfolio construction. And some asset classes responded sooner or believed that [there] was more materiality. For others, the learning or the lesson was this happened to play out maybe faster and in a more material fashion on particularly stock prices than what they were expecting.

The learning there was directionally we understood what was happening, but the prediction of magnitude ends up being very difficult and you saw that variance across asset classes. That was certainly one of them. That happens to be a big factor last year in 2022.

Rob Campbell (06:14):

On that same topic, I can imagine faced with new information, understanding the potential directionality you can either make too few decisions, or too many decisions with respect to the stocks in your portfolio. Wondering if there's anything that the team brought up in that regard?

Paul Moroz (06:29):

Well, too few or too many. You might be referring to heading one direction with decisions. You get information, certain information that suggests that you should be heading one direction and you start to realize that that is not the direction you should be going, you've gone too far. And with duration and interest rates, you could have taken a choice to cut higher duration stocks or have cut growth stocks and realize that wow, interest rates aren't going to 6% or 7% and kind of get caught out.

Now, I call that fishtailing. You have to adjust the odd—it would be like, I don't know, playing baseball and you're leading off first base. If you get too far off first base and the pitcher hasn't thrown the ball, they can pick you off. It's difficult to find the right balance in an environment like this, but for each one of our people that had a learning that, well, “I didn't move fast enough with the new odds,” “I didn't recognize it was a material move enough…”

And think about the big events—go back to that point in time where Russia was starting to put troops on the Ukrainian border. You might not have thought that they were going to invade and that Russian securities wouldn't be effectively traded in the West, but that's a pretty big leap. If you treat every piece of information like that, you'll find yourself fishtailing.

These are very difficult problems of trying to right-size information and understand, "Okay, how material should this be?" We try as hard as we can to measure it and make it a science. We certainly do that and did that with interest rates: “What happens in our models when we increase interest rates, when we increase the discount rates? What's the offsetting effect when the companies turn around and raise prices?”

Paul Moroz (08:30):

And in some cases there's gaps between theory and practice. We noticed there were spots where we didn't think there was that much of a change in the valuation of a company and the psychology of the market was driving greater price change than we thought. Now, we still might be right, it just might take some time to catch up. That's the other element to this—you're learning, but you're learning from a very fickle Mr. Market that has its own emotions and psychology, and we can talk about those concepts too.

Rob Campbell (09:03):

Let's do that. I mean, certainly something that I picked out from a lot of people on the team was whether it's academics versus reality, or I think the way you put it was, the company versus the stock being two very different things. This aspect of psychology, the dance of the stock—

Paul Moroz (09:19):

Are companies and stocks the same? And the answer is no, they're not. As investment analysts we analyze companies, but that's different than the stock because the stock prices in all sorts of emotions. It can price in the potential of companies, it can price in fear that people have. That's the dance of the stock that I think you're referring to.

It is difficult at the best of times to tease those things apart. We do so as a result of our process to stay on track with that, but it remains a bit of an art of investing—to really separate that psychology from the business and understand when there's an interaction that's important.

I think in addition, a lot of people felt that—and as you would as a client, as an investor—you look at your statements [if] the stock market has gone up, you feel happy. You feel that you can take on the world. Or, if your statement shows that you're down, you feel depressed, you feel like selling.

I mean, this is the concept of Mr. Market. And the one learning from one of our people who is so good, he just said, "I am Mr. Market. I have to recognize that I'm not immune to this and that I have these emotions too, and I have to be more in touch emotionally with myself." That's so true. It's such a great lesson to learn.

Honestly, when you think about emotional intelligence, it applies not only to investing in the stock market but has all sorts of applications outside in the real world. Just being emotionally aware and emotionally intelligent. And these are human challenges that we've been dealing with since the Stoics.

Rob Campbell (11:11):

What's the learning then? Is the learning to figure out how to be aware of your emotions and to put them aside and to really focus on the mechanics of the discounted cash flow model because these are long-term investments? Get rid of the psychology from your analysis? Or are you saying something different with respect to how to interpret that psychology?

Paul Moroz (11:31):

I'm saying a few things. When you become really good at making decisions, it's almost like you can hold up what you believe that the market is thinking, what the psychology of the market is doing, and you can separate the fundamentals and look at that extremely objective[ly]. And I think that you also recognize how important process is to stay on track and such that you're almost a passive observer. You become extremely introspective in those different views and can make decisions as best you can based on the odds and probabilities and uncertainties.

But knowing how that psychology, what can happen if it changes or shifts, and having been through the technology crash in the early 2000s, you have a sense for how that can change very rapidly with the psychology of a stock. And it's also… Rob, it's very difficult. It's easy for us to say, "Well, you just separate. There's this thing called intrinsic value and you build a discount of cashflow model, and that's separate than psychology," but what happens is there's interaction between these two concepts.

You can become very optimistic about the future, and you can imagine how that optimism supported by other people that are feeling optimistic at the same time might sort of leak in these different ideas that go into the fundamentals of the business. That might be growth rates that all of a sudden you are noticing that lots of analysts, investors on Wall Street, are putting assumptions in their models that's higher growth. And likewise, if you're too scared about the world and how that's going to turn out, you can go the other way.

Being emotionally in touch is just really important and to separate out that company from stock and the line that we're using to make this distinction, which I think is a wonderful line, is "numbers versus narrative." Just as a nice way to try to separate those two realities. They can still be attached, but process-wise, that was a major learning for some people. Especially how quickly the psychology changed in 2022.

Rob Campbell (13:52):

On this topic of the psychology on emotional fitness or recognition, you had a learning that I really liked, which had to do with, I guess, decisions that are harder than others. This concept of "return on cortisol." Can you expand a bit more on that?

Paul Moroz (14:06):

[Laughs] Cortisol is something produced in your brain when you're doing something that's stressful and it's really not a great hormone or compound. I think it applies to investing, it applies to life. It's this idea that you can earn a certain return on things, but what is the cost? How much stress do you have to deal with? How much baggage does that action or decision come with?

Certainly as I get older, if you have something… making a decision that doesn't come with that increase in cortisol, you don't have to worry about something, you're not dealing with the stress or the emotion, those are a lot easier to make.

Paul Moroz (14:48):

Sometimes you find that those same things in the stock market, too. Where, if you work too hard at it, if there [are] too many options or outcomes and it takes too much time, it might not optimally be a great investment to make. I've learned that years and years ago with some of my Global Small Cap [portfolio] decisions. That's something that I believe is important for people to consider when they're making decisions.

Rob Campbell (15:20):

I can imagine that part of that may have to do with not having enough options. If you've got to work really hard with the few options at your disposal, there might be a lot of stress involved. Whereas one of the learnings that I heard from the team this past year was just on the value of inventory, of having lots of different ideas that are ready to go, such that when some new card comes up or information arises, you've got the ability to shift because you've done the work already and that might reduce the amount of cortisol involved. You don't have to all of a sudden cram a whole bunch of analysis into a very short period of time.

Paul Moroz (15:53):

It could be. You're kind of taking a different spin on “return on cortisol” almost from a portfolio construction approach. But that's certainly one of the elements where we constantly have to be thinking about: "What is the bottleneck to our process in making that decision?" And one of the learnings was, yeah, the bottleneck to selling something might have been inventory list. We've learned that over the years and have expanded the inventory list, but as a general learning or principle, you have to be aware of what the bottleneck is.

I went through a report the other day and the bottleneck to the investment thesis was actually liquidity. That was the key issue. So, reassessing, that'll be a different bottleneck for different portfolios and different investment decisions, but that was definitely one that came up. And having a broader, deeper inventory helps.

Rob Campbell (16:53):

Speaking of bottlenecks, but shifting in yet another direction, one of the terms that I also heard this past year but during the post-mortem was this concept of “simplify, clarify, focus.” Get rid of things that might become bottlenecks with respect to what you have on your plate. I think this was one of your learnings actually, and just wondering if you can expand on that one.

Paul Moroz (17:13):

Well, this is both a learning and objective that we had as part of our Research team. First, the learning originally came from reading a book about how civilizations fail. And one of the resulting conclusions was the sheer amount of complexity takes a toll in different forms. And we started to think about this and recognize that, wait a minute, this is a very general human principle. It's almost like physics. It applies to individuals and family units and companies. And we thought about what we can do; how do you counter that complexity while you simplify and you focus and you clarify?

Paul Moroz (18:02):

We made some changes and adjustments that executed on those principles. That worked really well. Even something for as simple as how my colleague, Christian Deckart, who co-manages [the Mawer Global Equity portfolio] with me—the way that we manage our responsibilities, we are constantly clarifying, simplifying, focusing to get the best results. We just shared that principle and rolled it out with the rest of the team.

Rob Campbell (18:31):

And I heard that from a variety of groups, this concept of field markings. In fact, [laughs] I think it went even all the way down to how you guys fill out expense reports and just the tension between, okay, let's make things easy for Paul. "Paul, submit your expenses however is easiest for you," versus the person on the other end who might get 35 different versions of how an expense report is organized. I presume that there's some tension in there that's worth unpacking.

Paul Moroz (18:59):

That's a great example. It's a simple example of what happens when you have lots of complexity. Honestly, you just have to stop, think about the process, and clean this stuff up. And it would be like... imagine if you lived your life in the same house and old things that you didn't use, you just took down to the basement and you never stopped and cleaned it up and organized. You would have one incredible basement. So stop, simplify, clarify with the expense reports. That's a simple procedural thing came up as a learning and that will be fixed and rectified in order to be more efficient.

Rob Campbell (19:38):

I want to go back to the emotional conversation because I think it was a big topic throughout the group. It was a challenging year emotionally on, well, just anybody investing in markets, and one of the learnings that I picked up from one of the newest members of our team was just on the value of journalling. Can you talk about that, and is this widely adopted across the team? How do we put into place and how do you think about that?

Paul Moroz (20:01):

Well, I think there's a really significant benefit to doing so. First of all, our reports. I mean, that is really journalling, documenting our investment decisions. So, every report we write is to facilitate that. But I think that some of the journalling can be expanded both to understand your emotional awareness and expanded to other investment decisions as opposed to just your regular review of a company.

And just consider the emotional benefits or consider the emotional physics of what's actually going on in your brain: you have the thalamus, which takes in sensory information and as it is believed, shoots off that information at two places. One place is the neocortex of your brain, which is the logic center, but at some point it was also discovered that at the same time, it takes a back alley route and it's shooting that same information, or at least some of it, to your amygdala, which is the emotional side of your brain.

Paul Moroz (21:07):

So now you have this race between your emotions and processing things logically. And so anytime you introduce process and logic, you're really slowing your brain down and saying, "Hey, let's take this highway to the neocortex," but also recognizing just the physics of your brain and that's the way it works.

By understanding how you feel, understanding your own emotional awareness and why you're making those decisions, I think can add a lot of value. Lots of people across our firm are journalling in different ways. I think that there's a significant opportunity to standardize or take to the next level what we're doing with journalling and integrate it with all the series of investment decisions that we're making and just in a much more standardized format. That's something that we're working through as a team and considering how can we take this to the next level.

Rob Campbell (22:08):

I heard a couple people through this post-mortem process experimenting with this. There's an asset class team [where] that's how they start their week. They talk macro, they talk micro, and then they talk about each other's emotional space. "Did I have a hard sleep last night? Am I angry this morning? Did I have someone close to me pass away?" Shifting that awareness.

I [also] heard somebody else on the team talk about [how] at the beginning of every day, they had this wheel of emotions and they just took the time to place themselves so that they had a better understanding of where they were as they carried out their day.

Are you saying that the next step, I guess in journalling (okay, we write research reports) [is] to actually record and track somehow what state of mind we were in as we made these decisions? Is that the vision?

Paul Moroz (22:51):

I think culturally, let's go back to what we do as an organization. Repeatable, value-added decisions. And so as part of an excellent decision franchise, you have to have the cultural pieces of being emotionally in touch and aware of yourself as you're making decisions. Can journalling help? Can communication help? Can just your own awareness, recognizing when you are excited or not—I mean, I think this is really important not only to making decisions, but dealing with your coworkers, dealing with other people.

You can expand it beyond investment decision-making, but it starts to become as you think through what this is and how your brain works, it's a critical component of making decisions and connecting as a team.

Rob Campbell (23:43):

Another one I heard was just the ability to recognize your emotions quickly might be the more achievable goal than striving not to make mistakes.

Paul Moroz (23:54):

Absolutely.

Rob Campbell (23:55):

Training yourself to have that awareness.

Paul Moroz (23:57):

Yeah, having a simple awareness of knowing when you're tired, when you don't need to pick up the phone, when you don't need to send that email. Just shifting the odds of a better decision because you understand emotionally where you're at and figuring out, "Should I have this conversation now? Do I need to have it now? Do I need to make this decision?" That's a big part of it.

Rob Campbell (24:21):

"I am Mr. Market." [laughs]

Paul Moroz (24:24):

"I am Mr. Market." That's right.

Rob Campbell (24:27):

All right, well, I think that covers it from my perspective. Paul, was there anything else that you picked up that you thought was worthwhile sharing with clients?

Paul Moroz (24:35):

No, we covered a lot of ground. I'll reflect back on why we're doing this—and it's not that we necessarily get the answer, but it's constantly driven to improve and to learn and to get better. And then recognize that we make mistakes.

We have to invest with a large dose of humility, recognizing that there's going to be all sorts of things that happen where we're going to get [it] wrong. This is part of really guarding against behavioural errors. So, part of our process, we'll keep on evolving it, and by the way, if any of the listeners are keen on learning more about emotional awareness, I think the book to go out and read is *Emotional Intelligence* by Daniel Goleman, and that is an excellent overview of the physics behind that science and some really practical applications for how you can become more emotionally aware and how that can improve relationships and better decision making.

Rob Campbell (25:41):

Great. And I think that's one of the things that I always appreciate about these conversations—is they give me things to take away not just with respect to investment portfolios, but it's much broader. It's about life in general. So, thank you. Appreciate you taking the time and to the team for having that vulnerability with each other. I guess I'll see you again this time next year.

Paul Moroz (25:59):

Absolutely. Thanks, Rob.