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EP 115 | Playing the plan: Mawer's international equity portfolio

Disclaimer (00:22):

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Rob Campbell (00:39):

Well, Peter, I have to ask before we get going: is it Lamp-ert or Lamp-air?

Peter Lampert (00:45):

(Laughs) It's German, so Lampert.

Rob Campbell (00:47):

Okay. Very good.

Peter Lampert (00:48):

But "Lamp-air" is a nice nickname.

Rob Campbell (00:50):

Excellent. Let's jump right in. Peter, many recent guests on the podcast have shared their thoughts on the market environment, but let's start with your 30,000-foot view as portfolio manager of our International Equity strategy.

Peter Lampert (01:02):

Yeah, it's been a very eventful year. Clearly, one key thing stands out: the key driver of equity returns or returns across all asset classes this year has been rising interest rates, with the Fed starting to raise interest rates in response to very high levels of inflation.

There's always variety of reasons. Sometimes it's hard to pinpoint one specific reason driving stock performance, but this year it's very clear that the key driver is those rising interest rates. And longer duration stocks—stocks where the cash flows are further out into the future—are the most impacted. So, our portfolio, if you look at the duration of the cash flows, if you look at a simple metric like price-to-earnings multiples, our portfolio typically trades at higher levels given the high-quality of the companies that we invest in and the very strong, long-term outlooks.

Peter Lampert:

But when you have discount rates rising and a valuation reset, those are the companies that get hit the most. So for us this has been an unusual period. Typically, we've outperformed in down markets. I've been at Mawer working on this strategy for the last 14 years, and in 13 of those calendar years we've outperformed. And clearly this is different this year with the pullback in markets not being driven by, so far, economic concerns or fundamental[s] for businesses, lower cash flows—but really just the discount rates.

Rob Campbell (02:28):

Interesting. And so it sounds like there's perhaps a bit of a surprise with respect to, I guess, the magnitude of the downdraft in our portfolio, but in terms of the companies that we own, any real surprises so far this year?

Peter Lampert (02:40):

I think you're right: the magnitude of the drawdown has been a bit of a surprise for us. We've always been expecting this derating to occur because quality stocks have rerated the gap between valuations, between quality stocks, and the rest of the market has widened more and more. So, at some point, we expected that would correct. And we've been willing to ride out that short-term volatility because it still makes sense for us as long-term investors to hold onto these stocks. But you're right, even though we were expecting this, the magnitude has been more than we expected.

But you asked about surprises specifically in the stocks—that's been a positive for us. We expect our companies to perform very well even in tough environments because we focus on those high-quality companies that have strong, competitive advantages to provide good value propositions to their customers and can do well in a variety of economic scenarios. But they've been performing even better than we expected.

Specifically, the major challenge so far this year has been the high levels of inflation, and we've seen our companies pass through inflation very well, really flexing the pricing power that they have, which is a testament to the strength of their business and the value they provide to their customers. And we expected that they'd have good pricing power, but it's been even better than we expected because they haven't really been tested in the last 10 or 20 years and periods of lower inflation.

So now, in this period of high inflation, we've seen across the board pretty much better-than-expected results from strong pricing growth and passing through inflation.

Rob Campbell (04:08):

Given that the big trend so far this year has just been the direction of interest rates—we're reporting the podcast on the day in which the Fed just raised by another 75 basis points—has that had a big impact on activity within the fund? Thinking back 12 months ago, the nature of yield curves has changed rather dramatically. Has that driven any activity in the portfolio?

Peter Lampert (04:30):

No, we haven't on a stock-by-stock basis. We've stress tested our discounted cash flow models for higher interest rates, but it hasn't really driven changes in our investment decisions. And the reason is because, again, going back to that pricing power, companies that have good pricing power should be able to pass that through. And so if you look at a discounted cash flow model or forecasting cash flows out 15 years, over that time, the discount rates are moving up because of higher inflation expectations, but the cash flows are also moving up because we expect these companies to pass on the higher inflation and generate higher revenues and cash flows as a result of that.

The result of those two factors is pretty close to neutral. In some cases it is a slightly negative impact, but really doesn't move the needle from a long-term perspective of our estimate of the intrinsic value of these companies. It really shows up in the short-term volatility. But the key to that, for that to hold, the companies have to have the pricing power. That's why I emphasize that.

And going back to the positive surprises, we've seen TSMC increase prices by 20% last year and another 6% this year. That's in an industry (semiconductor manufacturing) which, typically (prior to last year) had seen annual price deflation. Now they've not only increased prices, but they've said they're going to keep prices flat even going forward, not return to the deflation of the past.

Our distributors have been standouts. Bunzl, which distributes everyday supplies to coffee shops, retailers, grocery stores—bags and coffee cups—that's been a great business because they're just passing through the inflation. The distribution component of the total cost is fairly small. The products that they're distributing are fairly small value relative to their customer's overall budgets. Same story with Ferguson, a distributor of plumbing supplies; IMCD and Azelis, distributors of specialty chemicals. These are all small costs but high value, critical components to their customers. And as a result, they've been able to pass through that pricing power.

Rob Campbell (06:34):

Great. How would you characterize some of the adjustments that you've made to the portfolio so far this year?

Peter Lampert (06:40):

I think there's been a focus as there always is on following our bottom-up philosophy: investing in wealth-creating companies with excellent management teams and discounts to intrinsic values. And we've seen, as I referenced earlier, the rising valuations or quality companies being rerated and getting more expensive. As a result of that, a number of our companies and some of the highest quality companies that we've had in the portfolio have reached the top-end of our estimated fair value range. So we've been trimming those back. In some cases for a number of years, and in some cases exiting completely. And at the same time, looking to add to companies that have more attractive valuations. In some cases, the qualities may not be quite as high, still certainly meets our threshold [for] high-quality companies, but with more attractive valuations.

Rob Campbell (07:26):

Can we dig in just a little bit further? In some ways I must think that it's really hard to step away from companies where you have tons of confidence in the business model and the management team, but where, when you run your valuations and look at the various scenarios, it's just a little probability that you'll meet the third element of that criteria. Is that just emotionally difficult to do in cases where perhaps we've held a position for 10 or 15 years?

Peter Lampert (07:49):

Yeah, it can be difficult. And one thing we do to help protect us from that or making emotional or behavioural errors and getting emotionally invested in the company is just always going back to our process, going back to our tools. And then when it comes time to trade, to trade in small increments, so you don't have to make a big decision all at once. And that can break the inertia, make it easier.

The best example of this is Halma. This is a company that we've first invested in in 2008. We exited it this year. So, we've held it for fourteen and a half years and it's been a fantastic investment for us. It's compounded at 19% annually over that time in pounds, where it's listed in the UK. And we've consistently ranked it as the highest quality company in the portfolio. It's a phenomenal management team. We hold them up as an example to the other companies in our portfolio as good practices—what they should strive for in terms of how they run their business, in terms of their compensation plans. But since 2008, we held onto it; in 2016 it was getting more expensive, we started trimming it but just gradually, and we've been steadily trimming it for the last six years until we finally exited this year. So that makes it a bit easier. We didn't have to make a big call on valuation and say, "This is the exact moment it's getting too expensive." We just trimmed it as it got more and more expensive. We brought the weight further down in the portfolio.

Rob Campbell (09:04):

I can see how doing things in increments would make it easier to step out of positions with something like Halma.

Peter Lampert (09:09):

Yes, because it is such a fantastic investment. And we owe a lot of gratitude to the CEO Andrew Williams, and the management team, and everyone at Halma that's led to those fantastic results over the last 14 and a half years—even longer—that they've been doing this. Halma is a unique business because it's actually a collection of 50 different businesses organized into three different categories. They do a wide range of different things, but the three main categories are: safety, so for example, they have one business that makes elevator sensors; the other category is environment, so they have a business that detects water and gas leaks in pipelines; and the third business [is] healthcare, where they have a business that makes single-use components in cataract surgeries. So these are all good businesses in their own right. They operate in attractive niches. They're small but critical components and that allows for good profitability.

Peter Lampert:

But what management's done that's so fantastic is taking the cash flows from those good businesses and re-deploying them into acquisitions, continuing to compound and build out. They have the platform and to just keep adding more businesses that fit these characteristics. They've been very thoughtful about the types of businesses they buy, how they leave them decentralized to operate, but put in a set of KPIs (key performance indicators) and compensation plans to align the businesses with shareholder value. And it's just been a real model that, like I said, that we hold up to other companies. It's rare to find such a high-quality company, such a phenomenal management team, but we have to be disciplined and stick to our valuation principles.

Rob Campbell (10:46):

So, what do you do with that now? Like you said, it's still a great business; it's no longer in the portfolio. What would you need to see to consider coming back into Halma? Presumably given your comments earlier about how high-quality companies have sold off more this year, I presume Halma is down quite considerably. What would you need to see from a valuation perspective to consider adding it back to the portfolio?

Peter Lampert (11:08):

We'd look for much more attractive valuations. So either the stock price to come down quite a bit further, or the business to continue growing while the stock price is flat. The other thing that I hadn't mentioned is the CEO, Andrew Williams, actually announced his retirement next year. We think that he has a good management team around him, the CFO will be taking his place. So, we have good confidence in that. But it will be nice to sit on the sidelines and see how that transition goes—if they're able to maintain the phenomenal strategy and diligent execution that they've had over the years. So, we'll continue to monitor this certainly like we do; [we] keep an inventory of stocks that are extremely high-quality that we can look for opportunities in the future.

Rob Campbell (11:51):

Would you say that experience with Halma—so, high-quality company, sold off more than the broader market—has our reaction to other stocks in the portfolio that fit that mold... have we been leaning in so far this year to companies that have sold off disproportionately? Or are we biding our time at this point?

Peter Lampert (12:06):

No, we haven't been looking to add to the names that have sold off the most. As a rule of thumb, we don't typically double down because it's always a balance for us between having conviction in our investments and all of the analysis and research we've done, the conviction that these are good long-term investments, but balancing that with the humility and acknowledging that we could always be wrong. And that's a big part of our culture at Mawer—having that humility and recognizing that no matter how good your analysis is, the future's uncertain. You could have gotten something wrong or a low probability risk could play out. And we need to acknowledge that. That said, we are looking for opportunities. Some of them are becoming too attractive to ignore, and we will be adding to some of them selectively.

Rob Campbell (12:49):

In terms of where we have been adding so far this year, I wondered if I could ask you about two of the recent additions to the portfolio. The first is AstraZeneca, pharma company. We do have some other pharma exposure in the portfolio. What is it about AstraZeneca that earned its place alongside those other companies?

Peter Lampert (13:05):

Yeah, AstraZeneca is one that we've been watching for a number of years. They've seen a dramatic improvement in the business since they had a new CEO in 2012. Pascal Soriot joined from Roche, which is another portfolio holding of ours. And from a high level, all of these big pharma companies—global multinational companies with broad diversified portfolios—from a high level, they may all look the same, but we find quite a big difference when you really dig into them. And one thing that we look for that we think is a major differentiator, the companies that can have a sustainable long-term competitive advantage comes from their culture and their R&D capabilities.

And that's one thing we've always really prized in Roche and respected them because they really focus on R&D and coming up with meaningfully better drugs that will make a difference for patients. And that's what society values; that's what payers and governments are willing to pay for. And they've been successful. It means taking some risks. It means focusing on areas that your competitors aren't focusing [on]. But it's really paid off for them.

Whereas a lot of the big pharma companies try to take a lower risk strategy trying to get safe financial returns, and aren't really targeting those big, meaningful differences for patients. With Pascal Soriot joining AstraZeneca, he brought that Roche mentality to AstraZeneca and we've seen a major improvement in their R&D. It takes about 10 years to develop a drug so it's taken some time for that to play out, but by now we have the confidence that, like I said earlier, we never know that we're definitely right, but on the balance of probabilities, it seems like they've improved their R&D capability, become an R&D-led company not a sales driven company first and foremost, and as a result we think they have a much stronger, long-term future.

Rob Campbell (14:54):

That's the culture element. Just the shift from a sales-driven company to an R&D-led business.

Peter Lampert (14:59):

Exactly. And it ties into how R&D scientists are compensated, how much risks they're willing to take, what compounds or drug candidates they're willing to focus on, and also being willing to take risks but then cut their losses when they have failures as well.

Rob Campbell (15:18):

Got it. Interesting. The other business I wanted to ask you about is one that is perhaps newer as a business model to the International [Equity] portfolio and that's—and I hope I'm pronouncing this right—that's Thales. Can you talk a little bit about that company?

Peter Lampert (15:31):

Yes, they are French electronics specialists that provides components into military and civil applications. About just over half of the business is into military and the remainder, just under half, into civil aerospace. So, their focus on electronics is in communications, controls, and sensors. And these are clearly mission critical and they're recognized; they've been a longstanding technology leader. They're based in France, so most of their key customers are in France and the rest of Europe, but it's always been a good business with good technology. And management has really improved in recent years. They've focused more on profitability and efficiency and so the business has become more profitable. Clearly it's a great business in terms of barriers to entry being extremely high, revenues being very stable. Most of their revenues [are] contracted under long-term agreements. But one of the things that's held us back in the past are the ESG risks, so environment, social and governance. In this case, the social risks being the main one.

Defense contractors have typically been viewed as a negative for society. We think the Russian invasion of Ukraine has really changed that. People, especially in the Western world, understand the need for these companies to defend and protect our way of life. And the governments are also responding to that and in Europe especially by announcing higher military spending in their budgets. So, the direct impact on the company is twofold. One, we expect higher revenues over the medium to long term. It will take a number of years for these higher budgets to trickle down into actual contracts for Thales, but it improves the medium- to long-term revenue outlook, and two on the discount rate that investors apply to the stock, we expect that to narrow over time as the perception shifts from being a negative from a ESG point of view to actually positive in helping society and important for the Western way of life, which would be a valuation boost for investors.

Rob Campbell (17:33):

Can I shift, just given your discussion of discount rates? Given that inflation has been the big theme, given that discount rates have been very low for a long period of time, and just given the volatility that we've seen in bond yields really across the world, how do we deal with that as investment managers?

I know you spoke a little bit to it before, but specifically, how do we account for the potential volatility in discount rates either for an individual company or when looking at the portfolio overall?

Peter Lampert (18:02):

Yeah, for the individual companies like I was describing before, we do the sensitivities in our discounted cash flow models and do sensitivities on the discount rate, and also on the cash flows or the inflation embedded in the cash flow growth. And as long as those move together, it doesn't typically have a large impact on our estimated fair values. There are risks when they don't move together, especially if a company doesn't have pricing power where the discount rates move up and the cash flows don't. But again, we're focusing on those high-quality companies that are more likely to have pricing power.

So, if the long-term fair values for fundamental investors aren't really changing, the risk is more about the volatility in the portfolio and having periods like we've seen this year with significant drawdown because of the abrupt change in interest rate expectations.

Peter Lampert:

We think over a long period of time that gets smoothed out, but we do try to manage that in terms of having a balance of durations. We have some shorter duration stocks in the portfolio and some longer duration stocks as well, to help mitigate the impact of rising interest rates.

Rob Campbell (19:02):

Speaking of abrupt movements, one of the features of the current market environment that I've noticed is just that there have been some pretty sharp currency movements as well, specifically for the parts of the world that you focus on: things like the euro and the yen, multi-decade lows, the U.S. dollar being extremely strong. How has that impacted any of the companies that we own, or your thinking on the overall composition of the portfolio?

Peter Lampert (19:25):

Yeah, our portfolio companies are based outside the U.S., so they are mostly reporting in euro or yen, or in another currency. And we've really seen those currencies depreciate relative to the very strong U.S. dollar, with the U.S. dollar strength clearly being driven by higher interest rates in the U.S. with the other central banks being slower to raise interest rates in the case of the ECB, or not at all in the case of The Bank of Japan. I guess the immediate impact is that that's been a negative headwind on stock returns for European and Japanese and other stocks relative to U.S. stocks. But we expect as companies report earnings, as we get into this earning season, that many of these multinational companies have U.S. operations and we would expect that they'll get a bump from the stronger U.S. dollar when converted back to their local currencies.

That's more of a short-term impact. Longer term, the competitiveness of some of these companies could actually improve if these exchange rates are maintained at this level for a long period of time. For example, Japanese exporters, it's just now much cheaper to buy from them. So it could actually impact the competitive advantage of companies and disadvantage to companies—say, manufacturing in the U.S.

We also look for any risks or sharp edges that could come when you have strong moves like this. So we've gone through, for example, looking through the portfolio for companies that have revenue and cost mismatches, or revenue and debt mismatches, where they generate revenue in say euros or yen but have significant costs or U.S. dollar debt. And that can be negative. We've seen [with] the Asian financial crisis many companies went bankrupt from that problem. But we went through and did a double check. We think our portfolio companies are in good shape, as we'd expect. That's something we look for going in. We look for companies with low levels of debt with conservative management teams that don't take those kind of unnecessary risks.

Rob Campbell (21:18):

[I] wanted to ask about a strong U.S. dollar. Typically, or at least historically [it] has tended to put a lot of pressure on emerging markets, countries, and companies. Has that been the case so far this year? And maybe just speak to the emerging [markets] part of this ACWI ex-USA portfolio.

Peter Lampert (21:34):

15% of this portfolio is invested in emerging markets, but it's important to know those emerging markets are maybe different than the ones that we read about in the headlines every day, like the Sri Lankas that are having serious problems. So for us, emerging markets is China, Taiwan, Korea, India and these are generally holding up fairly well. All of these countries are energy importers. They've had headwinds from higher energy prices, but their currencies have held up relatively well. They've depreciated slightly against the U.S. dollar, but much less than say the euro or the yen. And we are not seeing major stresses in their economies. China has its own issues with especially tackling imbalances and excesses in their property market. So that's not really related to the global situation, but that's a headwind for their economy. As far as the other emerging markets that come to mind with high energy prices, high food prices, those really hurt the poorest countries and countries like Sri Lanka, maybe Argentina, Pakistan, these countries certainly will be most impacted, but from a global investment perspective or from the perspective of our portfolio exposures, not really meaningful.

Rob Campbell (22:46):

And then in terms of where we have, perhaps, a lot more meaningful portfolio exposure, I want to ask you about Europe. Seemingly, Europe is facing a pretty grim outlook with Russia set to squeeze natural gas supplies, inflation being exacerbated by the weak euro. I think we've got a lot of exposure to European companies. Can you just talk both about Europe in general but then about how we're handling that within the companies that we own?

Peter Lampert (23:10):

Two-thirds of our portfolio is invested in European companies. These companies are headquartered in Europe, but typically they're multinationals operating around the world with large exposures in the U.S. and Asia. So, on a look through-basis, about one-third of the portfolios' revenues are generated in Europe. And that's more the risk when we think about exposure to the European economy for our portfolio, but certainly they're facing a pretty tough environment. In addition to all of the global challenges that the rest of the world is facing, they have an acute problem with their natural gas supply. Clearly the EU has already agreed to reduce their gas consumption by 15%. And there's a risk though that it could go even further if Russia cuts off supplies. So, that will have a big headwind on the economy; natural gas is important for a lot of manufacturing and that will very likely tip Europe into a recession.

We go through the portfolio one by one, stress testing companies, how they would operate in such an environment if there is natural gas rationing, if they can't operate. And so far, again, the companies are performing very well, but we're looking ahead to the risks. One example is Air Liquide. They're based in France, they operate globally, but 40% of their business is in Europe and they provide industrial gases like oxygen and hydrogen to their customers, such as steel makers, which use it in their manufacturing process. So their key inputs are air, which they get for free and natural gas. So their main cost is up five or 10 times since last year, given European natural gas prices. And so far they've been able to pass all of that through.

Peter Lampert:

In their contracts, their customers have take-or-pay contracts with inflation pass through clauses. So, Air Liquide has not been impacted whatsoever; their profits are still extremely strong. But we have to be concerned about a scenario where there is gas rationing, where their customers are forced to shut down their plants completely or Air Liquide is forced to shut down its plants because they're all large natural gas users. And we're not entirely sure if their customers would continue paying under those take-or-pay contracts in that extreme scenario. So that's one we've reduced slightly on this concern, but overall, it's a very good company, it has a strong balance sheet. We expect it to get through any problems and it still has a good long-term outlook.

Rob Campbell (25:34):

Peter, at the top of the call, you talk about how inflation and rates were the major theme so far this year and it being a pretty strong determinant of stock prices. Of course, another strong input into stock prices is just earnings. And I think we've danced around this, but just want your take on the earnings outlook. As recession fears have come into the picture in the last couple of months, what are you seeing, what are we watching, and how do you see that playing out?

Peter Lampert (26:02):

We've definitely seen the market shift its focus from concerns around higher interest rates to concern around a recession and what that would mean for earnings. And so we think largely the move in discount rates is probably done unless interest rates expectations move significantly higher from where they are today. But like you said, the next concern that investors are worrying about is a recession and what that would mean for earnings, which companies would be impacted. And we're not making a bet or making a prediction on a specific scenario, but we want to build a portfolio that can be resilient in many environments, including in a recession.

And that's, I think an area where we feel good about the portfolio, in terms of these high-quality companies that I keep referring to typically have resilient cash flows, strong balance sheets. Yes, some are cyclical, many are not, and some will be impacted more than others in a recession. But across the board, we expect our companies to do reasonably well, to survive in a recession, and thrive afterwards. So, it's not a scenario for our portfolio that we're overly concerned about, but certainly that's where the market concerns seem to focus today.

Rob Campbell (27:10):

Well, we've certainly covered a lot of ground in this conversation. [I] want to thank you, Peter, for coming on the podcast. Any final thoughts that you want to leave with listeners and with our clients?

Peter Lampert (27:20):

The key message that I always like to emphasize is the importance of taking a long-term perspective and certainly for us as long-term investors, that's what we do every day. I think for equity investors, they've seen significant losses year-to-date and there's fears around a potential upcoming recession like we just mentioned. But one of my favourite quotes is, "You make most of your money in a bear market, you just don't realize it at the time," which is attributed to Shelby Cullom Davis. And I think what's nice about that is the lower valuations really set you up for better long-term returns with two caveats: one, that you invest in good companies that can survive the downturn; and, two that you can stomach the volatility without cashing out at the bottom.

Rob Campbell (28:01):

That's certainly a great quote. One to think about. Certainly hope you're right. But Peter, again, that sounds like a good place to end and thanks so much for coming on the podcast.

Peter Lampert (28:09):

Okay. Thanks Rob. It's always a pleasure.