the art of boring™

EP 119 | Playing the plan: Mawer's global equity portfolio

Disclaimer (00:22):

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Rob Campbell (00:39):

Welcome to the podcast, Manar Hassan-Agha, your first time on The Art of Boring!

Manar Hassan-Agha (00:43):

Thank you very much, Rob.

Rob Campbell (00:45):

So, Manar, you're an analyst on our global equity team and we're here to talk about the [Mawer] Global Equity strategy. Just on your role specifically, so you're an analyst, but one of the things that we ask our analysts to do in addition to focusing on companies is to have a generalist perspective and think about how individual businesses stitch into the overall portfolio. And so from that perspective, wondering if you can just kick it off—I think many of our listeners will be quite aware of the broader environment in which the portfolio is being managed, but your thoughts on the current market environment and what's top of mind to you as you think about the portfolio?

Manar Hassan-Agha (01:17):

The markets are very humbling, Rob. There's a lot of market pundits out there, so I'll try to keep this brief. It'll come as no surprise that we're in a bear market, and one of the unique pain points is that you're losing more money on your long bonds than on your long equities, whereas historically they've been negatively correlated, so you had some cushion.

But the basic theme is that the Fed and the global central banks have taken away the punch bowl from the party…and the problem is it's 3 a.m. and the world is already drunk. Central banks are restoring the price of time, interest rates to financial markets, and tightening the screws on monetary policy, and that really acts like gravity on all assets. This is primarily in response to what seems to be persistent inflation. And you add to that U.S. dollar strength, geopolitical risks, lingering pandemic effects, Europe energy insecurity and a host of other risks out there, and you have yourself seemingly a nasty cocktail.

Rob Campbell (02:08):

You mentioned it being humbling. Mindset wise, as you're putting together a portfolio, if you're getting bad news—whether it's in stock prices or fundamentals—I imagine that's quite different than the better part of the last decade that we had.

Manar Hassan-Agha (02:19):

It's very different. I remember the good old days where you picked stocks and they all went up and you patted yourself on the back. But certainly [there] seems to be a lot of macro headlines; it seems to be all about the macro today to some degree, but we see that volatility as an opportunity, especially as some of the sell-off has been kind of indiscriminate.

Rob Campbell (02:36):

Can you dig into that a little bit more? Specifically in terms of how that's helped with the portfolio over the last year?

Manar Hassan-Agha (02:38):

We focus on vulnerabilities and fragilities, not the trigger events. So, let me give you an example. I don't know if you know this, Rob, but there are no general speed limits on the highways in Germany, the German Autobahn. You can go 300 kilometres an hour on the highway, and while that's not recommended, it's not illegal. So you may think it's inefficient if I don't go at 300 kilometres an hour, but that's because it introduces a lot of natural human fragilities.

The trigger event for the accident could be all sorts of things: you just lose control of the car at those speeds—you drove the car at 300 kilometers an hour. So, you don't know what risk people were taking until the trigger event. But we focus on the fragility; it's only when the tide goes out you discover who's been swimming naked.

You can think of the layers of our risk management process in a Swiss cheese mental model. This is where our risk has to fall through a series of layers of Swiss cheese with different holes in them in order for the risk to really hurt us.

So, the first layer of cheese is our decision-making environment. We have skin in the game; it's a culture of ownership, a culture built on trust and accountability; we have cognitive diversity on the team. The second layer of cheese is our security selection process. That's where our research is complete and efficient and adheres to our investment philosophy. The third layer of cheese is our portfolio where we try to ensure being balanced in diversification. And then the last layer of the cheese is a systemic review of the portfolio with all the risks and themes.

Rob Campbell (03:59):

A truly cheesy analogy, thank you. Just at that third layer, the portfolio construction layer, can you talk about some of the more significant discussions that you're having specific to the Global Equity strategy in terms of exposures?

Manar Hassan-Agha (04:10):

Yeah, Rob. So, we all know the saying, "don't water your weeds and cut your flowers"—we try to be in both places at once and have contradictions in our portfolio. There are some high-quality businesses we still want to be in because we may underestimate their ability to create value, and the length of their competitive advantage. Ultimately, we may emphasize or de-emphasize these companies, but we manage that through position sizing.

Rob Campbell (04:31):

Can you be more specific, though, just in terms of the contradictions? What are some examples of that within the portfolio today?

Manar Hassan-Agha (04:37):

In terms of the contradictions, Rob, to give you an example, we have some capital-light information technology businesses that are actually higher in duration. So, you can think of S&P Global, which is a phenomenally high-quality business, as well as Intuit. Intuit does the accounting and the Mailchimp, etc.

So, it has these capital light businesses that are growing and compounding over time. They are high-duration businesses, but our valuation bands are more uncertain than our assessment of quality in that case.

We offset that with something that has lower duration, [is] more capital intensive. You can think of BMW. We talked about the German highways, so why don't we talk about German cars? BMW has a lower duration. It's like three or four times P/E on a backward basis, just to give you a sense in terms of plain vanilla statistics, it's more capital intensive, so you got to make the car, so you have to have manufacturing plants in the supply chain. And that has a fundamentally different exposure because that follows its own rhythm and beat in terms of the auto cycle.

So, that's just to give you an example of some of the contradictions we have.

Rob Campbell (05:35):

Interesting. I think another exposure that might be even different than the ones that you mentioned, perhaps somewhere in between, but JDE Peet's. I know you led a lot of the research into that investment, so just curious how that fits into the overall portfolio?

Manar Hassan-Agha (05:48):

Yeah, so for the audience, JDE Peet's is the number two marketer of coffee behind Nestlé. And this was a broken IPO down 30%, which had a large shareholder publicly disclose their desire to sell their shares, and so this created this kind of overhang on the stock. They were also going through a reset of expectations and a CEO change.

This really fits our philosophy well. If you think about it, it's a wealth-creating company with high returns on capital above its cost of capital stemming from the combination of scale advantages and customer stickiness from habit, and brand intangibles. There's also an excellent and engaged management team. There's a credible consumer goods family office, and a CEO with significant skin in the game. And it was at a reasonable valuation both on traditional metrics and our Monte Carlo DCF.

Manar Hassan-Agha (06:32):

And our variant perception at the time is that they can pass on inflation stemming from the combination of their strong competitive positions; 80% of their revenues comes from positions in marketplaces, whether they're the number one or number two player, if you think of market share; and, there's an inelastic coffee end-market that's increasing prices, but from a very low base. So, five cents a cup of coffee.

I don't know about you Rob, but I drink two, three cups of coffee a day and it may be the last thing I cut my spending on during a recession.

Rob Campbell (07:01):

[Laughing] Yeah, pretty inelastic. You mentioned this concept of [variant] perception, which I've picked up in reading research reports that we produce. It's not a part of our investment philosophy per se, but just wondering if you can expand on that? What is it, and how do you test whether you do indeed have a variant perception to the broader market?

Manar Hassan-Agha (07:18):

Yeah, that's a great question, Rob. We think about that all the time. You have to ask yourself, when we say the stock is trading at a discount to our intrinsic value, what do we mean by that? Why is it trading at a discount our perceived intrinsic value? Who's on the other side of the trade? There's a lot of smart people with money out there, so we have to ask, "What's our edge?"

We definitely look for companies that fit our investment philosophy; that puts you in the right parts of the forest. But we have this additional tool, the "variant perception" or "mispriced risk." And really, variant perception is an analytical tool that defines a thoughtful, well-founded view that's different from market consensus or expectations. And that's different from being contrarian, because a contrarian simply takes the opposite side—whatever you say, Rob, I just say the opposite. While someone with a variant perception is forming a different view through a disciplined, intensive analysis process and can develop a much higher degree of conviction in their position.

So, when we talk about elasticity of demand and why we think JDE Peet's can pass on inflation, we are doing an analysis in their competitive position, we're doing an analysis on the coffee end market. We're looking to the past, we're trying to look to the future. And we can get a degree of conviction in that position, so it's a well-founded view.

There's a saying that, "if you don't know who the patsy is, it's probably you." Of course we can't always get it right, and often we get it wrong, so sometimes we're the patsy. But asking yourself these questions consistently can give you an advantage that might stop you from doing stupid things.

Rob Campbell (08:41):

You mentioned it showing up through valuation. But I'm curious, as you look through the portfolio or across time, are there sort of these consistent places where we tend to find that we have a variant perception?

Manar Hassan-Agha (08:52):

We do it on a stock-by-stock basis, and really, we're open-minded and not ideological about anything, so there's not a consistent place that we see it. The latest theme has been broken IPOs and spinoffs to some degree. But again, if you go searching for something, Rob, that's exactly what you're going to get. In our idea generation process, we keep the filter loose; more wide, more open, because you don't want to just filter from the start, from the beginning—just broken IPOs, for example. That will create an issue where your biased or only the things that survive are the ones that you've picked initially. We sample from all forests. In our idea generation process, we fill the top of the funnel, and we'll put them through our idea generation process and our intensive analysis process.

Rob Campbell (09:34):

You mentioned JDE Peet's and the ability to price or to pass along inflation. It's obviously a big theme, I'm sure every podcast over the last year or two we've talked about it. So, give me the state of affairs within global equity: how are companies doing with respect to pricing? Where has it been more challenging where a company is doing a great job?

Manar Hassan-Agha (09:53):

I love Game of Thrones, and here's a quote for you, Rob—Lady Olenna [Tyrell] is one of my favorite characters—"Once the cow's been milked, there's no squirting the cream back up her udder."

That's perhaps the crude version of the inflation/toothpaste out of the tube [analogy] (that's awfully hard to get back into the toothpaste).

There's a lot of self-reinforcing mechanisms once the inflation kind of genies out of the bottle. If we're in an inflationary environment and that persists, then the first principles suggests that our wealth-creating companies should do well in that environment. So, businesses with pricing power that are capital-light, or capital-intensive but they have a lot of sunk capital, so a lot of the capital they spent in the past and they don't have to reinvest a lot going forward.

In our portfolio, an additional example would be CGI, which is an IT advisor, has sticky relationships with governments. They're going through their IT spend, there's a lot of recurring revenue in that sense; the governments are not going to overhaul their IT spend. And they're able to pass on, because it's really a fee-for-project business, so they're able to pass on some of that pricing.

Rob Campbell (10:51):

And where [has] it been more challenging?

Manar Hassan-Agha (10:53):

One place that's been challenging, Rob, is in insurance. For example, we own a business called Admiral, which does car insurance in the U.K. Used car prices were going up so fast, what happened is, you've already priced a one-year contract trying to forecast or think about what one year out your costs are going to be, and so that hits them by surprise.

Manar Hassan-Agha:

We are still comfortable with that because we don't think that's permanent impairment in the business. Next year they're going to definitely price their contracts to reflect the inflation pressure they see in the auto cars. So they have a lag in their pricing power; it's not a direct pass through.

Rob Campbell (11:28):

Thinking more broadly about the portfolio and markets—and whether it's inflation, we've talked a little bit earlier about investing in a bear market versus a bull market—one thing, or one question I often get from clients is, "Are there different aspects of your process that you're emphasizing a bit more today than you were, call it, a year or two ago?"

Manar Hassan-Agha (11:47):

You know, our investment and risk management process doesn't change. I say we view risk as the permanent impairment of capital and not necessarily volatility in prices, but you don't want to overstretch that concept such that all drops and prices are just swept under the rug under this volatility concept. That's where the humility and the intellectual curiosity comes in.

In the bear market, we don't change what we do, but the portfolio management is more in the spotlight. Did you know, Rob, that eight times more people die on Mount Everest on the way down than on the way up? It's the same thing in markets. To finish first, you must first finish, so you have to survive. Shore up cash and liquidity; size smaller into your positions. You can't freeze; never freeze when you're under attack. You've got to keep moving and focus on capital preservation.

The other key part is you have to be optimistic when the returns start making sense and when you think pessimism is excessive.

Rob Campbell (12:35):

You talked about Admiral, I think we added to that recently. You talked about finding ideas through broken IPOs. Any other examples of where we've gotten a bit more opportunistic lately in terms of additions to the portfolio?

Manar Hassan-Agha (12:49):

We have a position in Moderna, which we think is an interesting opportunity. They had one of the fastest vaccines out on the market within 11 months, whereas historically vaccines took 10 years plus to make. So it's been a significant advancement in that modality in therapeutics. Of course it got really heightened, and you see the post COVID kind of fizzle out of the stock. That's kind of the nature of the beast with the sentiment around it.

We still think that their vaccine franchise is quite durable, and we think that they have a good shot at penetrating another modality. They have de-risked the commercial aspect, which is a super critical risk within biotech. Typically, you have a binary drug (zero or one), whereas they have a commercial COVID-19 vaccine and they have bivalent boosters today out in the market. They have several Phase 3 drugs in their vaccine franchise. They have several other their verticals that they're attacking, so they have a lot of shots on goal.

Manar Hassan-Agha (13:42):

And then 30% of their market cap is in cash. We think the management team has done a good job on capital allocation so far, buying back shares with what they perceive to be a dislocation in the price.

Rob Campbell (13:53):

I think a big question that clients have is, "We're in a bear market; when is it going to turn?" [laughs] Is now the right time? A lot of these high-quality companies have really been beaten down just given the valuation corrections so far this year. Moderna was certainly an example of one that has come down significantly in price before we bought it.

But just more generally, are you finding lots of opportunities that you're excited to get into at the moment?

Manar Hassan-Agha (14:16):

Well, what was interesting about Moderna particularly, Rob, and then I'll attack your question, is we think it was kind of an uncorrelated bet. It has nothing to do with market timing or macro. These biotech stocks, really, it's about the pipeline, the probabilities you ascribe to the pipeline, and the total value of the pipeline. So, you could see a market where something's down 20%, S&P 500 is down 20%, but Moderna is up 20%. Because really, it's a materialization of their pipeline that's significant to the business.

Since I'm on the Game of Thrones theme, one of the more Machiavellian characters is Petyr Baelish, and one of his lines that always stuck out to me is, "Chaos is not a pit; chaos is a ladder." And so the volatility in the market we think is an opportunity for us today to sift through the debris and find diamonds in the rough. It is getting richer with ideas and we're filling the funnel, because the base of what we do is find good ideas, right? If you find good ideas, the portfolio construction process becomes a lot easier. But generally speaking, it's not obvious that stocks are cheap. We've seen significant multiple contractions, we're yet to see kind of meaningful earnings revisions. In recessionary times in the last 40 years, you may see 15 to 20% earnings per share contraction.

We're not trying to bottom-take the market or time the market, but the returns on the math has to make sense to us. You have a higher hurdle rate; the 10-year in the U.S. is at 4%, and you also have inflation. We need to be adequately compensated for our equity risk, and we look at that on a stock-by-stock basis and try to assess to see if there's any mispriced risk.

One thing I'll leave you with is, "generals always fight the last war." Sometimes you hear that saying. You have to entertain the idea that the winners of yesterday are not necessarily the winners of tomorrow. My German colleague likes to say, "You have to skate where the puck is going, not where it has been."

Rob Campbell (15:55):

Can I ask about EM, emerging markets? The exposure in the portfolio is quite modest today. I'm curious why that is, and whether you're seeing some opportunities start to emerge there?

Manar Hassan-Agha (16:06):

We're open-minded and not ideological about our risk exposure. Ultimately, we look for investments that fit our philosophy and then have that element of mispriced risk. Our emerging market exposure peaked in 2016. And when we plot the securities on our matrix, their peers and the alternatives in our opportunity set are more attractive. But that doesn't have to be the case tomorrow, and we can see a time where we would increase our emerging market exposure on kind of a bottoms-up basis, and then on a total portfolio basis.

We're in the business of relative security selection, so you always have to benchmark your ideas against each other. When I look at the emerging market index today, there are pockets that have actually held up really well during this bear market. But that's kind of been masked by China as a large weight in the index. To give you an example, Brazil equities are up 10% year to date. India's basically flat relative to 20 to 30% drawdown that we're seeing.

Rob Campbell (16:55):

That makes me think of the broader point, and probably one of where we started. So, emerging markets: lots of reasons to be optimistic about the long-term view associated with certain markets and their potential, but an asset class that tends to be more fragile in the short-term can bump around a bit more.

So, this question is less about emerging markets and more just investing in general: as a long-term investor, what gives you hope? We've talked a lot about risks that are out there today; certainly they're front and center. What are some of the reasons to be optimistic and not super defensive in a portfolio right now?

Manar Hassan-Agha (17:26):

Over the long term it's really hard, Rob, to bet against human ingenuity. And the other aspect I'd like to highlight is everything moves in cycles—that includes the prevailing accepted wisdom. So we have to be humble and have humility here; cycles have moved at warped speed in the last few years. We went from deflation to reflation to inflation…I don't know what's next; we don't try to time the market.

But we try to focus on what's important and knowable. There's a lot of important things out there that are not knowable.

What we think lands us in the right spot over time is wealth-creating companies, excellent management teams, trading at a reasonable valuation. We think that lands us in the right spot, and it's really hard to bet against human ingenuity.

The last point I would just say, is "skepticism calls for optimism when there's excessive pessimism" out there, right? That's a Howard Marks quote, I think. But in reality, you have to determine when you think there's a little too much pessimism in the market. I'm not saying that's where we are, but stay diversified and balanced and calibrate your adjustments and your portfolio tilts.

Rob Campbell (18:24):

Okay, if I'm hearing right, you're not unequivocally saying that "winter is coming."

Manar Hassan-Agha (18:29):

[Laughs] That's a great one. We don't know if winter's coming or summer is coming. We think that's important, but not knowable. And so we'll focus on what's important here, and that's our investment philosophy and following that and adhering to that.

Rob Campbell (18:39):

Very good. Manar, thanks for being on the podcast, thanks for joining me.

Manar Hassan-Agha (18:43):

Thanks for having me, Rob. It's been a pleasure.