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EP 120 | Playing the plan: Mawer's U.S. equity portfolio

Andrew Johnson (00:00):

Hi everyone. Thanks for tuning into this episode with Grayson Witcher, Portfolio Manager of our U.S. Equity strategy here at Mawer. Our conversation ranged from hot topics today like currency, interest rates, and inflation, but we also talk about some themes that may impact longer term performance such as renewable energy and deglobalization. And I couldn't let him go without asking his thoughts about a potential slowdown in the global economy and what impact that may have on the portfolio. I hope you enjoy the conversation.

Disclaimer (00:52):

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Andrew Johnson (01:10):

Welcome back to another installment of "Playing the Plan." Today we are joined by Grayson Witcher, Lead Manager of the U.S. Equity strategy here at Mawer.

First thing's first: welcome back to the podcast, Grayson.

Grayson Witcher (01:22):

Hey Andrew, great to be back.

Andrew Johnson (01:23):

The last time you joined us was just a few months ago in April of this year, but a lot has happened since April. What have you been up to since the last time we spoke?

Grayson Witcher (01:34):

Well, we're working away—the markets have been volatile. A lot has changed over the last year to date. That creates a lot of opportunities for us. The good news is that when markets are flat or are slowly moving up, there's much fewer opportunities, so when markets are a little more volatile, it creates more opportunities. So that's been good. But otherwise, just playing the plan.

Andrew Johnson (02:01):

Excellent, yeah, so we're going to dive into the details of the portfolio shortly, but one of the topics that we've discussed a lot this year on the podcast with you and other guests has been the impact of inflation and rising rates. Those have somewhat a clear impact to valuations in particular. Another topic that has been coming up in client meetings is, "what about currency?"

We've seen the U.S. dollar rise substantially so far this year—really, going back to last summer—against a basket of global currencies. What impact does a big currency swing like that have on both the top line performance of a portfolio like yours and at the company level?

Grayson Witcher (02:43):

So, a couple of things. A few reasons why currency is something that we spend a bit of time on, especially in times like these, [is] currency is driven by rates. So you see different rates in different economies because, really, you can invest your money anywhere in the world—for a lot of people.

So, if you get a 5% return on a government bond in one country and 3% in another, you're probably going to move your money from country B to country A and invest at a higher interest rate, all else equal.

So the rates matter. Inflation also matters to this: higher inflation usually leads to a weaker currency because you have decreasing purchasing power. A couple other factors that we think about too [are] a strong economy typically is a good thing in many ways, including for currency. And the other unique fact that the U.S. dollar has is that it's a reserve currency, so you tend to see investors flock to safety in recessions or times of uncertainty.

So that's a big help for U.S. equities because you'll see the U.S. dollar being propped up a little bit as people move their money from perhaps some riskier markets to the U.S. market during a recession or preferably before the recession so that they can protect some of that capital.

So what do we do? Maybe a couple more tangible examples of how we're thinking about this: one is a revenue cost mismatch. Some companies have revenues in one currency—maybe they're getting paid in U.S. dollars, but their costs, for example, their labour costs might be in another currency because their workers are in a different country. We don't have significant exposure to that. That's something we're pretty mindful of and so we've tried to avoid that.

The other one I'll mention is translation. That impacts their companies more because a lot of the companies we invest in are big multinational companies; they have operations all over the world. So while they have big U.S. operations, they might also have businesses in Europe, for example.

Maybe they sold a product for $100 last year (a hundred U.S. dollar equivalent in euros last year) but given the weakness in the Great British pound or the euro, those sales could be worth 20% less this year than last year. So that's just less money that's being moved over from that geography to the U.S. at the end of the year.

Grayson Witcher (05:18):

One thing we've done to address that is just tweak our portfolio a little bit in terms of shifting a little bit to more domestic companies. It's not the only reason we bought some of these, but it's a consideration. So, companies like utilities that are all 100% U.S.-based or company like Martin Marietta, which is an aggregate company is U.S.-based; or Paychex, which is another company that's primarily U.S.-based.

So those can help reduce some of those currency risks.

Andrew Johnson (05:49):

Excellent. So obviously, the U.S. dollar is still cementing its status as a safe-haven currency and some great examples of how currency affects the businesses that you are investing in.

Coming back to the topic of inflation—generally speaking, we're all aware of how this is showing up for consumers. I think we have a pretty good idea as to how it shows up at the company level (generally speaking) but with persistent consumer inflation, it's typically only a matter of time before those consumers will require higher wages, higher salaries to afford those higher prices.

Are you seeing meaningful wage pressures in the businesses that you own? And what are the potential impacts or ways in which companies can manage through that?

Grayson Witcher (06:32):

Wage inflation has been around 5% recently, so quite high, certainly in more recent times. And that's combined with unemployment being low. Unemployment [is] at about 3.5% percent, which is a 50-year low. So those work together.

Why is this important? Well, if you're getting paid 5% more than last year, you're probably going to keep spending or perhaps even spend more money than you did which increases demand for products. The companies that you work for are probably going to try and offset the increased labour costs by increasing the price the products they sell. They don't want their margins, the amount of money they make, to fall, so they're going to try and offset that by raising the price of the product they sell. It's just a vicious cycle. As they raise their prices, then workers demand more money the following year to pay their bills. It can be a really tricky thing to defeat.

One of the things that is a little bit different is that wage inflation seems to be more impacting some of the lower paying jobs a little bit more now. For a while, it's had a pretty big impact on some of the higher paying jobs, which are some of the companies that we deal with a little bit more. So if you think about a company like Google or Visa or Texas Instruments—they're trying to find some of the best programmers in the world, they're trying to find some of the best engineers in the world. Those have been in short supply in recent times and so they've had to pay higher wages each year and seen wage inflation for several years now.

So I think some of those companies are a little bit more used to wage inflation. We're seeing it more now in companies that are perhaps a little bit less used to it as in the lower wage jobs. So you saw Amazon raise wages for their warehouse workers not too long ago to $15, and they've since raised them again.

Grayson Witcher (08:12):

We tend to have less exposure to companies with a lot of lower wage workers so we feel like the portfolio's a little bit more protected. We went through an exercise recently company by company and looked at that and felt like our portfolio was in good shape there. So that's positive.

One small example of how you can benefit from wage inflation and what some of these companies are doing are we have a company in a portfolio called S&P Global. They are primarily a ratings business, so if you think about getting a bond rating—if you issue debt and you need a rating for that debt so that buyers know how risky that debt is—you go to S&P Global.

They bought a company about four years ago now called Kensho [that's] an artificial intelligence (AI) analytics business. What they've been doing since they bought it is using that technology to try and automate more of the processes at the company.

So that's how they're offsetting some of that wage inflation pressure is that they are finding processes within the company that they can automate using analytics or artificial intelligence and replacing people with machines, basically, in some of those roles. So that's been quite effective for them. We've seen similar things on a number of the companies we're looking at. So there are ways for these companies to offset that.

Andrew Johnson (10:09):

Some great examples of just how the macroeconomic situation is finding its way down to the company level here in your portfolio. I wanted to shift gears a little bit into some of the micro-level topics that we've talked about before.

The last time that you were on, you talked about the utilities sector and you just mentioned it again. In particular at that time, you explained a deeper dive that you did on the industry. Can you just briefly remind us of what you did there and why you did it, and ultimately, whatever came of it? Did you make some investments or some divestments to that?

Grayson Witcher (10:42):

We didn't own any utilities for at least 15 years prior to looking at them in 2020-'21 and that was a good decision. They didn't perform that well; underperformed the benchmark over that period, but we thought we'd revisit again.

What we found that was a little bit different than over the prior decade was that utilities now have a runway to deploy that capital, and they can deploy it at a 9-10% ROE. So that's pretty positive. A lot of companies can deploy some capital, but often they can only deploy a certain amount of capital before they're going to run out of good ideas. And once you run out of good ideas, the returns tend to fall off.

With utilities, they seem to have probably a 15-year+ runway of good ideas where they can invest and get a 10% return on equity, and that's because they need to spend money to improve the electrical grid and to invest in renewables. So yeah, we did a big deep dive on the industry, spoke to nine companies, many sell-side analysts, did a bunch of reading on the industry. And as a result of that we added two companies to the portfolio—the Southern Company and AEP, American Electric Power—based on that core thesis, that they can deploy capital into improving and making their grid more resilient and they can invest in renewables such as wind and solar.

Andrew Johnson (12:24):

Are you seeing them deploy that capital as alluded to? And are you seeing some benefits of that in the portfolio already?

Grayson Witcher (12:32):

We are, yes, absolutely. They have a long-term plan, which is another attractive feature of utilities. As you know, Andrew, we're long-term thinkers. We're investing, try[ing] to invest over a five to 10-year timeframe. Utilities are very similar in that that they have a five-year plan on where they're going to invest capital. And they've followed that plan and it's worked quite well over the past year or so.

They've been a bit of a safe haven in these rocky markets and they've been able to deploy that capital into projects that are helping out, that are making the grid more resilient in the face of things like hurricanes and wildfires that you see more of these days.

And they're able to diversify the sources of energy; it used to be coal was a big part of it or natural gas, and now shifting over to still having some of those but also having wind and solar, which is also quite positive given the macroeconomic environment where you're seeing things like the Russia-Ukraine conflict where it seems like sources of energy can be cut off to certain parts of the world. So it is quite valuable to have wind and solar as an alternative.

Andrew Johnson (13:52):

I want to pick up on some of those investments into renewables. That strikes me as a theme that is likely more prevalent than just within the utility sector or the energy sector for that matter. Are there other businesses that you own where there's a tailwind to their long-term growth potential because of that theme that you just touched on?

Grayson Witcher (14:12):

A couple come to mind: one is Amphenol and another is Linde. Amphenol is a company that makes interconnects. So, if you think about electrical wiring between different parts of devices, they are basically wiring the connection between those different devices. So, you could think about your vehicle: maybe 10 or 15 years ago, you might have had windows that manually rolled up or down, or you might have moved a mechanical switch over to turn the heat up or down. Whereas now, it's probably, on most newer cars, it's a touch screen (and you touch the screen).

All that [still] happens, obviously; it still happens because you have to open and close vents or move windows up and down, so the mechanical movements are still happening. It's just happening with more interconnects behind the scenes.

Grayson Witcher (15:04):

So, this is a company with a great management team, a great business, and we think some pretty attractive skew. One of the reasons is because of exposure to electric vehicles (or EVs). Not only do they make these interconnects that I just mentioned between, say, the infotainment centre between the passenger and driver's seat, but they also make the interconnects between the battery and the motor on your vehicle. So, a lot of these interconnects are quite inexpensive. They may be 1-2% of the product costs; the average cost of them I believe is 66 cents. So, very cheap for a company like Ford or GM making a car for $50,000. They're not too worried about 50 cents or a dollar for an interconnect. But they certainly don't want to have any issues with those; they don't want to have to have a recall because they try to save two cents on some wiring going to untrusted source.

The other big factor is with Amphenol, you're seeing two to four times the content in electric vehicles that you did in ICE vehicles (internal combustion engine vehicles). And that's even higher in higher end EVs like the Tesla—Model X is about four times the content.

So, they really benefit from some of these shifts to greener alternatives. And that seems to be the way the world's going these days, and so they're a big beneficiary from that. So we like the fact that you get that upside from a company like Amphenol while still getting some of the core things that we like to see like a strong management team and a reasonable valuation.

The other one that I mentioned was Linde. So this is very similar, actually, to Amphenol. They've got a great management team and we've known them for years and owned the company for years. One of the things that's interesting about this investment is they both benefit from higher oil prices. They're an industrial gas company, and so you use different gases like oxygen in different industrial processes. You might want pure oxygen in a combustion process, for example.

They're both used in energy like oil and gas right now to help with refining in chemical production. So they're benefitting from some of the higher oil prices right now, which is good in terms of helping the resiliency of the portfolio. As you know, we're not trying to bet on the economy moving one way or the other, we're trying to make the portfolio more resilient in different scenarios. So they benefit from that, but they also benefit from the shift to hydrogen.

So, you're just starting to see this now a bit more, but we think this is going to make a fairly big impact for companies like this over the next five plus years. Hydrogen is a high-energy density fuel with zero emissions. The problem in the past is that to make it, you basically had to burn fossil fuel, so that offsets the benefit of it. Now, you're starting to see with more solar and wind being built, you're starting to see excess energy at certain times of the day. So, maybe there's just a lot of sunlight across the country in the middle of the afternoon, and it's just more than you need to power businesses and homes.

So what you can do with that is use that excess energy to make hydrogen "clean" hydrogen because you're using green energy. So that's quite positive. It ties in to utilities, which we talked about. Linde's going to be a big producer. They're big producer on hydrogen today, but we think over the next five plus years they're going to be a much larger opportunity for them, and so we think that's a great investment opportunity over the next five plus years.

Andrew Johnson (19:08):

Just sticking with some of those longer-term themes that may impact businesses that you own or would like to own—deglobalization has been talked and written about extensively. This was something that was unfolding to some degree the past few years. COVID obviously accelerated that with the supply chain issues that came about. More recently, you've touched on the geopolitical tensions that are out there that are flaring up may accelerate this deglobalization theme even further. What kind of impact does that have on your decision making within the portfolio?

Grayson Witcher (19:44):

We've seen a big shift. I mean, I think in the several decades prior to this, there was a globalization theme where you saw a lot of manufacturing being shifted from countries like first world countries like the U.S. to more developing countries like China and other countries in Asia. Those countries have benefitted and developed as a result of that.

As you mentioned, Andrew, now we're starting to see a bit of a reversal of that. Partly, it's countries like Russia and the war with Ukraine. Russia's not a huge part of the global economy, but they're certainly part of it, and so the sanctions have impacted them.

China's also seen tensions [flare up because, well,] I think it was highlighted by the pandemic, really. I think a lot of companies didn't realize how dependent they were on China or on single factories and in different parts of the world that, when they couldn't get products out of that factory, that was a big problem for them.

So, I think a lot of companies are seriously thinking about diversifying their supply chain now and moving some production closer to the end markets.

One example of this that I think could illustrate the point is semiconductors. So, semiconductors are the brains and the memory of computers. A lot of them were made in low-cost parts of the world. A huge amount are made in Asia. So, we've recently seen the passing of a bill called the CHIPS Act in the U.S., where the government has really realized that these semiconductors are critical to the functioning of the economy. A lot of the stuff that we use today from automobiles, smartphones, computers rely on these chips, and if you can't get them, you're in a lot of trouble.

So, the government in the U.S. is really trying to incent these manufacturers to bring production back to the U.S. and to take it away from China. One company we own that's involved in this, is Texas Instruments.

This company has a great management team and that's really one of the reasons we've owned them for several years. So, they're really ahead of this theme.

One of the things I'll actually highlight while talking about this that I think is just important is that I did the initial work on Texas Instruments several years ago, but the most recent update, a colleague named Ian [Turnbull] did the update on this. He was looking at several semiconductor companies globally—he works on the [Mawer] EAFE Large Cap team, so he was looking at companies in Japan and other regions of the world—and said, "Hey, you know what? I'm doing this update on semiconductor companies, do you mind if I take a look at Texas Instruments, too? I can do the work for you and perhaps give you a bit of a global perspective that you might not have had otherwise."

Grayson Witcher (22:49):

I think that's just a bit of a sidebar to highlight the fact that we have one process, one team at Mawer. It's quite an advantage that we can think globally on things like this. As part of that update, we talked to the company and they have a number of fabs [semiconductor fabrication plants] which makes the chips in the U.S. [and] have been shifting even more of their fabs to the U.S. over the past several years. Eight of their 12 are in the U.S. now and they're building five new high-throughput fabs over the next few years.

So this is a great way to benefit from having domestic production, not having to rely on China, and not having to worry so much about supply chain issues or shipping or just geopolitical tension interfering with their ability to get supply. This has been great.

The other thing that I'll highlight too, is once again, this is something that is quite beneficial for long-term investors like ourselves. A lot of other investors are, I guess, upset with the fact that they felt like maybe Texas Instruments shouldn't be spending this money right now. These plants take few years to be brought online so you're spending money now and you're not getting the returns for a few years. But for investors like ourselves, this is perfect because these are high return projects. Yes, you're not getting the money now, but if you're thinking over five, 10, 15 years, the return on capital for these projects is quite high. So this once again aligns perfectly with the way we think about things and makes the portfolio more resilient by taking out some of the supply chain and geopolitical risk.

Andrew Johnson (24:38):

Yeah, that general theme of deglobalization strikes me as a massive shift happening in the world. You and I grew up in an age where, really, [it] was marked by the proliferation of manufacturing and trade around the world. I think this is going to be something that a lot of our listeners and our clients are certainly paying attention to as we move forward because it could contribute to some of the longer-term inflationary pressures that we've been talking about.

You mentioned Martin Marietta earlier. Is that another name that might fall into the camp of this general theme?

Grayson Witcher (25:10):

It is, and this is a nice combination of micro and macro. Martin Marietta makes aggregates. So, gravel. Nothing too special there—they mine it out of a quarry. What is interesting about this commodity versus others is that commodities like oil and gas are global, so they're very expensive. They're easy to ship. A lot of the production comes from different regions of the world. And, to a certain extent as we're seeing in Europe right now, you can be fairly reliant on countries like Russia at times when you don't want to be.

Aggregates is the opposite of that. It's a very hyper-local commodity because gravel has a low weight-to-value ratio, meaning that it's quite cheap. You're not going to pay a whole lot of money for rock. So that means you can't ship it very far because it's very heavy. To take a truckload of rock from a quarry to your house to make a new garage pad or to pour a new foundation or something like that; to lay it under a new road—you don't want to be trucking it across the country. In fact, typically about 50 miles is the distance that you can ship it before it becomes too expensive.

Grayson Witcher (26:25):

So, that attracted us because it leads to less competition. These quarries are tough to build generally because people don't tend to want a big quarry right beside their neighbourhood. It creates dust; there's huge trucks driving in and out all the time. So, they're hard to get permits for. As a result, there's not too many of them in big cities, so you're really only competing with maybe one, two, three other quarries when you're selling these products. The competition is much more restrained.

So as a result, you get a bit of the benefit of a commodity, which in this environment, one of the benefits is they tend to be able to increase prices with inflation. So as you're seeing, like we talked about before, inflation being a little bit higher than it has been in the past, these producers are able to increase prices of their products with inflation so they don't see their margins fall, but they don't have to worry about the huge swings in commodity prices or other regions of the world bringing out more production that's going to really crush the prices of their product.

So that's why we added this to the portfolio fairly recently; we really like that it added some resilience to the portfolio. It's a strong competitive advantage business, trading at a reasonable price, and in a good economy it does quite well, but it also is able to add resilience to the portfolio in times of inflation when a lot of companies get hurt.

Andrew Johnson (28:02):

Maybe just before we let you go, I want to pick up on that theme of resilience in the portfolio. Given the rapid rise in interest rates that we've had so far this year, another theme that has emerged is the risk of a slowdown or even recession in parts of the world. We've already had a significant rerating of stock and bond prices so far in 2022.

So, here's a two-part question for you to wrap things up on: one, is there more pain to come, given the economic damage that we might be seeing unfolding over the next year? And what, if anything, can you do about it in the portfolio?

Grayson Witcher (28:38):

On the first part, "is there more pain to come?", there certainly could be. It does seem like inflation is staying quite high. You're seeing wages continue to increase. You're seeing more companies looking to increase wages, which is probably going to lead to more pressure there. Unemployment seems to be staying low and rates are going up. A lot of companies haven't seen their earnings really correct a whole lot yet, so that doesn't seem like they've felt the brunt of some of these cost increases yet.

Grayson Witcher (29:41):

So there certainly could be more pain to come, but as you know, we don't tend to try and spend too much of our time thinking about these kind of things. We prefer to build resilient portfolios and invest in companies that are going to do well if the economy does well, does better than expected over the next year or two, or if the economy does worse than expected over the next year or two.

So, a few examples of these that we think are going to lead to good outcomes regardless of how the economy does are companies like AmerisourceBergen. So, they are a distributor of medications. This is one where very few people stop taking medications in a recession, for example. A lot of medications dramatically improve your quality of life, and so that's probably going to be one of the last things you're going to stop doing, if you lose your job or you have less money to go around. So as a result, they're going to keep moving drugs, prescriptions from point A to point B, from the manufacturer's facilities to their warehouses, to the pharmacies where you pick them up. So we view that as being a fairly resilient business.

Another example would be a company like Hershey. Of course, many of you are going to be familiar with Hershey, they make chocolate [which] tends to be a relatively cheap indulgence. You don't really need to eat chocolate, but when you only have to spend a dollar or two, even if the economy's tough, you might cut back some of your spending on other indulgences that are more expensive and maybe just focus on something like this.

You saw that in 2008/'09 time period when we went through a big recession in North America. They grew throughout that period. And they're mostly exposed to the United States—over 90% of their sales. So you don't have a lot of currency risk with them as well (going back to one of the points we talked about earlier).

Another example, another couple examples would be Intuit. Intuit has two businesses. They make tax software, TurboTax, and they also have a small business, [QuickBooks, an] accounting software. Unfortunately, you cannot stop paying taxes if you're making less money or if the economy's tough. So they keep collecting money, and your small business is going to likely to continue run. There'll be some businesses that don't make it through, but that tends to be a fairly small amount, and a lot of businesses keep running. So those tend to be fairly resilient.

Grayson Witcher (32:07):

One last one would be Verisk. This is a company we've owned for a while. They collect data from insurance companies, and this is data that's required by regulators. So, if the regulators want to capture a lot of the insurance information on aggregate rates of car accidents, for example. Companies can use that to price their car insurance. The insurance cycle tends to be independent from the economic cycle, so we view that as a way to create resiliency in the portfolio. If we're worried about the economy and a recession, the insurance cycle operates at a different wavelength to the economic cycle. The insurance cycle, for example, is doing quite well right now while the economy is doing it quite poorly. So that's a way to create some resiliency in the portfolio because those companies tend to be making a little bit more money now when others are making less because of the weakness in the economy. So, that's one of the reasons we like that. It creates more resilient portfolio.

So, those are handful of examples of companies where we think they're going to do well in a variety of different scenarios.

Andrew Johnson (33:24):

All right. Well, three things I know I can't avoid: taxes, insurance and, ultimately, chocolate. That's a great place to wrap up. I always enjoy our conversations, Grayson, so thank you very much for making time for us today, and I look forward to the next time we get to chat.

Grayson Witcher (33:40):

Thanks, Andrew. Had a lot of fun as always. Thanks for the chat.

Andrew Johnson (33:42):

All right. Take care.