the art of boring™

EP64 | Introducing the new Mawer EAFE large cap strategy

Disclaimer:	**00:25**	This podcast is for informational purposes only. Information relating to investment approaches or individual investments should not be construed as advice or endorsement. Any views expressed in this podcast are based upon the information available at the time and are subject to change.
Andrew Johnson:	**00:40**	Throughout the podcast you're going to hear us talk about "the Fund." For clarity, the strategy we are referring to that launched on Canada Day in 2019, is our EAFE Large Cap Pooled Fund. We also have a mutual fund that launched on May 29th of this year. Welcome back to the podcast everyone! Today we have David Ragan, who is the portfolio manager of our brand new EAFE Large Cap Fund. Dave's been on the podcast before, and I think you're all very familiar with him. But we also have the fund's equity analyst, Stanislav Lopata, who we affectionately call Stas. So, welcome to the podcast, guys!
David Ragan:	**01:13**	Thank you very much, Andrew. Appreciate it.
Stanislav Lopata:	**01:15**	Hello, thank you for having us.
Andrew Johnson:	**01:16**	Stas—I believe this is your first time on the podcast, so first, welcome, and thank you for joining us. And second, I thought we could just start by having you share some background on yourself for our listeners.

Stanislav Lopata: 01:27 Thank you. It is indeed my first time on the podcast. I am delighted to be here, thank you for having me. So, I joined Mawer slightly more than a decade ago. And so far, it's been a fantastic journey. I think one aspect of the firm's culture is a very supportive environment for personal and professional development. So if you look back over my career with Mawer over the past decade, it's been a lot of transition. From initially starting in the rotation program in equities and bonds, then moving on to the Canadian equity team, where I worked for a number of years, then shifting to the U.S. equities, and then more recently, I was on the global equity team.

So, I think the way it's relevant to this EAFE Large Cap portfolio, is the breadth of experience and investment perspectives that I've developed over these years, and I think it would be very helpful for this fund as we move forward.

2:26 The other aspect of my experience I think that's relevant, is, if you look at the world and how it's connected these days—American companies, European companies—they have a lot of touch points. For example, you think about Nike and Adidas in consumer sportswear; SAP and Microsoft in enterprise software; even Visa and Adyen in payments processing; we own all these companies in different portfolios. And that's the beauty of our global platform within Mawer—even though these companies are competitors, we get to see the entire industry, how it evolves, because we share information on our investment platform and we're able to spot both opportunities and risks early, I think, in industries.

03:14 So I think that's a very helpful angle. And importantly, having worked on a number of teams at Mawer over the past decade, I've been fortunate to learn from very competent investors over the years. I call it, "standing on the shoulders of giants." We follow the same philosophy and process—the Mawer way of investing—yet there is a deep cognitive diversity. And each team has its own strengths that I think I would be able to adopt and apply to managing the EAFE Large Cap portfolio.

Andrew Johnson: 03:42 That's great Stas, thanks for that. I think that's some great background on you, and also you touched on it with speaking to the relevance of your experience and what that means for being involved with the EAFE Large Cap Fund that we're here to talk about today.

So, why don't we get into this new fund that we've launched and let's just start with the basics: what is an EAFE Large Cap Fund?

David Ragan: 04:01 To those of us that have been in the international markets for, I guess, 16 years now, EAFE is a self-explanatory term, but to most people it means nothing. It's an acronym, actually, exactly describing what the index invests in. So, Europe, Australasia, and Far East. It's all the developed markets around the world. And then the large cap is also in our fund's name and that tells you it's the larger end of companies.

Mawer has a long, storied history of naming our funds in very unique and entertaining ways by telling you exactly what we invest in.

Andrew Johnson: 04:37 Dave, you just mentioned large cap, so let's start right there with maybe some details. What does that mean? What is large cap when we're looking at the EAFE?

David Ragan: 04:46 Large cap is a very fuzzy term, and if you talk to 10 different investors, you're going to get approximately 10 different numbers. The large cap companies… some people cut it off at seven billion, some 10, some 15, 20…we're cutting off the smaller names [and] the midcap names mentioned the EAFE index. So, this fund will just be focused purely on the companies that are approximately $10 billion higher; hundreds of billions of dollars in some of the cases of the ones in the fund.

05:13 But one thing I should mention about this fund is it's imagined the same way as the rest of Mawer's equity asset classes—looking for the same kind of companies. Those high quality, compounding investors, high return on capital, smart management teams, reasonable prices. We just have cut off a subsection of the market, really, to provide investors who want to control, say, their emerging markets exposure, or their small cap exposure…this is a great vehicle for them, and they get the same, typical Mawer quality.

Andrew Johnson: 05:44 Yeah, so if it wasn't clear in your comments about describing the EAFE area of the market, that does exclude emerging markets.

I just had a thought: I was curious about…you mentioned knocking off a subset of the market. When you look at the portfolio itself, what does that mean in terms of a typical range of number of holdings that you're expected to have in a portfolio like this?

David Ragan: **06:05** The range of holdings…it has been in the 50s (number of unique names in the portfolio) since we started running this just over a year ago. We started running this internally, and then we funded an actual fund, coming up to almost a year ago. ([We] started on Canada Day last year.) Yeah, it's been in the 50s. I could see this one having maybe 40 to 70 names.

Andrew Johnson: **06:26** Then what would that compare to, say, for example, the wider portfolio, like the International Equity Fund that we manage?

David Ragan: **06:33** It's basically the same. The happy medium of "concentrated." So, you know the ideas, you know the companies, have conviction in them, but shop that hedge and that diversification against the unforeseeable problems that, talking in the time of COVID, you can never know what's going to happen. So, it's got that diversification and that benefit as well.

Andrew Johnson: **06:52** I want to explore something that you touched on, because you mentioned that we've been running this actually since July of last year, and I've been around long enough and you guys too, to witness our Global Small Cap Fund be launched, our Global Equity Fund, Emerging Markets recently, Global Bonds. If you can, from a very, very high level, just take me through what goes into launching a fund. How do you go from nothing, to a fund that is available for investors? What are the steps along the way?

David Ragan: **07:19** There is an unbelievable amount of administration that has to happen—hoops that have to be jumped through. Fortunately, we have an amazing operational, legal, administrative group at Mawer that really took a lot of that burden off of our shoulders. Then the heavy lifting comes when it's, "okay, we have to fill up this portfolio." Stas's introduction…he's too humble. He is a voracious learner, super high-energy individual, and [has an] ability to just plow through company after company.

I'm familiar with this universe. I've worked in this universe for 16 years. I think it probably took him a month or two to go through the entire universe itself and come up with a very similar [laughs] list that I had. So, these are the kind of companies that we're eventually interested in. There are some new ones that he came across that I hadn't, and vice versa.

David Ragan: 08:05 And I think that was the majority of this initial prep stage, where it's really getting to know the universe, getting that portfolio that we're happy with, learning how to work together because we're new to working with [each other]. Everybody else, seemingly, [in] research had a chance to work with Stas, but finally it's my turn. So, that was a part of it too. We actually took over a year to really get things smooth and running and make sure that, "okay, if we do this, this is going to be a Mawer-caliber of product." And we don't launch things that are going to be mediocre. We only want to do things that we can be top-quartile or, ideally, top-decile at.

Andrew Johnson: 08:40 Stas, how does it feel to hear those comments from Dave? And maybe more importantly, can you build on some of the comments in your experience so far?

Stanislav Lopata: 08:48 David is very kind. What I'm benefitting from, as I said, is standing on the shoulders of giants. And, what I think about when you asked the question, "what does it take to launch a fund?" I think there is an enormous amount of effort that might go unnoticed: from operations to compliance, to communication with current and prospective investors—including the research efforts. The reason I've been able to go through such a large number of companies in a very short period of time, is, we have a large number of tools in place within research that we've built over the years. And basically, the companies that we've looked at over the past three decades, we have notes saved [on] all of them, anything material we've ever come across on management, on business model industry, it's all there. So we have a very deep knowledge base from around the world.

09:46 Think about customers or competitors or suppliers—we have quite a bit of knowledge that we're able to tap. I think that's really the factor—that we have a lot of support within the firm, and we can easily pursue opportunities when we see them, because we have the resources in place to do so.

Andrew Johnson: 10:06 That's great guys, we've talked a little bit about the what, the how. I want to just ask the question why we would launch a fund like this? Dave, you did allude to it a little bit earlier in your opening comments, but why are we launching an EAFE Large Cap Fund?

David Ragan: 10:19 First and foremost, I think we can do it very well. Second, in all honesty, in the International Fund, I've had clients asking for us to do a product like this for years—they've wanted something that they can control their small cap, they can control the emerging markets.

Stanislav Lopata: **10:34** Andrew, if you think about an opportunity set for investors in the world with credit yields at levels where they're at, increasing in volatility in commodities and currencies affecting emerging markets, growing political trade uncertainties…I think what investors probably look for in their portfolios is stability. The essence of this fund from my perspective, is that we invest in companies that are leaders in their industries, benefitting from favourable demand and supply dynamics, and effective management overlay.

11:05 And so, within [the] EAFE Large Cap Fund, we aim to have a collection of businesses that are well entrenched, typically highly profitable, generally operating in multiple industries and geographies, and importantly, can adapt to whatever change comes their way. So, when you consider trends like digitalization, rising trade barriers, changing consumer preferences, environmental implications, and even more recently, very unprecedented events like lockdowns and closures of countries, I think what I see going through most of our holdings in the EAFE Large Cap portfolio is that these companies have high level of profitability and adaptability to shift and adjust to [a] changing environment, because they are entrenched, because they benefit from [their competitive] moat, because they have very strong relationships in place with their customers, and they have a real value proposition.

12:02 So, focusing on resiliency, I think, is one very important aspect when we choose companies; stability within industries—where they operate; and importantly, the management teams themselves. And finally, when we look at the quality, we also try to buy these companies at attractive prices so that we can compound capital at attractive, long-term returns.

David Ragan: **12:23** Stas already highlighted some of the core aspects of Mawer's culture: it's very open, very much an open-office concept—lots of conversations used to happen, physically, just in the open area, even between asset classes. But now we go to an online [Microsoft] Teams platform. So, there's relying on other teams, but I would really highlight the international equity team of our International Equity Fund. Since this is really a subsection of that, there is a large amount of cooperation between these two teams.

David Ragan: 12:52 One of the reasons we decided to have a separate team run this, is there is diseconomies of scale in a team. As you add more people, it's more difficult to have a really candid, active conversation. So we try and limit the size of our teams. And this is different than a lot of other managers that seem to just add another person, add another person. Eventually, not everybody knows what's going on, there's one magical individual at the top theoretically making the right decisions…but obviously, Mawer doesn't believe that one individual makes the right decision all the time. So, we have those smaller teams, but they're very close knit. They understand all the companies in the portfolio. So the EAFE Large Cap team—Stas and I currently—will be leaning on them heavily to share the workload, to source ideas, to debate ideas. But yes, Stas and I are the decision-makers on the EAFE Large Cap Fund.

Andrew Johnson: 13:41 I do want to end things with a couple of holdings, but before we do that, I'd be remiss if I didn't just ask how the strategy is doing in the current environment. We've spoken with other portfolio managers across the research team about what's going on, but maybe very quickly, how is it behaving relative to what the market is doing?

David Ragan: 14:00 We're not very superstitious people in general, however, both superstition and ego preclude us from really talking about performance. It's been surprisingly good. The COVID-crisis really hit is business models that we typically do not invest in: highly levered companies, companies with weaker business models, higher risk business models like the airline business, oil and gas businesses, where we have a lot of options in this universe and we don't have to be in energy. We actually have zero weight in energy. That's obviously really suffered. So, this crisis…the fund has held up well; it protected client money on the downside.

Stanislav Lopata: 14:42 I think what we've observed over the last nine months since launch, is the resilience aspect of our portfolio. Companies themselves have shown to be resilient in terms of stability of demand, or shifting where they needed to shift to preserve profitability. And, in many cases, making investments that would help these companies to emerge stronger coming out of this crisis. I was very pleasantly surprised with how our companies responded individually and then how the portfolio as a whole reacted in this very unusual environment.

David Ragan:	**15:19**	One thing that's really underappreciated by most investors is, 98% of the time in the bull market, that management team that's not making short-term decisions. That's not putting the company in a weaker position during that bull market, hoping that things will be okay by the time the bear market hits. The excellent management team is paranoid. They're always thinking tomorrow could bring a crisis, [and] "I don't want my beloved company going bankrupt, or going into severe financial problems because of this." It doesn't pay off 98% of the time, [but] that 2% of the time that you actually hit this crisis, these management teams are worth their weight in gold. And really something that we look for. Again, it's underappreciated most of the time, but really highlight[ed] the last few months that I would say our management teams are really appreciated and their long-term view on the business is very much appreciated and has been paying dividends to shareholders.
Andrew Johnson:	**16:12**	I have to assume that a scared management team is very attractive for the reason that we're probably scared investors—that's how we go about doing things as well.
David Ragan:	**16:22**	We're long-term, we're paranoid. We're not scared. In this business, you can't avoid all risk. You just have to make sure that you're conscious of the risks you're taking, you're being well-compensated for this, and the business can withstand a short-term hiccup, hopefully. It's really incredible to watch how many businesses were declaring bankruptcy pretty much right as COVID hit. That's an extreme level of weakness. Other ones have lasted a month or two months, three months with government support, but there's very high levels of weakness in a lot of businesses out there. And we don't really want to take a part of that.
Andrew Johnson:	**17:00**	That's great, thanks guys. Like I said, I did want to highlight a few holdings, maybe one or two, that can not only illustrate our investment philosophy, generally speaking, but maybe give a sense for clients as to the type of holdings that they can expect in the EAFE Large Cap Fund. So maybe Dave, I'll start with you. Do you have a particular name that you wanted to highlight?

David Ragan: **17:20** One of our top holdings right now, actually, is the company called ASSA ABLOY, which most people have never heard of, however, every day you come in contact with. They are the largest lock manufacturer in the world. They call them "access controls," I call them, "locks and things that keep people out that aren't supposed to be there and let people in that are supposed to be in there."

17:40 It's a really attractive company which I think is really underappreciated. You initially might think, "a lock company? Okay, locks go in when you build a new building, and that's it." Well yeah, that's part of the business, but a large portion of the business actually comes from replacement. So, you think about how cyclical the business would be when the lock on your office door, or your front door breaks. Even in the worst economic times, you have to replace them. So, around two-thirds of their business, actually, is very much not cyclical, and they have a huge install-base around the world, which provides that relatively recurring revenue stream.

18:18 One of the nuances of our thesis is that the life of a lock used to be incredibly long. When you think about the traditional lock on the front of house or in a hotel, it could have been there since the house was built. 30, 40, plus years. But as people introduce electronics into these locks—and hotels are probably the best example—20 years ago (okay, maybe 25-30 [years], I'm older than I realize sometimes) they evolved into the cards. Which, okay, someone loses the key, it's not the end of the world, they just issue a new card. (This was the card you put in the slot.) And then five, seven years later, it's the card that you just tap. And now, you're just actually getting to the locks that connect to your smartphone. So, you don't have to check-in at the hotel, you just walk in and your smartphone opens your door.

19:03 That's four changes of these locks in, say, three to seven years each. I mean, this is still a smaller part of the market, but as time goes on, these are larger: radio frequency signals change, security settings requirements change. The replacement cycle on locks could improve and just be a positive tide for ASSA ABLOY sales.

So, that's ASSA ABLOY, one of the top three holdings in the fund, and one I think is a good example of the kind of business and the insights that we try to bring to our investments.

Andrew Johnson: 19:33 Yeah, when I'm asked to give an example of a resilient business model, I tend to lean on ASSA ABLOY quite often in my responses. Stas, did you have one that you wanted to share?

Stanislav Lopata: 19:43 I have not one, but two! I'll share our investment thesis on Essity, which is a Swedish consumer products manufacturer. Essity, in essence is a very boring business. It manufacturers wipes, baby diapers, toilet paper, incontinence products under very well-known brands across Europe and in some markets in Latin America and Asia. A boring business, but if you look at profitability and growth over the last five years, on average revenue grew 8% operating profit at 10% a year, and earnings per share grew at 12% per year. So, not so boring results from this boring company.

20:23 The reason Essity stands out to us is, it's the number one supplier of tissue and incontinence products in Europe, and it's at least twice the size of the next largest competitor. It's a spin-off, so there isn't a lot of easily available financial information, but when we looked at the results under its recently spun-off parent, what I observed is there is almost two decades of profitable growth at the operating level.

20:52 The company grew operating profit at 8% a year for almost two decades. And the reason the company's been able to do that, is through product innovation, organic growth, effective acquisitions, [and] very high focus on effective cost management. The company has been able to continue to grow its asset base, and now there are about 90 manufacturing plants around the world. And this company continues to deliver stable, attractive, results for shareholders.

21:24 When we invested in Essity, initially, I thought that the valuation looks attractive relative to the base business. And if they can do what they've done over the past two decades, there could be an upside. What I didn't expect was to see runs on toilet paper around the world during this pandemic, and I think that was another surprising outcome from this pandemic.

David Ragan: 21:48 One interesting thing about Tempo (in Germany), as we call Kleenex or facial tissue, Kleenex, in Canada. I mean, it's a number-one brand there by far. They ask for a Tempo, not a facial tissue, not a Kleenex. It's a "Tempo," and that's Essity's brand.

Stanislav Lopata: 22:02 The second company I can tell you about is Shimano. It's a Japanese bike parts manufacturer, and what's notable about this company is next year, it will celebrate [one-hundred] years since its founding. And interestingly, Joseph Shimano is the fifth president of the company, and he is from the Shimano family. So, the reason I think this business is a very good business to own, is, they have about 50% market share globally of all bicycle parts and 70% global share of gears and breaks.

If you look at profitability over the past five years, it doesn't look encouraging—it's basically been flat in terms of profit growth over the past five years in Japanese yen terms. But I think what is changing is two things: one is, that China has been a major drag on demand growth, because of a bust that China has experienced in bike sharing.

23:02 So, if you look at what happened to China over the last 10 years, there were a lot of companies that rolled out bike sharing programs, and they were driving a lot of demand for bicycle parts. That bubble burst about three to four years ago, as all those start-ups ran out of money. And basically, that's been a drag for demand. I think we are approaching sort of…a troth of this phenomenon in China. If you look at other geographies within Shimano's business, they've continued to grow nicely.

And so, going forward, I think you could expect continued demand growth, profitable growth from this company. Then the second shift that's happening is ecommerce. Consumers increasingly are used to this Amazon phenomenon where they order something and they expect it to show up the same day. This is something that's very hard to do with complex logistics of bike manufacturing. [So] what Shimano has been doing over a number of years is moving the manufacturing closer and closer to their consuming market.

24:08 For example, they've been building production plants in Eastern Europe to reduce transportation time from their plants in Eastern Europe to major demand centers across Europe. So, I think what's been happening, is, demand trends are improving. The company continues to build its manufacturing base and continues to enhance its competitive moat. Even this pandemic has been a benefit to this company, because we hear many stories that bike shops basically sold out of bikes because people want to be outside, they want to travel—at least across short distances using bicycles. I think this company can continue to prosper for decades to come.

Andrew Johnson: **24:51** All right! So some fairly boring business models. We had locks, we had tissues, and toilet paper and bike parts. Excellent stuff. It goes to show you that even with a new fund, we can still find those boring business models out there.

I want to thank you for joining me and our listeners today. I'm really looking forward to talking to both of you when we check in on the EAFE Large Cap Fund down the road. So, thanks again.

Stanislav Lopata: **25:15** Thank you.

David Ragan: **25:16** Thank you very much.