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EP82 | Playing the plan: Mawer's EAFE large cap portfolio

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Andrew Johnson: 00:40 All right, welcome back to the podcast everyone! Today we are joined by Stanislav Lopata, AKA Stas, as he's known here at Mawer. I actually think you're lucky, Stas, because we have nicknames for a lot of people around the office, and I think you got off easy with yours. So' just for our listener's sake, Stas is an equity analyst here at Mawer. He's worked with several teams, but more recently he's been working with our global mandates in particular. This is his second time on the podcast. Stas, a warm welcome back.

Stanislav Lopata: 01:10 Thank you very much. I'm delighted to be here.

Andrew Johnson: 01:12 Well, we're delighted to have you, Stas. Over the past...probably nine months or so, you and I've had a couple of conversations. And on occasion, we've talked about taking time for reflection. And this has certainly been a year where many people have embraced that, given all that is happening in the world. So, what are some of the things that you've been reflecting on?

Stanislav Lopata: 01:32 Well, the COVID pandemic is a very unusual time. And it's indeed been a good opportunity for a quiet reflection. To me, it was really about what really matters in life. And I think what it reinforced is the importance of people around us, people we trust, and the strength of our connections with those people.

01:52 What helped me to stay grounded during the pandemic is our firm's collective mission, to do the right thing. When the market was falling back in March, the world seemed pretty bleak when the pandemic was rapidly raging throughout world...I think this mission of doing the right thing for clients really helped to stay focused on what was important at the time.

02:14 For example, at the firm, we have a firm-wide meeting every Friday, and that's where our president, Craig Senyk, brings all the people together (about 200 people these days on the call), and we share our stories, learnings, experiences. All of us [are] really trying to just act and operate as one team for the benefit of clients.

02:35 And these meetings are great. For me, they highlight how much work goes into making this firm such a great place, as well as the comradery that goes into it. And what we do is share learnings and experiences in terms of how we try to make this firm a better place.

Stanislav Lopata: **02:52** So, we think day and night about investing, but also our people think about making our client experiences better, in terms of cybersecurity, client service, data integrity, even communication.

03:21 And then it also highlighted the power of people and connections at the personal level. As I said, the world seemed pretty bleak back in March of 2020, and yet my colleagues…many of them, were [on calls] just sharing a joke, having a conversation about stocks that we looked at, and it was just a great opportunity to connect with my colleagues, including David Ragan, Vijay Viswanathan, and Paul Moroz.

03:48 There was comradery that we all shared, and that helped me personally to go through this very unusual time. So, I think that's what really mattered then, and still does now.

Andrew Johnson: **03:58** That's great, Stas. I often fall back on sports analogies because, well, it's one thing that I know well. And often the best teams in terms of execution are also the best communicators. I think what you've highlighted here is the importance of communication. They're clear, they're consistent, and persistent. And what you just outlined there is a great example—where we needed to ensure strong communication as we dispersed generally as a workforce.

04:21 Now, I presume you've also spent time reflecting on the pandemic's impact on markets as a whole. So, this has been a common question that I've asked our guests over the past several months. What has stood out when you look at the markets in particular?

Stanislav Lopata: **04:37** The pandemic has been a different kind of recession than historically. In part, you have a significant government intervention globally. Much of the world's borders are still largely closed; there are still many uncertainties that we face within the economy, and yet when I look at equity markets, which bottomed a year ago…

Stanislav Lopata: **04:55** Since March of 2020, equity markets globally are up. Generally, 70-80% year over year. And so I think this highlights [that] it's not easy to predict market ebbs and flows like these. And frankly, we don't try. It might be easy to get distracted, in my opinion, by the headlines of media, stock market quotations. At the firm, what we focus on is we follow our process.

05:20 Our investment process has guided us effectively through many cycles, different cycles, for almost 50 years—since the firm was founded in 1974. In addition, our chairman, Jim Hall, is there to occasionally remind us about what's important in investing and how to navigate uncertainty.

05:37 Jim has lived through many cycles, including the one back in the day when Nortel was a speculative darling in the investment community. I used to work with Jim directly on the Canadian equity team, and I recall he told me stories [about] how difficult it was to manage the weight in clients' portfolios, in terms of Nortel impact.

05:59 We owned a small ownership stake at the time in the 90s, and as Nortel kept rising, back then, Jim kept selling down to manage the risk in the portfolio. And I think this highlights our approach in general—that we try to find good businesses, but we are also very much mindful of the prices we pay.

06:17 And so, back in the day, it paid off to be mindful of the price that people were willing to pay for Nortel shares. And that worked out very well for our investors as well, at the time. We focus on fundamental principles: on the quality of the companies we invest in; looking for opportunities to own these companies at an attractive price; as well as manage [the] overall risk in the portfolio and exposures that we have in order to consistently compound capital for our clients.

Andrew Johnson: **06:43** We're approaching two years since the launch of the EAFE large cap strategy here at Mawer. You've given some great context on the market environment just now. Let's just take it a step further and maybe talk about the portfolio itself over an admittedly short, but very unique timeframe that you've been investing for this strategy.

Stanislav Lopata: **07:01** Yes. We continue to follow the process that is universal to our firm. We also look for opportunities to improve the process. One recent example is an innovation we are trying, [which] is to consolidate financials at the portfolio level. And the way I see it is, "ownership mindset in action," so to speak. Our portfolio holdings are subsidiaries that we own, which compound value at the business level.

Stanislav Lopata: **07:25** So, we combined financial statements of our holdings into one consolidated set of financials. As a result, we can track earnings growth, for example, quarter over quarter for our entire portfolio. We can also compare our portfolio-level earnings and profitability to the broader market universe.

07:42 Last year, what we observed is that our portfolio earnings have been materially more resilient during the pandemic versus the broader market. And portfolio-level resilience is one of the primary factors that we consider when we construct[ing the] EAFE large cap portfolio.

07:57 The portfolio is a set of data, but the market—we're comparing to the market as a whole—that adds a lot of companies to aggregate. And that's what we do as well.

Andrew Johnson: **08:06** Okay. So, you're comparing the earnings for our portfolio companies versus the broader market. I can certainly wrap my head around getting a clear understanding of the earnings at the portfolio level, but when you're talking about the broader market, that entire investible universe, how are you able to get a handle on all of that data?

Stanislav Lopata: **08:23** We have a team of technology and data specialists within the Mawer research team to help us build tools and analysis. This particular tool—portfolio level aggregation of financials—was developed by our tech expert Alex Lam. He was able to aggregate the entire universe of companies, consolidate financial statements for all those companies, and then compare it to the set of our companies.

08:49 And so [now] we can see how our companies compare at the aggregate level on profitability, leverage, earnings growth, so we can keep track of value creation at the portfolio level. And we can do that over multiple time periods.

09:05 Just to give you another example of the power of data, Alex recently ran a screen for me of all Japanese companies whose CEOs studied in the United States. I found that this combination has been favourable for investment results, which is combining Japanese technical skills and American management skills. We own two of these companies. One is Hoya, manufacturer of high precision glass, and the other one is Nexon, developer of video games. And that's what it is: it's combining Japanese technical expertise and American management competencies. And so far, that has resulted in very good results.

Stanislav Lopata: **09:44** We also were able to generate a list of inventory ideas from Alex's screen, and we're working through that as well. So, our technology team is now an integral part of our investment process, and I think our competitive advantage in investing.

Andrew Johnson: **09:57** Now, Stas, you mentioned the word "earnings" several times when you were talking about the aggregation of that type of data across the universe and across the portfolio. And earnings is one of those suitcase words that we talk about a lot here at Mawer that has many different definitions. What are we talking about when we talk about earnings, for this purpose?

Stanislav Lopata: **10:16** For this specific example, we looked at operating earnings. And the reason it's important to look at that in aggregate is…we get daily stock quotations, yet, what I think about is investing at operating businesses. Our companies are really just subsidiaries that we own that compound capital and generate value at the operating level.

10:39 And so when we compare profitability [and] operating earnings at the business level, over time, we can see there is real compounding of value at the portfolio level.

Andrew Johnson: **10:58** We always like to include a discussion or two around a couple of holdings in the portfolio that are illustrative of our philosophy and our process in action. And one theme that has been unfolding for decades, really, and around the world, is the evolving nature of supply chains. Just…becoming more complex. There's [also] demand for shorter time periods from end to end.

11:23 We've actually seen this bubble up in many opportunities throughout our portfolios. In particular, I'm thinking about software businesses that serve supply chain planning and the distribution logistics areas of the market.

11:33 One important part of the supply chain is served by freight forwarding. And these types of companies (and there's a couple of stocks in the strategy that operate in that industry)…one in particular is DSV. So, take us through DSV. And I'm just realizing that maybe a great place to start is to explain what exactly freight forwarding is before you start talking about the company itself.

Stanislav Lopata: **11:54** Indeed. DSV is a company recently added to the EAFE large cap portfolio. DSV is a global logistics service provider. So, another company we own is Adidas, and for Adidas to take their running shoes that were manufactured in China, it takes about 30 touch points for those running shoes to get from Chinese manufacturing plant to a retailer in Europe.

And so, what DSV and our other holding, Kuehne+Nagel, logistics companies do is to help Adidas manage that freight from a point of origination to a point of destination. Putting it onto a ship, and then maybe a train. In some cases, an airplane to get from A to B.

12:38 And these days, this business is very complex. And the complexity has been growing. For one, [the] pandemic has dramatically changed the way transportation takes place. For example, pre-pandemic, about half of all the air freight has been transported in [the] underbelly of passenger planes. With significant reduction in passenger flights, companies now have to find other ways to transport their goods.

13:03 And so, DSV and Kuehne+Nagel are right in the middle of it benefiting from this complexity. Also, these companies are global in nature; they have offices around the world, and complexity is their expertise. So they help many of our other holdings, frankly, to transport goods from A to B, and making sure that it is done on time, cost-effectively, and reliably.

13:27 Another good factor about the logistics business—it is still very fragmented. By our estimates, there are more than 200,000 logistics service providers around the world. Many of them are very local, small businesses. So, this provides a significant opportunity for DSV and Kuehne+Nagel to continue to win market share—because of their systems, expertise, global networks, relationships with their customers, as well as to consolidate the industry. And both companies have had a very good track record over many decades [in continuing] to grow market share in this still very fragmented industry.

Andrew Johnson: **14:04** I'm curious as to how you came across these two names. You mentioned that they do serve some of our current holdings in the portfolio. Was it awareness of that? Or was it a more specific part of the scuttlebutt process that we undergo through our investment process?

Stanislav Lopata: **14:20** When we were building EAFE large cap, at the time of launch, we went through all the companies in the universe from A to Z. And that way we initiated our ownership stake in Kuehne+Nagel. We liked the business and the management team, we thought the price was attractive. And as we've seen the industry develop through the pandemic, and there are a lot of favourable developments as a result, we've naturally come across DSV multiple times. And that company is also a very good operator, yet they have different end market and geographic exposures.

14:53 They also have a different approach to systems development. As well, DSV is more inquisitive, and Kuehne+Nagel is more organic growth focused. So, even though they operate in the same industry, their approach is quite different, and both of them have been very effective.

So, we decided to own both companies because they provide portfolio diversification as well as attractive execution, and still diversification across multiple end markets.

Andrew Johnson: 15:21 Great overview. You hit on two things that I wanted to highlight. One was going through all of the investible universe, A to Z, something that we refer to around here as "brute force screening." Really, just putting the work in to find businesses that might fit our philosophy. And then second, (we speak to clients about this a lot), even though we have similar type [of] businesses within the portfolio, you just hit it right on the head, which is, in these cases they can benefit and be diversified in many different ways just based on how they run their business story, how they have different tailwinds behind them, and serve different end users in the end.

15:54 Speaking of different end users and different businesses altogether, one other business that we recently invested in is Anglo American, which is, from my understanding, a globally diversified mining business. Just take us through Anglo American in a similar fashion.

Stanislav Lopata: 16:08 Anglo American is a global mining company producing iron ore, copper, precious metals like platinum and palladium, as well as diamonds. Historically, our firm has not been fond of investing in mining companies, because typically it's a commodity business with very limited differentiation, and historically has been difficult to consistently make money in this industry. Yet, commodity prices have been going up rapidly in recent quarters and for a few years now.

16:40 And so we decided to revisit our thesis, take a close look, understand these businesses better. What we observed is that it seems like [the] situation has changed meaningfully for the better. On the demand side, there is continuing to be healthy demand in terms of construction, industrial applications, even electrification (in terms of demand) for copper. On the supply side, companies increasingly talk about discipline. And that's really as a result of rapid price declines in 2015-2016, that reminded the industry that this template is important. And so what we've seen is, there are meaningful constraints on the supply side that we think is very favourable for prices.

We also observed that due to ESG considerations, many of the newer mines have to comply to very strict environmental requirements. And so that significantly delayed development of new mines.

Stanislav Lopata: **17:39** And finally, in mining, it takes 10 to 15 years in many cases to develop meaningful supply. And so what we think is, there is a favourable combination of healthy demand, rational supply, constraints and supply, and management teams that openly talk about discipline as well as shareholder value creation, rather than the production growth, which was the mantra in the past.

18:05 In addition, Anglo-American, we think, is [an] attractively priced stock because even though commodity prices have rallied quite a bit in recent quarters, we think the stock price is actually pricing at much lower long-term prices, and it seems like there is quite a bit of margin of safety in the price that we're paying for this company.

Andrew Johnson: **18:23** Excellent. Thanks, Stas. Those were two great overviews. Just before we let you go, was there anything you wanted to leave our clients and our listeners with?

Stanislav Lopata: **18:32** I think what's important is...just a reminder that even though we see a lot of unusual headlines in terms of how the economy is developing, how the world is progressing, politics across many countries, we continue to stick to the process; [the] time-tested philosophy that has worked for us for almost 50 years. And it's fairly simple: good businesses led by effective management teams that we can purchase at an attractive price.

19:01 The execution of this philosophy is actually very difficult, and that's what we've learned over the years. But we continue to grind it out and turn stones over, looking for attractive opportunities to invest [client capital]. But I think this pandemic also highlighted that we continue to be flexible in our approach. We have certain beliefs about what makes a good business, and yet we're willing to test our assumptions so that we can continue to evolve if the world changes. And I think [the] COVID pandemic is a good example of how quickly can the world change.

Andrew Johnson: **19:35** Certainly can. That's a great place to wrap things up, I think. Stas, thanks for joining me, thanks for joining our listeners. I always enjoy our conversations, both online and offline. So thanks for that. And I really look forward to having you back on the podcast.

Stanislav Lopata: **19:49** Andrew, thank you very much for having me. It's been a great pleasure.