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EP 156 | U.S. equity: Capitalizing on innovation and protecting against pitfalls

[00:00:00] Andrew Johnson: Hi everyone. Today, I'm joined by Colin Wong, Portfolio Manager for our U.S. equity strategy. We kicked off the conversation looking at the strong performance from both the U.S. economy and the stock market. Then we spent some time exploring the transformative impact of AI and potential investment opportunities.

We also talked about infrastructure and government spending more generally and the impact that that may have on certain business models and sectors. Finally, we covered some of the recent changes to the portfolio to ensure it stays resilient moving forward. Enjoy!

[00:00:33] Disclaimer: 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.

[00:00:50] Andrew Johnson: Hey, Colin! Welcome back to the podcast.

[00:00:52] Colin Wong: Thanks, Andrew.

[00:00:53] Andrew Johnson: It's good to have you back. It's been about a year since we've had you on to talk through both the U.S. market as well as the U.S. equity portfolio here at Mawer. So why don't we jump right in – the U.S. market has had a strong run over the past six months or so. To kick things off, I want you to just walk us through the factors that led to that strong performance toward the end of last year and in the first few months of 2024.

[00:01:16] Colin Wong: So the U.S. market has been very strong, like you alluded to Andrew, especially in the fourth quarter last year and first quarter of this year. Between that six-month period, the S&P returned over 23% in a half-year period. As you know, Andrew, we are bottom-up investors, so when you ask me that question, my mind immediately goes to thinking about the bottom-up driver that led to the current rally or the last six months that we've seen.

There are really three sources of stock market return. And number one source would be earnings per share growth. Second one is multiple expansion and third one being dividend. So roughly out of that 23%, roughly 20% of that return came from multiple expansion during this period, while roughly 1% came from dividend and the rest being earnings per share growth.

So during that period, P/E multiples of stocks went up from the low twenties to mid-twenties. When we think about what may impact stock multiples, it comes down to three major factors. Number one would be the expectation of further earnings growth in the future. Second is the discount rate, and then third is investor sentiment.

When we look at each of those three factors, let's start with factor one – earnings per share growth going forward. If you recall, a year ago, there was a lot of talk about potentially seeing a hard landing in the U.S. So a more severe economic downturn. That morphed into a commentary more closer to a soft landing. And now more recently, we're talking about no landing, as in there might not be a recession at all. That has helped people's

expectations and the market's expectation of earnings growth going forward.

Another factor would be until very recently, the interest rate seemed to have peaked and was coming down for the six months period. Of course, we've all seen what has happened in the last month or so, and we're seeing some of that reversal coming back during Q2 of this year so far. Lastly, investor sentiment has been mostly positive. Many believe that the worst is behind us. There's renewed excitement with productivity growth and things like AI and such.

If we peel back the onion one more layer, what we're noticing on a bottom-up basis is that many businesses and many business segments are actually flat or just slightly up. So they're doing okay, but not great. But there are a few noticeable winners, and they're up a lot. A good example of that would be one that we see a lot in the headlines: Nvidia. Stock prices during this six-month period have doubled, while another darling of the market Eli Lilly, which sells GLP-1 weight loss and obesity-related drugs, is up around 50% during that period. So we're seeing some really significant winners, while a lot of companies are doing okay or decent.

[00:04:07] Andrew Johnson: Just hearing you talk through all of that, one question on the mind of many clients and listeners is just given that broad-based strength in the market, are there any risks or vulnerabilities that are top of mind for you as you're managing the portfolio?

[00:04:21] Colin Wong: So anytime when we sense that the market – of course, we don't know exactly what the market is thinking – but when we're seeing a lot of market commentaries mentioning one thing, the risk is always that the opposite plays out. If we zoom back six months, one of the big factors that led to the current rally was the discount rate coming down and interest rates having peaked roughly around 5% in the U.S. 10-year yields. And it went all the way down to the high threes.

At that point, there was increasing consensus or talk of the Federal Reserve potentially cutting interest rates sometime during this year. Of course, that was a positive factor for the market rally, but the flip side could also be true when you talk about vulnerability. When a lot of people believe in one thing, and we lose that probabilistic thinking, a lot of money is spent behind one specific outcome, and if the opposite outcome comes up, that could be a significant source of risk.

A lot of the time, when we think about risk management in the team, we ask ourselves, “Well, what are a lot of people talking about? What are some of the market consensuses that we hear a lot about, how that might not be true, and how that might impact our portfolio?”

[00:05:30] Andrew Johnson: Now you mentioned AI, and the market is, as you alluded to, showing a certain level of anticipation around the positive things that this may bring as it rolls out into both our personal and our business lives. When you think about AI's potential to transform various industries, what impact do you see it having on general market dynamics but also related investment opportunities in both the near and long term?

[00:05:55] Colin Wong: There's no doubt that artificial intelligence (AI) has the potential to transform many industries like the Internet did. When we speak to many companies on our everyday research, the sense that I got is I would liken the current progress of AI to something that we saw back in the late 1990s to early 2000s with the Internet. In that, I mean a lot of businesses are using this technology a little bit. So much like in the late nineties, many big companies would have a website, but if you were to go on their websites back then, there wasn't a lot of information on it. At the same time, even during that time, there were some really heavy users of the Internet already.

A poster child example of that would be Amazon, which has its whole business embedded on the Internet. What we're seeing today is that many businesses are using AI to do various smaller tasks. For example, it could be

answering simple customer queries or automating certain repetitive tasks. There are a few that are increasingly heavy users of artificial intelligence, and we own a few of them. These heavy users include Microsoft, Alphabet, and Amazon, and those three companies., what makes them stand out is that they're not only using AI to improve their internal processes.

For example, Alphabet would be using AI to optimize its power consumption in the data center. They're also embedding AI into their products. So many of us have heard a recent announcement from Microsoft, its big launch of AI CoPilot within the Office suite of products. In fact, that is something that we're testing out here at Mawer to increase our own productivity.

Perhaps most excitingly – it's even the next level up between these three companies – is that they are building data centers. They're hosting a lot of these AI models in the cloud and providing companies, businesses, and individuals with computing power that enables innovation and enables different companies to test out different use cases for AI.

A common theme you notice across these investments that we're making is that they all have a very profitable existing business while investing into the future, which is AI in this case. Not trying to be cynical about the potential impact of AI, but large transformational changes happen very rarely, and it almost never plays out as most people expect. If you remember four years ago, RNA vaccines were all the hype, and there was a lot of talk about RNA vaccines having the potential for curing many different forms of cancer.

Seven years ago, we would be talking about blockchain and how that could supplant most of our record-keeping system. A decade ago, we might be talking about drone deliveries where we would be getting deliveries almost instantaneously via drones. All those platforms have made significant progress in furthering the technology in those fronts. But it's probably taking a lot longer than what a lot of people initially expected, and the impact might not be what we initially anticipated. That's why we have taken this approach where we're buying companies to have profitable existing businesses, so that gives us downside protection but also investing in the upside of potential AI disruption.

[00:09:24] Andrew Johnson: That's really great context. Another area that may be taking a backseat to the current AI news cycle is infrastructure spending in the U.S. There have been two major pending acts from Congress in recent years that have invested or earmarked over a trillion dollars across several different sectors to be spent on projects in the next five to 10 years. From your perspective, what are the potential opportunities that may arise from something like this, whether that's for current holdings in the portfolio or potential investments in the future?

[00:09:57] Colin Wong: I would even broaden that theme further, Andrew, into a more general theme of big government spending, and certainly we're no stranger to that here in Canada. The U.S. federal government spent over $6 trillion - trillion with a T – last year, which is a tremendous amount of money. So that level of spending is very stimulatory and really supports the whole economy and most businesses we own. Of course, there are some that are more directly impacted or more significantly impacted than others.

A couple that I would highlight in our portfolio that are being supported or being beneficiaries of the spending, one is Martin Marietta Materials. They own rock quarries that sell rocks for everything from road construction to residential home building to large infrastructure projects. Much of the government spending you spoke about is geared toward infrastructure, and Martin Marietta is poised to receive a lot of that funding indirectly from the government as these roads get built, as new power plants get built, etc.

Another one I would like to highlight is Carrier Global. A lot of us are probably very familiar with their products.

Carrier makes and sells heating and ventilation systems for homes and commercial buildings. Part of the government spending has been earmarked for energy-efficient products, so Carrier is benefiting from various rebates that the government might give for selling high-efficiency heating products like heat pumps or air conditioners.

It’s important to note that this government spending not only provides upside to these businesses that we own, but it's actually a significant source of downside protection. So if a recession hits, as we know it will eventually, these government programs tend to continue spending no matter what the economic cycles are. While the private sector might be retrenching, the government money will continue flowing, providing us significant downside protection for these businesses.

[00:11:59] Andrew Johnson: In the meantime, that spending may also, at least to some degree, play a role in the inflation story going forward.

To wrap things up, Colin, I thought we could talk through a couple of the recent changes to the portfolio. There are two in particular that our listeners are likely very familiar with. On one side, you and the team have exited our holding in Intuit, the provider of TurboTax and QuickBooks software that many people would be familiar with. And on the other side, you increased your holding in Nike. So talk us through those decisions and how they fit within the broader portfolio construction process.

[00:12:32] Colin Wong: That's right. We recently exited Intuit, a company we owned for over a decade, and it's been a great holding for us. It's been a 10-bagger for the fund. As you allude to, this company is the maker of TurboTax and QuickBooks for accounting and tax filing. The idea actually originally came from me doing research over a decade ago on another long-term holding of ours, Paychex. Intuit was flagged to be a potential up-and-coming competitor against Paychex.

So Intuit is actually a very good example of our investment philosophy at work – of buying wealth-creating businesses with excellent management teams and holding them for the long term. Why is that? Well, wealth-creating businesses become more and more valuable over time, but you have to be willing to be patient to let that wealth creation play out and see its full impact. And this is where our long-term approach comes in.

Another core part of our investment philosophy is thinking probabilistically about valuation. And this is another important reason why we were able to hold Intuit for so long. Periodically, stocks will get a little ahead of themselves. Instead of selling the whole position – like we would if we believe we only have one value for a stock, and if the stock price went above that then the stock is overvalued – we're actually more flexible than that.

We think probabilistically. So we think, “Hey, there is a significant chance that a company is worth more than what we think it is worth; things are even better than we thought; there are positive outcomes in the future that we have not anticipated.” While we were holding Intuit for the past decade, there were various times when the stock price had gotten a little bit ahead of itself, and certainly we've trimmed during that time. But we're able to keep our mind flexible enough for potentially significantly better outcomes, which played out over the past decade.

In the end, when you ask about the exit, it really stems from the fact that the stock was trading at the higher end of our value range, and we saw a better opportunity to deploy capital elsewhere. You alluded to one just now, which was Nike. So Nike is one of those better opportunities that we're currently seeing in the market, and we redeployed some of that capital from Intuit to Nike.

Most of us know Nike as a well-known clothing brand globally. Apparel spending has been going up globally for decades now, and Nike is well-positioned to continue to benefit from this trend going forward. It has a strong position and brand rooted in sports, and sports participation has also been going up globally, serving as a tailwind. The company has savvy management with an innovative and competitive culture.

With all these positive attributes, at the core of it, Nike is still a consumer business, and with that brings the ebbs and flows that come from consumer trends and consumption patterns. At the same time, the company has a decade-long history of navigating through different consumer trends and the ebbs and flows of consumer spending.

Currently, we might be hitting a consumption slowdown in China for Nike. There's a gap in product rollouts between launching their new generation of products and the older generation of products. We're seeing that reflected in the stock price, so we think that presents us a good opportunity to add to this compounder over time.

[00:15:54] Andrew Johnson: Well, Nike's certainly getting their fair share of our household budget these days with two kids playing sports. I think that's a great place to wrap up, Colin. As always, I appreciate any chance we get to chat about the portfolio. I'm sure our listeners do as well. Thanks for joining us and looking forward to the next one.

[00:16:09] Colin Wong: Thanks for having me, Andrew.

[00:16:12] Andrew Johnson: Hey everyone, Andrew here again. To subscribe to the Art of Boring Podcast, go to mawer.com. That's M A W E R dot com forward slash podcast. Or wherever you download your podcasts. If you enjoyed this episode, leave a review on iTunes, which will help more people discover the “be boring, make money” philosophy. Thanks for listening.