the art of boring™

EP 188 | The Long View: Global Equity Positioning in Uncertain Markets

[00:00:00] Today on the Art of Boring: Portfolio Manager, Manar Hassan-Aga, and our global equity strategy. We talk where the portfolio has had more and less exposure to tariffs, how we're navigating bigger day-to-day moves in stock prices and where we are and aren't seeing opportunities.

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[00:00:15] Rob Campbell: Manar. Welcome to The Art of Boring.

Manar Hassan-Agha: Thanks, Rob. It's a pleasure. Thanks for having me.

[00:00:20] Rob Campbell: Well, I should say welcome back because I think you know this, but one of my favorite podcasts from last year was when you came on to talk about the art and science around position sizing. If you missed it, listener, go back and check it out. Episode 151. We spent 40 minutes on this topic and it was just fascinating stuff. But from what I remember, Manar, a portion of our discussion was devoted to what do you do with position sizing when stock prices move a lot, and you shared a number of frameworks and base rates to help guide decision making in those volatile environments. And you can probably see where I'm going with this. We've seen a lot of volatility in markets so far this year, and especially over the past month. A lot of it negative, but also some real upside volatility too. And I'd love to spend our time together today just walking through a number of instances in the portfolio where stock prices have moved around and just understand how you and the global equity team have been dealing with the volatility.

Does that sound good? Perfect. Let's start I guess more generally, the last couple of weeks, maybe a month and a half, of just trade policy and the volatility that that has brought into the market. Just your general thoughts on the current moment.

[00:01:30] Manar Hassan-Agha: Yeah, I mean, highly applicable. I'm glad to do a detailed, deep dive into position sizing today. I was joking with the team—half joking with the team—that ChatGPT has changed the world, but not in the way the world may have thought. There was some speculation that the tariffs were calculated using ChatGPT as kind of a basic methodology and that's kind of reverberated across the globe.

The nature of the calculation is interesting in itself because it's focused on the trade deficit versus the actual tariff rates that are put on from the countries to the U.S.

And that's interesting because some countries structurally have trade surpluses given the U.S. is the consumer of the world. Rob, I have a trade deficit with my local Walmart, right? So that's not necessarily a bad thing because

I'm purchasing my groceries from them.

So not all trade is bad. It's not a zero-sum game, but it does feel that way through the calculation. And that creates problems for management teams that are quite significant because during Trump 1.0, for example, a lot of CEOs began mitigating their production away from China into other countries like Vietnam. Just to see sort of a higher tariff on this poster board, and that uncertainty has fed into decision making, where there's a mismatch between long-term commitments of capital expenditure and the uncertainty of the regulatory regime.
Why spend money if in five minutes later or a tweet later, the whole tariff complex is going to change.

[00:02:55] Rob Campbell: It sounds like you're seeing real hesitation in your conversations the last couple weeks with management teams with respect to the deployment of capital.

Manar Hassan-Agha: Absolutely. And I think that there's not been a lot of places to hide given the nature of the tariffs. Kind of pretty broad based. But also, I mean, if you think about long-term capital commitments relative to, let's say you want to reshore manufacturing. But if they're going to keep changing constantly, it's hard to make that decision.

And so that whole pause reminds me of some type of supply shock, like you'd see in COVID where we had lockdowns in the pandemic and the escalations have some reflexive element which we've seen in China and the U.S. Now there are some optionalities, Rob, in the reversals of policy. Right. There's an option that you have there because you can kind of reverse it. The longer that it's not reversed, the greater likelihood that there is damage that's harder to reverse.

[00:03:47] Rob Campbell: Can we talk about the global strategy itself? Global equity, obviously in the type of environment that we've had, there have been some positions that have moved down significantly. Can you talk a bit about where we've had perhaps more exposure to trade policy within the portfolio?

[00:04:00] Manar Hassan-Agha: And just linking this back to position sizing, I think that the whole Trump oscillation and whipsaw, so to speak, is a good example of the futility of trading too much on news flow. It's kind of like a great example that's happening in warp speed. The question is really: is the present value of all future cash flow swinging by five to 10% every few hours?

And so there's a lot of complexity and futility in that macro prediction. We own an apparel company that sources significantly from Vietnam, for example, and Cambodia. The impact of the tariffs obviously are direct on the cost of goods sold. But there's also second order effects on the consumer, which is if there's inflation that erodes the purchasing power elasticity of the consumer towards this discretionary.

The apparel company we own, we feel has strong relative scale advantages. The key, Rob, is that it's happening to all its competitors. Most apparel companies are producing in those areas of China, Vietnam, Cambodia, Sri Lanka, and Bangladesh, for example. And so as long as that's being applied evenly across, then we would expect the players with the relative scale advantages to win in that environment.

[00:05:10] Rob Campbell: So you're saying that the competitive dynamics between companies, the apparel companies, doesn't change that much, but what about the fact that every American is going to have to pay more

for their apparel?

[00:05:20] Manar Hassan-Agha: I think that every American might have to probably pay more now. This will depend on the pricing power of the business. It's not as significant when you look at it on a cost of goods sold basis, because this business has really high gross margins, and as a result, 10% pricing is required roughly to protect the profit on a dollar basis.

And so that would be $10 on a hundred dollars item. Again, not great. But not terrible. Certainly there might be some elasticity, but you can imagine there are certain players within this industry that have been growing really quickly, kind of peers or competitors, but they've been spending all these investment dollars and they have lower profitability to be able to withstand this degree of tariffs. So I suspect that they'll have to grow a lot slower, reduce their investment dollars and exit the industry potentially, or really reduce that.

And then we look at ultimately over five or 10 years, Rob, whether the underlying generator of decision making for the business is doing good. So in this case it would be, are they producing new products? Are they continuing to focus on what's in their control? And how robust is their balance sheet? And this is a kind of a net cash business.

[00:06:24] Rob Campbell: As you mentioned earlier on the futility of trading just given, I mean, presumably as we record this...things could be changing. But lots of offsets and competitive advantages that remain intact despite a more challenging environment. Can I ask you though, you talked about this particular company, but when looking at the portfolio overall, is it fairly representative of the type of exposure that each company might have?

[00:06:47] Manar Hassan-Agha: Yeah, this is critical and something we think about a lot, Rob. We have low overall kind of export-based models with direct exposure to tariffs.

[00:06:55] Rob Campbell: Okay, so this particular company would be sort of one of the exceptions in the portfolio?

[00:07:00] Manar Hassan-Agha: Yes, I wouldn't own a 50 stock portfolio diversified with apparel companies. Certainly from an export-based model, we have pretty low direct exposure on a relative basis. And this links directly to position sizing. Like what is your comfortability in that?

Over time, most stocks will follow their intrinsic value growth, but you want to have robustness within the portfolio. We have a preference, our tendency for asset-light, service-oriented, reoccurring type businesses, toll road businesses like the insurance brokers, Marsh and McLennan, or Aon, kind of earning capital-light royalty on growing insurance premiums over time. Mostly kind of domestic-based, service-oriented, and certainly without taking the risk of insurance.

What we're noticing is the second order effects of these tariffs on cyclicality are tending to have a bigger impact. So you have these direct exposure companies. Those obviously have been impacted in terms of their stock price at least directly. But the second order effects also are creating a bigger impact on cyclicality. So this is the idea that the consumers are going to get hurt. And so consumer discretionary advertising, for example, Publicis, because it's the largest advertising agency in the world.

There has been some perception of second order effects expectations that the ad market is slowing down. And that's a pretty reasonable expectation, although we do think that Publicis is more resilient than expected given the mix of the business today and it's quite a reasonable valuation.

[00:08:28] Rob Campbell: Since you mentioned the consumer, actually one of the observations that I've had when looking at the portfolio's experience so far this year is that a number of consumer-oriented businesses that we own, despite your point that there might be some hesitation to spend, a lot of them have done quite well this year on the back of perhaps a more disappointing 2024. And so I'm just curious, what's the anomaly with some of those holdings?

[00:08:50] Manar Hassan-Agha: What we're seeing, Rob, is consumer staples had a pretty rough post-pandemic period. And so broadly, some of the consumer staples had a margin hit due to the inflation. They struggled with volumes. Now what we're seeing is a volume recovery in some of the businesses, particularly some of the ones we own, and some normalization in the inflation rate, which allows them to recover their profitability.
The interesting part of this here, Rob, for us from a position sizing and portfolio management perspective, is there's a lot of randomness in the short term. And so imagine you're relying on the short-term price action for your decision making. Well, clearly it's been a bad basis for good repeatable decisions because many of those stocks that we're referring to within our portfolio are top performers this year.
And so if we step back, we think about shifting the focus from line items to the whole portfolio. And the idea is that parts of the portfolio are always going to disappoint you all the time, right? So consumer staples last year, maybe big tech this year. And that comes hand in glove with good diversification. But over time, what we're trying to accomplish is if you eliminate all the factors through diversification and principle thinking, we want to end up with a portfolio of businesses. The factors that shine out of that are good business, good management, reasonable prices.

Rob Campbell: I would suspect you're seeing management teams make some good decisions. I'm curious if you can talk just to Admiral Group and its experience so far this year.

[00:10:20] Manar Hassan-Agha: Admiral Group had a tough 2024. It's the largest UK motor insurance business. The thing with the motor insurance business, you get inflationary pressure on the car repairs, for example. And so you might misprice insurance for one year. Now it's a short-tail insurance business, so the next year they reprice and capture those trends. So there's a lot more volatility in the stock relative to the profitability of the business.
But when we look at Admiral, I think it's a very interesting story because most property and casualty insurance companies, the industry itself, the base rates, they don't create wealth. They're not very great businesses because the business is commoditized and capital intensive and typically really pressured. A lot of capital chases it on the upcycle.

But Admiral has really high persistent returns on equity. And our goal is to figure out what business it's in, because it's clearly not necessarily in the P&C insurance business, at least directly. The story here is that Admiral has a competitive advantage in underwriting the insurance premiums, which it then seeds to other insurers. It offloads it to other insurers. So it becomes, in our view, more of a broker because it's seeding the premiums, and so it's much more capital-light of a business as a result of that.
We think of it a little bit more as an insurance broker as we're trying to understand why there's a high persistent ROE, and I think that's one mental model we apply: looking at the returns and trying to understand what business

it actually is in versus just the base rates of the industry. That's a good starting point, and then you can see if it's the exception to the rule.

Rob Campbell: Okay, so Admiral Group, doing a really good job for the portfolio so far this year. Can I ask about UnitedHealth, which perhaps hasn't. It had a pretty big down day, last week I think. What's happening with UnitedHealth?

[00:11:55] Manar Hassan-Agha: What's interesting, Rob, is again, short-term price randomness. It was having a phenomenal year to date. I think it's something that we own businesses for eight to 10 years, but it's having a pretty phenomenal year to date on a relative basis, in part because it's domestic... it is the U.S.'s largest U.S. healthcare insurer, with kind of adjacent businesses, because it's completely vertically integrated, and it has a pharmacy benefit manager and it also has this attractive analytics franchise for health data.

But long story short, it was kind of more defensive and it had already been priced to some degree in terms of risk premiums coming around from the administration. And so this is not unusual for it. Every four years you have an election cycle and there's always an increased level of uncertainty around the next administration. Will the U.S. move towards a fully public healthcare system?

What UnitedHealth has shown over long periods of time is that the status quo is quite sticky. The business has significant scale advantages and that allows it to be the most efficient operator, and it's moving towards value-based care. More logical assessment of UnitedHealth would be the government would want to work with this, because it has the highest scale advantages and the most efficient operation in order to improve care.

Now this reminds me of Admiral we just talked a little bit about, Rob. What's happening here is the insurance business. You try to estimate the cost. So in this case it would be the medical utilization rate. How many people are coming in into the hospitals and your different services. And that can be lumpy and volatile, right? There is an element that you can't predict as well, but it does reprice. That repricing typically corrects in a shorter timeframe, and that regulatory headwind tends to create volatility. But when we look at the business, it's very wealth creating because it's quite asset-light. There's great alignment from a management standpoint and quite a reasonable valuation because a lot of that uncertainty is being priced today on the business.

[00:13:37] Rob Campbell: Okay. So, a move like that presumably evokes a lot of emotion, but it sounds like what you and the team are doing are really going back to base rates and recalibrating the odds. It doesn't sound like the odds have changed that much in your assessment.

Manar Hassan-Agha: Our assessment is odds haven't changed much within the investment case or the thesis around that. The base rates remind me, Rob, in the position sizing podcast, we talked a little bit about revisiting Michael Mauboussin "man overboard" moment. And in the man overboard moment, the stock is down more than 10% relative to some benchmark and recalibrating your temperament and your emotion, which is essential, and effectively you go down the list of the quality, the valuation, the momentum. It's a base rate check kind of checklist. And it just allows you to kind of take back control of your own emotion and look at it more rationally.

[00:14:20] Rob Campbell: Manar, some of the big market movements that we're seeing, are they providing opportunities for you and the global team? Are there companies that you wanted to hold? And what we often get

is just, "Hey, U.S. Tech, some of these big companies," it's been part of the market that's sold off most precipitously over the last little while. Are you and the team seeing opportunities there? And if not, where are you seeing opportunities at the moment?

[00:14:42] Manar Hassan-Agha: I'm a big fan of Game of Thrones, Rob. Peter Baelish in Game of Thrones says, "Chaos is not a pit. Chaos is a ladder." And so certainly I think that some of that chaos can provide some opportunity. I don't know that you want to rush into things directly impacted by the fire. If there's a fire, I'm not sure you want to rush into the fire, but I do think that there is opportunity around things that have sold off just generally due to some cyclicality, temporary hits perhaps to the profitability of the business, but not potentially permanent impairments in the earnings quality and earnings power of a business.
We have more recently started buying a stock around pessimism at the time around the Chinese consumer particularly. It's a beauty and cosmetics business. It's quite balanced from a revenue exposure and supply chain perspective, which we liked. So very robust. And beauty and cosmetics has been around for more than 7,000 years, back to the Egyptians and so on. So this is quite a durable business.

Rob Campbell: Vanity.

[00:15:36] Manar Hassan-Agha: Vanity. Vanity is quite a durable trend here, Rob. Now you have to stay with the times. Obviously it's changed in terms of what is being used as beauty and cosmetics. But this is a company that has a lot of scale advantages in distribution and marketing. It spends more than the next few competitors by a couple of factors.

I think the distribution points and the balanced revenue and supply chain exposure, while it has proved to be pretty fruitful, we couldn't have predicted perhaps the degree of these tariffs. But certainly that balanced supply chain exposure was helpful. And the business has a tendency to outperform the beauty market and kind of take share, and it's been capitalizing on a lot of missteps of peers.

I think what's important here is that there'll be a lot of kind of nascent beauty competitors with the online age. Like you can just launch...Rob and Manar's eyeliner on Instagram.

Rob Campbell: Yeah, you'll be the face of that.

[00:16:27] Manar Hassan-Agha: I don't think it'll be a very successful business, Rob, unfortunately, but let's imagine we launch an eyeliner business on Instagram. There's not a lot of barriers to entry anymore. It used to be, you needed to have TV marketing, massive expenditure. So we can launch our eyeliner on Instagram and get $50 of sales. But the barriers to scale are massive because you need distribution. You need all the distribution points. You need the right supply chain.

And if you think of that within the tariff standpoint, you need a balanced manufacturing exposure. Imagine we were sourcing all our eyeliner from China because that's easy drop shipping. And now we're facing 145% tariffs, effectively.

So we try to keep an open mind, have strategic inventory. I think that's the key, Rob. One of the things is that the generals are always preparing to fight the last war. So there is an element where we're trying not to invest in the

present, right? Certain things have really won, perhaps, over the last five years. We have to be sharp and our mental model around that is: what will the next person think in 12 months? So it doesn't necessarily have to be the thing that's won over the last five years.

[00:17:34] Rob Campbell: Manar, can we end just with your thoughts on portfolio behavior? Obviously it bounced around a lot the last little while, but how do you assess that looking back over the last couple of months?

Manar Hassan-Agha: We've tried to stay disciplined around the idea that we're long-term business owners of these businesses. That over time most stocks follow their growth and their intrinsic value as long as you don't overpay. And so we continue to focus on staying balanced across quality and value.
Certain days have had quite notably better downside capture. So that is consistent with how we would expect the portfolio to move from a behavioral standpoint. And over time we believe that our portfolio statistical advantages around valuation, around returns in terms of quality, around our alignment in the insider ownership will reflect in the growth in intrinsic value.

But coming into this trade war, we were diversified globally and we continued to do that from a first principle standpoint—Canada, Europe, and across market cap ranges often. So I think we have a solid balance around that from a global equity strategy standpoint.

And I think it was Cliff Asness who said something that resonated with me, Rob. "The difficulty of doing the right thing should not be an excuse to do the wrong thing." So we'll continue to do the difficult thing, which we think is the right thing: to be diversified, to be balanced, and stick to the philosophy and process. And we trust that will play out over time.

[00:18:54] Rob Campbell: Very good. I think the wrong thing, Manar, would be for you and me to have a side gig with an eyeliner company. So let's not do that.

Manar Hassan-Agha: Yes.

[00:19:02] Rob Campbell: But certainly do appreciate your time and insights. As always, love having you on the Art of Boring.

Manar Hassan-Agha: Cheers. Thank you.