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EP 167 | Semiconductors, GLP-1s, and Defense Companies: Powering the International Equity Strategy

Rob Campbell: Hi, everyone. Rob here. International equity, portfolio manager, Peter Lampert joins me on the podcast this week. We talked through some of the main drivers of portfolio returns this year and spend time in a market that has gotten a lot of attention lately, Japan. Peter talks through one of the portfolio's newest additions, Hitachi. And I think you'll enjoy hearing what Peter and the team actually do in assessing management, both qualitative and quantitative elements designed to evaluate strategy, operational excellence, capital allocation, and ultimately whether we can trust them.

[00:00:00] Rob Campbell: Peter, welcome.

[00:00:02] Peter Lampert: Thanks, Rob. It's great to be back as always.

[00:00:04] Rob Campbell: I'm super glad you're back, especially since the International Equity Strategy is having a great year. I'm wondering if we can start there. What's going well in the portfolio?

[00:00:15] Peter Lampert: As always, we stick to our investment philosophy and process, and over the long term, we think that's a winning strategy, but in the short term, markets are volatile. From year to year, sometimes things go our way and sometimes they don't. This year, we're happy to have had a strong year in our International Equity Strategy, both on relative and absolute performance terms.

There are three main drivers. One is semiconductors, two is obesity medicines, and three is defense companies. If we just briefly walk through each, on semiconductors, there's obviously been a lot of enthusiasm around artificial intelligence (AI). Everybody's looking at NVIDIA. They're not the only winner here, though. It goes down the whole supply chain. We have holdings like TSMC, which manufactures all of NVIDIA's chips as well as for many other customers. ASML and ASMI are two different companies that provide the necessary equipment to the likes of TSMC to make these advanced chips.

Our view has always been that there are very strong companies looking from a bottom-up basis with strong competitive advantages in the semiconductor supply chain because the manufacturing is so complex. As a result, most of these companies have near-monopolies in the niche in which they operate. The barriers are just so high that once a company establishes technological leadership, it is very difficult for anyone else to catch up. All of the companies I just mentioned – TSMC, ASML, ASMI – that applies to all of them. They have this great backdrop of growing demand with more and more need for more advanced chips. AI is just really an accelerant for that.

Now we're seeing a spending boom. All of the big players are investing in CapEx and demanding more AI chips, benefiting the entire supply chain. But that wasn't our view. That's not our thesis. We're not making an AI bet per se. That just falls into this long-term need for more technological advancements, and this is just the flavor that it has happened to come through.

[00:02:18] Rob Campbell: Technology is still a relatively modest proportion of the overall portfolio if I'm not

mistaken. Some of these stocks have done so well, Peter. What have you been doing with them? Did the increase in stock prices reflect a genuine increase in intrinsic value?

[00:02:30] Peter Lampert: Yes, in many cases, that has been the case as the stock prices have been moving higher because the fundamentals have been improving, the outlooks are improving, and the long-term demand outlook has strengthened for many of these companies. In the case of TSMC, for example, that industry has gone from deflationary to inflationary pricing. So in the last few years, not only are they seeing more volume demand, but they're able to push through price increases, which wasn't the case historically.

We think that's sustainable over the long term because their competitive advantage has widened over the competitors. The technology has gotten so difficult. Nobody else can match them, and that gives them pricing power. NVIDIA has even come out and said, “We're happy to pay TSMC more. They are so valuable to us.” Maybe they're not capturing enough of that value. So that's an example where the long-term growth rates in our DCF model have increased.

Intel, one of their major competitors, is now planning to outsource its most advanced chip-making model to TSMC. So even though Intel makes its own chips, it can't keep up. It can't make the most advanced chips, and it needs to outsource to TSMC. So that's another competitor dropping out. They will still try to catch up longer term, but at least in the next five years or so, they will not be catching up. That is more business for TSMC and more market share.

When we go back to our DCF models, we are increasing our assumptions. The fundamentals and the long-term outlook are getting better. Our fair value range is shifting such that the intrinsic value in our estimate is higher. But at the same time, in some cases, we think even with that shift, the share prices have moved even faster so that they've moved higher in the fair value range. We have trimmed back some of the positions. So all three that I mentioned, we have reduced the weights. They are still important holdings in the portfolio, but we have managed the risks around that valuation.

[00:04:24] Rob Campbell: You mentioned obesity. I'm presuming you're talking about Novo Nordisk.

[00:04:27] Peter Lampert: Certainly Novo Nordisk is the big one. That's what people are talking about. Everybody's focused on Ozempic and Wegovy, their diabetes and weight loss medicines. As we've talked about on previous podcasts, when nobody else was investing in obesity, Novo Nordisk took it seriously and continued to invest. As a result, they are leading this market right now. It's also now that the market is so large that people are expecting the obesity market to be the largest therapeutic drug class, larger than anything else. Everyone else is trying to get into this.

Roche has acquired GLP-1, another obesity medicine that they want to develop. Chugai is developing one. These are other portfolio holdings. So those stocks have also done well. They've joined in the rally. In some cases, we think the market's getting a little optimistic. Many of these drugs are still many years away from getting to the market, but it is going to be a big market. There will certainly be more than just the two winners, which are Novo Nordisk and Eli Lilly today. Others will enter that market longer term. We have a number of companies in the portfolio that could benefit.

[00:05:35] Rob Campbell: And finally, the defense companies you mentioned.

[00:05:38] Peter Lampert: As everyone's aware, after Russia invaded Ukraine in 2022, defense companies had a short-term pop. The stock prices moved higher, yet we still bought them after that, thinking that the long-term investment case had dramatically improved. So it was not just a short-term bet that there would be more spending during the war, but in the long term, the calculus had changed. European governments are more willing

to invest in defense. The populations are more supportive of that, and the perceptions have shifted from defense being a negative to society to actually positive.

It's important for Western society to have strong militaries supplied by strong defense companies that can protect Western values. That's the long-term view. It just so happens that there are also a number of great bottom-up companies in Europe. BAE, Rheinmetall, and Thales are the three leaders in their home countries of the U.K., Germany, and France, respectively. These are some of the leading defense companies in Europe. They are best positioned to benefit from that increasing defense spending. They're very well-managed, have leading products, and have very strong long-term outlooks.

So the market has come around to the view that it's not just an initial pop, but the long-term investment case has gotten much stronger for these companies. And that's been another driver of the strong portfolio returns that we've seen in 2024.

[00:07:00] Rob Campbell: What's interesting to me just covering those three areas is that, of course, we focus on wealth-creating companies. You would expect that as a result of those competitive advantages, the intrinsic value of the businesses would increase over time and indeed for their stock prices to rise. But it does sound like across all three elements, we have been prudent from a risk management perspective, not letting those positions get too big.

[00:07:23] Peter Lampert: Definitely. We have been trimming back in all cases, even though our fair value ranges are shifting higher as the outlook improves.

[00:07:31] Rob Campbell: That begs the question, where are you finding interesting new ideas for the portfolio? For those who follow the international strategy, it's hard to ignore that several of the additions to the portfolio over the past years have been Japanese companies. Coincidence? Or can you give us some insight into that?

[00:07:49] Peter Lampert: We happen to have found a few opportunities in Japan; Hitachi and Nippon Sanso are two of the most recent additions, both Japanese companies that meet our criteria. One of the themes playing out in Japan has been a narrative around improved corporate governance. That's been a long-term push in Japan since 2013 for companies to meet global standards and focus on creating value for shareholders. That's a mindset shift in Japan that hasn't always been the case.

For that reason, it's often been more difficult for us to find companies in Japan run by management teams who meet our high bar from a global standard. But there have been some changes. We think there's a bit more hype than substance in terms of the amount of changes that we've seen. It certainly is not across the board. We think the average Japanese company or the majority of Japanese companies are still managed less well than most global companies, but there are pockets where we have seen huge improvements. And because of that, companies like Hitachi and Nippon Sanso now meet our criteria.

[00:08:59] Rob Campbell: Can you give us a little more insight into Hitachi specifically? Because I think it is one of the biggest additions over the past year.

[00:09:05] Peter Lampert: It's a top 10 holding for us now. If we go into M42, our internal notes database, I see that I had visited them in Tokyo in 2014. I'd met with the management team at that time and my assessment was that they were saying all of the right things. At the time, it was a messy conglomerate. They had a clear strategy and a vision to streamline the business, to become a more profit-oriented and return-focused business, to shed some of the weaker business lines, and to bulk up in the stronger business areas. But it was just too early to tell or make a judgment if they would be successful on that.

Many companies have great plans but fail to execute on them. So we've followed the company over the years, and now it's fair to say that the company has executed extremely well. They've shifted the portfolio. They're now very well-positioned to benefit from areas where they can have market leadership positions, earn higher returns on invested capital, and have strong growth drivers. Specifically, they can benefit from the digital transformation and the green transformation while helping their industrial customers really make that shift.

In that process, they've really adopted global best practices. Five out of their 12 directors on the board are non-Japanese nationals, which is very unusual in Japan. They've really gone out and acquired other companies around the world. They've brought in that talent, promoted that talent, and gotten over any of those cultural differences to embrace other views and global best practices. We think that's a big reason why they've been successful in making this shift and now are best-in-class in terms of meeting global standards, focusing on return on invested capital, and creating value for shareholders.

[00:10:47] Rob Campbell: Your mention of management has me wondering – and I've had this question from clients over the years – with excellent management teams being one of the three elements that we look for in companies. But that being largely a qualitative judgment, it sounds like from your description of Hitachi, one of the things that might glean or give us some insight is just understanding what management has said and whether they have actually followed through on a strategic logic. What are some of the other things that you do to really evaluate management?

[00:11:17] Peter Lampert: For us, we've made it systematic while also leaving room for that subjective judgment as well in the process. The first step is breaking it down into subcomponents. Management's job is really to set the strategy, to demonstrate operational excellence, to demonstrate strong capital allocation and trustworthiness, and to show that they're aligned with shareholders. If we break down each of those four components, in some cases, the assessment is more qualitative, and in some cases, it's more quantitative.

For example, in Hitachi's case, the strategy and the portfolio shift that they had planned made a lot of sense. They wanted to compete in areas where they were stronger and could attain market-leading positions and be rewarded for that. But at the same time, the numbers have to back that up. Do the numbers show they have come through on that? Are they in businesses where they can earn higher margins and higher returns on invested capital? And yes, that has been the case. We've seen those improvements come through. It's the same with operational excellence. The beauty of Hitachi is that it's easy to benchmark it against some of its listed peers. Its IT division is very similar to an EPAM or Globant and we can look at the metrics.

How have they been growing? How are their margins? Are they gaining market share? Are they managing costs? On their electrical side, we can benchmark them against Schneider, for example, and see how they're performing. Looking qualitatively, understanding some of the improvements that they've made, but also quantitatively, do the numbers support that story. For Hitachi, the capital allocation piece has been extremely important. They have made a lot of divestitures and acquisitions. In those cases, firstly, we want to understand: Do they make sense? Are they aligned with the strategy where the management team is taking Hitachi? That's usually the easier one to assess.

Then digging into the numbers, the capital allocation: Do we expect that they're creating shareholder value? How much are they paying for the assets? What return do we expect? Are they earning a return on capital higher than the cost of capital? In Hitachi's case, we think they've actually been doing a good job of that. They've been disciplined on the prices that they're willing to buy and sell. Lastly, the trust piece. Especially in a big conglomerate like this, there's a lot of transactions that have taken place. It can be messy. There are some related parties and some joint ventures. Have they done anything to harm shareholders? Have they shifted value away from the main listed company?

So those are things that we want to look into and check. In this case, Hitachi came back with a clean bill of health. We think that they are managing the business in the best interest of shareholders. They are aligned. They have set targets to earn a higher return on invested capital aligned with shareholder interests. As you can see, we're looking at the qualitative aspects and trying to understand the story but not taking anything for granted and backing it up with the numerical evidence as well.

[00:14:05] Rob Campbell: My takeaway from that is just the proven track record being an important thing that we want to see first before we'll be comfortable investing. Peter, where I'd love to end the conversation: Clients always love to hear macro views. I recognize that we're a bottom-up investor. Your description of how we've just happened to have found a number of companies in Japan, and we're not taking a view on Japan specifically for those additions.

But for those of our listeners who are a little bit more macro-inclined – from your conversations with companies and management teams while doing your bottom-up work, do you detect any clues with respect to the bigger picture that you think are worth sharing and perhaps might be a little bit off the radar for your average listener?

[00:14:44] Peter Lampert: Macro is a tough place to add value or have insight or to make money from some sort of macro insight. It is important for us. We call it situational awareness, watching what's going on in the world. How is the economy evolving? More from a risk management or risk mitigation perspective, are there risks we need to be aware of? The big one right now is the possibility of the U.S. going into a recession. If you look at asset prices, stocks are priced for a soft landing in the U.S. We've had very high inflation and high interest rates, and normally, that would trigger a slowdown in the economy and a recession.

There is some weakness showing in the labor market and in consumer spending, especially among those lower-income consumers, showing up in the results of the dollar stores in the U.S., for example. By and large, investors are still expecting the soft landing to play out. The biggest risk that we see is where those expectations are not met, where investors are surprised because the economy is weaker than expected.

[00:15:47] Rob Campbell: If I could interject, your perspective is as an international equity portfolio manager, so somebody who's not investing in U.S. companies. This preoccupation with the U.S. is just because it is the giant in the room. This is the biggest economy, the one that impacts and ripples across the rest of the world. Is that right?

[00:16:04] Peter Lampert: That's exactly right. Not only from an economic standpoint, because the U.S. is such an important contributor to the economy and global trade, but also from a monetary standpoint in terms of what the Federal Reserve does and how asset prices price long-term bond yields in the U.S., setting the cost of capital largely for the rest of the world. That's why it's important even for international investors. That's why we're looking at the U.S. dollar stores, even though we're certainly not investing in those in this portfolio.

[00:16:30] Rob Campbell: Okay, some concern about the health of that economy, perhaps. Do you see that bubbling up in individual companies that you invested in? And ultimately, what do you do about it?

[00:16:39] Peter Lampert: So far, we haven't seen any significant exposure in the companies in our international portfolio, even the ones that have exposure to the U.S. consumer. Where we have seen the weakness is in China. Many companies have seen weakness in their China business, but I didn't mention that off the top of my head because that's well known. I think it's well-recognized that the Chinese economy is very weak and slowing. That's a drag on global growth. It's going to be the U.S. that makes or breaks the global economy at this point.

In terms of our portfolio and how we're positioned, as always, we want to have a resilient portfolio that can do well in all scenarios. As you pointed out, this year, year to date, it's been a strong market with more bullish sentiment, and the portfolio has done well. We've been able to keep up in that environment. But I think importantly, we're also very focused on the downside protection. If some of these downside risks come out, we expect the portfolio to outperform in those scenarios.

We did have some stress tests so far this year, such as in early August. On August 5th, the Japan market was down 12% in one day; a very huge move. The yen was extremely volatile, and a number of markets around the world were quite weak for about a week. They bounced back. It seems like a distance memory now, but the portfolio outperformed quite significantly during that, demonstrating the downside protection. I'm reassured to see that. I'm happy to see that the downside protection is coming through. Hopefully that would repeat if we did get a larger, more sustained downturn as well.

[00:18:11] Rob Campbell: Well, I appreciate that insight. Obviously, our aim is to deliver results over the very long term for our clients, but it is reassuring to see that pattern of behavior hold up even over shorter-term periods. Peter, that's all I had for you today. Thanks so much for coming on, and I appreciate you sharing your insights.

[00:18:25] Peter Lampert: Great. Thanks a lot, Rob.