



[00:00] [Rob Campbell] [RC] With bond yields on the rise, Portfolio Manager Dave Ragan joins me to talk about what a higher hurdle rate means for the stocks that we own, the good, steady businesses that we've walked away from, and how he decides what's worth the risk when the bar keeps rising. My conversation with Dave, up next.

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[00:36] [RC] Dave Ragan, welcome back to The Art of Boring.

[00:38] [David Ragan] [DR] Thank you very much. Appreciate it, Rob. Good to be back.

[00:40] [RC] We're here to talk about international equities, and so, of course, the first question I'm going to ask you is about the U.S.

We've seen a pretty remarkable rise in long-term yields, whether it's the 10-year or the 30-year, and I know we spoke about that with Paul most recently. Our quarterly update with Stu and Kevin talked about that a little bit. I want to get your perspective, though, from someone who doesn't invest in the U.S. specifically, but for whom I imagine this rise in yields is still quite material.

[01:08] [DR] The international strategy does not invest in the U.S., but the U.S. is the largest market in the world. Everything that happens in the U.S. drives, I think, what happens around the rest of the world as well. The 10-year government benchmark continues to rise and just peaked around 5.3%, which is exceptionally high, given the recent history. It's much higher than it has been in the last five years. But in the longer historical context, it might not be actually that much higher.

[01:38] [RC] What does this mean from a company perspective when you see that kind of a rise in yields? I asked you, just international versus the U.S. Has this rise in yields really happened across the world?

Why is this important to international companies?

[01:51] [DR] It's definitely happened around the world. Germany, back in the lows, just post COVID or during COVID, was negative 50 basis points as a government rate. Now, it's up to 3.46%. The UK and France, their rates are going up partially also based on fiscal concerns of the governments and their lack of spending discipline. The UK is 5.5% right now, and France is close to 4.8%. Even the longtime deflationary country of Japan has seen inflation and seen rates go up, going from 0% to now around 3%. It's been very much a global phenomenon.



However, the one notable exception would be China, where market interest rates continue to tick lower. They are having more economic issues, but there's also a lot of outside reasons why that's lower. The Chinese have tight capital controls, so a lot of capital is stuck in the country.

The real estate market was the historic area where the Chinese population could store value, but a long-running real estate correction has made that unattractive. The stock market hasn't been attractive either, so there's a lot of money just being stocked away in bonds.

Even banks, they're not lending as much as they normally would. They're actually just buying bonds. There are a lot of reasons why China is a bit of an anomaly. Generally, I would say outside of China, it's a global phenomenon.

[03:13] [RC] You share just very generally, so thinking across the board, in terms of the work that you and the team do, what do these rising yields mean in terms of valuing companies?

[03:24] [DR] The core thing it does is it increases the discount rate. The discount rate is the rate at which we take all future cash flows that a company will generate and then discount them back to today to find the value of the company. So higher government rates mean higher discount rates mean lower values to equities unless they have higher growth.

It's often a product of inflation, so you're also looking at the businesses. How is the pricing power? In regards to your question, will a company have to eat this higher cost and that will hit their margins, or will they pass it through and they'll see higher growth. It changes a lot. We've had discussions recently where five years ago, a 9% IRR was incredibly attractive, but 9% isn't what it used to be. It's not that much higher in many of these markets than the bonds.

So when investors are making that comparison of should you invest in equities or bonds, they're looking at that relative spread, and that's what we're doing. You have to get a higher and higher IRR to make it more attractive, materially more attractive, to take that equity risk on.

[04:27] [RC] If the current value of future cash flows is worth less today, all else equal, why is it that we haven't seen much of a correction in equity markets so far?

[04:35] [DR] I think the big moves in 2022 were very much more chaotic. Inflation was really spiking. It actually spiked to over 9% at its peak in the U.S., and the market was worried that central banks had lost control.

They were coming in too late. They were slowing it too late. And also, valuations during that period were much higher.

This period where the interest rates are going up, but it's 1% over a reasonably short period. We're not coming from basically zero rates to interest rates of a few hundred basis points. The move is less.

The valuations, I would say, have already been normalized somewhat. We did have the big correction on valuations during that 2022-2023 period. So we started the period with better valuations.



It's much more organized. It's a few moves. It's not lots of moves. It's not rapid moves. I don't think there is a perception that we think central banks have lost it. And then also, there is good growth.

AI is obviously a huge driver in the markets today. It's driving a lot of the returns and their growth rates of 30%, 50%, and 100% a year. That doesn't matter if interest rates are 1% to 2% higher. What matters is the growth. So those are helping drive it.

Oil prices are high. Those are very profitable businesses right now, so they're helping drive it. And even entities like banks, where this higher interest rate, a relatively benign credit market where they're not seeing loans going bad, they're making more money.

So again, that's helping drive the market today when it was a lot more challenging and risky and scary back in 2022-2023.

[06:07] [RC] I'm glad you brought up 2022 because I wanted to ask you about that. Looking back, it felt to me that with that sharp rise in interest rates at the time, it prompted some activity on our behalf in the portfolio to adjust for different conditions. Are we seeing the same degree of activity within the international portfolio today?

[06:27] [DR] No, I think there's a lot less. The style diversification in that period, we saw an opportunity to increase the resilience of the portfolios to help reduce some of that volatility with the higher quality, higher-priced names. I think a lot of those changes that we made back in 2022 and 2023 remain so today.

We have more style diversification and one of the key ones in this case is duration diversification. Some high-quality, higher-priced companies, higher growth, but also some more moderate-quality, and more moderate-priced companies. So, a lot lower duration of assets. We have that diversification. We haven't really reacted as much.

The AI exposure that we have built is really unrelated to discount rates. That is a good portion of the portfolio. So no, I'd say the transactions that we've done in the portfolio with this rise in interest rates have been lower.

We have added to some of our banks and some other entities that do better with a higher interest rate environment. But I think that's been a lot more moderate than in the past.

[07:25] [RC] I was going to ask if you could elaborate a bit further. You talked about these two sides, things that will do well. Can you bring that to light maybe with some specific examples either that we've added more recently or we've always had and have relied upon to provide that ballast on both sides?

[07:39] [DR] A great example is a bank that we initiated in the portfolio more recently. This bank is one of the core banks in Ireland. And of course, everybody who knows the history of the global financial crisis will probably wonder, Ireland, that was one of the PIIGS.

And this is exactly why I think we got our reasonable price on this one, because there is that reputation of a problematic environment, a problematic high-risk banking environment. The reality is, this is just a post-forest-fire area where it's one of the safer areas because they've been so heavily regulated. It's changed so dramatically.



The competitive environment has improved so much that it has turned into what we would say is one of the good banking environments, where you have consolidation of deposits and loans and mortgages into a few entities that are acting rationally. They're focused on lending domestically.

One of the key aspects of this good banking environment is that these deposits are controlled by a small number of entities, and they fund the businesses. Funding is relatively stable. When interest rates go up, the cost of funding does not go up, so they earn a higher spread on the loans to deposits.

We would say that the deposit beta is 0.2%. So when its rates go up, deposits only go up by 0.2% of how much the interest rates go up. You get that widening spread, you get more profitability, and this is always a reasonable valuation.

It has come a long way, but it's still looking relatively reasonable. It does provide that diversification in the portfolio where it benefits from interest rates staying higher, even going moderately higher, especially in this market where credit costs and the economy are doing okay.

It's not exactly booming everywhere in Europe. I was just in London for a financials conference, and all the banks pretty much universally were saying that they're not seeing any credit issues. So that's another Goldilocks scenario.

[09:47] [RC] What about on the other side? You mentioned how the IRR spread over the risk-free rate in many instances is lower than what you've seen historically. What's an example of a business that we own where maybe that spread is smaller than it's been historically, but we feel pretty comfortable taking on that risk?

[10:05] [DR] I think it's more the opposite. We've walked away from a good number of companies and stocks that we would have held in the 2010s when interest rates were low and falling, because these companies are earning good returns on capital. It's very stable, but it's growing at 5-10%, maybe 5-8%.

That's just not sufficient anymore, especially if you're trading 20 times earnings or higher. It's a different environment where we're walking away from those ideas because they don't have sufficient growth to make the math work on that higher discount rate, and it's happening more often. I'm not saying that the markets are overvalued at this point, but I would say that it's a lot more neutral than it was when interest rates were 100 or 200 basis points lower.

[10:49] [RC] What about in China? You mentioned China earlier, how rates there are lower. I would imagine as a result of that, the IRR spreads must look quite attractive. Are we seeing lots of opportunities in China as a result?

[11:01] [DR] The spread looks larger. We always take the discount rates and the risk-free rates as a given. This is what it is there.

However, we then have a judgment factor where we decide how much of an equity risk premium to put on top of these risk-free rates. Given the reasons I stated before on why I think the Chinese rates are artificially low, we're adding more of this discount rate on there. There is higher political risk.



I think they are artificially low, so we do want a much higher return level from an investment in that area. One of our top holdings, Tencent, its IRR is still above 10%, and that's more reasonable, even though that would be a 700 or 800 basis point spread, which would usually be exceptional in most cases. I think it's more attractive, but it's not as screaming attractive as it would be in normal cases, because we have that adjustment. We have that unusual discount rate.

[11:55] [RC] You mentioned that the opportunity set today looks different than it did in relative attractiveness to, let's say, the early 2010s, I think was the period that you referenced. You also mentioned how there's just more style diversification in the portfolio today. What should investors make of all this?

Or put differently, we've come through a period in which I think the quality factor has had some significant difficulty compared to other factors in the market. Where does that leave you today in terms of looking forward to where the value might actually reside?

[12:26] [DR] You never know where the market is going to move, where the value is going to arise, so you have to have a toolbox ready. You have to have that quality view, because I still think reinvesting in a business at a high return on capital and having a long, large growth runway is very attractive. It's more attractive when discount rates are lower and falling, but that's not always the case.

That's a good piece to have in your portfolio. There are some businesses that are going through some hyper-growth periods, and we're spending a lot of time understanding how long it can grow, how high, how long, and that would be the AI names, like memory names or picks and shovels, where it's actually semiconductor equipment or semiconductor manufacturing. We also have capital-cycle businesses where these ones may be a bit more commoditized.

It could be something like BHP Billiton in the portfolio, but that's one where you're looking at the CapEx, how much supply is coming on, how easy it is coming on relative to the demand growth, and there's a cycle. It goes up when the prices of a commodity go up. Everyone's spending as much money as they can to try and bring on their capacity, and eventually they ruin the party.

Oil and gas is another great example of this. I'm born and raised in Calgary. Every time that oil prices go up, CapEx goes crazy and ruins the party.

Those in the right part of the cycle, you can earn money with some good companies with some good assets, and it does provide diversification of style. We're not nailed down to only one way to do things because that creates more risk in the portfolio. Then having all these different facets of diversification is very valuable.

[13:59] [RC] Very good. Dave, that sounds like a great spot to end on, a great message, the value of diversification. Thanks for coming on the podcast.

[14:05] [DR] Absolutely. Thank you.

[14:07] [RC] Hi, everyone, Rob here again. To subscribe to The Art of Boring podcast, go to Mawer.com.



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Companies Mentioned:

BHP Billiton