the art of boring™

EP 238 | More Chess Pieces: Adapting Portfolio Construction to a Different Market



[00:00] [Rob Campbell] [RC] Episode 208 of The Art of Boring, back in February, was entitled “Nostalgia Is Not a Strategy: Adapting the Investment Playbook to a Changing World Order.” Paul Moroz, my guest back then returns to expand on the same topic. We talk market structure, information flows, and outsized stock price movements. Ultimately, Paul makes the case for why the current environment demands that investors rethink the execution of portfolio construction, even as time-tested first principles remain very much intact.

[00:30] [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.

[00:40] [RC] We are recording this towards the end of October, and it has been a heck of a week. We have seen some big price movements, both for the better and worse across a number of businesses, buy in large, we can seen some of the lustre coming off the AI trade over the last couple of months**.** What are some of the things that you and the team are really focused on right now, either that pertain to what's going on out there, or that might not, in terms of what's happened this past week?

[01:17] [Paul Moroz] [PM] What we've been doing is trying to focus on creating balance to the portfolio, recognizing that this new technology, AI, and the stocks that represent the AI CapEx complex are going to be volatile. It's not a straight line, and it's going to be not just this last week, but a period of time, could be years, where there will be emotion that spills into those stocks. And emotion that spills out of those stocks.

Our team is focused on the fundamentals, providing appropriate exposure as the business environment evolves, and then seeing places where valuations perhaps give us an opportunity to add to or subtract. We're moving on that. What's so fascinating is the way the market is trading in this environment is different than 10 years ago, because I think the structure is different.

I'm not sure how much I've talked about this before. You have more options trading. It's zero-day options, which we never had before. You have greater retail participation. The frequency of that trading and market activity has perhaps followed the evolution of media and communication, social media, which is often short soundbites and the spillover of thoughts and emotion from humans that ends up in the stock market. That impacts trading.

I think there's a lot more thematic trading than in the past. What you see is these baskets that trade across the globe. Maybe it's more defensive one day, it's more AI CapEx the other day, but the changes don't necessarily relate to the fundamentals of the company. They relate to the emotion or the trade.



What does that mean for us? What are we thinking about it? It's staying grounded in a simple question: what is this worth? What is any one investment worth? And as the market swings towards the higher or lower end of the fair value range, how can we adjust the portfolio, still in a balanced way, but keep on improving the odds quality of the portfolio, the valuation, the underlying business momentum? How can we improve things as the market evolves?

That's what we've been giving a lot of thought to, myself as a portfolio manager, and others across the team, in these volatile markets.

[03:45] [RC] To start really zoomed in and then eventually zoom back out: you mentioned zero-day options, and some of the big changes in market cap we saw this week, whether it's Microsoft going up or something like Google going down. You've seen a change in the way that businesses are marked, or what they're worth**.** But how do you guys think about that in the moment, as a team, when an earnings announcement comes out and you see the reaction in the market? How do you digest that, and figure out what to do?

[04:12] [PM] You have to take that information in and understand: are you sized right? Are you sized approximately right for the exposure that you want? Let's take Alphabet as an example, which just reported. People don't understand, perhaps, that we've moved from just meeting or beating earnings expectations. That used to move the stock a decade ago, and now the stock trades on a few numbers, or a delta.

I think the big thing with the Alphabet release was their growth rate for their search business grew at close to 12%. That's price and number of clicks, versus it seems like the market was expecting something like 15%. Then that set the stock down over 10%. Now, let's put this in perspective: Google still grew 25% over the year, but that subtle change drives the market.

So what do you do? You take that information in and say, okay, are we seeing a deterioration in clicks that relates to AI queries? Is that something we have to think about, the business model evolving? Is this just a random walk in terms of the variation? You're not going to exactly predict that specific number every quarter. Does it mean something completely different? How much should you be adjusting or fine-tuning your models when you get that information in?

That's the balancing act we have to do for really every company that comes in, thinking about the size of it. Now, interestingly, with the Alphabet case, we thought, size-wise, we went into this quarter and had actually trimmed the position prior to that, and by a pretty good size, trimmed 80 basis points, as that business has evolved, and as we took into consideration the price, the fair value range. We just want to shift the odds of the weight in the portfolio a little bit. I'm talking for global equity right now.

That process, it's not like you get the answer when you get a number out, and it's still that debate in the case of Google around search. That's going to be open for a long period of time, and it's unclear what direction it goes. So much of our job is let's keep on moving as the business world evolves, shifting on valuation, and sizing our securities appropriately in the portfolio.

[06:34] [RC] You mentioned the basket trading, the really short-term trading, the market structure impacts on how things are different today than even a few years ago. I've heard this described, I think, by Cliff Asness, as the



less efficient market hypothesis: with so much noise and things moving in the short term, there's actually a greater opportunity for long-term oriented fundamental investors. Of course, the experience of the last little while has been the opposite. How do you square those?

[06:59] [PM] You have to be able to get into the rhythm of the market and be able to weather the volatility before you can take advantage. Over the past year, we've made some changes to the portfolio. We needed to diversify it to a point, but one of the thoughts we immediately had is we wanted to have more names in global equity to take advantage of this market structure, close to 90 names now versus 50 names over a year ago.

You have more chess pieces, more pieces on the chessboard to move around. There are things that have moved rather quickly, for context, like within a couple of months, a 10% or 15% move.

The way you have to take advantage of that, I think, is it's not just deploying cash evenly into the market and expecting things to work. You have to understand where something is in the fair value range, and then what sort of psychology is playing into the market. There are different patterns that you see. Often, after earnings, there's a reset. It can be better to deploy capital.

I've said in the past that we may go through earnings season, particularly in the United States, with a little bit more cash, to take advantage of some of those. We're changing how we deploy capital, very specific limits on securities after a reaction that we understand.

The other piece of that, Rob, is you have to be really aware, to make sure there isn't something rolling off, positive or negative, with the business itself as the price moves. That can be a mistake people make: just because the stock moves higher doesn't mean it's more expensive, or just because it moves lower doesn't mean it's cheaper. You have to understand the fundamentals, and whether there's actually something that's justifying or driving that, or whether it's just basket trading.

[08:54] [RC] What's an example of that?

[08:56] [PM] Well let’s talk about Google, and that one is a little ambiguous. Was the price change just the stock getting cheaper, or is it pricing the probability that what we're seeing, a decline in growth, is actually maybe a leading indicator of something? So, that one's not so clear. It's actually a nice case study.

You can say, okay, is search actually rolling off? Is that what the market is pricing in? Or, there are other people that think that their AI moat will just be monetized, and a lot of the AI activity and agents, that's just additional to Google. You can take that argument.

But that's one where you could very well look at it and say, well, it's not necessarily cheaper. After the stock dropped, we didn't add to it. Things are moving fast enough that you don't always add to a position or move your positions around. And that’s just one example.

[09:48] [RC] And like you said, some of the work there was done ahead of time. On the other side, something like Berkshire Hathaway, that's a position you've thought a lot about over the last year or so. Where are we at with Berkshire?



[10:01] [PM] Berkshire is, of course, a very famous conglomerate where you've had a change of management. There's also a change in the age profile of the people running it. We had thought that Berkshire made sense to exit the portfolio. It's not in our other U.S. portfolios, but we separated that strategic decision from the execution of that idea.

As I'm talking about how the market has changed and you get these movements, we've just recently sold Berkshire. You have this psychology that falls into the market, some of these AI names heading downward, and a lot of the perceived flight-to-safety names increase. Berkshire was one of them. It moved about 10% on the month.

We took a very tactical decision to exit at a particular price that we felt was a lot more attractive within its fair value range. Now, these things are incestuous: Berkshire is a big holder of Google stock, as an example, but it's like they get lumped into a different bucket. I'm not convinced their stock was moving down because of that. They own lots of things; Google is a small part of it.

That, I think, is an idea of how we're thinking about executing on the strategy. We held the stock for over a year, knowing that we'd probably exit it, but there was a better time. Now is the time.

[11:28] [RC] What I'm hearing through some of the conversation so far, Paul, is just a lot of emphasis on the tactical side of things, the execution. Has that always been the case in the way you've approached managing a portfolio like global equity, or is there something different today?

[11:45] [PM] It's the environment. I really think, going back over a decade, the price stutters of the market—perhaps we're fundamental, long-only players—so your execution, again, same strategy but different execution: your execution had to be different.

Ten years ago, what would happen is the market would sort of roll forward slowly, grind its way up. If you put a limit order in the stock market, the stocks often would just walk their way up. They'd go up with their fundamentals and you'd just sort of miss out.

In that era, I consciously remember training myself to say, okay, this is the current market regime; if we want to get filled on the companies we want to invest in, we have to utilize market orders. That was the tactic, executing the same strategy: buy companies at a discount to intrinsic value, with able, honest management teams, but the tactics were different.

Back to what's changed today: it's options, it's retail, it's basket trading. It's the means of how people receive their information, how they consume it. Information used to be consolidated institutionally with brokers; you'd phone up a broker and they'd be the network of information. Now we're scraping X, or there's information popping up on Reddit or in other places across the web. The form of it is often more short-term, and it just impacts the stocks differently. It's different now.

[13:18] [RC] It's maybe worthwhile—I know you were on earlier this year—to talk about other things that are different today than 10 years ago.



[13:24] [PM] Oh, for sure, that's different. There's more stress on commodity prices, volatility across the board. Think back to other world leaders who would tweet out—I'm not sure what the verb is on X now—commands or comments about the direction of the world. That is radically different: you can blast out this message to the market, and that can move markets. That's a lot of volatility.

The world order is different. Interest rates are a lot higher. If you haven't looked at what's happened with global bond yields, check it out; there's a lot more competition for capital. I think we have to be cognizant of having gone through a very low interest rate era. There wasn't as much competition for the stock market, and now there's more competition for capital in different places. That includes credit, that includes different countries.

It depends whose numbers you look at, but as we build out data centers, it could be anywhere from $5 to $15 trillion over the next decade, and that capital has to come from somewhere. It's competing with other places. It's a long-term feature of this economic period that makes it different in terms of trading.

[14:45] [RC] Talk about cash—just cash in the portfolio, mentioned earlier, wanting to have a little bit more on hand heading into an earnings season, for example. That sounds tactical too. Talk a bit more about that.

[14:56] [PM] If there's more volatility in the stock market, even keeping your discipline around this: let's start with this for the viewers and listeners. Imagine a band where you're a couple of standard deviations around fair value, and a stock might oscillate around that. If you get that volatility, you're more likely to trade, or invest, if it moves a standard deviation towards the low end, or you're more likely to trim if it moves up a standard deviation ahead.

With that greater volatility, your cash is going to ebb and flow. It should. Your cash position should have more volatility; it might get run up at times, and it might get run down. Then, of course, in a higher interest rate environment, the sheer opportunity cost of holding cash is different than during the COVID years. So you have to treat it a little differently, tactically, given the environment we have.

In addition, because these baskets often drive the market, there's this idea that just deploying capital into the market means less cash drag. I'm like, well, not necessarily, with basket trading, because if you're on the wrong side of that, that might not make sense. If you actually pull capital out of a stock that is doing well and is more defensive, you might actually preserve this upside to the market without having that stock, which has, for some reason, become negatively correlated to other stocks in the portfolio.

The way I've been terming it, Rob, is individual stocks: the beta isn't linear across them. You can't just add them together, because your correlations are flipping back and forth. All this to say, the environment for executing on the strategy, I believe, is different, and there's more volatility in cash as a result.

[16:45] [RC] It strikes me, through a lot of this, Paul, that you're almost asking yourself—and people on your team as well—two things that I'm sensing are maybe contradictory. On the one hand, you're asking them: in this world of noise, and X, and Reddit, slice through that and figure out what matters. But you're also asking people to almost embrace that noise. I think earlier you said, be in the rhythm of it. How do you square those two seemingly opposing points of view?



[17:11] [PM] You have to keep both of them in mind. We had a very similar conversation with one of our analysts this morning; we were talking about Amazon, who just reported, and there was some commentary about what was priced into the stock or not, whether we should change positioning. So there is that psychological element, and how it translates into where a security is in its fair value range.

But I also made the comment: let's not forget Jeff Bezos's original letter to shareholders, and how he painted a culture of long-term thinking and investing in business. That business, and most businesses out there, it's going to be what they do over five, 10, 15, 20 years. It's both. If you lose sight of that latter part, then you can't. But the volatility around that—if you can frame them both, I think it's a wonderful opportunity in this setup.

[18:10] [RC] To end—the answer might be the same—we've mainly spoken about how the execution has changed, given the way the market has evolved. Can you close by sharing what's the same? What's the same in terms of long-term investing, fundamental investing, as five or 10 years ago?

[18:26] [PM] I come back to that question of: what is it worth? Why do we invest? Why can you make money investing in private companies, where the stock market isn't moving around all the time? It's because those companies produce cash, and you either reinvest that cash to grow your cash earnings, or you pay out dividends, or that company gets bought by someone else because what they're doing is valued. That is the same.

Asking the question, what is it worth—even if there's volatility around that—we're still in the same business of harvesting and reinvesting that cash, even if it's the managers that are doing it a level down.

[19:07] [RC] So there might be more to it. It might be more difficult. There are aspects that might provide more opportunity today, but, like you're saying, fundamentally it's the same mission. Paul, thanks for coming on the podcast.

[19:12] [PM] Thanks for having me.

[19:14] [RC] Hi, everyone, Rob 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, please leave a review on iTunes, which will help more people discover the Be Boring, Make Money philosophy. Thanks for listening.

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