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EP14 | Playing the plan: Mawer's U.S. equity portfolio

00:58	**Cam Webster**	With us today is Grayson Witcher, the U.S. Equity Portfolio Manager. We're happy to have him here, to share a few insights on what's going on in the U.S. And, maybe a few example companies that have been driving the portfolio, over a few years, given we're long-term investors.
01:17	**Cam Webster**	So, before we start, just getting into it ... want to say welcome to the podcast, Grayson.
01:23	**Grayson Witcher**	Thanks Cam. It's good to be here.
01:25	**Cam Webster**	What we usually do with guests is ask you to give the listeners a brief summary of your background ... so, maybe a little bit of your education and then your path to Mawer, what your prior experience was and how long have you been here?
01:38	**Grayson Witcher**	Well, I grew up in Calgary. And then, went down to the U.S. for school and did engineering at Harvard University. And then I worked in the U.S. for four years after that at Morgan Stanley and actually worked on the credit side of things, fixed income world.
01:55	**Grayson Witcher**	Then I moved back to Canada, to Toronto, to a company called Blair Franklin and worked there for a little bit before the opportunity popped up at Mawer Investment Management and that was ... wow ... about 12 years ago, now.
02:08	**Grayson Witcher**	So I joined the firm 12 years ago and it's a very similar process to what we still do now. I did the analyst rotation, worked with all the different Portfolio Managers, before finding a good fit with U.S. Equities.
02:38	**Cam Webster**	So, you haven't seen a downturn yet? Decade long up-cycle.
02:43	**Grayson Witcher**	For the most part. I caught the 2008 recession here. I joined in 2006. And I caught a portion of one before that.

02:56	**Cam Webster**	Interesting that you started in credit and made your way to equities. So, what was the driver there? Just sheer employment?
03:04	**Grayson Witcher**	No, they're pretty similar actually. When you think about credit and equities, there's a lot of similarities, especially the way we do things here. ... And the way I did things when I was working in the U.S. Basically, you're doing discounted cash flow models, doing credit research, speaking with management teams. Understanding the business. Understanding the valuations.
03:28	**Grayson Witcher**	So those two are identical, basically. And, the last step was the only one that was different... Instead of valuing the bonds, you try to value the equity.
03:42	**Cam Webster**	Okay. So it's safe to say that you've been, kind of, a pure analyst for a couple of decades.
03:48	**Grayson Witcher**	Yes. Almost 20 years. And, you know what else? The credit side was helpful in that it helps you think about things from a risk standpoint. And I think there's a lot of similarities to what we do here in terms of thinking ... just thinking about the downside. Thinking about the risk in a business, rather than just thinking about the upside, which some equity Investors are a lot more focused on. We're trying to protect capital. Let our clients sleep better at night, by thinking about the risk and the returns.
04:32	**Cam Webster**	Your experience as a credit analyst certainly helps you gauge where things are in terms of corporate leverage in the U.S. In our latest Quarterly, we discussed what the research team at Mawer found recently, in terms of management Interviews, that maybe the approach to leverage amongst management teams is less risk adverse versus what we just talked about. Why don't we start there, Grayson and give us some perspective, in terms of some of your more recent conversations, what's the attitude to leverage out there? Are you getting confirmations that there might be, amongst management teams, more risk taking behaviour, around debt? What are balance sheets doing?
05:12	**Grayson Witcher**	That's a good point. When you look at leverage in the U.S., we can pull up a chart that shows leverage being at 50-year highs, basically. That's

looking at the corporate leverage, debt to cash flow. There's many different ways to look at it but I think it seems like it could be an issue.

05:34 **Grayson Witcher** So we meet with a lot of management teams over the course of a year. We've probably met with between 250 and 350 management teams each year. And so we get a lot of exposure to what's going on out there in the U.S., with the management teams and how they're thinking about things. And I'd say over the past couple of years we've seen a real shift. We've seen that transition from say, ten years ago, after the recession, management teams were very scared. People were hoarding cash. They built up a big cash pile ... because, they were worried about what was going to happen next.

And that was the mentality, then. And, that's slowly dissipated. And now, I think, we're on the other end of the spectrum, where you're seeing a lot of management teams increasing debt substantially. It's hard to tell why. The economy's been strong, for a while.

06:21 **Grayson Witcher** I think there's been some kind of affirmation, self-affirmation. Because if you had a lot of debt, your returns are higher. And that kind of strategy has worked for many years. And so you get that positive confirmation.

I think there's also, a lot of other investors out there who want companies to increase debt just to juice their returns. Get those returns faster. They're not long-term investors like us. They're just looking to make a quick dollar in the market. And so they want to see them buy back a lot of shares. Really quickly. Or, do something ... like make a big acquisition and see that stock price pop on that news. And so you could be seeing them be pushed from a number of different angles. It could bankers, it could be short-term investors. It could be just management teams, themselves.

07:06 **Grayson Witcher** We're seeing more and more of that where companies are quite comfortable with a lot of leverage. I think that's just part of the natural cycle. As you get further and further away from the downturn ... the memories of a downturn. A lot of people forget.

07:20 **Grayson Witcher** I think that's where ... it's helpful to have a perspective like ours where we're holding companies for five or ten years and hopefully longer, where we're thinking about what happened, ten or fifteen years ago... and so we can protect capital.

07:32	**Cam Webster**	Well, private equity seems to be bringing in a lot of money. Are they the ones lending it out?
08:03	**Grayson Witcher**	I think the people that are lending to these companies depends on the situation, but, in many cases, it's the traditional lenders. It could be the public markets. So it could be either through high-grade credit, or high-yield credit. That's two markets that are going to be the big ones. The banks are doing some lending, for sure, I think it's not too dissimilar ... they don't want to keep a ton of this on their balance sheet. And so a lot of it is going out to the public markets. There's going to be some of these private equity investments, where they could be tapping the leveraged loan market. That's a market that's really exploded over the last several years. It's almost the size of the high-yield market now.
08:43	**Cam Webster**	And that's a real change?
08:45	**Grayson Witcher**	Yes, it's a change. It's growing, rapidly, over the past several years. That's a big shift. So there could be some risks there.
08:52	**Cam Webster**	Yeah, I'm just picking for pockets of risks. So if we're going to get a credit cycle blow-up, maybe, in the current environment, are you hearing anything from management teams that suggest that maybe you and your team can conclude that ... well, these are two specific areas that we need to watch.
09:12	**Grayson Witcher**	I think possible areas to watch could be just a combination of ... what often happens in a correction is you can get interest rates rising. So you're starting to see that in the U.S. That will push borrowing spreads up. As the Federal Reserve increases their overnight rates, and the yield increases, you'll see the impact of that flow through. And that will increase the borrowing costs for companies. You'll also see it in the credit portion. If you look at high-yield credit spreads right now ... those are very close to those of the last few decades. And so the borrowing cost for a high-yield borrower are pretty

inexpensive right now.
And the other thing we've noticed is ... we think that some of these management teams perhaps believe their business is more stable than it might be. And you look back, over five or ten years, and you see there's not a lot of volatility in your business. I think some of these management teams start to believe that it's more stable that it actually is.

10:13 **Grayson Witcher** And so you could get the combination of borrowing costs going up, and then your cash flow is falling at the same time. You get that double whammy which often leads to where you have a lot much harder time paying for the debt. Or the market is worrying about you being able to re-finance or pay for your debt. So I think there could be some risk there.

10:35 **Cam Webster** I appreciate that overview of where credit risk is in the U.S. How do you deal with it, as a team, as a portfolio manager? How do you go about it in the process of evaluating what level of leverage is appropriate for a company?

10:52 **Grayson Witcher** As you know, we typically look at risk adjusted returns and this falls into the risk adjusted bucket. If you look at the leverage of the U.S. portfolio, and the other portfolios at the firm that we manage, typically, the leverage is at or below the index levels.
We tend to focus on companies that have less leverage than average. And, at this point of the cycle, too, we're becoming worried about leverage. You'll see us tweak the portfolio a little bit.
At this point in the cycle, we may de-emphasize companies that have too much leverage. Or where we think ... yeah, leverage is just a little bit higher than what we're comfortable with, given the business model.
You'll also see when we do screening to look for new ideas, more so now, we'll just be ignoring companies with too much leverage. It's because there's a threshold where the risk is just too high for us, where it could be a good business model. Which is a shame... we're seeing that more often now, when we go through screening for new ideas.
So in terms of the pillars of our investment philosophy, it could be a very good business model. The management team could be very high quality, perhaps, aside from their appetite for risk. But that risk pillar would be the one where I just .... don't feel like we're being compensated and it's

just above that threshold.

12:46 **Cam Webster**

I want to move gears more toward the structure of the U.S. economy. I think we've all experienced the convenience of Uber, and some of the sharing economy impacts. But how do you look at that type of structural change over the long term? What kind of holdings might you highlight in terms of being exposed to that, but on a risk adjusted basis? How do you look at it?

13:12 **Grayson Witcher**

That's a big long-term trend. No doubt. I recently ... a year ago ... did a deep dive into the technology sector because it's such a big part of the U.S. universe. I delved into some long-term themes that we thought would impact that sector and came up with a 75-page report on some of these themes that could impact technology and other industries over the next ten years.

And one of the things that came out of that was the idea of the sharing economy and just how significant the impact could be. When you're thinking about businesses that people are well aware of now...it could be Uber, AirBnB, BRBO ... basically, the general idea is that, in the future, people will better utilize assets.

It could be something like a hotel room or it could be something like a car. A car is a perfect example, where it is only used for most people 20 minutes a day, or half an hour a day. Or, an hour a day, when you commute, back and forth. And, maybe you make a trip to pick up your kids from school... but, really out of a 24-hour day, the use is very minimal. And so that's prime. That's why you see companies like Uber and others being developed. They're trying to get better utilization of those resources. So that is a long-term trend which is good for some companies like Bookings, which we own in the portfolio.

14:37 **Grayson Witcher**

We also think about it from a risk avoidance standpoint, too, where you want to make sure that you avoid companies that are dependent on selling consumer stuff that they may need less of in the future. If you're going to use a car-sharing program maybe you only need one car. Or, you don't need any cars. You just uses a twentieth of a car by sharing it with other people.

So we think about it on both side of the risk and the reward standpoint.

Bookings is a good example of that. Bookings changed their name. They used to be known as Priceline which is probably what people would know them as, which is a competitor to Expedia. Those would be the two big businesses in North America.

15:15 **Cam Webster**

And, day-to-day, what they do?

15:18 **Grayson Witcher**

You use their websites as a travel agent. You can see the inventory of what's out there and the prices and can book it. So, it's basically, the new version of a travel agent that you might have used twenty or thirty years ago.

15:38 **Cam Webster**

And why do we own it? You did your 75-page report ... what led you to Bookings, in terms of putting it as a position in the Portfolio?

15:48 **Grayson Witcher**

A few things. One is the business is a fairly high-quality business. If you think about where you'd go to book a flight or a hotel for your next vacation, it's probably going to be Expedia or Bookings. They have a very big market share of the online bookings market.

That's a good competitive advantage. They also have scale. An important aspect of their business, it's a little bit different than a typical technology business, is that they have to sign up a hotel or a condo to their platform. And that takes people to do. It's not just a software business.

If you want to book a hotel in Frankfurt, someone has to have gone to that hotel and said ... will you use Bookings or Priceline? Okay, then we'll install our software and you can use that software to book your rooms. That's a software that many of those hotels will use to book their own rooms even if someone walks up and tries to book a room.

It takes time to do that. That's the kind of complexity of their business. That's a little bit different than some tech-businesses, where it's quite easy to set up.

16:54 **Grayson Witcher**

That's the business model, which we think is solid. And the management team is an excellent management team. That's one of the highlights of the business, we think. They've just done a great job creating value over time. Whether it's things like capital allocation... they bought the Bookings business, a European business, and it was a great asset. They were able to buy that, many years ago. They have a good culture. And, they think about

things similar to how we do...very strategic, long-term focus.
Then from a valuation standpoint, it's a reasonable valuation. The company keeps growing, quite rapidly. And so, the valuation has remained quite attractive.

17:39	**Cam Webster**	I don't want to paint too rosy a picture here on things we hold, so ... what about the risks, Grayson? What risk would Bookings have to get through?
17:48	**Grayson Witcher**	The worst case for this company would be that the hotel would offer you a cheaper price to book it directly. Right now, you're not allowed to do that. But, that could be a risk. In our view, that's probably the biggest risk out there... that somehow, these hotels find ways to attract customers that are cheaper. And then you think... it's not overly challenging, if you're looking at a website and trying to book a hotel. It's quite easy to go to a few different websites and check them quickly. And so it's a real risk and that's been factored into our investment. One of the ways it's factored in is just through keeping our weight a little bit lower, over time, to compensate for that risk.
18:30	**Cam Webster**	Grayson, that's a great example of how we're exposed in U.S. equity to the sharing economy. Part of the research team's philosophy is to travel, pretty extensively. Why don't you give us a sense of what you were looking for in that trip to Silicone Valley, recently. And what you took away from it.
18:52	**Grayson Witcher**	What we often look for when we go on these research trips ... a big part of it is relationship building. Nothing replaces that kind of face-to-face interaction. And when we're going to be long-term shareholders of a company, I think it's important for us to build that relationship over time.
19:08	**Grayson Witcher**	An example of that would be Visa. I think I wrote the initiation report on this one in 2009, and we initiated the position in 2010. So we've owned it for a long time. And, over that period, we've spoken with and met with Visa many, many times. And so that's part of that relationship building. And then, this time, on my most recent trip to San Francisco, I was able to have a meeting with the new CFO.

19:36	**Cam Webster**	What I'm hearing is that, maybe, it took eight years to actually get access to the CFO. Am I on the right path there? Or-
19:45	**Grayson Witcher**	Yes. Yeah, that's right. And it really depends on the company. But obviously Visa is quite a large company and so it can take a while to build up that rapport and build up that confidence in them that you're the type of investor they want. And you can meet with different people.
19:58	**Cam Webster**	Okay. We're on an interesting tack here. You went to Silicone Valley, and I was expecting you to come back with that you were going there to talk to all sorts of people about tech investing ... and you say the best example is Visa. So, is Visa a technology company?
20:16	**Grayson Witcher**	They're categorized as a technology company, but they're probably more of a financial company. I think people are becoming more familiar with how the business works now. But when we first initiated, I think there was a little bit of opaqueness in terms of how the business works. What Visa does is, they're really rails that your transactions are going to ride on. They don't lend money. When you go to Visa, you have your Visa card in your wallet, and you pull it out to make a payment. And that information, stored on that card, goes from your card to the card reader, and through the Internet...that's a portion of what they do. They don't do the lending, that's actually your bank. And so they don't have the lending risks that some people used to assume they did. It's more of a transaction for them. So every time you make a transaction, they get paid a little bit of money, a very small amount. But it builds up over the billions of transactions that are done every day and week, throughout the world.
21:10	**Grayson Witcher**	And, they've set up a great business, where, if you think about it, it's a bit of a chicken and egg problem, which is really a kind of network effect that you see in a lot of the businesses that we like to invest in. Where it's very hard for someone else to set up a business like that now. Because you have to have all the merchants. When you have a Visa card, or any credit card, you want it to be accepted wherever you go. You don't have to have 20 different cards for each different type of store you go to. You want to have it accepted universally. That's one side of it. And then,

on the bank-side, the bank only wants to issue a card where people are going to want to use it. And so you have this real strong network effect, where it's really hard to replace a company like Visa or Mastercard.

21:51	**Cam Webster**	I just want to offer listeners maybe a really concise definition of what we mean by network effect.
22:01	**Grayson Witcher**	I think a network effect is a situation where the more people that use something, the better it becomes. So, classic examples would be like a Visa or a Microsoft Office, in my mind, where the more people that use it, the more it becomes a standard. And so if you're sending a word processing document, or a spreadsheet, if you don't send it in Microsoft format, the other person probably can't open the document. And so they have to use it as well. The more people that use it, the stronger that business becomes.
22:30	**Cam Webster**	One of the interesting things you mentioned, Grayson, in talking about the Visa example is that relationship. Can you combine another recent research trip with an example of a holding where that relationship exists?
22:44	**Grayson Witcher**	The last research trip I was on, I went to Pennsylvania, to Philadelphia and Pittsburgh. And one of the companies I met with on that trip was a company called Ametek.
22:53	**Grayson Witcher**	Ametek is a diversified industrial company. They make many, many different products, industrial products. It could be things like a 3D scanner. Or it could be something like an ultra-high-speed camera that you use for taking pictures of things that move very fast.
23:10	**Cam Webster**	Like the Olympics...So, the 100-meter sprint. Or, the speed skating. Something like that?
23:17	**Grayson Witcher**	Yeah. Exactly. They make some pretty interesting products. It's a company that we've owned for a long time. I think it's been over ten years now we've owned shares in this company. So we've built up a good relationship with the people that work there, over that period, through going to meet them in Philadelphia many times. And talking to them on

the phone, many times.

23:42 **Grayson Witcher**

One of the interesting things learned on this trip about the way they do things is when they look at acquisitions, when they're looking to buy new companies, one of the tools they use is Monte Carlo analysis, which, by chance is, one of the same tools we use, here.

Monte Carlo is basically ... instead of thinking about things in a black or white frame, you think about things in more of a spectrum, or in shades of gray. So rather than saying ... this company is worth, 55 dollars because that's what the model says that we put together, you say ... hey, it could be worth 55 dollars, or it could be worth 35, or, 45, or,75, depending on how you tweak the different variables that go into it.

It's interesting to see that they do a similar type of thing when they're looking at acquisitions. They'll change several different variables depending on what kind of company they're looking at. And then they'll look at ... okay, how much is it worth in this scenario; in this scenario; in this scenario? And, it's just fascinating to see how you can find these parallels between the ways different people do things. And we view Ametek's management team as one of the best management teams in the portfolio.

25:01 **Cam Webster**

I'm going to play devil's advocate a little bit on that and say ... well, okay, Ametek uses Monte Carlo. We use Monte Carlo. We've owned it for ten years. It's the best management team in the portfolio. How do you avoid bias in your analysis? So, Ametek...maybe they miss a quarter. Maybe they do a poor acquisition. How do you make that decision to say ... well, we've been close to this company for so long, they use similar tools, we have a similar mindset ...

25:27 **Grayson Witcher**

We have a bunch of different tools to do that. I can I mention a couple of different processes that I think might get to what you're talking about. One of them is what we call a Short Report, when we're doing our in-depth analysis on a company. And the Short Report is really trying to take the other side of the coin. So instead of saying ... what's good about this company?... we'll pretend that we don't like this company at all. And we'll find out every reason why we should not own this company. And really shift our mindset and say ... let's try and find 20, 30, 40 things ... reasons why this is a bad company to own. And so, really, flip your mindset so it's not just a box-checking exercise. It's really trying to think about what could go wrong with this business.

26:10 **Grayson Witcher**

That really helps to keep us honest. I mentioned that we'll do annual check-ups on the company, at the very least, where we do what we call a Delta Report. We'll re-visit the investment thesis; what's changed over that period.

Sometimes, the same person will do that within the team, but many times we'll switch the person that does it. And because we are generalists, and we don't have someone who's specifically focused on only industrial companies, for example, we can do that. ...That helps as well...getting a different perspective from someone who may not have had the same tie to the business before. They're coming at it with a fresh set of eyes and a fresh perspective.

26:58 **Cam Webster**

I think that's a really good way to wrap up our discussion. You really got to the processes that we at Mawer follow, to try to make good long-term investments decisions.

27:11 **Cam Webster**

Thanks for all of your thoughts and answers to those questions. So what we like to do is wrap up with "one Mawer thought." I know you're very humbly a most excellent squash player. Can you give listeners a sense of maybe lessons you can apply on the squash court that you apply to investing?

27:39 **Grayson Witcher**

Goal setting ... that's helpful to have ... a vision of where you want to go. That's quite helpful in sports like squash where you might have, for the next year, or for the next three or five years, goals of where you want to get to. And I think the same is true for investing and how we do things here. In a few weeks we're going for our annual U.S. retreat, we call it. Where the U.S. team gets together for a full day to talk strategy and talk about where we want to go; how we can improve what we do and make things better and become better investors and challenge each other to do better.