the art of boring™

EP43 | Playing the plan: Mawer's U.S. equity portfolio

Rob Campbell	**00:38**	So, this week on the podcast, we have U.S. portfolio manager Colin Wong. Colin, welcome to the podcast.
Colin Wong	**00:44**	Thank you for having me.
Rob Campbell	**00:45**	Definitely! And this is your first podcast with us, so definitely, definitely, welcome. Today, Colin … it's another edition of the "Playing the Plan" podcast series, where we want to take you through the portfolio that you help to manage, which is our U.S. equity portfolio. I thought an interesting place to start would just be about your background. You spent your entire career here at Mawer and started back in 2009. Can you tell me a little bit about why you got into the field of investing?
Colin Wong	**01:13**	You're right—I came out of school (I went to the University of Western Ontario), and started working at Mawer 10 years ago. So how I got started investing was… I'll give you a little bit of the long version: when I was growing up in Hong Kong, it was just before the Asian financial crisis. So, people are really into making money in the stock market and the property market there. In fact, it was so popular that there'[re] TV shows that are made about investment managers and businessmen. And that really inspired me when I was a young kid watching these shows, [and] to want to become these idols on TV. So that's how my initial interest got started, and over time that grew as I read more books, did more courses on this field.
Rob Campbell	**01:59**	And so you landed at a shop that's a little bit more "boring." You maybe didn't get the personal celebrity you were initially after [laughs]. What is it about Mawer that really resonated with you?
Colin Wong	**02:09**	That's another funny story. To tell you the truth, I did not know about Mawer before joining Mawer—before the whole interview process. When I was coming out of school, looking for a job, it was during the financial crisis in 2008, [and] I went to my fiancée at the time, now my wife, and I asked her: "what are three places you want to live after I graduate? And please write it down on this sheet of paper and I'll look for jobs within these three areas."

Calgary was one of them. And it just so happened Mawer was one of the companies that were listing for jobs. I applied and the rest is history!

Rob Campbell 02:47

So, Colin, you started at the firm as a small cap analyst, but eventually landed on the U.S. equity team. I'm just curious—U.S. equity is, at least in my mind, kind of like the Mount Everest of long-only portfolio management. Meaning, it's kind of the toughest market—or at least has proven to be—in order to add value. What is it about U.S. equity that really motivates you or gets you up in the morning? In other words, how come you landed on that team?

Colin Wong 03:11

Right. I think a big part of it is I really enjoy the challenge. Like you mention, it is a very efficient market. At the same time, there are some of the most innovative companies out there, so it really is a double-edged sword, in that you get to pick from some of the best companies in the world. At the same time, your competitors—the other investors—are also very efficient and good at their job. So that really motivates me to really compete with some of the best in the world.

Rob Campbell 03:38

Awesome. And I'm struck by this idea that you joined the firm and started your career in 2009, exactly the same year that I came into the industry, and maybe that's a good segue way to just talk about the U.S. equity market and the remarkable decade that we've been through; 2009 was really the bottom of the equity market coming out of the financial crisis. How has having your career coincide with that investing environment shaped your views as an investor, and your experience over the past decade?

Colin Wong 04:05

I think, like you mentioned, it has been a very long bull market. It's been 10 years now, and so a lot of the learnings, if you took it strictly, would have been all bull market learnings, so, "keep buying a company that goes up the fastest. Don't worry so much about debt. Pick the even more aggressive manager."

So, it was very easy, I [found], for us to get in a trap of taking the reins off even more of the horse (as a jockey), as the portfolio progresses, as some of these holdings progresses. … Me and a lot of our teammates have to remind each other to think, "hey look, there are both sides [to] things: there are good times and there will be bad times." So that's one of those things we try to learn all the time, but we try not to learn the wrong lessons—that's what I'm trying to say.

Rob Campbell	**04:50**	Yeah, I mean it's an interesting one because all of your learned experience—at least from the time that you started at Mawer—would have been, as you said, in this environment where growth companies got rewarded. As you said, taking on leverage was the right move, just given what transpired in terms of interest rates. So how do you actually go about getting that better perspective? Is it other people on the team? Or what do you do to make sure that you're not shaped by this unidirectional market.
Colin Wong	**05:16**	I think it's a big gamut of things. Number one is definitely talking to other people with past experience. When I first joined, there were other people that had a lot of experience, for example, Gerald Cooper-Key [had] been in the market for over 30 years, so talking to him has been helpful. Martin Ferguson has mentored [both] me and Grayson and given us a lot of perspective. Jim Hall has been through a lot. So, there are a lot of people here that have those experiences that are willing to share it. Another thing is, across the research team, we really think about things probabilistically. And once you are willing to adopt that mindset, then you know that everything you're seeing is just one outcome of a gamut of potential outcomes. So, right now we're seeing a bull market, at the same time, we could easily imagine that hey, look, five years ago there was a bear market. One year ago there was a bear market. Tomorrow, the bear market's going to start. So, really adopting that flexibility in terms of our own thinking, that, to me, is the biggest piece.
Rob Campbell	**06:14**	That seems really important. So, how does that manifest itself in practice? In terms of how you work with Amit and Stas and Grayson on the U.S. equity portfolio? And then obviously other investors at the firm that might share interest in some stocks that are in the U.S. equity market? Do you find that there's a lot of coaching around that? Do you have to constantly probe or push yourselves to incorporate different assumptions into your models? How does that actually play out?
Colin Wong	**06:39**	I think it's even more systemic than that. It comes down to hiring, the people that we hire. That's one thing we actively look for—people that are flexible in their mind, and willing to change their mind. And so once we hire the right group of people who already, through their own life experience, believe in this, it's much easier to work with that. And then we put them in an environment that allows for this.

For example, our decision-making framework here is leader decides with input. There is nothing in there that says that the leader has to agree with the input. So, if I'm giving a recommendation on a specific stock to Grayson, for example, there is nothing in the process that says that he has to agree with me, or I have to change his mind, or vice versa.

Colin Wong 07:24 We can both disagree, but he's going to take my input seriously, and perhaps adjust his own probability in his head, and act accordingly. So, I think having that flexibility in that system where we're not forcing people to conform is key.

Rob Campbell 07:39 So culture, a respect for the markets, and a humility towards that, holding your stories lightly—a lot of the stuff that we've talked about on prior podcasts—but also, clear decision rights being really something necessary for this to work.

We've talked a little bit about what we do to gain perspective as to what could happen…it has been a remarkable decade for U.S. equities…but a bit of a hiccup last year? Or at least a bit of a sneak-peek as to what could happen—in the sense that there was a fairly large drawdown that happened towards the end of 2018, and we've certainly rebounded so far this year. Can you talk a little bit about what were the drivers behind that, and how that played out in the markets?

Colin Wong 08:19 In the latter half of last year, I think there were two major forces that sort of spooked the market, in my opinion. One was the increase in interest rate. We went through a very low interest rate environment, both in the U.S. and globally, and there seemed to be some inkling—especially in the back of last year—where that era was coming to an end. And so, if thinking about Finance 101, if your discount rate of whatever security or assets you buy goes up, your price goes up, so that's one factor.

08:53 The other factor was increasing talk of trade wars, an intense relationship between U.S., perhaps China, and also some macro uncertainty—things like Brexit and even [the] U.S.-Europe relationship; NAFTA going into question. So, a lot of those macro uncertainties also, I think, contributed to the market draw down.

Rob Campbell 09:18 And so since then, one of those two things has reversed—meaning that central banks seem recommitted to "lower for longer." The other hasn't, and arguably has gotten worse, in terms of PMI data coming in from around the world and just continued slowing in global growth.

		Why have the markets been able to look through that? And maybe put another way, what would it take for investors to no longer be so optimistic about what's coming out of the Fed and other central banks?
Colin Wong	**09:46**	I do think that the discount rate piece is not to be…discounted [laughs] too heavily. It's very important, that's number one. And number two, you're right—I think a lot of the trade wars, a lot of the macro uncertainty, is still around. At the same time, if you look at the flip side, some of the earnings of some of the structural growers—for example, some of the ones that we have in our portfolio, Visa and MasterCard—they have done very well in terms of continuing to grow through this macro uncertainty. So, I think there's a healthy tension between what's happening in the economy, or what's potentially happening in the economy, and earnings of these companies—which is so far, so good.
Rob Campbell	**10:25**	Okay, so as long as earnings hang in, investors might still look to those lower discount rates as being supportive of equity prices. So, as we think back over the last year, I think you might expect in an environment of heightened volatility for managers like us who are stock pickers to find all kinds of opportunities to step in and buy stocks at attractive prices. And yet, as I look back over the past year, the activity in the U.S. portfolio has been modest, is that fair? Only a handful of new names. Can you talk a little bit about just why that is, and maybe highlight a couple of stocks that we have found and added to the portfolio?
Colin Wong	**11:02**	I think you're right—especially if we look at our overall turnover. I believe our overall turnover is roughly 11% in the last 12 months, and that's a little bit lower than our norm at roughly 15%. So it's a little bit lower, not dramatically lower, that's number one. The way we think about that is, turnover really is an outcome, rather than something we work to shoot for [or] a specific number. The low turnover…it's funny, it's because it's almost a function of our investment philosophy, in that we buy wealth-creating companies, run by strong managers… and so time is our friend. And that's what led us to a lot of low turnover.
Rob Campbell	**11:42**	And maybe…I guess if you've got an 11% turnover, that translates into an average holding period of about nine years, so certainly a long time horizon. Where have you been finding opportunities?

Colin Wong	**11:56**	So for background, there are three usual reasons why we would trade, buy, or sell securities. Most often is that we find something else that is more attractive out there than what we have—especially the least attractive holding in our portfolio. The second reason is when the fundamentals of the holdings we have significantly change, or the company significantly changes, either for the better or for the worse. And then finally, if the prices really get out of whack, really get out of the fair value range—then we'll act.
	12:28	So, in terms of what we have added, some companies we've added—Microsoft is one we added in the last 12 months. And the reason why we added to that company? For reason number two, and of course a little bit of reason number one. Reason number two was that we have an alert system that monitors numbers of holdings that are out there, that we're interested in. Microsoft was one of them, and what the alert came out in terms of Microsoft was, that this company is accelerating in their revenue growth, as well as earnings growth. And so that alerted us to look into the company further, which then we discovered that yeah, there's a structural reason why Microsoft is doing well and will likely continue to do well. The fundamentals have [gotten] a lot better over the last two years than there was three, four years ago. So that led us to do more work, and we compared that to our least attractive holding in the portfolio at the time and thought, "yeah, it really makes sense for us to add Microsoft to the portfolio."
Rob Campbell	**13:29**	Did that least attractive holding come out? [Laughter]
Colin Wong	**13:32**	At the time, I don't think we exited one specific company one-for-one, but we did lower the weight on a number of our holdings that we thought, "the prospect was not as good as Microsoft."
Rob Campbell	**13:42**	Colin, was there another company you wanted to talk to?
Colin Wong	**13:44**	Yeah! The only company we've added so far this year, it's A.O. Smith, and that's another company that came up in our alert system. So both of these companies we were aware of for a long time, and we put it in the alert system so we can track [them], both quantitatively and qualitatively. So for A.O. Smith specifically, there was an alert saying that, "hey, look, this stock price has fell through what we thought would be a reasonably low price for this company," and that led us to go back, re-examine our thesis, and it turns out that we think it is an attractive opportunity, so we initiated a position earlier this year.

Rob Campbell	**14:23**	Colin, [I'm] definitely familiar with Microsoft, it rules a lot of my day! [Laughs] But [I'm] less familiar with A.O. Smith. Can you share just what that company is, and what are the drivers behind the investment thesis?
Colin Wong	**14:33**	A.O. Smith…you might not think you use it every day, but perhaps you are using it every day, because they sell hot water heaters. So, if you go down to the basement of your home, you might have one of their hot water heaters. They have the biggest market share in North America; they have roughly 40% of the market share in North America, in terms of hot water heaters. So, you might be using their product every day. They also sell commercial hot water heaters, so in this building I'm sitting in right now, the hot water could be coming from their hot water boiler.
	15:02	And the investment thesis is quite simple: they sell hot water heaters and roughly 80-85% of the sales in North America are replacement hot water heaters. So when your hot water heater at your home breaks, you call the plumber, and the plumber says, "hey, look, it's going to cost you more to fix it than to get a new one. Why don't you just get a new one?" So then you might say, "yes! please get me a new one." And then the plumber would go order a new hot water heater for you [and] install it. That really is their basic business. So, a lot of the business for A.O. Smith is recurring—as you can imagine, if your hot water heater breaks, it's not something that you think about fixing or not…[it's] something you definitely want to fix.
Rob Campbell	**15:44**	Don't want a cold shower!
Colin Wong	**15:45**	So that's the wealth-creating side: being the market leader, having a recurring cash flow, having a good brand name. And then the managers—the team there—has executed very well in the past decade. They have helped themselves to become the market leader in North America, as well as the market leader in China. They've gained market share basically almost every single year in China in the last decade—that's increasingly a big market for them. So, two of the qualitative factors are very, very favourable. And then on the flip side, we look at the price, the valuation. That was also favourable, and that's what originally alerted us to this company. At the time we initiated it, it was trading at 16.5x earnings, so it was significantly cheaper than what the average multiple would be on the market, and it was trading at the lower end of our fair value range once we put it in our discounted cash flow models.

Rob Campbell	**16:43**	Yeah, seemed to check all the boxes. Speaking of companies with recurring revenue…the U.S. portfolio we talked [about] earlier, the difficult market environment that we've come through…I'm struck by just how remarkably well the portfolio held up during the down draft, but also, how it's kept up since then. And as I think about some of the stocks that have done well for the portfolio over the last little while, they do have that element of recurrence of revenues. So I'm wondering if you can speak to a couple of those? Hershey is maybe one of them?
Colin Wong	**17:11**	Hershey is a company we added to the portfolio—initiated a position in the portfolio—roughly a little bit less than a year and a half ago. And that company came up as part of our "bathroom list" review process. The bathroom list is our annual review of our existing holdings.
Rob Campbell	**17:29**	Can you elaborate as to where the term "bathroom list" comes from? [Laughter]
Colin Wong	**17:32**	Absolutely! So, if you go into a bathroom in a restaurant, on the back of the door you'll very often see a sheet of paper [that] will have signatures on it. And basically, what the bathroom list is, is just a checklist for the staff to say that yes, you cleaned the sink; yes, you scrubbed the toilet; yes, you rinsed off the floor. And so very similarly for us, we have some maintenance work we need to do with the holdings that we have, to make sure we keep up-to-date, and that we refresh our thesis, we refresh our mind on what's the investment attractiveness of these companies we hold. So, very much similarly we have a number of things we need to do to make sure we're up-to-date and stay informed with our holdings.
Rob Campbell	**18:21**	So this is "know what you own?"
Colin Wong	**18:22**	Correct, correct.
Rob Campbell	**18:24**	Sorry, go back to Hershey. What were we doing with Hershey?
Colin Wong	**18:26**	Right, so for Hershey, like I said, it came up when we were looking at our consumer staple companies, namely P&G (Proctor & Gamble) and Pepsi. And at the time, many of these consumer staple companies were … going down a lot. For example, P&G, a company we owned at the time, was down up to 40%, even though the company itself continued to be doing quite well. And why was that? That's because a lot of these consumer staple companies were being disrupted by changing consumer preferences.

		For example, people wanting healthier food rather than drinking and getting another can of cola. Being challenged by challenger brands—so these are new brands that might be born on social media or started from natural food stores.
	19:16	And, as well, they're seeing a change in distribution channels, distribution methods. The most famous example there obviously is Amazon, and also Dollar Shave Club. So, a lot of those headwinds were also combined with macro headwinds such as high interest rates, cost inflation for them, and [a] rising U.S. dollar. These companies as a group have traded at a significant discount to S&P 500, and probably the lowest we've seen relative to S&P 500 in the last decade. You would have thought, after I said all that, we added to Hershey because we disagree; that things were hunky dory and things were fine.
	20:00	In fact, that was not the case. We actually agreed with a lot of those negative sentiments. At the same time, we don't think those negative factors are going to hit every single company in that sector equally. So when we looked at Hershey… this is a company that sells chocolate. They're the market leader in chocolate. The top three players in chocolate own 80% of that market, and a lot of that market is driven by holidays—so things like Halloween and Easter. And a lot of it was [also] driven by impulse buys, so, someone standing in a convenience store waiting for the checkout, seeing a chocolate bar, and buying it. We believe because of these aspects, they are less prone to a lot of these disruptions. And so we pick and choose our places, instead of just following the market as a whole. And we thought at the time they were unfairly lumped with the rest of the sector, which we were also worried about in a lot of senses, but not for Hershey specifically, or less so for Hershey specifically.
Rob Campbell	**21:06**	I think that makes a lot of sense to me; a lot of those impulse buys, at least as I understand, are in sort of secular decline. You think about more candies or mints or things like that, whereas chocolate perhaps, is not. Which, maybe combined with just the market dynamics or the industry dynamics of there being only really two or three main players in that space, provides some insulation. But how does that apply to Proctor & Gamble?
Colin Wong	**21:29**	Yes, Proctor & Gamble have a slightly different story. They still have very defensible franchises. So, for example, things like Tide soap, or Charmin toilet paper—these are pretty enduring franchises. A lot of their brands have been around for 100 years. So, there is certainly staying power, but they are prone to disruption.

And for Proctor & Gamble specifically, the big change there was that there was a new CEO, David Taylor, that came in and that really accelerated many things. What specifically he did, was he looked back and said, "look, for a long time we've been ceding market share in terms of volume. And being happy losing market share, in exchange, will increase the prices to every higher level to make up for that loss in market share. And at some point, that's probably not going to work. That's kind of milking the customer too hard. What we have to do is we need to double down on our innovation, we need to double down on our marketing and packaging, and double down on differentiating our product versus our competitors', and get into some of these new distribution channels, and be a leader in those."

And so subsequently, he has executed and done a lot of that. If you search diapers, for example, on Amazon, very likely the number one thing that comes up will be Pampers, which is a brand owned by P&G. And that really shows how far they've gone in terms of executing that strategy.

Rob Campbell 22:58

Great. And with P&G specifically—and this maybe hearkens back to your earlier comment about leader decides with input and clear decision rights—I'm curious because I know that maybe there wasn't unanimous agreement that this was the right time to add to P&G, when some of these challenges were more robust. In fact, our global equity portfolio had exited the name at the time. Can you just speak to how those discussions took place, how you collaborated with the global equity team, and how the U.S. equity team wound up where it did?

Colin Wong 23:25

So our Global Equity Manager, Paul Moroz, often (in fact most weeks), will sit in on our weekly U.S. meetings, so he's kept well abreast of what we're looking at, how we think about things. So that's number one. Number two is that...remember when we talked about turnover, or low turnover, and I mentioned that the three reasons why we were buying and selling securities? And the most [common] is that we have different opportunity sets? So, [if] we find something that's even more attractive than something we own, we might make a switch. And I suspect there's a lot of that, because we're faced with different sets of companies that we can buy and cannot buy.

24:04

Obviously, global equity being able to buy any security around the world...that's probably another factor. And then finally, [it's] back to the culture factor. It's okay here to agree to disagree.

		We don't always have to agree and have the exact same view on everything, and I think that's the case where Paul saw something and put more weight on some of these disruption factors, and maybe we had a different view—thinking that some of these disruption factors matter, but we thought management was changing things around, and also the stock prices were low enough to compensate us in taking that risk.
Rob Campbell	**24:38**	Great. Colin, another stock that's done well in the portfolio and that the team has been adding to is AptarGroup, and that's maybe another one that listeners are not as familiar with. Can you talk a little bit about what that company is, why the stock's been doing well, and why we continue to have confidence in it?
Colin Wong	**24:57**	So AptarGroup is another one of those companies much like A.O. Smith that maybe no one has heard of, but maybe use their product every day. What they make is, for example, the top of the soap pump—the pump part. A lot of times [those are actually] made by AptarGroup. So they have different divisions to make these kinds of pumps, or lids for containers of all kinds of products. They have home and beauty products, they have pharmaceutical products, which is another big part of their business. In fact, 70% of their profit comes from pharmaceutical products. And so why this company has done so well, especially in their pharma division, they have come up with a lot of innovations and wins in these new packaging formats—in terms of things like nasal pumps or injectable medicines.
	25:46	And that has propelled that business to grow at a high single digit-type rate. It's really the best of both worlds, because of the pharma business, because it's a small price point as far as a non-discretionary item; it's very safe at the same time because they're executing, they're getting that growth. And that's why we continue to own this company.
Rob Campbell	**26:07**	Yeah, it's one of those keystone business models. Like you said, a very small proportion of their customers' costs, but really critical to their products' functionality. Can you talk a little bit more about some of the barriers in the healthcare space when it comes to regulation and drug approvals? That seems like another important part of the thesis given how much of their business is in that industry.
Colin Wong	**26:27**	So for that part of the business, if a pharmaceutical company makes a nasal spray and submit it for FDA approval, Aptar's pump is actually part of that regulatory approval, so it's almost like part of the drug itself, because the drug delivery is as much as the drug itself in terms of getting through the approval process.

		Once that whole package gets approved, it's very rare or very difficult for a customer to switch out an Aptar pump for someone else's pump, because they would need to go back to the FDA to show that "hey look, this new pump we're using works just as good as Aptar's pump." And what would be the customer's gain? It might be cents based on each product. So the temptation to switch is very low, i.e. gaining a few cents or maybe up to a dollar. But the cost of switching is very high, which is going back and getting FDA approval.
Rob Campbell	**27:22**	Not to mention if the drug company says, "this product is good for three years" or, it's got an expiry date three years in the future…they've got to test that, don't they?
Colin Wong	**27:29**	That's right. So there's a long lead time.
Rob Campbell	**27:32**	That's right. Interesting! So, we've talked a little bit about things that have gone well in the portfolio, but there perhaps have been some stocks that haven't gone the way that we might have hoped. And Google—or Alphabet—just being one of them over the past year or so; maybe a name that's been in the news. Can you talk a little bit about what's been happening with Google and how our thinking on it has evolved?
Colin Wong	**27:53**	Alphabet is a company that we have owned in the portfolio for around 10 years now, and so like many companies we own, this is a massively value-creating business run by innovative managers. One little known fact about Google is that they actually have nine businesses, or nine different products, that have over a billion users. So, clearly they've created a lot of value over time. So, when you ask: "well, the company has relatively underperformed in the last year or so, what's happened?" Of course, we never know exactly what's happening, but we suspect there are three major factors that caused that under performance.
	28:31	And that would be revenue growth is slowing. The second factor would be earnings, or free cash flow, has been stagnant. And then finally, there are more and more talks about regulatory risks, or regulatory scrutiny on the company. So, for each of those factors…for the first two, the way we look at it is: there's a big gap between the value that Google is providing for its customers (as measured in usage of their product), … and the revenue growth. And then a gap between the revenue growth and profit growth. It seems to us to be a matter of ability and willingness to monetize the user's usage. We have had many, many discussions, countless debates internally about whether they're able and willing to monetize the value that they create for the customer.

	29:27	We don't profess to have gotten to the end of it, or have the answer, but what is clear in all these discussions is that the strength of the franchise is rock solid, so people continue to love these products and use these products. Another thing that's not up for debate is that they have over $100 billion of cash on their balance sheet, and the team there is very innovative—they continue to come out with new products. So, a lot of those factors give us some comfort in terms of downside protection in that there is a lot of value here, and cash, and good managers. And then on the flip side, there is a lot of optionality for upside, so things like the self-driving car (Waymo), Google Cloud, or smart home devices. We like those kinds of trade-offs in general that things are relatively capped on the downside, but with substantial upside potential.
Rob Campbell	30:23	Can I just poke at that, though? Because one of the features of the market recently, and we talked about this over the past decade, [as] just being these really strong growth companies having performed remarkably well in this market environment. And obviously the portfolio has benefitted, given that we've been in Google for a decade. But one of the things that I've noticed in the market lately is that companies that have a lot of growth priced in, in environment of just slowing economic growth in general, seem to have been unduly penalized—and maybe Google falls into that category. What would it take for you to really question the investment thesis? In other words, what are some of the signs/major indicators that you're looking at for Google?
Colin Wong	31:04	We're always questioning our thesis, we're always paranoid [laugh]! That's one of the features about working here. We're never rock solid or feel very, very strongly about any issue—it's that flexibility piece. And in terms of Google specifically, what would make us more seriously reconsider would include the inverse of a lot of things we just talked about. So for example, if their franchise were not rock solid; if there was another search engine out there that was way better than Google and getting all the users—that would make us question.
	31:33	Another thing would be well, they have a lot of cash right now…what if they start doing silly things with that cash? If they start making ever more ridiculous acquisitions, or spending on projects that don't make sense at all—that would make us question. And then lastly, the innovation part. If they stop innovating in the tech world—it's very, very competitive—if they don't innovate, someone else will innovate for them, and take their market share. All those things are things that we continue to check, double-check, back check, and that's why we do the annual bathroom list update—we go back and re-examine our thesis. Is this still happening?

		Are they still coming out with new products that people love? Are they still being prudent with shareholder capital?
Rob Campbell	**32:16**	And for what it's worth, Colin, I have found ways to step away from Facebook, [but] I can't imagine a world in which I would get rid of Google in my life. It just sort of seems to be there. So, to the extent that that reinforces the moat, or some of that investment thesis—there's one anecdotal data point. I'd like to talk about another stock, and I'm sorry to bring it up because I know that you hate losing money. But one of the biggest detractors in the portfolio over the last little while has been Allergan. I'm wondering if you can talk to that stock—whether you see our investment in it as a mistake, and sort of what's transpired over the last few years?
Colin Wong	**32:51**	Yes, Allergan definitely has not worked out the way we hoped it to be when we first initiated it into position. This is a classic example of, really, the fundamentals shifting in the company in a way that we a) did not expect, and b) for the worse. When we bought the company, the general thesis was that we have a good management team that has grown by acquisition and allocated capital prudently over time. And the franchises that they own, most namely Botox, is a growing franchise generating a lot of value, and their portfolio drugs are diversified enough that there's a good staying power in general.
Rob Campbell	**33:34**	So this is a specialty drug company, essentially?
Colin Wong	**33:36**	Correct. And also they just sold a division—a generic drug division of their business to Teva. And they were about to get cash for selling that business, or stocks in Teva, and then in turn they were going to take that cash and pay down the high debt load that they had at the time. And finally, the stock was trading at a discount of what we [thought it was] worth. Then subsequently, call it two years in, I think a lot of our investment thesis has been disproved, or has been strongly discredited. For example, in terms of them paying down the debt—they paid down some, but not as much as what we hoped for, what we thought they indicated they would do. That's number one.
	34:19	Number two is some of the franchises have proved to have less staying power than what we thought. Botox still continues to be solid, but a few other of their franchises have seen pretty significant drops in sales because of competition and generics.

		And then finally, even in terms of the management, we've gone more negative on how they allocate capital, because they've done a number of more dubious things. For example, when one of the drugs that was going off patent, they tried to transfer the patent right to a native American tribe and doing something really what one could call "innovative," but another way—
Rob Campbell	**34:59**	"Creative."
Colin Wong	**35:00**	But another way to look at it might be like yeah, it's really borderline. So, things like that really made us question our positiveness on the management team that we started with.
Rob Campbell	**35:10**	Right, so another maybe feature of the decade is strong, high quality, growing companies have done very well, but also companies that are maybe not as high quality, that have some of these issues… cheap companies have gotten cheaper, and Allergan seems to be one of them. Where are we at today with that stock?
Colin Wong	**35:26**	There is somewhat of a happy ending to this story, fortunately! Allergan has been announced to be taken over by AbbVie. So, while we still lost a little bit of money in the stock overall, it's minimum, number one, more relative to the market than anything. We're waiting for that deal to go through, currently, and happy that we got lucky this time.
Rob Campbell	**35:49**	I was going to say: it sounds like we're more happy to tender our shares. Let's shift a little bit, Colin. So you're sitting in the world today, and I know that you're uncomfortable sometimes, putting on your prognosticator's hat—in terms of what the future unfolds—but what are some of the themes that you're watching right now, and that you're either really energetic about or excited about, and those you have more concern with?
Colin Wong	**36:15**	Some key topics that continue to come up lately, is that some of the good quality companies have continued to run and continue to trade at ever-higher earnings multiple, and so the question we ask ourselves is, "okay, it makes sense if a company improves that the stock goes up. But does the improvement make sense compared to how much the company has improved?" And in some cases, we say, "No, it's not." The stock has gone up way faster, way more than what the fundamentals of the company would suggest.

	36:55	So, long story short, the valuation bit, is one thing that we're fairly worried about or we have a strong eye on. Another thing we think about is the increasing talk or risk of a more significant trade war than the more isolated instances we've seen so far. There could be a tougher Brexit, for example. A no deal Brexit. Or President Trump could initiate an even more substantial trade war with China, or even Europe. These kinds of trade uncertainty tariffs really, [are] also front of mind for us. And then finally, the discount rate has been very volatile in the last two years. It's gone—in the U.S. specifically—from 1.5% all the way up to 3% for the 10-year yield, and [is] now going back down to 2%.
	37:47	So, that has a big impact on a lot of our discounted cash flow models, in that: if a company shows a 7% IRR, we look pretty good in a 1.5% 10-year yield discount rate to environment. But the same is not true if the discount rate goes up to 5%, for example.
Rob Campbell	38:07	Interesting. So what is the portfolio's exposure to trade wars? Can you talk about some of the names where you're a little bit more worried, and have you and the team done any specific work on that?
Colin Wong	38:17	Yes, we have. It's very easy, a lot of the time we find, to say, "yes, this is a risk to the portfolio" but to not do anything more about it. What we try to do is we try to be more systematic in looking at our exposure. For tariff issues or trade war issues specifically, what we did recently was we used a software to pull all the public transcripts. So, these include earnings calls, presentations that the companies make in the public, investor days…basically any public appearance that's been recorded and transcribed. So we [made] a transcript for all of the portfolio companies we own, and it turns out in a three-month period, there's over 400 pages! [Laughs]
	39:01	After we got this document, we just basically did a basic word search on things like tariff, trade war, duties. And after that, it's just brute force: going one by one to look at "hey, this company, the CEO spoke about trade war in this way, talked about the impact of a duty this way." And then we tallied it up across the portfolio. The outcome is that we think that there's roughly 17% direct exposure, or 17% of our holdings have direct exposure to some kind of tariff or duties right now. It means that they might be importing a product from China that's going to be impacted by trade war, so by an increased tariff.
Rob Campbell	39:44	Or selling a product to China? I mean, is it both sides?

Colin Wong	**39:47**	Yes.
Rob Campbell	**39:47**	So 17% of the portfolio—I guess that makes sense, given that the US is a relatively closed economy, or self-reliant economy. What have you done, if anything, about some of those holdings that you think have more acute exposure? Or is it simply good enough to know?
Colin Wong	**40:02**	Having exposure is one thing. Obviously, the other side is the magnitude of the exposure, like you alluded to. We looked down the holdings and it seems like the magnitude of direct exposure for these 17% of the holdings are still relatively muted. So we're okay with holding on to most of those companies, or all of those companies, right now. So we haven't done anything, which is funny because we did a lot of work and we didn't do any action. But oftentimes it is like that, because what we're trying to do is guard against: what if there is a company with a lot of exposure, that's heavy exposure? We want to know.
	40:39	That's number one. And number two is (in terms of what we're doing about it), it's that we're actually more worried about some of these secondary effects—secondary risks that come up. It's not the tariff itself. A lot of the companies mention the knock-on effect, which is things like customer demand going down. One of the companies we own, Linde, sells industrial gases in China. And some of these gases go towards making steel in China. So when there is an increased tariff for auto parts, for example, to be imported from China to the U.S., that would impact steel demand locally in China, and that would impact Linde's business, for example. So we're much more worried about that than we are on the direct exposure—at least right now.
Rob Campbell	**41:30**	Well, and I guess…I was going to say the other side of it is, okay, so 17% of the portfolio, maybe you have some indirect exposure…but that doesn't mean that we know what's going to happen, right? So, the opposite could happen too—or anything, I think, for a portfolio that is resilient, regardless of the scenario. Can I take that to: "hey, can you paint me a picture of why 10 years into this bull market, we're going to keep going for a long time?" [laugh] What does that scenario look like?
Colin Wong	**41:58**	Maybe to look at the base rate: if you look at a rolling 10-year period—since you're talking about 10-year return in the post war period since 1945—roughly 20 to 30% of the time, depending on what data you look at, has been a very robust 10-year return period.

		So it's not an anomaly that we've been doing well for 10 years. It's actually 20 to 30% of the time in the U.S. market since the post war period has been these good times. So that's number one.
Rob Campbell	**42:27**	Can I clarify that? When you say 20 to 30% of the time, the 10-year period has been a good period, do you mean as good as the past 10 years? I mean, surely more than 20 or 30% of the time we've been positive over 10 years?
Colin Wong	**42:41**	Right. I guess how I define this is on a rolling 10-year return basis for the S&P 500: if you achieve over 15% return per year, over 10 years.
Rob Campbell	**42:52**	Got it, okay. So very strong.
Colin Wong	**42:53**	Yes.
Rob Campbell	**42:53**	Yeah, wow that's remarkable!
Colin Wong	**42:55**	Yeah, so there is certainly nothing written in stone that says that because the market has been going well for 10 years, it has to go down tomorrow. In fact, if we look at Australia, they've been recession free for 27 years now going! So, once again—it's to be resilient in both scenarios because we really don't know. We're not trying to call if there's going to be a recession next year or is it going to continue to do well. We want to do well in both cases.
Rob Campbell	**43:24**	And so having a portfolio that's going to protect on the down side and hopefully participate in the upside as well.
Colin Wong	**43:30**	Right, and that's why we care so much about the strength of the business: wealth-creating businesses and having strong managers to run these businesses, because the strong managers will help us navigate through the ever-changing environment in the world.
Rob Campbell	**43:45**	Great. Well, Colin, that sounds like a good place to end. Thanks, Colin! And again thank you for all the work that you've put into the portfolio over the last 10 years. Hope to have you on again soon.