the art of boring™

EP60 | Playing the plan: Mawer's U.S. equity portfolio

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Andrew Johnson: 00:39 Welcome back to the podcast, Grayson!

Grayson Witcher: 00:42 It's good to be here!

Andrew Johnson: 00:43 How are you doing?

Grayson Witcher: 00:44 I'm getting by. I can't complain. A little bit different setup than usual, working from home, but it works pretty well. Not too many distractions from the kids, but pretty well in general.

Andrew Johnson: 00:52 That's good to hear. I just want to thank you for taking the time to sit down with our listeners today, because I know that everybody's pretty busy. We've got a lot to talk about in terms of just how much volatility that we've seen, and all of the events that have unfolded.

Something that I think got a little bit lost over the last couple of months, is that the end of 2019 actually marks the full 10 years where you've been lead portfolio manager on the [Mawer] U.S. Equity Fund. So first, congratulations on picking probably the best decade to start your lead PM career [laugh]. But what I really wanted to explore, was, in your view, what's changed over that timeframe and maybe some things that haven't?

Grayson Witcher: **01:32** Yeah, absolutely. It's been a great period. I've really enjoyed the work. It's hard to believe that 10 years have gone by that quickly, but a lot of things haven't changed. Some things have changed. A few things that have changed...people are really the key to our business, as you know Andrew, and the team has changed a little bit on that front. When I first started, it was Darrell and I as a team of two. And he retired, so I was a team of one for a while. And we eventually built up the team from one person to two people to three people to four people...and that's been great. It's allowed us to do a lot of things we couldn't do before.

02:04 And in addition to that, there's been new asset classes that have launched at the firm: global small cap, global equity. Those asset classes have some overlap with the U.S. equity fund, which allows us to have some great discussions with Paul, Christian, and others on those teams about companies that we both own or are interested in owning. So the people have changed a little bit.

02:26 There's been a few process change[s]. The "inventory list" is something that has really changed. When I first joined the U.S. team, my first goal was to understand the portfolio. And so once I understood the existing portfolio, the next challenge was to find some new ideas. (This is what we have, but what happens if we want to sell something in the portfolio for whatever reason?) We need to have something else to buy on the other side. And so that's where the idea of the inventory list first originated. It's kind of almost...like the idea of having a bench, like in basketball, for example. You've got your starters, which is your portfolio. These are the best players that you think are out there, the best companies that are out there.

03:05 But sometimes there are injuries, or something changes, or the competition changes. And so you need to have some bench players who you can bring into the game on quick notice. You kind of snap your fingers, you send them in, and they're ready to go. And so that's where the idea of the inventory list came up; we need to have a list of companies that are ready to go whenever we are. So we built it up over time. We have a big inventory list now.

03:29 The third thing that's changed is one of the key pillars of how we think about things. That's management. So as you know, management is key to how we look at companies. When I first started, we were just kind of building things out. We really didn't speak to many management teams at all. In fact, the first year I was on the U.S. team, we spoke with less than two management teams a month. And fast-forward to the last few years, we speak to over one management team a day. And so that's a big change. The foundation of the team, that make-up of the team has allowed us to talk to more people. And that's pretty key. I think that really is a differentiating point for how we do things, because management can add a lot of value.

04:07 The last thing I'd mention, is we know the universe a lot better now—the U.S. universe. There [are] roughly 5,000 companies in the U.S. About 1800 of those are ones with market caps that are kind of in our typical range. And [if] you look at our proprietary database, which we call M42, that now has 1600 companies, (U.S. companies) in it. So we've almost covered—and by "in there," I mean it has got notes that we've put in ourselves. It isn't just kind of...general news taken from pulling from a news source. This is something we've specifically put in there, or notes from a management meeting, or our thoughts on the company. So this is proprietary information we're putting in there.

04:50 And so we've got notes on 1600 of those 1800 companies. So that's a real advancement, and a huge advantage for us, I think. And it just builds over time. So that's a good starting point. And then, you also think about the number of companies we're tracking on a detailed basis. I'd say it's roughly 300 companies now that we know pretty well that [are] on our inventory list or portfolio, so we have a pretty good group of companies we can choose from, within that. So those are some of the things that have changed over the last decade.

Andrew Johnson: **05:20** Certainly a lot has changed in terms of your approach and the team's approach to how to do things with the U.S. Equity Fund. I think one of the questions that we're hearing a lot from clients—and I think it's pretty natural to some extent to try and draw these parallels in trying to compare how this current market environment is like the global financial crisis 10 years ago, when you were preparing to take on the lead responsibilities for the fund. I did want to get your take on that one. I guess one similarity has been just the level of volatility itself. But maybe, what are the differences, and is there anything that you're drawing on from that period of time?

Grayson Witcher: **05:55** Yeah, I think experience is a big part of investing. So, let's touch on some of the similarities first and give you some context. I think what might be similar is, like you said, the volatility is there; the stock market's been quite weak. Unemployment has been quite weak, which is typical for a recession. So, last time we got to roughly 10% unemployment, this time I've heard (it's very early on), but I've heard numbers around 13% already, [that were] talked about in the early weeks of the crisis, here. And so that's been pretty similar. Housing was the big driver last time and that could be somewhat similar this time—as you can imagine, people who have lost their job have a hard time paying their mortgage, and so you get things that cascade like that.

06:34 So those are quite similar. The big difference in my mind this time, or a couple of big differences—one is the health aspect to it. Clearly when you have a pandemic driving things, it leads to kind of another layer of worry for a lot of people. And I think it can be a lot more widespread. So, when you think about during the last recession, 10% of people lost their jobs, those are the ones that are going to be the most acutely impacted and so there are big changes in their lives.

07:01 There's going to be some other people who are worried about the stock market, their portfolios, maybe their house price has gone down, but it seemed a little more contained last time than this time, where, when you have a pandemic, it impacts really the whole population. Certainly, older people are the most at risk, but as you've seen, a lot of the hospital admissions have been for people anywhere from age 20 to 50. So I think that changes the risk a little bit.

Grayson Witcher: **07:29** This time has also been more driven by small businesses and businesses shutting down. So, you think of last time, last go around, yeah, some businesses were really impacted but a lot of them were less impacted. You just have change and maybe demand went down a little bit. So that's not great, but you're able to get through it. You have a restaurant and there's a few less people showing up on a Friday night, but you can get through it. Whereas this time, there's massive impacts for a lot of these small businesses. You might be a falafel shop that caters to the lunch crowd downtown, well, you may have no one coming into your restaurant anymore. Or you might be a dry cleaner. Well, people probably aren't dry cleaning clothes if they're not going to social functions or to work, and so you just could have zero people showing up at your door. Or a yoga studio could just be closed down. So, those are a lot bigger changes than last time around. The good news, I think, is hopefully we get through this and go from that real bad phase to more like last go-around, where things are more challenging, but they're doable. Everyone can spend a little bit less and make do. But I think there will be some kind of ongoing challenges for sure. Do people travel as much? Do people want to go back to being in really crowded areas? And to sports arenas, where there's 25,000 people? Some of those may be slower to come back, and so that could be a shift.

Andrew Johnson: **08:45** Yeah, I think that a lot of the things that I've read, or if you get trapped inside Twitter for too long, you come to the realization that a lot of the population are banking on a pretty swift bounce back. And I think reality is probably somewhere different than that, where, we're not just going to flip the switch back on. There is going to be, probably, a trickle effect in the recovery phase. In the face of all of that, what are some of the specific things that you've been doing lately, you and the team, that are probably a normal part of what we call "playing the plan," but may also be more acutely relevant, just given the recent volatility? What are some of the things that you and the team have been doing from maybe a process standpoint that might be worth sharing?

Grayson Witcher: **09:29** Sure, I can give you a few different examples of what we've done. Like you say, a lot of this stuff we do on an ongoing basis, but I think in times like this we refocus on them and reprioritize some of the stuff we're looking at. One example is we've looked at the debt in the companies we own. As you are well aware, at Mawer, we typically shy away from companies that have a lot of debt. When we're investing over a 10+ year time horizon, we tend not to want those types of companies on a risk-adjusted basis. But you always do have a few in the portfolio that are a little bit on the higher end of the debt spectrum. And so, we went through those as a team and revisited some of those to make sure they were going to be okay, they could get through some of the challenges. And we've made some changes based on that.

10:10 We've also been stress testing the portfolio. So, different members of the team split the portfolio into "bathroom-list" groups we call them, "bathroom-list" groupings. These are industries that we look at. So, we've broken the company out into those and we've looked at stress testing that. We said, "hey, let's see what's changed in the last few months, and what might change going forward," and let's look at each portfolio holding from a bottom-up perspective and see what's the downside as well as what's the upside. Some of these might benefit from it, or there are some that might not be too impacted. So, whereas the stock price might've moved, maybe the actual underlying business hasn't changed much. So we have looked at stress testing upside/downside.

10:50 We went through a screening exercise. So, again, this is something we do on a regular basis of course, but we did one just a week ago, actually. We're looking at our universe of companies and seeing what's out there and what might've changed, what might be more attractive. Looking through our inventory list, looking through other companies that we put into our M42 database, and others just out there in our universe to see what might've gotten more attractive over the last month or two.

So, those are some of the processes that we've gone through. We've made some actions in terms of the portfolio, nothing too drastic really. The changes have been pretty minor, but there have been some where we've trimmed companies or exited companies like LKQ, Nielsen, based on worries about debt for example, or business risk and imported parts from China or Asia, in LKQ's case. We trimmed the portfolio holding KAR, we trimmed back Booking [Holding]s, which is an online travel agency. So there'[ve] been some small tweaks on the margin as well, where we didn't think the risk was being properly reflected by the market.

Grayson Witcher: 11:53 And luckily, when you look over the last several months as well, some of these changes were made three, four, five, six months ago. So that's the good news too, as we work our way through. We have this process in place for a reason. And you can see the benefit from it when we've trimmed companies like Union Pacific, or PPG, which is a paint company. We exited LabTech late last year, where we just thought the valuation didn't reflect some of the risks out there. And so those have turned out to be pretty good decisions in hindsight.

So I think some of those just highlight the benefit of having this process in place that regularly looks through these companies and makes some of these decisions before everybody else does.

Andrew Johnson: 12:31 Yeah, I think that's a great overview of some of the inputs that you and the team have been doing. Maybe let's talk a little bit about the output. The fund has certainly not been immune to the negative returns that we've seen around the world, but it was down less than the S&P 500, which is your benchmark. So in your view, what's been providing that downside protection versus the market returns?

Grayson Witcher: 12:53 Yeah, it's been characteristic of the U.S. Equity Fund and a lot of different funds at Mawer, just given the way we think about things from a risk-adjusted return standpoint. We like to protect capital in the downturn. This time around...it's always a little bit different. What's worked this time around? I'd say generally avoiding companies with a lot of debt has worked. You've seen a bunch of those companies get beaten up pretty badly as people become more acutely aware of the risk of having a lot of debt. Cyclical business models—a lot of those have been beaten up, and we tend not to have too many of those companies in our portfolio, that are really dependent on one particular outcome. We really like to focus on companies that do well in a number of different environments, not just one potential environment, one potential outcome.

Grayson Witcher: **13:38** We haven't had any oil and gas companies in a while in our portfolio, so that's been pretty beneficial, relative to the index. It's not a huge sector in the U.S.; that hasn't been official, because they have gotten really beaten up over the last while. And I'd just say owning business models that are durable. I think that's our hallmark, really, and that's what we really strive to do: find durable business models, ones that can make money in many different environments. And so [if] you look through the portfolio, some of the better performing ones are ones that you'd expect to perform well in these environments. It could be names like healthcare companies like Gilead or Becton Dickinson, which makes needles; or Baxter, which makes IV pumps. Those ones might even get a little benefit from environments like this, where you have a pandemic. But generally, when the economy is doing poorly, people don't get sick less often, or go to the hospital less often—those kind of things. They're really unaware of what's happening in the economy, so those tend to do pretty well.

14:34 Tech companies too—there [are] some tech companies that we tend to focus on, [which] are ones that we think are more durable and that can make money in all different environments. It's ones like Intuit, which owns TurboTax. Maybe your taxes are a little bit delayed, but you're still going to pay your taxes. You're not going to be able to avoid taxes just because the economy is doing poorly. Or QuickBooks, where you have to manage your business. Those kinds of things are important and perhaps even more important when you want to do it on your own, rather than going to talk to an accountant, for example, in person. Or it could be businesses like Microsoft. You have to work somewhere: working at home, working at the office you use Microsoft. [Now] working at home you use a lot of Microsoft products. So those are the type of companies we skew towards and you've seen some of those durable business models do quite well in the recent correction.

Andrew Johnson: **15:20** When I think about what you just said, I think it's always probably nice to have some home runs in the portfolio, but I think what you're saying, really, is about trying to have a couple singles and doubles throughout the entire game to really set yourself up for success. Because in essence, investing is really about dealing with the future. And it's an unknowable future at that. I think you touched on this a little bit earlier in some of your comments, but as you grapple with that future, what are some of the potential changes in behaviour as a result of the responses to the pandemic? And what are some of the challenges and maybe opportunities that may come with those within the portfolio itself?

Grayson Witcher: **15:57** Yeah, so what has changed: we're looking to really eliminate—we've had a discussion about this, many discussions over the past few weeks within the U.S. team and in the broader research team at Mawer—we're trying to really find where the sharp edges of the portfolio are, if there are any, and eliminate some of those. It could be things like restaurants or businesses that depend on big gatherings. It could be movie theaters, arenas, or things like that. And trying to make sure we avoid those. Or ones that are really subject to travel, which may return or may not return really quickly.

16:33 And then, trying to find companies that benefit from those. (Hopefully we had some exposure to that ahead of time, which we did in many cases.) And we might choose to lean on some of those a little bit more and add to some of those positions. So, it could be things like…what could change going forward; it could be themes that are already in place that are just amplified now. So, I'm thinking about things like delivery versus going to a store to buy stuff. So, Amazon-type companies where maybe you don't want to go to a store to buy groceries or to buy a new pair of pants or laundry detergent—or whatever it is. You want to have it delivered to your door. So that's a theme that was already taking place, but I think it's just going to be amplified now. That's why we own companies like Amazon.

17:16 Along the same line of thinking, another theme that we've benefitted from over the last five or 10 years has been the shift to e-commerce and online purchasing. We've owned Visa for probably close to 10 years now. And so that's been a very beneficial theme for us. And I think that's something that probably continues with some of the changes that could happen. If you're buying more stuff online, maybe you're buying less physical goods, and you're using Netflix more, instead of going to a movie theatre. These kinds of things really lead you to use your credit card more often rather than cash or other forms of purchasing goods. And so that benefits companies like Visa, MasterCard, or PayPal that we have in our portfolio.

17:57 Other shifts: working from home. We're all trying to adapt to the new changes in our world, working from home. And so you get a lot of benefit from companies like Microsoft, which had positive themes going for it before, with things like cloud computing. But they have additional benefits now, where you're using their products just as much at your house or using Microsoft Teams for video calls or other things like that.

Grayson Witcher: **18:20** [And the last one I'd mention]...again, I think these are some of the more powerful themes that were already in place [and] that are just amplified. One theme that we've invested in for many years now—actually probably close to 10 years, maybe even over 10 years—is the insurance brokers. The world is getting riskier all the time, you're getting shifts on that front: climate change; getting your accounts hacked; getting credit card numbers stolen. All types of stuff. And so you're seeing the benefit of that from people having to buy more insurance. And while we don't necessarily want to have the exposure to insurance companies directly where we have to pay the bill for fixing that problem, we've invested in insurance brokers like Marsh & McLennan for a while. I think that's another thing you're seeing from this—these pandemics can lead to a lot of different types of insurance claims. And so this is just another way to benefit from a theme like that. So those are some of the ways the world has changed and we can benefit from it.

Andrew Johnson: **19:16** I think one area that we've talked a lot about over the past year or so with the fund has been the inventory list. And you've described what the inventory list is earlier. It's essentially a list of our companies that we keep where we've done all of the work to get to a point to basically make an investment decision. In other words, put it in the portfolio and at what weight or not. And one of the things that's been standing in the way of many of those companies on the inventory list has been the stock price. In other words, the valuation in our view, is trading at the higher end of our estimated range of fair value. Which I think you know, for us, really highlights the important relationship between price and value. But has the recent downturn in stock prices, generally speaking, provided any opportunities to add some of those names to the portfolio?

Grayson Witcher: **20:02** It has. We haven't made a lot of changes. I'd say on the surface of things it may look like there hasn't been a lot going on, but I would say that behind the scenes there's been a lot more going on. We've had a ton of discussions within the team of some of our inventory list holdings. And we haven't made a lot of changes, like I said, but a lot of them are getting pretty close to where we've been interested. So, when we look at our inventory list, (just to back up a little bit), we do all the work on the company. We'll speak with the management team, we'll do a DCF (a discounted cash flow), we'll write a report on the company. But the reason it's on the inventory list rather than the portfolio, is there may be something that's just a little bit off, that's just missing. So, it might be the valuation's not quite where we want it to be; maybe the management team is not quite the standard we want it to be; or the risk is a little bit higher than we'd like.

Grayson Witcher: 20:47 So for the ones where the valuation's a little bit off, one of the things we do is we set a price target, which is kind of a crude way to remind ourselves when it might be more aligned with valuation that we think makes sense, where we can get an attractive return. We have noticed that a number of those companies that were a long way off from where we'd be interested investing three or six months ago, are now very close to where we'[d be] interested. So behind the scenes there's a lot of new ideas that are popping up that we're revisiting. And so I think that's exciting.

21:19 And on top of that, we're also looking at screens of the universe just to see if there's anything that's not on inventory list that might be attractive. [We took] the universe down to a shortlist of about 15ish companies about a week ago that we think are attractive. And so that's something that we're going to be narrowing down further to see if any of those make it onto the inventory list or into the portfolio over the coming weeks. So a lot of potential ideas are coming forward.

Andrew Johnson: 21:43 Let's talk about a holding or two in the portfolio. Is there an example of a relatively longer term holding that we've had that you want to highlight that maybe points to the exact kind of business model that we're looking for to not only survive through these types of environments, but maybe even have an opportunity to thrive or continue on exactly as they had been? If I'm remembering correctly, I think there's a handful of stocks that have been in the portfolio since you took over as lead portfolio manager. So is there anything in that grouping that you want to talk to?

Grayson Witcher: 22:15 Absolutely. I can talk to one of those or even a couple of those. Yeah, because when I think back off the top of my head, there are several companies at least that have been in here the whole time—have been in here for 10+ years. Things like Marsh & McLennan, AMETEK, Procter & Gamble, Becton Dickinson, Pepsi, Dentsply. So there's a number of them. One of those would be Marsh & McLennan. They're an insurance brokerage company. They facilitate the buying of insurance. And so what we like about that is they benefit from a theme of increasing complexity and increasing risk in society. When we think about some of the big risks out there today, many of them probably weren't on the forefront of many people's minds 10+ years ago. It could be things like online fraud, credit card fraud. It could be directors and officers' insurance—[that's] really kind of ramped up. Could be things like climate change, or even pandemics now, the risk of pandemics to your business. And so some of those might not have been on the forefront of a lot of people's thinking a decade ago, but now they are. Companies are trying to protect themselves against some of these risks.

Grayson Witcher: **23:24** Marsh & McLennan benefited from doing the same thing five, 10 years ago as they're doing now. And so when we think about it, we still like that business model. People want to buy risk, want to buy insurance to protect themselves from risk. And I think they're still going to want to do that. And so this is a good risk-adjusted way for us to benefit from a theme like that. And in a time like this, it's also important to note that one of the benefits from a portfolio makeup standpoint of a company like Marsh & McLennan is the correlation with the rest of the portfolio. It's not so closely tied to the rest of the economy, insurance events. It could be hurricanes, could be pandemics, it could be online fraud. These kind of things don't tend to happen…they're not tied to the economic cycle. In fact, they might be in some ways [inversely related]. Certainly weather events aren't tied at all. Weather it doesn't know if the economy is doing well or doing poorly. [So] some of the things might be kind of inversely related to the economy. There might be more fraud when people are working from home, or when people don't have jobs. And so we still like that business. We still think it's quite attractive on risk-adjusted basis.

24:26 One other would be Becton Dickinson. We've owned that company for many, many years now, and I've been down to visit the management team many times as well. This company makes needles. It's one of their core businesses. And so again, this is a business that doesn't depend on certain outcomes in the environment, in the market. People tend to need to get blood taken or need to get shots or vaccines all the time, it doesn't depend on how the economy's doing. So we like that business.

24:54 And one of the things that I'd point out about Becton Dickinson that we've always really appreciated, is the quality of the management team. It's always been, what we view, as one of the better management teams in the portfolio. And when we go down and speak to them and visit them in their offices in New Jersey, you get a better grasp for that. And I think that's something that you can't screen in the numbers. If you're just trying to find a company on a quantitative basis, that's something that may not pop up. But when you find a good management team, they can keep adding value for you.

Grayson Witcher: **25:21** One of the benefits of being a long-term investor (one of the reasons we like it) is that you don't have to keep coming up with new ideas. It's tough to find really good investment ideas. And so if you're turning over the portfolio once a year, you may have to find 40 or 50 or 60 new ideas a year, which is really hard to do. Whereas if you're investing over five or 10 years like we are, you might need to find six, eight, 10 new ideas a year, which we think is much more manageable.

25:52 And so when you can do that, and when you can find businesses where they have real high-quality management teams like we think Becton has, they can do a lot of work for us and for our clients. And they can evolve with the world. They've changed their business a little bit over time, where it's still the same core business, but they've added/acquired a couple of larger businesses and done a great job bringing them into the business to adjust for the changing healthcare landscape. And so they're a great management team that keeps surprising us to the upside. So that's another business we've owned for 10-plus years that we're still excited to have in our portfolio.

Andrew Johnson: **26:25** Yeah, I think Marsh & McLennan and Becton Dickinson, for me, are among the dictionary definitions of "Be boring. Make money.TM" Kind of...attaching ourselves to great business models and great management teams, and then constantly reassessing things and participating in that compounding growth of those businesses.

Grayson, just before we wrap up, another question that I wanted to ask is just... given that we've already talked about the 10 years as lead PM, if you put yourself 10 years in the future, what do you hope our clients are saying about the fund, and you, and the team?

Grayson Witcher: **26:58** Yeah, that's a good question. You know, we do an annual retreat for the U.S. team and we think about some of these issues on how can we provide the most value for our clients and what's the best way to do that? For us, I think what we want to be kind of known as 10 years from now, is really a lot of the same things we are known for now, but really just...kind of more of the same. Continuous improvement is something that really resonates with us, and those risk-adjusted returns. I think that's really important for our clients.

Grayson Witcher: **27:29** It's a case of when you think about, especially in times like these where it's challenging for many reasons, I think there's two things that we can do to add a lot of value for clients. One is hopefully protect some of their capital. Ideally, lose no money for them, but the reality is oftentimes we do lose some, but hopefully a lot less than others out there—the index and other investors. And so that's one thing we can do.

27:55 The other is [to] provide peace of mind for clients. And so in doing that, and in providing more stability for our clients, I think that provides a real service as well in that clients don't have to worry as much about their investments. They can worry about other stuff that's more important—their family, their own businesses, their own jobs. And they can avoid some of those capitulation moves that you often see with in the markets. That's where you ride the markets all the way down and then you get kind of fed up and you go to cash right at the bottom because you just can't take the volatility. And so hopefully we can avoid some of that volatility for clients and allow them to benefit from the upside. Things always recover and they will again this time. So I think having this stability and protecting some capital for clients will be very beneficial for those reasons.

28:43 So yeah, I think at the core of it is, 10 years from now, we hope that we can add a lot of alpha for our clients—even more than we're doing now; do everything a little bit better, which would hopefully lead to more better performance, more alpha for our clients; and we can do that on a risk-adjusted basis, so that we can protect client capital in choppy markets like this. And then we can reinvest that in great quality companies and make even more money for them in those good markets so that they can use that money to do the things they want to do in their lives.

Andrew Johnson: **29:15** I think that's a great spot to close things out. Thanks again, Grayson, for everything that you and the team have been and continue to do for the portfolio, and our clients. I'm really looking forward to talking again in the future.

Grayson Witcher: **29:26** You, too.