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EP63 | Playing the plan: Mawer's global small cap portfolio

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Andrew Johnson: **00:41** Hey Christian, how's it going?

Christian Deckart: **00:42** Very well, how are you? Glad to be here.

Andrew Johnson: **00:44** Yeah. I'm glad that you're here. I was actually thinking before we hopped on here, on any given typical day at the office, you and I would be spending at least a few minutes exploring the topic of just how vastly superior my hockey team is to yours. And we haven't been able to do that as much lately. But I did see that the German soccer league started back up, so I assume that's bringing you a little bit of joy.

Christian Deckart: **01:08** And I will congratulate you that your guys have gotten exactly zero penalty minutes last month, which is close to—

Andrew Johnson: **01:15** —It's a record.

Christian Deckart: **01:16** It is! Especially for a team that plays like yours.

Andrew Johnson: **01:19** [Laugh] Well, on that note, why don't we move right into the global small cap portfolio? Actually, before we [do that], I wanted you to leave your deputy chief investment officer hat on for a few minutes, because I wanted to hear about…just what life is like for you and the research team lately, given the current situation. And we've talked to both Paul, as CIO, and Vijay, as director of research, about some of this already, so don't feel as though you need to go into a great amount of detail. I was more curious about what has remained the same for you and the team through the current environment?

Christian Deckart:	**01:53**	Well, I think we are very lucky in our profession in asset management, because what we do does not depend on people being able to visit us every day. We like to think of ourselves as long-term investors, and usually, we have clients that think of themselves, as well, as long-term investors. So they've given us money for a fairly long period of time. And we invested to the best of our knowledge in wealth-creating companies, run by excellent management teams, and bought at a discount to intrinsic value.
	02:22	Now, doing that, first of all, means there is not that much day-to-day interaction with our clients, and not that much day-to-day interactions with the companies we have invested in. We have regular due diligence meetings where we follow up, but all the things we need to do there, we can perfectly do remotely as global investors.
	02:41	We have been trained to work remotely for a long period of time because well, a lot of our clients, frankly, are not in Calgary. And a lot of the companies we invest in are not even in Canada, or not even in North America. So, in a way, just by the function of our business model—what we do—we've been pretty well-equipped to start facing this.
	03:01	What has changed maybe a little bit, I think, [is] collaboration has become even better. As a team, we've all moved on to Microsoft Teams—this is a plug for the global equity fund, which holds Microsoft shares in it. So, we all have moved to Microsoft Teams, so, encouraging everyone to do that as well. It's a great collaboration tool: we have the ability to video chat with each other, discuss in threads, send each other chats. So, I would say collaboration hasn't become worse during the lockdown. If anything, it has become better because we're all now on this—how shall I say [it]—virtual platform.
Andrew Johnson:	**03:33**	I'll just pick up on the word "collaboration" there, because one of the concepts that I know that we've talked about in previous discussions around the office, is this idea of "intellectual best ball." So, that comes from golf terminology, where the group of players will play the best ball that's out there from each of the players on the next shot.
	03:53	In our world, it's something that actually Warren Buffett talks about when he refers to his team, and how they explore and pursue different investment ideas. So, I want you to take us through how you and the team embraced that type of approach.

Christian Deckart: **04:09** Well, first of all, the ideas—everyone wants to beat the market, have above-average returns with below-average risk. So the question is, well, how do we get to that result? And one of the ways we think is, well, two brains are better than one brain, and 30 brains (we are 30 people now in our research department) obviously work faster than one brain, so, if one of us has a good idea, we try to make sure that it gets shared and other people can pick it up. Because if I'm thinking from A to B, and I tell everyone, "hey, I've got to B." Well, B might be the end point where my brain can take me, but someone else might take that idea from B to C, because well, they have another brain, they have another life experience. They have a different background.

04:51 As a reminder, at Mawer, many of us have not just business or finance backgrounds, but different academic backgrounds. We have people with engineering background, political sciences background. I have a law background. We have someone with a PhD in neuroscience. So, the idea is to take people with different backgrounds. And that allows us to bring different ways of thinking, or mental models as Charlie Munger would call it, to problems. And collaboration is important because then one person could take an idea from A to B, but someone who's in a better position can take it from B to C.

Andrew Johnson: **05:22** How do we actually go about doing that?

Christian Deckart: **05:24** We have sharing meetings. (I'm now describing the old world pre-COVID!) We have sharing meetings: the teams meet once a week; every asset class meets once a week. And then the whole research team meets once a week. We have retreats. And then there's informal sharing of ideas in the kitchen, around the open office where we work.

05:42 Now, the open-office step brings us to what's changed. Well, now with COVID, we no longer sit in an open office. And so we have discovered for our purpose that actually Microsoft Teams is as good as being in an open office, if not better. So, someone who has a good, helpful thought puts it on there. Everyone can see it. And if they have additional thoughts, they can develop that thought further.

Andrew Johnson:	**06:02**	And one of the tools that we've always used is our internal database of notes and other information that we store on companies. We call it our M42 database. I'll let you talk about that, but I mean, that's just one example of what we've already had in place. You spoke about taking ideas from A to B and then somebody else picking up on that from B to C—it's powerful to have something like that available to us, not just now where we're in separate physical locations, but on an ongoing basis, even when we're in the office.
Christian Deckart:	**06:33**	Yeah. And I'll talk about two aspects there on M42: the first one is the technical aspect, but the second one, how it fits into our culture. The technical one is just…yeah, it's been around since I think 1999. I think the last number I saw was more than 300,000 notes on more than 8,000 companies. So, just think of those numbers. Every time we interview a management team or we talk to a customer, competitor, supplier of a company…we log what these people said in there.
	07:01	If we read a good publication in an industry journal, we're going to put it into M42, and then everyone on the team can see it. So, if a management team tells us, "oh, we've warned about this for 10 years." Well, we can go back. If we've spoken to that management team 10 years ago, in our database, we see exactly if they said it or not.
	07:19	The idea why that was created more than 20 years ago, was, you might know the problem from the organization you work in—well, there's a client who calls that wants something or need something, and at some place in your organization, the information is there. It might be on a paper, on a hard drive. It might be somewhere in an email, but you can't find it now. So, often the problem is not that the information hasn't been gathered somehow, but that you can't access it.
	07:46	So, that's why the idea here, more the 20 years ago, was: "whatever you do, put it on M42." Everything goes there so that the whole team can find it. And I think Microsoft Teams now—or whatever other sharing platform people might use, but here it's Microsoft Teams—allows you to have more discussions around current topics. So, that's the technical aspect. But I think M42, if people ask me, well, "why is that a competitive advantage? Everyone should be able to copy that." Well, there's two [reasons] why it is.

Christian Deckart: 08:17 I think it's the amount of time we've worked on it, the amount of data we've put in there, and that obviously we don't share [it] with the outside world. It's our data. And then secondly, it's the cultural aspect—that we work in a firm that's employee owned, [that] we don't compete against each other on the research team. We work together, we have that collaboration culture. So, actually, people do put their best information in there.

I could very easily imagine an environment where people don't put their stuff on there because they might think they compete for compensation with the other people that should be on their team. And so they hold back information. And that is what also, for more than 20 years, we have worked on as a firm—to create this culture of [a] sharing, open meritocracy. It's that incentive and cultural system around it that really makes M42 so powerful.

Andrew Johnson: 09:06 I just want to pick up on a couple of words there, because you mentioned both "management teams" just a few minutes ago, and then you just mentioned "incentives." And when I think about those—and you're exploring all of these different ideas and areas where we can allocate capital—how important is it to have a management team that is well-aligned with shareholders?

Christian Deckart: 09:26 That is something that can give you a margin of safety as an investor, because well, think of it right now: the coronavirus has hit the world. And let's quickly talk about global small cap: we own about 70 companies around the world. Now, as an investor from Calgary, how am I supposed to know if the decisions that the local management teams are taking in real time here, if they are the best possible decisions?

09:51 We might be able to know that in a few years or when they next report the quarterly numbers, but it's really a principal agent problem. How do we know that they actually take the best decisions that are in the long-term interest of shareholders? And so, one of the simplest ways is to make sure that the self-interest of these management teams that go to work every day, and have to take these tough decisions right now, every day, that they have the same interests as our clients, our investors—the people that have provided the capital for that business to run.

Christian Deckart: 10:20 And it's just our experience that people that have skin in the game, that have the same interest as shareholders, in the long run, we'll probably end up taking better decisions from a shareholder's perspective.

Andrew Johnson: 10:33 If I'm an investor out there listening to this podcast, for example, what are some clues that I can look for when I'm assessing a management team that would point to strong alignment?

Christian Deckart: 10:42 We often look at simple things, what we call "the inductive evidence." So, how many shares do they own? To what dollar or Euro value does that translate compared to the salary they draw? If you have someone who holds, I don't know, $20 million in stock and draws a salary of $100,000, well, I would say that's a pretty strong owner. The ratio in that example—20 million versus $100,000—is 200 times. So, I think that person will think more like a long-term owner than an employee, because the risk of course is with management teams if they're not aligned, [is] they can jump ship easily, right? They can say like, "oh, this is a difficult situation. I'm out." And that is something which leaves, well, if you will, the shareholders holding the bag. So we prefer aligned management teams. And we think that over time, we see the results from that.

Andrew Johnson: 11:28 What are some examples in the portfolio that you can think of off the top of your head that stand out to you as fairly well-aligned?

Christian Deckart: 11:35 A good example I have in my head here is Fielmann, which is the largest optical chain in Germany. So if you need glasses in Germany, you go to a Fielmann store. (Or a lot of people do that—they are the market leader in Germany.) They have [had] to close, overall, a large part of their stores. And in Germany, for instance, what they did is, the government will pick up a part of the salary as they have to close—that's a bit different from other regions—but the government picks that up.

12:02 And for the most valuable of their employees, the trained opticians, Fielmann has said, "yeah, okay. The government picks up a part of the bill, but we will top you up. We will make sure you earn just as much now that you're not going to work as before." And we think that, from a shareholder's perspective, [is] a very smart decision. Because you don't want to lose these people.

Christian Deckart:	**12:21**	So, apart from the positive social benefit that it has—these people do not have to lose a part of their compensation—it's also just economically smart to make sure that your most valuable employees are still with you after the crisis. So yeah, Fielmann has invested or is investing some money right now into this. They are foregoing profits. They're paying people more than they would have to. But that, from a purely business standpoint, [is] the smart thing to do. Plus, it is a decent thing to do. But it's also purely just from a capitalistic standpoint pretty good.
Andrew Johnson:	**12:54**	So is there any other examples that come to mind?
Christian Deckart:	**12:54**	We have one example where I prefer not to name the name of the company, but one example of where we have encouraged the company to keep spending on advertising…the business they are in, the risk might be that in a situation like this, they cut all the advertising costs. And we have to be clear here: the business I'm talking about, one of the largest cost blocks is advertising. And so, we have encouraged them. We gave them a ring and said, "you should know this: we're long-term shareholders. And if you think it makes sense to invest money into advertising right now, then please do it. We will not be disappointed or shocked or angry with you if you show a negative result for a quarter, if you think this creates long-term shareholder value."
	13:30	And this, again, brings us back to alignment. With these people, we have full trust because the CEO of that company owns a large chunk of the business. So, he will be what we call "long-term greedy," as well. Not too much worried about the short-term, but, like we hope our clients are—very much interested in long-term success. We want, long-term, the best risk-adjusted returns. But that, in the short-term, sometimes means forgoing profits. And that is in this case, what we encouraged that CEO to do.
Andrew Johnson:	**14:00**	I think that's important to remember for investors. And those are two great illustrations of alignment with our investment portfolio holdings. We just talked earlier at the outset about hockey and soccer, and I think those are two sports where the players on the field at one point in time, either playing offense or defense. How important is it to strike that balance in the investment portfolio?

Christian Deckart: 14:24 We always have in our portfolios, what we call the "natural contradictions." So, we try to have exposure to cyclical companies, non-cyclical companies. We try to have the portfolio balance out many—as they would be called in the modern investment world—factors. We do have cyclical names in the portfolio. I'm thinking of Addtech out of Sweden that we own, which is industrial producer, or Chase Corporation out of the U.S., manufacturers many things that are often used in industry. So, those are our cyclical names.

14:53 On the other hand, we have things that are, I would characterize as non-cyclical, that are in more stable industries. Probably the best example are our Japanese drug stores. We are shareholders in three different Japanese drugstore businesses, and if you think of a drug store, as well—the medication side as well as the convenience side that they have in some of their stores—that is probably more stable.

15:16 We don't bet on whether the economy expands at a fast pace, or with it declines. We don't bet on that. We're not a macro hedge fund. We try to balance all that by having these inherent contradictions in the portfolio. The only three factors we do not want to be balanced out throughout the portfolio is, we want wealth-creating businesses, with excellent management teams, and we want to purchase these at a discount to intrinsic value. But all the other factors—which industry a company comes from, which region—we want all that to offset each other, ideally as well as possible, so that in the end we end with those factors.

Andrew Johnson: 15:50 Whenever I hear defense and offense, when it comes to investing, it always reminds me of a Howard Marks quote. And I'm going to butcher it—we'll call it paraphrasing. But he always describes defensive investing as, rather than trying to get everything right all the time, the emphasis is more on not doing the wrong things. In other words: you're always still trying to get higher returns, but you're trying to do it in a way where you don't have as many minuses in the column as pluses. It's just more about growing through consistent, moderate progress. Is that a fair comparison to how you think about it?

Christian Deckart: 16:22 Yeah. And as you've started quoting great people here, I will—

Andrew Johnson: 16:26 —You're going to quote me, is that what you mean?

Christian Deckart: **16:29** —No. No. And I will not quote anyone from the Boston Bruins organization, that's for sure. I will quote, first of all—I think I read it in the Berkshire transcript just recently—"if you take a series of multiplications, as soon as you multiply just once with zero, the overall result is zero." So, I think that is very important to keep in mind with risk management.

16:46 No matter how impressive the numbers are in the front, if you multiply with zero once, well, that was it. It's the other thing I think I've heard about—the living weight of a turkey. Which goes up until the turkey's end comes, probably around Thanksgiving. So, if you multiply with zero, once, it's done.

17:00 And then the other great quote is from Jim Hall, our chairman. [Laugh] And, he recently just (it was on Teams) had a post about the life of a risk manager versus a gambler. And the gambler tries to get everything right, all the time. And he takes considerable risk. And the risk manager just tries not to blow up.

As investors, yeah. Risk management is what comes first for us.

Andrew Johnson: **17:23** It's tough to explain the benefits of that type of approach when times are really good. And it's often not until times are rough when you see the benefits of that type of portfolio approach.

Christian Deckart: **17:35** And I also point out, as I take client calls these days, people often ask like, "oh, have you upped your risk management?" And then, in this situation, my thinking is yes! but yes and we always to have resilient portfolios. We always try to prepare our ship. Think of—and now I'm sort of paraphrasing Jim Hall again—but when you sail out of the harbour, even if the sky is blue, you only want to leave the harbour with a ship that could withstand a storm. You don't go out with a bad boat, and then all of a sudden: "oh, there's a storm, now I need to start repairing my boat."

18:09 The storm is not the time to fix your boat. Your boat should always be in "shipshape" as they say in England. So, that's the other thinking around this. Yes, risk management is a bit heightened today and we think about other risks, but generally, always it's the right time for risk management.

Andrew Johnson:	**18:25**	You're right. Well, before we close it out, why don't we walk through a couple of examples of holdings in the portfolio that can really hammer home that concept of both risk management, but really kind of illustrate our entire philosophy. The one name that really stuck out to me lately has been De' Longhi, which is actually an Italian company. So, I thought it would be relevant to talk about that.
Christian Deckart:	**18:46**	De' Longhi—I mean, most of you might be familiar with the De' Longhi products, if you have a Nespresso machine, because that's one of their products, the Nespresso coffee machine. So, the pod comes from Nestlé, (again, a plug for stuff we own in the global equity fund). We do own Nestlé in the global equity fund, so, if you pour yourself a cup of Nespresso in a De' Longhi machine, you do good things for your holdings in the global equity fund and in the global small cap fund, so I encourage you to drink lots of Nespresso these days!
		But De' Longhi does the machine. It's Italian design, a lot of it is actually, of course, produced in China and also in Romania. The stock and had a weaker run recently, and we used the corona[virus] crisis (at the beginning of it) to build a position there.
	19:33	And as we started buying—I don't think there's causation here, it's more coincidence—management also thought that the price [looked] good, because they've announced a share buyback program. And I think this is also an example of an aligned management team. There is a De' Longhi family, and they probably looked at their share price and thought, yeah, this is an attractive price to buy. So, we liked that. We like share buybacks. Not at all valuations, but we like share buybacks at valuations that we think are attractive. And in this case, we think the management did (probably, we don't know the results yet, but probably) a good job in initiating a share buyback.
Andrew Johnson:	**20:07**	And do you recall how that idea came about for the portfolio?
Christian Deckart:	**20:10**	That is a good example of collaboration, again, within Mawer. So, the person, Peter Lampert, who runs our emerging market fund and is part of the international equity team—he had flagged that stock to me probably a year and a half ago. So, we had it on our list, we watched it. In M42, we keep very good track of who flags which idea when, so we can make notes, like, "look at this again at price XYZ, or when this or that happens." And so then we interviewed them, and we really liked what we saw, what we heard. That's what took it there.

Christian Deckart: **20:43** So the initial idea was from Peter Lampert. And for all those that are invested in the global small cap fund, and, by the way, now also in the global equity fund that have noted that we hold Bravida in our top 10 positions—that's also one where, well, we're obliged to Peter Lampert because he had spotted that for us.

21:00 On De' Longhi, we acted faster. I think from the time Peter threw that name over to us until we bought it might've been a year, or something like that. Bravida...I think it was more like two or three years. We waited for the valuation to change [laugh] and that worked out in that case. But those are two examples in the portfolio where, it's actually 30 people on the research team that worked together on this. On paper, yeah, there's only four members on the global small cap fund, but in reality, we're a team with 30 people and we work together. This is not a siloed approach. And that's why M42 works. That comes back to the culture, that we all truly work together.

Andrew Johnson: **21:34** Great. One other business model that is very different from De' Longhi and might be very familiar to some of our listeners, is Morningstar, which is based out of Chicago, [and] does a lot of work here in North America for the asset management industry. Maybe talk about that business model, how the idea came about, and what it means for us when we hold it up against our investment philosophy.

Christian Deckart: **21:55** I mean, Morningstar came along probably now two years ago, when...some might remember in global small cap, we had slightly tweaked the market cap range in which we can invest. It used to be that we c[ould] buy a company up to $3 billion U.S. dollars market cap at initiation. And then we changed that to $3 billion market cap at free float, plus an absolute limit of seven.

22:19 And Morningstar just fell into that expanded universe. We had looked at it before, but it was just outside our universe. And then as soon as it came in, we talked to management again. We were very impressed with what they've built up. It's largely a subscription business model—they provide very important data to people in the financial services industry. So, if you will, they provide the tools a lot of people work with.

Christian Deckart: 22:44 We then did a bit of what we call "scuttlebutt." So, we talked to customers and found out that, yeah, Morningstar has quite some pricing power. I mean, if prices go up a bit, people may not like it, but they still accept it because it's so important what Morningstar does. The value they provide to the customers is just so significant or meaningful. And we've liked a few of the acquisitions they've done. Namely PitchBook, which is sort of a financial database for companies that are not listed, that are still private.

23:11 And that's a growing business, also, a subscription business. And then, Sustainalytics. So, all those who look at ESG ratings, often when they do it, they will look at Sustainalytics ratings. So Morningstar, when we invested, had a small position in Sustainalytics and now they've just recently announced that they're taking over the rest. So, we as a firm are also customers of Morningstar now, so from that we're in a position to evaluate that business.

Andrew Johnson: 23:36 Yeah, I think both of those examples actually highlight just how agnostic we are as to where ideas come from, as well.

Christian Deckart: 23:42 The idea is to look at as many things as possibly can. If you want to find things, it's better to turn over more stones. Once a CEO, a long time ago, actually told me when I asked him about their sales process, he said, "it's just shots on goal. And if the goalie is good, i.e., if it's difficult, you just need to shoot more often." And that's our approach here: turn over more stones.

Andrew Johnson: 24:04 Well, I actually can't think of a better way to close it out with hockey as the analogy. I look forward to speaking to you in the future again—hopefully we get to talk some hockey in the future [too]. But, in the meantime, I just checked the standings and the Bruins are still ahead of the Canadiens. So, we'll leave it at that for now.

Christian Deckart: 24:19 And if they do directly go to playoffs, well, you can talk about hockey a lot for the next month, I just won't.

Andrew Johnson: 24:25 Thanks again, Christian.

Christian Deckart: 24:26 Bye.