the art of boring™

EP70 | Playing the plan: Mawer's emerging markets equity portfolio

Disclaimer	**00:25**	This podcast is for informational purposes only. Information relating to investment approaches or individual investments should not be construed as advice or endorsement. Any views expressed in this podcast are based upon the information available at the time, and are subject to change.
Andrew Johnson:	**00:41**	All right Peter, welcome back to the podcast. How are you?
Peter Lampert:	**00:44**	I'm good! Good. I'm always happy to talk about emerging markets.
Andrew Johnson:	**00:47**	Well, we're excited to have you. I was thinking the last time that we sat down was actually just November of 2019, I believe. So, why don't we start there? It's been a bit of a tale of two halves so far this year. How has 2020 been so far in terms of managing the emerging market strategy?
Peter Lampert:	**01:02**	Yeah, it's been a wild ride. A lot has happened since we last spoke in November. I think, obviously, COVID has been the major theme of the year, and how that's impacted people, people's lives, the economy and the stock market. So, certainly, we've seen the impacts in our portfolio, and the first half up to March with the big downturn and then a very strong recovery in the stock market since then. So, that's what we've been trying to navigate this year.
Andrew Johnson:	**01:30**	Why don't you take our listeners through…sort of what has happened in your view in Q1, and more recently in Q2? Given what you just mentioned in terms of the strong rebounds?

Peter Lampert: **01:39** Our portfolio has held up pretty well in the downturn in March, and that's because of Mawer's investment approach. We generally invest in resilient businesses, less cyclical companies, companies with low levels of debt, and companies that can ride out a storm (and the ship won't sink in a downturn).

So, for example, 70% of this portfolio—the Mawer Emerging Markets Equity Fund—70% of the portfolio is in companies that have net cash. They don't have debt. So, these are more resilient companies, but as well, we were still concerned when the information was coming out about COVID in China, early on. What was going on, and the impacts that would have. I remember back in January we were following this very closely.

02:20 As emerging markets investors, a lot of our investments are in China and that's an important market for us. So, in January, when the outbreak was happening in Wuhan, [it] still wasn't getting a lot of international media attention, still wasn't getting much attention from the stock market. But one of our colleagues was visiting Beijing, and she commented that "people are wearing masks here. The restaurants are almost empty." I was quite surprised to hear that, because in the news that we'd seen, we didn't know there was any problem in Beijing. And there was a relatively small outbreak in Wuhan.

So, that kind of showed the scale of the problem that the media in China and what the government was advising across China—they were taking this very seriously. Only a week later after that, they imposed a lockdown on Wuhan. And that's when we realized that this is a very serious situation that will likely have big consequences. And if they're locking down entire cities with tens of millions of people, that it will have big economic impacts, too.

03:16 So at that time, like I said, we tried to have a resilient portfolio that [could] do well, even if there is a big economic shock. But we were concerned [about (specifically at that time) China], that there would be a downturn triggered by these lockdowns, impacting companies that are more reliant: like the empty restaurants that my colleague saw; travel, that would be a big one. Our portfolio specifically happens to have a lot of exposure to travel, because that's a great long-term theme. Chinese people are travelling more and more, flying, staying in hotels. More people are getting passports and [are] able to travel, and can afford to travel. So, from a long-term theme, that's very positive.

Peter Lampert: 03:55 But we are very concerned in the short term how some of these businesses would hold up. And we were surprised that the stock market wasn't reacting. The stock markets were still hitting new all-time highs, even the Chinese travel-related stocks. Stock prices were holding up completely unaffected.

So, we trimmed most of our travel-related names, our investors in the Shanghai international airport. Anyone that's flown into Pudong airport, thanks, you're supporting the portfolio. We are investors in TravelSky, which does the backend software, the reservation software for all of the Chinese airlines. BOC Aviation, which is an aircraft lessor, they're the best in the business. They have the best planes and manage the risk the best, but if the whole industry—if people aren't going to be flying for years—even they'll be impacted.

04:41 So, we've reduced these. We even exited one name, Minor International, which owns hotels across Asia and Europe. And we were concerned—they had done a big acquisition and had a lot of debt to fund that hotel purchase. So, we really reduced our exposure there. And in hindsight, that has helped us.

Andrew Johnson: 04:57 That's great, Peter, thanks. A little bit about how we're doing there, also about what we've been doing in the portfolio.

What else have we been doing from a transaction standpoint? I'm curious because I know one of the themes even before this year unfolded was around increasing exposure to both internet and software-based businesses in a lot of our portfolios. Have you found similar opportunities in the emerging markets?

Peter Lampert: 05:19 Definitely. That's been a big theme for us. We have found [that] more and more of the economy is shifting or taking place online. And there are a lot of great businesses out there benefiting from that. So, that's a theme that we've had our eyes open for, watching for—great businesses that meet our bottom-up criteria: wealth-creating companies with great management teams, but benefiting from that long-term trend of more and more activity moving online, whether that's ad dollars shifting.

This might sound like an old theme. You think, well, everyone's already using the internet. But it's still amazing how much ad dollars are still shifting online. Games are moving from PC and consoles online. All of these industries are, and that's something we've been open to and investing in.

Peter Lampert: **06:02** We invested in Autohome, the largest website in China or app for auto sales. We invested in NetEase, the second largest games company in China that makes mobile games. We found a small online education company called MegaStudy Edu in Korea, also benefiting from the move online.

So, that's something we had been doing, even before COVID hit. And once COVID hit and everyone was locked down and more and more people were spending time online, a lot of these businesses just…this trend that was already happening just accelerated. The CEO of Microsoft made the comment, "we've seen two years of digital shift happen in two months." So, what he expected to happen over a longer period of time is just turbocharged now, with everyone at home, moving online. We, at Mawer, have seen it in our own business, just doing more and more online, video meetings, etc., etc.

06:58 So, there's a lot of businesses already benefiting from that and that's been turbocharged. And that explains a lot of the stock market rally—it's really been led in the U.S. You've seen the big U.S. tech companies—Amazon, Googles, etc.—really leading the rally since March. And we've seen the same thing in emerging markets.

We have some of the big tech companies in this portfolio, like Alibaba and Tencent, the two internet leaders in China. And we've continued to add more of them. I think what COVID has done—I mentioned the digital adoption being accelerated—the other impact that we've seen was the monetary stimulus. The very aggressive actions from the Fed in the U.S. and other central banks around the world, and government's fiscal stimulus as well, to pump money into the economy, to get money into the hands of businesses and consumers.

07:48 That has ultimately led to lower discount rates, lower interest rates, and expectations that those will stay lower for longer. And we value companies with our discounted cash flow models. When we adjust those discount rates and use lower discount rates, we get higher fair values for those stocks. So, from that aspect, even though the economic outlook has deteriorated, that's one reason why it's justified that stock prices would move higher—because of lower discount rates.

08:16 Now, the companies that would be most sensitive to a change of discount rates are the longest-duration companies, companies with cash flows further out into the future that get discounted back more. And so, those are the growth companies; these tech companies that we're talking about, the internet companies. People are expecting high growth and expecting that to continue. Those valuations are even more sensitive, or, that's why we've seen, I think, those stock prices move up even more than the rest of the market.

Peter Lampert: So, those low-discount rates combined with the digital shift accelerating have made this [a] very attractive place to be and helped our performance. Because we have a fair amount of exposure there.

08:51 But now it's getting to the point where valuations are getting quite high, and we're looking in other parts of the market to invest that incremental dollar.

Andrew Johnson: 08:59 Well, let's stay here on portfolio positioning then, because one of the ways that we've described our approach to building portfolios is trying to be in two places at the same time. Essentially, facing uncertainty [by] being ready for a number of different ways the future can unfold. Tech and high-growth companies are certainly one place to be. What does two places at the same time look like in your portfolio?

Peter Lampert: 09:21 For us, it's always important to stay balanced. We want to build a resilient portfolio that can do well in any scenario. So, if discount rates go up, and those long-duration high-growth tech companies are negatively impacted, there'll be other companies on the other side that are less impacted. (The more boring "cash cow" businesses with good dividend yield, stable cash flow).

So, we have a lot of that in the portfolio, too. We have a company called Tehmag in Taiwan. They distribute ingredients to bakeries. Pretty boring business. They distribute flour, butter, but they add some extra value for their customers: they'll recommend recipes (some fancy croissant), and have all of the specific ingredients that they need to introduce new products, etc. So, it's a boring business. It's pretty stable. They do a good job there. They have the leading market share. They add some extra value for their customers. And we like that kind of business—you get about a 5% dividend yield, nice steady cash flows, and you're getting the cash in your hands as investors. So, not reliant on high-growth expectations or cash flow far into the future.

10:24 Another one is S-1. This is the leading alarm system security provider in South Korea. Again, dominant market share, very recurring resilient revenues. Their customers are primarily businesses that are going to renew their alarm subscription every month. We have a lot of those companies in the portfolio, too.

Our goal is to not get carried away in any one direction or another: [it's to] have a resilient portfolio. That's what we mean by being in two places at the same time. Regardless how the economic future unfolds, what happens with discount rates, what happens with the economy, we want to build a portfolio that we think can do pretty well in any of those scenarios.

Andrew Johnson: **11:05** Why don't we dive into one of the holdings in the portfolio and really illustrate for our listeners the philosophy and the process that we have here at Mawer? I'm curious to hear about NetEase, because you mentioned it earlier with gaming and the acceleration that you mentioned that's happening with regards to moving online and just adopting things and participating more in that. Can you tell us about NetEase and what they do?

Peter Lampert: **11:26** Sure. NetEase is the number two largest video game company in China, behind Tencent, which is also in the portfolio. We've invested in Tencent for a number of years, so, we followed NetEase over the years as a main competitor. And the longer we followed it, the more and more impressed we've become.

In short, they just make great games that people want to play. And, if anyone's out there is a fan [of] Fortnite, download "Knives Out," give that a try. That's NetEase's battle royale game. You might like that one even more. But games in general is a great form of entertainment. It's low-cost. You can spend a lot of hours having fun. Most of their games are mobile, so you can play them anywhere, anytime.

12:09 And in the past, games had been more of a hit-driven business, at least that was our perception. So, it's unpredictable and maybe tough to invest as a long-term investor. But what NetEase has done and shown us is, no, they've had a pretty sustainable, stable market share—around 20% of the China games industry, behind only [Tencent], which has 50%. So, two very strong players. And they've done that because they keep coming up with great games and they have great titles, franchises that people want to play. Their biggest title, "Fantasy Westward Journey," has been around for about 20 years, and they continue to come up with new titles based on the same storyline that people want to play. And that's still their biggest contributor today.

12:51 Management's just done a great job. They've been innovative. They come up with great games and they also invest in new businesses too. They have a niche e-commerce business, a streaming music service, an online education business. And when we hear this, at first, we were kind of skeptical. A lot of tech companies just throw money away. They're just trying to invest in anything, hoping something's going to work out. But NetEase has a great track record: their past investments. We see it in the games business, certainly, but even the other investments they've made have panned out. Because not only are they innovative, they're willing to try new things. They have good ideas, but they have good financial return discipline as well. And so, when they're investing in a new business, they're thinking about, "how are we going to make money from this and get a good return?" And they're not just willing to throw money away without getting that return.

Peter Lampert: 13:39 To illustrate, NetEase was founded in 1997. Its initial business wasn't in games at all. They were a portal business. Think of similar to a Yahoo—they [were] like a Yahoo. Then, that was their first business. And then, they came out with the most popular email service, like a Hotmail in China, and then their games business took off. So they've had continued success over the years. And at the time back then, there were two other major portals, Sina and Sohu in China. And they're kind of around, but they've sort of died out. They've been eclipsed by Alibaba and Tencent. NetEase is the only one that's still around, still a major company, making great products for Chinese internet users.

14:20 If you compare that with what we see in the West, the companies that were dominant in the '90s like AOL and Yahoo, they've gone by the wayside and been eclipsed by the Googles and Facebook. And a similar story has played out in China with the exception of NetEase. So, it's pretty impressive. Based on their culture of innovation and coming up with great products—because they're focused on quality—they've been able to survive over the years and thrive. And like I said, we've seen that in the games business, and then we've seen that in some of their other businesses as well.

14:48 In terms of valuation, when we first started buying the stock in January, it was very attractive. We built it up to one of the larger weights in the portfolio at the time. But since then, the stock prices continue to move higher. Like I was talking about earlier with most of the internet stocks, they've kind of all moved up incrementally. We're not adding to it at this point. But it's a good holding, and we really like the management team and the way they're running the business and we intend to be long-term shareholders.

Andrew Johnson: 15:12 Now, I know that completing really intensive due diligence is a big part of our process. How many hours did you spend playing games with NetEase by far?

Peter Lampert: 15:22 [Laughs] You know, I tried "Fortnite" and I tried "Knives Out" to compare them. Fortnite, by the way, is backed by Tencent, so had to do the due diligence there. But yeah, unfortunately, a lot of their games are China only. They're only now starting to expand and really push into overseas markets, which is another great growth driver for NetEase. So, I can do some more due diligence going forward.

Andrew Johnson: 15:41 That's good. And I also know that we added NetEase to our international portfolio as well. Who got it first? Was it you or was it the international team?

Peter Lampert: 15:49 Well, we all work together; we're one team. We did put it into the emerging markets fund first, at a smaller weight. And as we built it up to a bigger weight and we had more conviction that, hey, this is looking pretty good. We should put it in the international portfolio as well.

Andrew Johnson: 16:04 China's certainly been a theme of our talk so far. The last time that you were on the podcast, like I mentioned, back in November, we talked about the protests that were happening in Hong Kong, and the unrest related to China's influence. Can you bring us up to speed on what's happening in the region now, and perhaps the investment implications?

Peter Lampert: 16:21 Yeah, I mean, China gets a lot of attention within emerging markets. It's by far the largest country. About one-third of this portfolio is invested in China. So, certainly we're looking around the world at emerging markets, but China's certainly the largest. We talked about the Hong Kong protests in November and since then, more has changed. And I think, if I could sum it up, China's just taking a more confident and assertive stance. Their economy's growing, their power has grown, and they're willing to flex that a bit more.

At the same time, the U.S. is also being more assertive and pushing back where they can. So, who knows how this is going to play out. We're not in the business of making any big macro predictions or geopolitical analysis, but it does seem that we have two large countries, and one or two might be superpowers in the future.

17:13 Ray Dalio has done a lot of great writing on this. I've read his articles, and he's studied the rise and fall of empires in the past, and how asset prices have done in those times, going back hundreds of years. And it seems you want to bet on the rising empires. So, we don't know which one that's going to be—if [the] U.S. maintains its dominance, or if China's going to be the new superpower, or two superpowers—who knows?

But it seems to make sense to me to have bets on both leading horses in the race. And that's Ray Dalio's takeaway too. It probably makes sense to have some U.S. exposure and some Chinese exposure in a diversified portfolio for most investors. I think for a lot of investors, especially in Canada, [they] probably have a good U.S. equity allocation. They may have a standalone U.S. equity fund or within a global equity fund probably have a pretty healthy U.S. weight.

Peter Lampert: 18:02 I think a lot of investors in Canada don't have much China exposure. And if they want that, I think the Mawer Emerging Markets Equity Fund is a good way to do that. Because China as a whole—there are a lot of problems. There are a lot of bad companies. I wouldn't blindly buy all of the Chinese companies. I wouldn't buy an index of Chinese stocks. But if we can weed through them and filter through them, which we do, using our bottom-up process and find the good ones that we think meet our investment criteria and [that] we can hold for the long-term because they are those wealth-creating companies with great management teams. (And we found a number of them that we've included in this portfolio.) That, I think, makes sense. For us, that's a logical, sensible way to invest and to have some exposure to China and other emerging markets too.

Andrew Johnson: 18:44 Certainly hitting the theme of being in two places at the same time there. As you mentioned, as we look to the future, we know we can't predict it, but we can prepare, like we mentioned, for different versions of it. And like other global portfolios, you have a vast geographic area to choose from, you can move up and down the market cap spectrum.

I'd be curious to hear your thoughts on how you and the team are preparing the portfolio as we move through time.

Peter Lampert: 19:10 Yeah, I think at the portfolio level, our goal is to just not get carried away. We have a good bottom-up investment process, we can find great companies that we want to hold for the long-term, but don't get too carried away in any one direction. We talked a lot about the internet stocks, but we're not going to have a hundred percent of the portfolio there. We're going to balance that out with those stable cash-cow-type businesses: the Tehmags and the S-1s that I mentioned.

We talked about China—we're certainly finding opportunities there. There's some great businesses there, but we're not going to get carried away. We're going to have a diversified portfolio. We also have big weights in Korea and Taiwan and other markets around the world.

19:45 You mentioned market caps—this is an all-cap portfolio, so we can invest in the large caps like Tencent and Alibaba. They are some of the largest companies in the world, but we can invest in some of the very small companies as well, which is exciting. Wherever we find the best opportunities, we can diversify along that dimension.

Peter Lampert: So, our goal is to not bet the farm, stay diversified, build a portfolio that's resilient, can do well in any scenario, and just stick to our process and keep doing that.

Andrew Johnson: 20:12 What's the most rewarding part of your job as a portfolio manager?

Peter Lampert: 20:15 There's two things. One is, it's just really fun learning all the time. Everything we do, we get to learn. We're learning about different companies, different industries, different countries. And to invest in a Chinese games company, you have to understand the industry. How are consumers (gamers) using these products, and what are the regulations? Why are there no foreign games companies in China? You have to understand all of this and learn all of this. And that's just fascinating to me in and of itself.

Now, of course, the second part is, it's a lot more fun if you're learning for (if there's) a reward. If there's some reason to put those learnings to use. And that's why I love investing. The goal is to find those great stocks and great investments based on the analysis we've done and the learnings we've had.

Andrew Johnson: 20:57 It's always fascinating and great to talk to you, Peter. We really appreciate you taking the time today, and really look forward to speaking to you again in the future.

Peter Lampert: 21:05 Great. Thanks, Andrew! And thanks to all of our listeners. Thanks for your interest.

Andrew Johnson: 21:08 Take care.