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EP79 | Playing the plan: Mawer's international 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**	Hey Dave, welcome back to the podcast! Good to see you.
David Ragan	**00:44**	Thanks Andrew, great to be here.
Andrew Johnson	**00:46**	How have you been doing lately?
David Ragan	**00:47**	Oh, I've been up and down. Had a skiing accident [laughs] so I've been mostly down recently. But it gives me more time to read and get ready for this podcast.
Andrew Johnson	**00:55**	Well, it's always fun to see the silver lining in things, so that's good to know. And we hope that you're on the recovery train and heading in the right direction sooner than later.
	01:02	I was actually thinking that the last time that we spoke on the podcast together, it was a little less than a year ago. I think it was late February, early March of 2020. So, it was just a couple of weeks before the initial stages of the pandemic response. And we spent some time during that podcast episode reflecting on your career at Mawer, and the now more than [a] decade that you've been lead manager on our international equity strategies.
	01:25	I wanted to start this episode with, perhaps, either a more difficult or an easier timeframe to deal with, and just ask you to reflect on 2020. So, when you look back at the markets, the portfolio, maybe even the team and the process, what are a few things that stand out?

David Ragan	**01:39**	I hoped last time we were talking, I was going to say that despite it being a full-on global pandemic, the markets are going to be incredibly bullish [laughs]. I doubt that because, I mean, it has been one of the most unique, different, unexpected periods of my career.
	01:55	When we talk about risks for companies, I think back and I don't think we've ever really talked about pandemics. We talk about wars, we talk about local health issues, outbreaks for animals, but a pandemic wasn't really in the cards.
David Ragan	**02:07**	But, I mean, I think the things that really stick out for me this year has been just how well the philosophy does with this uncertainty. You align yourself with good companies that have reasonable balance sheets, and you'll do well.
	02:22	The winners during the crisis—obviously online stuff—we did well there. We had great companies like Adyen that grew quite rapidly and continue to do so. But also, I mean, the losers over this period…we didn't have any airline companies because those are weaker business models, much more challenged. We didn't have any oil and gas. Again, that's a tougher business model; it's a commoditized business. So, a lot of the places that we weren't…and actually, our exposure to highly levered companies—ones with a lot of debt on the balance sheet—I mean, those will do fine in a bull market, but in a period of uncertainty like we just went through, they may not survive.
	02:56	So, I think I really attribute the year to not only where we were, but also where we weren't. I mean, I really think that's driven by the process. And then, of course, just always really, really proud of the team: just finding great companies around the world, reacting to this unprecedented period calmly; thinking about where are we at risk, which companies can make it through, which ones maybe will struggled in this period? But they'll be fine. And I think the team did exceptionally well in that respect.
Andrew Johnson	**03:24**	Well, that's great to hear. And presumably you've also had many conversations—likely over the last year—with management teams either from the portfolio or from companies that you're looking to add to the portfolio…what are some of the common observations or comments that you're hearing during those interviews? Or perhaps you've even had some reverse roadshows since the last time we spoke.
David Ragan	**03:44**	Very little changed over that period—we continue to talk to lots of different companies. We've always been working remotely, partially because we're based in Calgary, but also we travel a lot. So, just because you're traveling on a roadshow through Europe or Asia, you still want to be able to connect to the team and keep working.

	03:59	So yeah, very little changed. I mean, in talking to these companies, there was a lot of, "I don't know" initially, and that was a fair answer. We don't know what demand will be. And especially, if your business requires people to be connected at all, and that could be the manufacturing or that could be the actual end customer to be around other people, you just don't know.
David Ragan	**04:18**	So, then the good management teams were really talking about the resilience. Some of our companies raised some capital early on, just to make sure. And I think I appreciated the caution there. I think that was a smart move.
	04:30	As this played out, we're still somewhat in a period of, "I don't know." We have vaccines that are approved, but they're not rolled out to everybody yet. There [are] more variants coming out, we don't know how bad these lockdowns will be. So, I mean, we remain in that period of "I don't know." And again, we're not changing the kind of companies we're looking for—we continue to find those good companies that, well, it doesn't really matter. Hopefully what happens [is] their business will be fine. Hopefully they keep growing.
	04:56	We're still in a period of higher uncertainty, but there seems to be a little bit more light at the end of the tunnel. Though, I guess of course you throw in some uncertainty with a new government coming into the U.S., obviously a very different one. We'll see exactly what they do and potentially what happens to inflationary pressures with helicopter money, as it's called, just being sent out to everybody.
Andrew Johnson	**05:15**	What is your view on that? I mean, like you said, it's tremendously uncertain as to what the impacts of all of this money that's coming from both monetary policy being very loose, as well as the fiscal spending records that we've hit over the last 10 months or so, and probably more to come as we kind of dig ourselves out of this economic situation that we're in.
		I mean, you put yourself out five years from now, 10 years from now—this is a bit of an unfair question for you—but can you at least fall back on any sort of assumptions that can guide you around inflation expectations?
David Ragan	**05:45**	There's a lot more money out there that's being broadly delivered to people. However, I think most people are looking at this as more of a short-term phenomenon. Once everything gets back to normal, the biggest issue, then, is substantially more debt.

06:00 So, I don't know what's going to happen in the future with inflation. Some people think it's picking up; it's still seemingly quite low. There's remaining a lot of pressures to keep inflation low. There's more labour in the world than we need. Automation is always becoming more and more prevalent. So, that labour inflation may not really have that pressure to make it come to light.

06:21 But yeah, the debt…that seems to point to there's going to have to be higher taxes. Maybe we can play the long game where you just pay it off very slowly, but it seems pretty likely that there's going to be some changes in the tax regimes around the world.

Andrew Johnson 06:33 Yeah, and I think that also makes the assumption that when we hit another period like we've gone through over the last 20 years, the precedent has been set that central banks are willing to step in; fiscal governments are willing to be there to kind of catch everybody as we fall. So, it'll be interesting to see if we can break from that trend as well.

David Ragan 06:51 The end of the down cycle, the end of the bear market…it doesn't seem to be likely, but that's truly confidence driven. And if you get rid of everybody's belief that there is ever going to be a true bear market, then potentially you can get rid of them. However, that's a lot more positive psychology than I think we're probably capable of.

Andrew Johnson 07:13 [Laughs] I want to shift gears back to 2020 and really the dichotomy that we witnessed within markets itself. From an international equity perspective, can you help our listeners understand just how the portfolio behaved during those two periods that I'm talking about, which is really kind of Q1, early part of the year? Versus what we saw and witnessed in markets in the latter part of 2020, especially Q4?

David Ragan 07:37 In Q1, you really saw the downdraft where everything fell, but this is where I think our style and our quality of companies really helped preserve capital for our clients. And then this bounce-back happened over the next, say, six months. There's no vaccines at that time, but people see, well, again, governments are going to protect people. They're going to flood the system, keep companies afloat, et cetera, et cetera. The market started going back up and we kept up with that market.

08:04 It was really in Q4 when the bounce-back of everything...that really got hammered in the early part of the year. And the oil and gas companies, the travel companies...that's where we gave up some of the alpha over the year. I mean, the alpha created over the year was still surprisingly substantial. The period we've been in the last few months has been this bounce-back of companies that were absolutely hammered before. I don't really call it a value run, because it's really not just value companies. It's just what was really hit before. There may be some semblances of a value run more recently—just those lower quality, lower valuation companies. People can rerate those higher, again [as] they see a bit better economy, a bit more resilience going forward.

08:45 So it's been three very different periods all within the course of a year.

Andrew Johnson 08:49 And just looking back over the last 12 months to the end of December 31st, a couple of names that stood out to me that were kind of on the bottom-end of things in terms of lagging in the portfolio, were InterContinental Hotels, as well as AB InBev. And we had different reactions to both of those throughout the year. We've exited AB InBev, but maybe you could talk [about] those two names in particular and what kind of dragged them down through this past year.

David Ragan 09:15 Well, I mean, InterContinental hotels...it's pretty obvious they would be hit hard by this environment, where you go from people traveling and business travelers to nobody and hotels are pretty much empty. So, we still think this is a great company; one of the two-three major hotel groups, where their loyalty program is actually a huge competitive advantage; where people want to stay within this one plan because, well, especially if you're traveling for business, you stay at InterContinental, then you get your vacation time and you get a free stay somewhere nice and warm.

09:46 But this is one of those companies where we think the management reacted appropriately; where we don't know what's going to happen, it is obviously a higher risk. They did raise some capital early, but also when we looked at the business, the cash burn is quite low because, well, InterContinental generally doesn't actually own the hotel. There's somebody else who owns the actual building. They just hire InterContinental to be the banner, to manage the hotel, which really changes the economics of the business and reduces the risk.

10:13 So, InterContinental was hit pretty hard initially. It's come back surprisingly well, but we continue to think it's an attractive business.

David Ragan	**10:21**	AB InBev is a bit of a different story, where this has been a longer time that we've held this one. It is the best beer company in the world, the biggest beer company now, especially after their acquisition of SAB Miller. Taking the top two beer conglomerates and merging them...that makes an absolute behemoth. However, our learnings over a long time have been, well, these large acquisitions are fraught with challenges. Trying to merge two massive entities with potentially different cultures, different production, different geographies is quite a challenge.
	10:56	And AB InBev has struggled with this. And they've also made some unforced errors with taking on a lot of debt, which they had to do for this partially, but they could have issued more equity. But they also mismatched the currencies, where it's not a good idea to owe money in one currency and borrow it in a different currency, because, well, in the case of AB InBev, if that happens to be an emerging market currency that you owe money, that you generate money in and you borrowed in euros or U.S. dollars and the FX rates go the wrong way...suddenly that debt bail goes up by 10, 20, 30%. And that can be very painful.
	11:31	So, there's a lot of these issues that all came together. I mean, the size of the acquisition, that FX mismatch...this really resulted in us starting this period with a lower weight in AB InBev. It was one of the smallest weights in the portfolio, but just seeing continued problems, we went to the exit on AB InBev.
Andrew Johnson	**11:48**	Just out of curiosity, we've heard a lot in the news lately about the antitrust scrutiny and regulatory eyes that are on the tech companies in general, but when I hear about a company like AB InBev and SAB Miller coming together and essentially dominating the entire global market for beer, has there ever been historically any eyes regarding antitrust that come down on companies like that?
David Ragan	**12:11**	I mean, there's definitely...this transaction specifically was looked at very closely by antitrust individuals. And maybe InBev did have to sell some of its assets, where bringing those two gigantic pools of assets together in some markets resulted in them having too much power, so they divested some of those.
	12:28	But one of the problems with the business more recently has been just the massive influx of microbrews and smaller breweries that, well, it is showing that there isn't really any massive barriers to entry. While AB InBev does have a lot of power, it doesn't seem to be overly powerful. It definitely went through that scrutiny; they had to reduce some assets. But no, it's still reasonably fragmented and the barrier to entry is fairly low.

Andrew Johnson	**12:55**	That's great perspective. Let's shift gears and talk a little bit about some of the better performing names and actually a couple of higher weights in the portfolio. We saw a great performance out of Taiwan Semiconductor, as well as Louis Vuitton in the portfolio. So, two very different businesses. Maybe you could walk us through kind of what you saw with these two companies over the last three, four months.
David Ragan	**13:14**	Taiwan Semi is just the continuation of an investment thesis that—and this feels fantastic when it actually happens—when it really goes exactly as you laid out in the initial hypothesis.
	13:26	Making a semiconductor is incredibly difficult. There's hundreds of steps that have to be done perfectly or that whole semiconductor wafer is wasted. You don't get a good yield, you can't make money. It is an incredibly, incredibly complex process. And Taiwan Semiconductor is one of the companies that can do this. They can do it on the most leading edge, smallest nodes. And a node is just the pathway for an electron in one of these semiconductors. And they're down to a few nanometers. I think the current ones on the market are seven nanometers—they're working on smaller.
	14:02	And when you get down to that microscopic level, you can't even use regular light anymore. You have to use ultraviolet light. The wavelength is getting too big. And I had just geek out on this industry so much. With UV technology and the lithography—so that's where they make these chips—the current machine has to hit a tiny microscopic piece of tin twice with a laser hundreds of times a second when it drops into a vacuum to let out just the precise amount of UV light to make this work. That's just unbelievable.
	14:37	So, this is as part of the whole process. And Taiwan Semi...they can do it. Intel over the last year has said, "Yeah, we're not going to pursue the most advanced chips." A Chinese competitor has delayed efforts to, or delayed their plans to get into the smallest nodes, the most advanced chips. So really, you're getting down to Taiwan Semi and Samsung that can really do this stuff.
David Ragan	**15:00**	And it feels good to have...this was our thesis to begin with, this seems to be what's playing out. I mean, there's obviously risks to that, but that's a core reason why it's done so well. They're getting a very strong position in a very attractive market where obviously we see everything has a semiconductor these days. And if you want to be fast and you want to be power efficient, you have to use the smallest nodes and the most efficient chips...that's Taiwan Semi.

Andrew Johnson	**15:23**	Just comparing and contrasting that to the beer industry like we just talked about…I mean, those are barriers to entry. What you just described with their approach to manufacturing.
David Ragan	**15:31**	Yeah, and one of these plants costs billions of dollars. Anybody can buy the equipment, because again, there's just one equipment supplier for a lot of these steps. But to actually do them properly? The biggest companies in the world can't always do it. So, massive barriers to entry.
Andrew Johnson	**15:46**	And Louis Vuitton, what was the story there?
David Ragan	**15:48**	We think it's the best luxury company in the world. They just really understand how to manage a luxury family. And obviously the Louis Vuitton brand is one of the most important there, and it is a larger exposure to the company.
	16:02	Obviously these products are often bought as an experience. You don't necessarily just go down to your local Louis Vuitton and buy it. The best stories come from when you fly to Paris and you walk to the flagship store in Champs-Élysées and you have a glass of champagne as you go on a bit of a shopping spree. And then when anybody asks you, "Where did you get that bag?" you can regale them with this multi-minute story about how amazing it is. And it's all that goes around the bag. I mean, it's just a piece of leather that holds stuff, in theory. In reality, it's so much more. And this is what Mr. Arnault and Louis Vuitton understand.
	16:38	And during the crisis, people couldn't travel. So, these stocks were hit a little bit. What has really happened recently is partially, the online activity picked a lot up. People decided to partake in some retail therapy. COVID has taken a lot of you, you deserve a little bit.
	16:56	And then also just the relative performance of Louis Vuitton versus the other luxury brands…that was another area where, again, I was shocked. I was like, "Wow, they did so much better." Plus, during that period, they made an approach and have basically agreed to acquire the U.S. luxury brand Tiffany's, which Louis Vuitton, again, has a great track record of acquiring assets and getting more out of them from their abilities to manage a luxury brand. So, all that came together. And Louis Vuitton, which was one of our larger weights, continue to do well.

Andrew Johnson	**17:26**	Yeah, and from a conviction standpoint, I have to imagine when you witnessed a management team perform throughout a period like we've seen over the last year in the way that Louis Vuitton has, that's got to give you great confidence going forward in the decisions that they make, and you weight that accordingly with the portfolio.
David Ragan	**17:44**	One of my competitive advantages as a portfolio manager is my complete lack of confidence in anything like that especially. So yes, it does support the thesis. We have not yet rejected that thesis, but I would never say I have really high confidence with something like that, because you never know. It can change. And if you want me to talk about the negatives on Louis Vuitton, I got a laundry list there, too. So yeah, I think that's the key thing here is we're never just fixated on what's going well. We're thinking about, "Okay, what could go wrong?"
Andrew Johnson	**18:12**	Well, I think that's important to note. I think skepticism is such an important part of your role as portfolio manager, and really, all of the analysts on the Research team. So maybe, yeah, highlight a couple of the negatives for Louis Vuitton because it has been a good story for a period of time in the portfolio.
David Ragan	**18:25**	One of the biggest risks is the individual purchasing by Chinese people. Huge market, very attractive brand from the Chinese market, and that's not just bought in China, but it would be bought around the world. So, I mean, this is a market where you could have a political leader in China have a problem with this brand. There could be a reason why they would push against it. Mr. Arnault is not the youngest person; the next generation of management may not be as good as him and may be a family member. At least one of his children is in the higher levels of the company. So, that decision may not exactly be completely independent and completely in the best interests of all the end holders or the shareholders.
	19:07	And then, yeah, the worst thing you can do for any luxury brand is damage that brand. And that can happen by selling too much, it could be by discounting. If you try and ever find a Louis Vuitton product discounted, it's going to be very difficult. I think they may not do it at all, or definitely they don't do it very much because, well, the worst thing you can do is sell your customers something for $3,000 and then they see it a month later at $2,200. That really just destroys their brand and their perception of this product.
David Ragan	**19:35**	There's a lot of things can go wrong with this. But Louis Vuitton has been around for…I think over a hundred years. And obviously the management team in charge now hasn't been involved that long, but they've been there for quite a long time and have quite a stellar track record.

Andrew Johnson	**19:48**	Excellent. Yeah, thanks for rounding that out for us. I wanted to also talk a little bit about some of the transactions that you've made in the portfolio. I observed—looking at the turnover in the portfolio—it's really over the last kind of three to six months that I saw an uptick in the turnover numbers, at least from a dollar perspective. Were you and the team kind of adjusting based on valuation mainly, or was it more nuanced than that?
David Ragan	**20:12**	I think looking back, just thinking back over the last year, I mean not a whole lot has changed, but the market has been very volatile. Some stocks during that first initial collapse…they almost levitated. They just remained flat. And that was probably where we were most active: trimming those and adding to some other names that we thought still had a great position and fell in value.
	20:35	More recently, no. I mean, the team added one more individual over the years. So, Siying came back from mat leave and we've got six individuals scouring the world for good ideas. We've looked through probably hundreds of companies over this year. I don't think there's been any real reason why the turnover would be higher more recently. This is probably just normal: trim the expensive; trim and sell the lower quality; add to the ideas that improve the portfolio, whether or not they're a return potential or a quality side.
Andrew Johnson	**21:05**	I think it's important for clients to know that even though our implied holding period is north of five years—probably in the seven year type of range—but at any given time and over any given time period, especially as you just mentioned, if we see a lot of volatility, that implied holding period could go down quite short or we could sit on the portfolio for a long period of time and it could get out of whack in the other direction as well. That's good information, Dave.
Andrew Johnson	**21:30**	I did want to talk about one of the newer stocks in the portfolio, Philips, which we have that probably somewhat of a neutral weight in the portfolio currently. This is a name, actually, that I'm very familiar with—at least one of their former products. So, we recently updated all the lighting in our house, and I installed about 20 Philips LED light bulbs in various rooms. But after you and the team added the stock to the portfolio, I was reading up on it and I realized that they had spun off their lighting business a few years ago. And I think that might be a big part of the story here, so ,just give us a background on Philips and really, why it fits our investment criteria.

David Ragan	**22:05**	This is a funny story in the fact that...I think back in 2004 when I joined Mawer, this was probably one of the first stocks that we sold after I arrived. The company back then was night and day different than it is today. Today we have, you're right, they used to have light bulbs, they used to have a lot more consumer electronics and TVs and appliances, things like that. Those areas are just so competitive. You can't earn a good return in capital, there's not a lot of barriers to entry. So, this company was investing a lot of money in these areas and was really married to the idea that it produced all these products, because, well, you have been. And that was some of the reasons we exited initially.
	22:49	But I guess after 15-16 years, a company can change. You can change the mindset that we are producing these TVs and consumer goods and we have to somehow compete with a Samsung or other competitors that just...they have a lower cost base. They're a lot more efficient, they have better volumes. And Philips really has shown that they understand: they have a competitive advantage in medical devices.
	23:15	They have a good suite of medical products. They are working really hard to take that suite of medical products and add value through software and really helping a hospital that uses these products be more efficient. It's not as much pushing on that specific MRI device, for example. It's really pushing on, "Well, how can we make it more efficient? How can we get more throughput?" which is obviously very valuable to a hospital.
	23:44	And this change takes long time. This change...first of all, the biggest hurdle is the mental one, that changing [of] what we are as a company. And we've seen a lot of companies fail, like Blockbuster saying, "We can't change. We can't code digital," or, "We can't move to mailer, it's going to hurt our brick and mortar." That first change takes a while, then you get a new management team that really believes in it, sticks in it. Changing labour in Europe is obviously harder than over here.
David Ragan	**24:09**	But yeah, eventually this company's really focused itself on a good part of the market where it has competitive advantages and the returns have become a lot more stable and higher.
Andrew Johnson	**24:19**	And when you look back, you mentioned 2004—so, when you first arrived at the firm and it was on its way out of the portfolio, and clearly a very different business at that time...but on the Research team, you rely heavily on this proprietary database that we have, that we call M42, where we put a lot of notes in on various companies and a lot of different rankings and just opinions through time, through various different individuals...was that useful in looking back? Or was this something that was on the current inventory list for a period of time?

David Ragan 24:47

It's usually useful to look back. In this case, we checked back on it a few times, but it was just such a slow, painful process of them actually getting rid of things like the light bulbs, that [laughs] eventual checkup every, say, just looking back, three to five years. But yeah, when you can see I think more of a consistency of the same message—that the current management team is focusing on wealth creation and their actions are matching up with what they're doing, that's pretty valuable. I guess probably the most valuable thing for the last 10 years was probably to avoid Philips, because, well, it's still a company in transition and we have the notes to support that.

Andrew Johnson 25:27

That's great. Just before we let you go. And we wrap up here, as you look out to the rest of 2021 and really beyond that, one thing that has been on a lot of people's minds, including our clients, is China. Just in general. So, we've talked previously on the podcast about things like trade tensions, political, military tensions that are building, some of our investment history. You have a part of the portfolio that is invested in China. So just from an investment perspective for our listeners' sake, what, in your view, are the major opportunities and the major risks associated with investing in Chinese businesses?

David Ragan 26:04

With China, you have such an amazing, large economy with 1.2/1.3 billion people. That presents an amazing opportunity for our company. You can build a lot of strength, get a lot of volume on your domestic economy. Maybe that's enough; maybe it's a local business, or maybe you use that to springboard around the world. It's such an amazing advantage there. The U.S...you see this in that country as well. It's a huge economy. It's homogeneous, and that really helps a business build such a strong foundation that it's very strong when it competes around the world.

David Ragan 26:39

There [are] some challenges in China as well. It's a country that's a little bit more controlled than we're used to, and this control has provided some great opportunity for its people; it's really helped it grow much more rapidly than other areas of the world. But it's something you have to be aware of. If you're a business operating this company, you have to abide by what the country is looking for.

27:00

So, it does have a bit of that signature risk which we often talk about, and that's where one signature from a government or a regulation or a trade rule—anything like that—just that one little signature can cause a big problem in your business. And I mean, this is a risk in any economy, but even a little bit more so in China.

Andrew Johnson	**27:19**	All right, well, thanks, Dave. I always enjoy talking to you. Perhaps we will have a much more boring period of time between the next time that you and I get to sit down on the podcast together. So, thanks again for joining me and thanks for all that you're doing with the portfolio.
David Ragan	**27:33**	Thanks, Andrew. I definitely concur. I hope we can have a boring future—it's a pretty low hurdle to beat.
Andrew Johnson	**27:39**	And all the best with the recovery on the knee.
David Ragan	**27:40**	Thanks.