the art of boring™

EP 202 | International Equity: AI Enablers, Competitive Strength, Portfolio Resilience

[00:00] Rob Campbell: Coming up on the Art of Boring, portfolio manager Peter Lampert returns to unpack all things international equity. We spend a good amount of time on the portfolio's AI enablers: think power supply units, memory makers, and other unsung heroes of the semiconductor supply chain, all with a surprising link to the cutlery drawer in your kitchen. A particularly useful insight is the need to separate between companies merely benefiting from the AI capex boom from a demand perspective versus those who are seeing their competitive advantages and positions strengthen as a result. Beyond AI, we talk valuations, Japan, and some of the other bigger picture themes that may color the outlook for international equities over the next several years.

[00:47] Disclaimer: 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.

[01:04] Rob Campbell: Peter Lampert, welcome back to the podcast.

[01:06] Peter Lampert: Thanks for having me back.

[01:08] Rob Campbell: Always glad when you come back, Peter. It's wonderful speaking with you, and it's been a wonderful year for non-North American equities in general. What's going so well? I mean, it's been a period of 10, 15-plus years in which holding just US equities would have done you quite well for your portfolio. What's happened this year that we've seen that reversal?

[01:29] Peter Lampert: I think there's been lots of opportunities in international markets, and investors are looking around now after the strong performance that they've had in US stocks for many years. More investors are looking around and looking at those opportunities. I'm sure we'll talk about many of them today, but whether in Europe or Asia, there's a lot of great opportunities around the world that have been somewhat overlooked and overshadowed with the enthusiasm for US stocks and the success of the MAIC-7.

[01:56] Rob Campbell: Great. I did want to walk through certain aspects of the portfolio with you today, and I assume that part of the reason that international stocks in this portfolio have done so well over the past year or so has really been in the AI and the technology space. Stepping back as a portfolio manager, how do you think about your AI exposure in the portfolio, and how do you break it down?

[02:16] Peter Lampert: Coming back to the US and the rest of the world, there's a lot of focus on NVIDIA and how they're driving the AI boom and the MAIC-7, the hyperscalers, companies like Microsoft, Google, Amazon that are all employing AI and providing AI. What we see in the rest of the world is a lot of the AI enablers, especially in Europe, in places like Taiwan and Korea, where the semiconductor supply chain is centered. There are a lot of opportunities there. So we've gone through the supply chain and looked at where the best opportunities are.

One thing that we find is this is a real benefit of being a bottom-up investor. When we have such a thematic shift, many can see the long-term outlook and the strong AI CapEx spending. Many stocks get lumped together and we see that a rising tide lifts all boats. If we look through that, there are probably some companies that are having a short-term bump, and then that will revert.

As soon as the supply-demand mismatch reverses, the extra profits they have now should come away. There are other companies, the ones we're focused on, and what we're looking for is companies where their competitive position and their outlook have actually improved. They've gone from the position of strength, pre-AI, to even stronger in an AI world, and that's what we're looking for.

Then we're looking to diversify that exposure across the portfolio. Right now, about 20% of the portfolio, I would say, is tied to these AI beneficiaries. Still, there are lots of other great opportunities in the portfolio: it's not all AI, but within that AI bucket. We want to manage the risks and find the companies that best meet our criteria of being great, long-term wealth-creating companies.

[04:01] Rob Campbell: Can we dig a little bit deeper into some of that? We've spent a lot of time on TSMC on this podcast over the last couple of years. I know it remains one of the higher-conviction holdings within this portfolio. You mentioned the ecosystem, or the value chain, the supply chain that is built largely in Asia, Taiwan, and South Korea around TSMC. Can you bring to life some of what we're finding within that bucket of companies with magnificent competitive advantages there?

[04:27] Peter Lampert: Yes. As you said, TSMC is our largest holding and certainly a big beneficiary and enabler of the AI revolution that we're seeing. But there are many strong companies. For example, a company in Taiwan that makes power supply units; every server in the data center needs a power supply. The leader went from having the leading market share of about 30% in traditional servers to now about 70% market share in AI servers at higher prices, higher ASPs, higher volumes, and higher market share.

We think that's sustainable because this company has always been the market leader with the best products, the highest quality, and the highest reliability. It's just that for traditional servers; the differentiation didn't matter as much. Whereas in AI servers, downtime is so important and so expensive if your server goes down. Having that reliable power supply, electricity costs are so high, having that power efficiency that the leader can provide is a huge advantage. For that reason, we're seeing them strengthen their competitive position and customers are willing to pay for that.

We see the same thing with the leading supplier of rail kits. In a data center, every server is on a compute tray that needs to be able to slide out for access and maintenance. And again, the market leader there went from about 30% market share in traditional servers to now 90% or even 100% market share in AI servers. This is a small cost, but a high cost of failure. If the server rack breaks, if it drops and the server goes down, it's costly to replace and the downtime itself is costly.

So again, this company has always been the leader; it's just that value to the customer is that much more important. And we see these as sustainable long-term beneficiaries, not just benefiting from a short-term supply-demand mismatch. This is because of the decades of leadership strength that they have in their R&D, in their product know-how, and in being able to keep up with NVIDIA and the product roadmaps of the leading customers.

[06:27] Rob Campbell: Your description of the rail kit, if I open my cutlery drawer and it drops to the ground, so what? But I can imagine, with millions of dollars of AI servers on the line, that you want to be associated with the best in that regard. Can we shift to another area that I noticed in the portfolio? A bit more focus of what's to come on the memory side?

[06:47] Peter Lampert: Yeah, certainly. As we look through the supply chain, we've seen that a lot of the beneficiaries have been on the logic side. That's NVIDIA as an example: designing GPUs, which are logic chips made by TSMC, but there's a whole other half of the semiconductor supply chain. Largely, the leaders are based in Korea, so the leading manufacturers there and their suppliers have become an increasingly important bottleneck or choke point in the advancement of AI.

NVIDIA and its competitors are designing chips that rely more on high bandwidth memory, and it's a stronger outlook for the companies that can supply that. They're very supply constrained right now, and to the extent that they need to raise prices, they will bring on more supply but it will take time. In the meantime, they will earn supernormal profits, and what we're seeing is that cascade.

The leading makers of this HBM memory are also the leaders of DRAM and NAND memory, which are the more commoditized types of memory. As all investments and capacity is going toward HBM, we're seeing shortages in the other memory types as well. We're seeing memory companies benefit across the board, with a much stronger outlook.

Although that is a cyclical industry, where there have historically been booms and busts, we think now the technology capabilities are higher, barriers to entry are higher, and the supply constraints are longer. Cycles should last longer, and we're potentially entering a period of prolonged high profitability for the main memory manufacturers and their supply chain.

[08:24] Rob Campbell: We started the podcast just comparing the international space to the U.S. space. One of the differences has been valuation starting points, as potentially a contributor to why international equities have done really well this year by comparison. Does apply to this space too? Meaning, AI exposure seems optically pretty expensive in the U.S. market. Is it considerably less expensive in terms of the companies that we've been talking about?

[08:47] Peter Lampert: Yes, definitely. Especially if you factor in the growth outlook. That's another thing we're looking for, not only where the companies competitive positions have improved, but companies in niches that are outgrowing the entire AI investment.

While the entire AI CapEx investment is growing and bringing along everybody involved in the supply chain, the niches that we focused on are growing even faster. The power supply need, the need for rail kits, and the need for memory are outgrowing even faster than the overall growth in AI CapEx. When you factor in both the increased growth outlook, the even stronger sustainable competitive advantages, as well as the valuations, we think there are many very attractive opportunities.

To give you a sample, the HBM memory that we talked about, there are only three players globally that make this: the two leaders in Korea and a third player in the U.S. The Korean players, even though they're maybe the technology leaders, trade at much lower multiples, just on a simple price to earnings multiple. When we

translate that to our DCF models, we see much more upside there.

[09:50] Rob Campbell: I want to ask you one last question in the topic of AI enablers. Can you play the other side for us? How do you get comfortable with the aggregate weight within the portfolio to these types of businesses?

[10:01] Peter Lampert: There's a lot of businesses that are benefiting, and we think there's a strong long-term outlook, a good case for continued investment in AI. But it's still early; use cases haven't fully come through. The adoption needs to come through from end customers, corporates, and consumers to justify continued spending in AI. And if the consumer adoption is slower, the pace of investment could be slower, and there could be some disappointment and we need to manage that risk.

You know, I mentioned about 20% of the portfolio exposed to this AI investment theme, and that's within that, well diversified. I think we talked a lot about companies selling directly into the semiconductor or data center supply chain. That also includes companies further down, supplying electric grid equipment adjacent to, but also important enablers of the AI spending. Within that, we think it's well diversified, and we're managing the weight at a portfolio level. There's lots of other companies in the portfolio that have their own drivers and can benefit from other growth opportunities.

[11:04] Rob Campbell: Can we shift to some of those? One heuristic or shortcut might be: okay, you got 20% of the portfolio that's really enabling AI. Does that mean that the other 80% is at risk because of AI? We've seen some companies in the portfolio go back and forth, sentiment-wise, as to whether they're an AI winner or AI loser bucket. Can you speak to just some of those companies, what we're grappling with, what the nature of the debate is, and ultimately where we get comfortable with some of these businesses?

[11:31] Peter Lampert: When there's a change like this, investors are trying to make sense of it, trying to gauge the odds of success and failure. And for the existing incumbent software companies, it's a puzzle for investors. Are they well-positioned to add AI functionality to improve their offering and actually grow their revenues and profits from enhancing their products with AI functionalities? Or are they at risk from AI-native new entrants coming into the market? And we have a number of those in our portfolio, companies like Wolters Kluwer and RELX. They're industry leaders in their niches.

They provide software along with all the data needed to support their customers, which are largely doctors, lawyers, and accountants that rely on them for the essential reference information that they need in their day-to-day workflows. These companies are augmenting their products with AI functionality. Think of a lawyer drafting contracts, but instead of using something like ChatGPT, using something from RELX, a provider that they've worked with for decades. They trust the company and all of the data going in there is vetted by thousands of experts. They have a higher degree of confidence that the AI is giving them reliable output. That's the advantage they have.

At the same time, to maintain that trust, they have to move a little bit more slowly. They can't just come out as soon as there's a new product or functionality, throw it out there and see what happens. If it starts hallucinating and giving misleading information, they have to make sure that the products are ready for prime time before they roll them out. That's the advantage that AI startups have. They don't have thousands of in-house experts vetting all the data, vetting all the information. They don't have decades of a trusted brand to protect, so they can take those risks on new products. We've seen some traction there.

We've seen in the legal and medical spaces, there are very well-funded companies. VCs are pouring hundreds of millions of dollars into companies before they even have revenue. They're able to gain some tractions, to gain some customers. So, Open Evidence is one credible threat in the medical space, challenging Wolters Kluwer. Harvey is a threat on legal space, challenging both Wolters Kluwer and RELX.

For us, it's really case by case, trying to determine if the incumbents are well-positioned to navigate these challenges. If they have management teams that are investing, forward-looking, and thinking about how to adapt to this environment, or if they're complacent management teams, more at risk of disruption. We think these companies are well-positioned, but like you said, the market has gone back and forth.

At one time, these were priced quite robustly, thinking about the AI upside. Now, the market has become more pessimistic on them, looking at the AI downside and the disruption risk. For us, we're taking a long-term view. These remain core holdings for us in the portfolio, and they add to that diversification. If the AI adoption is a little bit slower, investor enthusiasm for these stocks probably returns, whereas for some of our other AI beneficiaries, it may diminish. So having that portfolio approach, with each individual company being great on its own, provides more resilience.

[14:45] Rob Campbell: I want to ask about Japan. We had one of your colleagues, Ian Turnbull, on the podcast not too long ago, who had returned from a trip there. I've noticed in the international portfolio that we have added a number of Japanese companies. And this would be over the course of the summer, but even going back a year or two, you've seen that weight come up. How much of this, Peter, is related to what you read in the news with respect to, “Oh yeah, we're seeing all these corporate governance improvements in Japan”? Or is there any other theme that connects why we just happen to have found some great Japanese ideas?

[15:18] Peter Lampert: Yeah, there've been a few different insights that have led us to increase our weight in Japanese holdings, and really, on a bottom-up basis finding great companies. You mentioned one theme that the market's been focused on is this push in Japan for improved corporate governance. For decades, Japan's been a laggard in terms of adhering to global standards and norms of creating value for shareholders and the mindset of earning a good return on invested capital.

But that's been slowly changing in some cases. I wouldn't say it's a ‘paint with a broad brush’ that corporate Japan culture has changed across the board, but we have found examples like Hitachi in the portfolio, where there is a fantastic world-class management team. One way they accelerated that shift from the old corporate Japan mindset to a world-class, modern global company is through acquisitions.

When they've made overseas acquisitions, they've retained that talent, brought some of the overseas people into the top executive level of the company, and really brought in the global best practices and global thinking. Which, it is quite rare in Japan to see a globally diverse leadership team. That’s benefited them, and informed their strategy to focus on areas where they can earn a high return on invested capital and build sustainable, strong, long-term competitive advantages. They’ve slim down from this very diversified conglomerate to a much more focused business, on key business segments where they have leadership opportunities to generate high returns. One example of that is in transformers; being the leader supplying transformers for the electric grid, which is important for this AI build out that we talked about.

But there's lots of other reasons that have led us to opportunities in Japan. Hitachi, that's on the large cap side. In the overlooked smaller cap end of the spectrum, we've found really good entrepreneurial management teams that have found unique market opportunities and are taking advantage of that. They're nimble, profit oriented, and in many cases they're competing against more traditional corporate Japanese companies that are much slower to react, and much more bureaucratic.

As a result, they can just be more efficient, more customer-focused, more competitive on price, provide better service, and they're winning that way. A lot of these happen to be in the tech industries, providing software or IT consulting, because that's an area we've noticed Japan, again, had been a laggard in terms of corporates adopting modern software and IT. Typically in Japan, companies have used in-house IT, developing their own custom software, and that relies on a large workforce of external IT consultants to maintain all of that legacy software. That's becoming more and more challenging for them to do, given the declining population and shrinking labor force in Japan. There are just fewer IT professionals to provide that service and companies that can provide that service or an alternative like off-the-shelf software, which is common in the rest of the world, doesn't require as much labor and is a much more attractive option.

We have a number of these companies run by entrepreneurial founders identifying this need in Japan and providing software for expense management, invoicing, travel management, and all the things that in the Western world we might take for granted. These would typically be done with off-the-shelf software but in Japan that typically hasn't been the case traditionally. So, lots of reasons why we found these various opportunities but generally, yes, there are pockets of improved governance. There are pockets where entrepreneur-run businesses are just out-competing their more traditional slower competitors and opportunities especially in IT demand.

[19:08] Rob Campbell: Peter, bigger picture and by the way, that discussion we just had in Japan might be part of the answer, but as you look forward to next year, dare I say the next five or ten years, what are the key places where you're really optimistic? Either opportunities or trends that you expect to be really in focus and then I do want to keep you balanced, what are you most worried about over that time horizon?

[19:32] Peter Lampert: There's a lot of opportunities in AI. We've talked so far about the companies enabling the CapEx build-out. But once we see more use cases of the AI tools, we'll see tons of opportunities, whether that's a company like a Walters Kluwer or RELX that can benefit from that. Tencent is another clear example, as they are already benefiting today from higher ad monetization through better AI targeting in their ad algorithms and by being the internet leader in China. They're in social media, e-commerce payments, and they have plenty of opportunities to monetize AI throughout their offering.

Once we see more and more use cases, and consumers and enterprises willing to adopt those, I think we'll see much more upside from AI. Another big area of spending and opportunity is in European defense. We've talked about this on previous podcasts, but we're going through a generational shift where Europe as a whole has underspent on defense and they need to catch up, spend more. There are many great defense companies that can supply, meet that need, and benefit from that theme.

In Japan, the underinvestment in IT that has gone on for decades, they now have an urgent need to close that with the labor shortage. Again, opportunities are there. Then there are plenty of opportunities that don't fit into any of these themes, just idiosyncratic opportunities. A company like Wise in the portfolio. Many of our listeners probably use them. I use them for my cross-border FX payments. It's been a great

business. They've disrupted the traditional legacy banks with cheaper, better cross-border payments FX offering. Now they're expanding from just providing that service to individuals and businesses but really providing that on a white label offering to banks themselves, the very banks that they've disrupted, because they have lower costs, better offering, faster service times.

That is an example, not really tied to any of those themes, but just a great execution by a great management team targeting a large opportunity. And then on the flip side, there's always risks. There's always risks that we have to manage. Everything we talked about, we look to manage those risks in the portfolio, whether it's thinking about the aggregate exposure to this AI CapEx build-out, the Japan IT industry, or the European defense industry. It's managing those risks, making sure the portfolio is well diversified, because you never know what's going to happen.

For us, we're not trying to predict the future, but just build a resilient portfolio. If we have an environment of heightened geopolitics, heightened trade wars, or heightened hot wars, these are all important risks that can derail an investment case. We need to navigate that, maintain a well-diversified portfolio and focus on the long-term.

[22:20] Rob Campbell: Well, Peter, I appreciate your time today. That sounds like a pretty good place to end. And I certainly appreciate your stewardship of our clients' assets for many years at this point.

[22:28] Peter Lampert: Thanks, Rob.

[22:30] Rob Campbell: Hi, everyone. Rob here again. To subscribe to the Art of Boring podcast, go to mawer.com. That's M-A-W-E-R.com forward slash podcast, or wherever you download your podcasts. If you enjoyed this episode, please leave a review on iTunes, which will help more people discover the Be Boring, Make Money philosophy. Thanks for listening.