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EP90 | Playing the plan: Mawer's emerging markets equity portfolio

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Andrew Johnson: 00:41 Welcome back to the podcast, everyone. Or if this is your first time listening, I guess, welcome to the podcast! We're happy to have you here. Today, I'll be talking with Peter Lampert. Peter has been with the firm since 2008. He co-manages our international equity portfolio alongside David Ragan. He is the lead portfolio manager for our emerging markets portfolio, which we are going to talk about today. Peter, you've been on the podcast many times, it's always a great conversation. Welcome back!

Peter Lampert: 01:07 Great to be back.

Andrew Johnson: 01:08 Peter, you recently wrote a piece for our blog, and in it you referenced the fact that you've been revisiting Philip Fisher's book Common Stocks and Uncommon Profits. Some of our listeners will be familiar with that book. And you wrote in that piece that it's required reading here at Mawer. So, I wanted to ask you why is that book on the list and what other books are on it?

Peter Lampert: 01:27 Yeah, it's a great book. It's over 50 years old, and it's stood the test of time. Phil Fisher really lays out a lot of the foundations for good fundamental investing. We hire people from all walks of life, backgrounds, different levels of investing experience when we bring new analysts to Mawer, and we want to help them get a great foundation. This is one of many books that new analysts read on the team. Phil Fisher does a great job of walking through (he's regarded as one of the great growth investors and a pioneer in this field) the characteristics that he finds in a good company, how to find that, how to evaluate that.

It has a lot of great concepts, like the importance of scuttlebutt, getting out there, talking to people working in companies and industries. We've integrated a lot of this into our process, in our investment approach at Mawer.

Andrew Johnson: **02:16** As you said, in Fisher's book, there is that chapter where he lays out a list of things to evaluate when looking at an investment. The first few, as I recall, center around the growth prospects of the business. And as you've mentioned, he is considered one of the early proponents of growth investing. That's actually a common question that we receive at Mawer, which is, "what style of investor are you?" So, I'll frame that to you, Peter Lampert: what style of investor are we, at Mawer?

Peter Lampert: **02:40** Sometimes we get called growth investors, sometimes we get called value investors. From my view, I think we're both. I see them as two sides of the same coin. Every business is worth the net present value of its future cash flows. The growth side is projecting out what you expect those future cash flows to be, and the value side is evaluating how much you're paying today for those future cash flows. The way we approach investing—the two concepts are inseparable, and you can't make a good investment by only looking at half of the equation.

Andrew Johnson: **03:11** How do you think Fisher would view the investible universe that you're looking at in the emerging markets today?

Peter Lampert: **03:16** I think he'd be excited as am I, as are we. There are lots of great opportunities in emerging markets. We find lots of great "growth companies," but to me they're just great businesses that we can buy and hold for the long term and paying reasonable valuations for that, especially when compared to other markets around the world. Valuations are, I think, much more attractive from what we're seeing. There is a subset of companies in the emerging markets universe that I think I'd love to get his take on.

03:44 I'd really be curious to see what he'd have to say about the blitzscalers—these companies that are massive companies, mostly in the internet industry like Pinduoduo and Meituan. They're investing billions of dollars, heavily loss making today, investing for that big prize, if they can become a leader in the future.

04:02 And all of the concepts that Phil Fisher talked about, I guess, in today's lingo we'd say companies that have a good product market fit, a good growth opportunity, and the right management team to take advantage of that, we find that a lot. But he did also care about valuation: "how much are you paying for that?" And he cautioned not overpaying/paying ridiculous prices for some of these great growth companies. I'd be really curious to hear his take on these blitzscalers. In the day of the internet today, the dynamics are a bit different and just how he would apply these ideas.

Andrew Johnson: 04:34 What's your take on those companies? You mentioned the aspect of looking at valuation. I presume that there's a wide range of fair value for businesses that are in high growth mode. What's your take on things right now?

Peter Lampert: 04:47 These virtual businesses are very exciting for two key reasons around software and internet businesses. First on software is that the marginal cost is close to zero. Once you've written the software, there's maybe some sales, but other than that, your marginal cost is close to zero. So, as you have scale, as you get bigger, you're more profitable. Microsoft was the best example of this that built a huge business off that idea. And then today with the internet as well, we have the benefit of huge network effects.

05:17 Companies that gain this scale and also benefit from a network effect, whether it's bringing together buyers and sellers on Amazon, bringing together users and app developers on the app store, or just having more searches on Google and having the data advantage that they have to make their results better, you didn't have these businesses with global reach, global network effect in feel Fisher's day. So, that's a big difference—just how strong these competitive advantages can be today.

05:46 And as a result of that—software bringing marginal cost is zero and internet leading to huge network effect businesses—we have incredibly strong businesses, incredibly strong moats, and there's a huge incentive for newcomers to try to achieve that position. Companies are willing to spend and invest billions and billions of dollars, burn lots of cash flow with the goal of getting to that huge payoff.

06:11 And this has always been the case—companies have always invested to get a payoff or growth, but I think the scale of it today is greater than what we've seen in the past.

Andrew Johnson: 06:21 How does that play out for you when you're thinking about portfolio construction? Does it impact the size of the stocks in the portfolio or the position size in particular? Does it influence the number of holdings that you need to achieve proper diversification?

Peter Lampert: 06:34 We think about this dynamic a lot, both on the individual stocks and then as well when it comes to the portfolio construction. So, on the individual stocks when you're evaluating one of these very high growth companies in high investment phase, the impact is that they have a longer duration profile. The cash flows are getting pushed out further into the future. And as a result, that makes them a bit riskier. They are more sensitive to increasing interest rates, and you just get a wider range of fair values.

Peter Lampert: 07:03 There's more uncertainty into how those cash flows will evolve, especially now with the intense competition we're seeing. We see that especially in the U.S. and probably even more so in China, which are the places where we have the leading tech companies and also the huge addressable markets that can have these big prizes.

As a result, it makes these companies a little harder to evaluate. The fair value ranges are wider, and we have to take that into account in our valuation estimates and the position sizes.

07:31 The second piece is on the portfolio construction. We have some of these businesses in the portfolio, and we think they have great long-term prospects, something like a momo.com, the e-commerce leader in Taiwan; Kakao, leading messenger social app in Korea.

But at the same time, because of that duration profile and the risks that they have, we want to balance that out in the portfolio.

07:55 So we've been actively looking for either stocks that also have [a] similar profile, but maybe in more off the radar markets, places like Russia and Kazakhstan, where they're not attracting the same amount of capital and competition so that path to good economics is more visible.

Or completely offsetting these high growth, long duration tech stocks—having completely different businesses with completely different profiles.

08:19 Things like mining companies and banks and traditional companies and traditional industries that would benefit from a cyclical upturn with higher inflation and higher interest rates, while some of those longer duration tech companies may not do so well. So thinking about having that right balance and having good diversification and mixing the portfolio is very important for us.

Andrew Johnson: 08:40 Let's talk about some of those holdings in the portfolio to help illustrate things for our listeners. We talked about how ideally we want to hold a mix of stocks in the portfolio that could fall into what we just covered earlier, where the range of fair value is heavily influenced by cash flows that are maybe years down the road. And presumably, the other end of the spectrum like you just outlined, are stocks that may have cash flows that are shorter in duration.

Andrew Johnson: 09:02 In other words, the valuation of the stock relies on cash flows that are much more visible in the next year or the next three years. Are you finding value within both of those types of stocks? And if so, what are some of the examples?

Peter Lampert: 09:14 The higher growth companies that we see, the ones where there's more obvious value, is in the markets that are, like I said, more under the radar. They're not attracting all this growth capital that we see in places like the U.S. and China. A great example is Tinkoff. This is an online-only bank in Russia. They started out doing credit cards. They don't have any branches, it's all through the app. And they've been growing exceptionally well. They have a very good offering that their customers like, and they're layering on additional services.

09:45 And because this, in other countries, would be considered a hot fintech business—it's highly competitive, they'd most likely be loss-making and be trading at some insane valuation—in Russia, that's just not the case. Capital is scarce. It's hard for competitors to get in, and it's not viewed as a growth market. So, here, we have a business earning a 40% ROE, growing 30% a year. Their net income last year was $700 million. I can't even imagine what the market cap would be if it was in a place like the U.S.

10:16 In Russia, we have a trading at 15 billion market cap, which is about 20x earnings. And that's after the stocks doubled since we bought it earlier this year. We still think it's very attractive. So, we see very compelling opportunities. After we found Tinkoff in Russia, we found a very similar business called Kaspi across the border in Kazakhstan—even probably more off the radar—but they're doing something similar.

10:38 It's a digital-focused bank. Their key product is buy now/pay later consumption loans, and they've leveraged that position to become the leader in digital payments where Visa and MasterCard are not yet widely adopted, so helping the economy move from cash-based to digital and mobile payments through their QR code system. And as well, they've leveraged that position to get into e-commerce. So, they actually have the leading e-commerce marketplace in Kazakhstan as well. Kazakhstan is a fairly small market with 18 million people, but they happen to be growing these under-penetrated markets.

Peter Lampert: 11:12 They're the leading position with about 70% share in each of those three categories and, again, trading at a very attractive valuation under 20x earnings again. If you saw these businesses anywhere else in the world, I think the valuations would be much higher. So, we do see very attractive valuations in emerging markets.

On the flip side, the shorter end of the portfolio, the shorter end of the duration, valuations are also more attractive. No surprise in less sexy businesses like mining and banking.

11:39 The question there that's kept us away historically was less around the valuations and more around the business qualities. Can we find businesses that have high returns on invested capital and strong competitive advantages to maintain those high returns on invested capital, with good management team over time? And we've done some digging and we found some great companies. One is Grupo Mexico.

12:02 This is actually one of the lowest cost copper miners in the world. Their main mines are in Mexico and Peru, and they have a great management team that's just focused on developing those mines. They haven't done silly things that a lot of other mining companies do like expensive acquisitions and trying to grow at the expense of deteriorating returns on capital. They've just stuck to what they do best, the markets that they know, the mines that they have and growing their production in those mines.

12:28 Because of their favourable assets that they have with the low-cost position on the cost curve, they've been able to be very profitable and earn good returns on invested capital even through the down cycle that we've recently had. And now with an outlook for higher copper prices, there's a lot of demand and hype around copper at the moment, because the new green economy will need a lot of electricity and copper wiring. They have a very good long-term outlook.

12:53 Maybe one more to highlight is, again, coming back to Kazakhstan, Kazatomprom is the lowest cost uranium miner in the world. They basically dominate the lowest 40% of the cost curve. They have the lowest cost of producing uranium, and they're a huge sizable producer. I don't think I've seen this in any other commodity market, even Saudi Arabian oil is not nearly as dominant on the low-cost portion of the cost curve. But Kazatomprom, they've been blessed with its favourable resource.

Peter Lampert: **13:21** It's a government-owned entity, but also publicly listed, and they're shareholder-friendly focused on maximizing the value for shareholders. They've curtailed production during the down market: we've had lower uranium prices; they've been a responsible producer focused on good economics. And again, with the green economy looking forward, it's likely that we'll see more demand for nuclear power replacing coal and fossil fuels. So, a good demand outlook with constraints supply in that market.

13:49 So, all the things that we look for in terms of good businesses that have good economics and good returns on invested capital, thanks to their competitive advantages. In this case, it's their favourable resources, the assets that they actually have in the ground, and a good management team that's able to take advantage of that for shareholders. We haven't historically found a lot of those in the mining industry, but we've been very happy to add these two to the portfolio.

Andrew Johnson: 14:14 Good reminder in there too for our listeners, for any investors looking at commodity businesses, it's one thing to look at the outlook for the commodity price itself, but even more important is that cost structure of getting that out of the ground. That's going to determine the profitability of the business. I was just thinking about your earlier comments about bringing it back to Philip Fisher's book and how he outlined in there, like you mentioned, a process around scuttlebutt.

14:37 I was curious: what did the scuttlebutt process look like for these holdings that you just mentioned? Or maybe just one of them?

Peter Lampert: 14:43 Maybe Kazakhstan is a good example, because in other markets where we have a lot of existing investments, the scuttlebutt is more straightforward in a place like China or across Asia. We have our Singapore office. Our analysts there have a lot of local contacts and they've made great networks on the ground. It's easy to get insights into a lot of those businesses. But Kazakhstan is an area where we were less familiar. We wanted to ramp up when we found some good prospects like Kaspi and Kazatomprom there.

15:09 Before we actually invested, we took the time to learn more about the country and understand it better. One thing I did was read a book about Nazarbayev. He was the president of the country for 30 years until he recently stepped down, although he's still involved in the government. And just that biography was very helpful understanding how he led the country from Soviet times through independence in building Kazakhstan. Kazakhstan is not a perfect country, they have their challenges.

Peter Lampert: 15:37 But I think they've had a lot of success. And his goal was always to have a peaceful and prosperous economy, focused on peace and stability and economic development for the people. And along with the natural resources they've been blessed with—I think they have lots of oil, and pretty much every other element on the periodic table can be found in Kazakhstan—they've been able to use that to their advantage. And as a result, they're one of the most successful countries in that region.

16:09 I think there's a misperception perhaps—they often get lumped in with the other central Asian countries, the other "stans" in the region, but I don't think that's a fair comparison. They're very different in how they've developed and the policies that they've pursued. We've also had the benefit of talking to people that have lived there. One of the analysts on our team actually grew up in Kazakhstan and another analyst on our team has spent time living in Russia and was familiar with the political environment in Kazakhstan as well.

16:39 So, it's great. We have a very multinational team. Half of our analysts or portfolio managers were kind of born and raised outside of Canada, and this gives us a lot of great global perspective as well.

Andrew Johnson: 16:50 Peter, you spent a few years in Singapore. Are there any parallels between how we've seen Singapore develop over the years into becoming this developed market, and what you've seen in Kazakhstan in particular?

Peter Lampert: 17:02 Yeah. I've also read the memoirs from Lee Kuan Yew, founding father of Singapore, and it's similar in that...there were a lot of similarities. Lee Kuan Yew ran the country also for...I think over 30 years. And again, it was very focused on developing a highly peaceful and prosperous society with economic development that would benefit the population. And to do that, they had a high level of political control, which is a similarity, but the result was good economic development.

17:35 The other similarity is that they're small countries in a big world and they've both done a great job of managing those different relationships. For Singapore, it was the case of coming out of being a British colony, maintaining the benefits and advantages that they had from those British colonial links, but also importantly recognizing that the new superpowers were going to be America first and then later China and leveraging those strengths as well.

Peter Lampert: 18:01 So, having that British past and being an English speaking country in Singapore, they were able to build good links with the U.S. And also being ethnically Chinese and most of the population having their ancestral roots from China, they had natural cultural links and were able to build business ties as well with China. And Kazakhstan's also done the same thing. They're bordered by two big powers—Russia and China. And of course, in Nazarbayev's time over the last 30 years, you can't ignore the U.S. as the superpower.

18:29 And they did a great job kind of managing those three relationships, maintaining good relationships with everyone to their own benefit. They did things like decommissioning their nuclear arsenal, which they had a huge nuclear arsenal from the Soviet times based in Kazakhstan. The U.S. wanted them to decommission it. They leveraged that to get a better relationship with the U.S. and foreign investment into their oil industry, for example. And then, as well, building the relationships with China.

18:56 Nazarbayev always had good relationships with Russia. He was from the Soviet government when he took over Kazakhstan. So, they've been able to maintain those good relationships with their neighbours.

Andrew Johnson: 19:06 Excellent. That's really great insight. Thanks, Peter. I want to bring it back to the portfolio, because we often talk about trying to be in two places at the same time. This barbell concept that you've been alluding to is a good illustration of that.

So, aside from the shorter duration versus long duration aspects, like you outlined previously, let's stick with Kazakhstan. How do two names like Kazatomprom and Kaspi complement each other in a portfolio, and how do they help us be in two places at one time? Aside from both being in Kazakhstan [laughs]?

Peter Lampert: 19:36 On the one hand, there is some geographic concentration there, and we have to manage our overall weight. It's about 6% between the two companies now in Kazakhstan, so that seems reasonable. We're not taking on too much risk there. But as well, it helps having some different dynamics and offsets that the two companies face. Obviously they're two very different industries—Kaspi tied to consumer domestic consumption in Kazakhstan, and Kazatomprom tied to the long-term outlook for uranium, which is nuclear power. And beyond that, they have different currency dynamics.

Peter Lampert: 20:08 Kaspi would benefit when the tenge increases in value (the local currency), and Kazatomprom would benefit when it decreases in value, because their uranium is priced in U.S. dollars.

So that's a nice little offset that we have in the portfolio. It means we have less currency risk there when these two positions sort of offset each other.

20:30 Throughout the portfolio, when we're thinking about portfolio construction, those are nice offsets to have. It starts, first and foremost, every stock in the portfolio has to meet our bottom-up criteria of being a wealth creating company with excellent management team at a discount to intrinsic value. But beyond that, when we're thinking about rounding out the portfolio, if we can diversify the portfolio and have more resiliency by having different exposures whether it's on the duration or currencies or geographic diversification, that's something that we actively look to do.

Andrew Johnson: 20:57 That's a good segue. Because before we end, just in case it wasn't made clear to our listeners—regardless of the shorter duration comments, longer duration cash flows associated with stocks that we're looking at, the common denominator, like you said, is we're looking for quality of the business model, management team, in addition to all the work that we do on valuation.

We've covered a lot of ground here! I guess we lifted some barbells, Peter. We went to Kazakhstan and back, and we learned a lot along the way. I'm thinking that we start a new podcast series where we have you on to talk through our required reading list like we mentioned at the beginning and all of the important learnings that we take from those books. So until then, Peter, thanks for joining us and bringing your perspective on the emerging markets portfolio.

Peter Lampert: 21:36 Thanks very much. It's always a good time.