the art of boring™

EP81 | Playing the plan: Mawer's global 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:	**00:40**	Hey, Christian. Good to see you again.
Christian Deckart:	**00:42**	Hey, Andrew. Good to see you.
Andrew Johnson:	**00:44**	Welcome back to the podcast. Did I hear correctly that it was just recently your birthday?
Christian Deckart:	**00:50**	That is true indeed [laughs]. I will not mention the number, but yes.
Andrew Johnson:	**00:53**	We don't need to get into numbers. And in fact, our compliance department asks us not to get into the numbers. But I was curious, what did you do for your birthday? Was there any wishes that you had?
Christian Deckart:	**01:02**	This birthday is...not much to do. Spent quality time with the family, as I hope many of our listeners are doing these days, making the best out of what is a difficult situation. I hope I made the best out of what was a, well, very different birthday from ones I've seen before.
Andrew Johnson:	**01:19**	I'm very sure you did. And happy birthday to you—or happy belated birthday to you from all of us here on the podcast team.

Christian, we recently just had Dave Ragan on the podcast, and we talked a little bit about the dichotomy of performance throughout 2020. And, looking back over the past year, obviously the market performance stands out…I think especially the tremendous comeback that we had after the crash in March, but also just how strong it's been in the face of economies that are still struggling. We're still facing lockdowns and restrictions; there's a tremendous amount of uncertainty around economic recovery; many people are still unemployed, relying on government support to bridge that gap. I was really curious on how you and the team are balancing the conflicting signals out there of the market, versus, say, the economic situation?

Christian Deckart: **02:05** First of all, I agree. It's been a story of two halves, or to be more precise, three quarters: the first three quarters and then the last quarter—especially if you want to touch on relative performance. You know our claim, "Be boring. Make money.TM" So, "being boring" made good money in the first three quarters as markets in the world were a bit more concerned about what might happen in the world. And so with a, I would say, risk-averse philosophy, thinking about downside protection, all these things, that is something that worked well in the first three quarters. And in the last quarter, the market became very optimistic around a vaccine development, a possible end to the pandemic. And so relative[ly], the last quarter was not strong. That is, by the way, what we had seen around the last U.S. election as well. If you recall 2016, what was called the "Trump Bump" at the time was also a risk-on rally, and "be boring" didn't make money in that time period here—Q4 2016. And Q4 2020, a bit similar.

The second part of your question was maybe how we deal with conflicting news, and I would say that's business as usual. The information you get in capital markets is always conflicting. If it was all one-sided, then there wouldn't be much need for a market at all. So, dealing with conflicting information, I would say, is almost the central problem that investors are always faced with. Things are always clear in hindsight, but when you're there in the moment, then it's never clear. The future is always uncertain.

Some things in 2020 have, of course, been extraordinary beyond what I would call the "normal" investing dilemma, in the sense that we have seen a lot of what I've heard named recently "Wall Street inflation." So, we've seen a lot of asset inflation, assets becoming more expensive, while the economy around us—many parts of the economy—have come almost to a complete standstill. I don't remember when I've been at a restaurant for the last time. I've been on a plane for the last time, I think, exactly today a year ago. So yeah, a lot of things. And I just saw the new announcement by Air Canada—more job cuts. And so, there are large parts of the economy that have come almost to a complete standstill. So I would say the conflict between real economy and stock market is beyond what we usually see.

Andrew Johnson: 04:32 I'll take a stab at some cheesy humour because 2021 is the one full year that we can actually say that "hindsight is 2020," as you mentioned. Hold for applause on that one.

Christian Deckart: 04:43 That's extremely funny, Andrew.

Andrew Johnson: 04:44 We've edited for the listeners all of the laughter that was happening behind the scenes here. But Christian, you hit on this because we often talk about "being in two places at the same time" as our response to that central problem that you outlined about conflicting signals and uncertainty that, as investors, we're faced with day in and day out. And what we mean by being in two places at the same time is essentially that we're trying to be diversified—both to mitigate the risk in the portfolio, but also to be poised for long-term growth as well. So, tell me more about how the team is accomplishing that. And in particular, if you could provide some examples of holdings that may benefit from a recovery versus, perhaps, some that are a bit more agnostic to the short-term direction of the economy.

Christian Deckart: 05:29 Let me start with telling you the opposite—the inverse of what you asked for. So, when we try not to be diversified. And where we're not diversified is on the three pillars of our investment philosophy. The businesses we invest in have to be wealth-creating, so they need a competitive advantage. Secondly, they need to be run by excellent management teams. And thirdly, we purchase them at what we believe is a discount to intrinsic value. So, these are features we want all our companies, all our investments, to have. But ideally, all the other features of the companies we invest in are well-diversified. Ideally, they're even contradicting each other.

So, we're trying to be in many different industries, in many different regions, and invest in all these different industries, different regions, so that in the end, after all what we call the "natural contradictions in our portfolio," that there's only three features that remain after all the netting off has been done. That's the wealth-creating business, excellent management team, discount to intrinsic value. So, that's where we try to be diversified and where we try not to be diversified.

On your question of two places at once, well, I think around a year ago, at the height, almost, of the COVID crisis, we made two investments that might seem very contradicting. One is a company that's well-known, I think, to our listeners—Amazon. That is a, in our opinion, wealth-creating business, excellent management team. And a year ago we got at what we thought was a reasonable valuation. And it was, or is, of course, a business that is benefiting from less real-world interactions, from more online shopping, from people being locked down, larger part of commerce being done virtually over [a] distance.

The other investment we did, however, roughly a year ago, was an investment in a company called On the Beach, which for our listeners outside England, maybe to explain—this is a company that's sort of the Expedia of the UK. So, if an English person wants to book a beach holiday in Spain, very likely they're going to go on [the] On the Beach website, and they're going to pick their flight, pick their hotel, pick their airport transfer, and then On the Beach packages it up for them. So, On the Beach is a broker a bit like Expedia for travel, but On the Beach [is] very specialized region-wise and product-wise. Region-wise, it's mainly UK, and product-wise, it's mainly short haul—so, short-flight beach holidays.

Now, On the Beach is, in a way, the complete opposite of Amazon, in the sense that while On the Beach benefits if the world's reopening again; if people in the UK can take a plane again, fly freely to Spain or Italy or wherever they want to go on the beach and take their beach holiday. So, in a way, the industry exposure they have, the macroeconomic exposure, is a stark contrast. And that way we're diversified. But where we're not diversified is that On the Beach has some of the same features, in our opinion, as Amazon. It's a wealth-creating business; in good times, they have a pretty high return on capital, so, pre-COVID. They're run by what we think is an excellent management team. And, we bought it at what we thought is an attractive price. So that, I think, are two good examples of natural contradictions in the portfolio.

So, as an Amazon shareholder, we are happy about the more moves online and the less people travel, if you will. And as an On the Beach holder, we're happy if people can travel more and lockdowns ends and the world returns to normal.

Andrew Johnson: 08:59 We spent some time in previous episodes talking about biases, usually in the context of trying to mitigate them. But there's one bias that is as a result of our investment philosophy, which tends to invest in businesses that have a higher level of recurring revenue. In other words, a high visibility on the cashflows that are going to be coming into the business over the coming quarters, the coming year. What are the trade-offs to that kind of bias in the portfolio?

Christian Deckart: 09:27

Yeah, I think that bias is almost ingrained in our motto, "Be Boring. Make Money. TM" "Be boring" is the opposite of excitement. It would be something recurring, which doesn't change much, and so on. So, historically, that's served us really well. This bias might lead us back to what we talked earlier about—the performance [of] 2020, performance in two halves. This bias towards often recurring revenue, stable businesses, good cashflow...that is very much in demand when the economy is uncertain, when markets are down, when there's skepticism. Then other investors, and we ourselves as well, take comfort in the fact that, or in the knowledge that, the company we own has a certain percentage, high percentage, of recurring revenues. And there is some real protection here of the cashflows.

When the market, however, is euphoric and very optimistic, like it was in the fourth quarter of 2020, then the idea to have a safe business doesn't sound, relatively, that appealing. It's almost like fire insurance on your house, Andrew. When it doesn't burn, it seems like a complete waste of money, but when it burns, that's when it seems like a good idea. So, being invested conservatively, having recurring revenues...people only realize how valuable that is, usually, in a downturn.

And I think, more generally speaking, looking at Mawer funds, and [the Mawer Global Equity Fund] over its existence, that links into the upside and downside capture ratios. We have to upside capture the question, if the market goes up by 100 units, how much do we participate for global equity over the last 10 years? We've roughly been in line, and we've created the value on the downside. So, when the markets are down, then over the last 10 years, usually our fund has dropped less. So, I think there is a link to the recurring revenue or the conservatism in general.

Andrew Johnson: 11:19

Yeah, similar function to the correlation between bonds and equities, often in times of crisis, investors will flock towards bonds for that safety because they have visibility on the income that they're going to receive. It's very similar with a recurring revenue business; that those will, even though they're equities and they will track with the equity market, they will typically hold onto their value a little better than the broader market. Especially some of those higher-growth, economically sensitive businesses that we try to avoid at all costs.

Christian Deckart: 11:47

And I have one more comparison maybe on this, Andrew. It's like your airbag in your car. It seems like useless baggage to take around when you don't have an accident, when everything's going well. It's only when you have an accident that you appreciate it. So it seems inefficient, ineffective to drive around with an airbag all the time. But well, our view is we don't know when economic troubles come, when tough times come, so that's why we prefer to have an airbag installed all the time and don't think it's a good idea to only go look for airbags when we see a crash coming.

Andrew Johnson: 12:19 That's a great illustration. Just to shift gears slightly, overall, 2020 from a [Mawer] Global Equity Fund perspective, there had been a lot more activity than probably in recent years—at least in terms of how you calculate turnover of names in the portfolio. Just taking a closer look at it—and it was actually clustered in those two periods of Q1 and Q4, and I'm making an assumption here that both volatility and valuations, respectively, played a role in that—can you provide just more context to that? And then I'll follow up with a couple of specific holdings that I'd like to ask about.

Christian Deckart: 12:50 So, I would say, let's start with Q1. Well, we all learned about what a coronavirus is, the pandemic. And so we saw how that conquered the world, if you will. A lot of things were happening. An easier one to describe is what happened on the valuation axis of the work we do. So, volatility creates opportunity. When there is market volatility, usually there's also dispersion between single stocks. And so, the volatility we'd seen in Q1 2020 made some stocks relatively cheaper and other stocks relatively more expensive, so there were opportunities to adjust the portfolio there.

And then at the same time, also, the world changed because a pandemic is something we haven't seen before. And many businesses all of a sudden appeared in a new light. There were businesses that I think most listeners—and you and I—would have agreed before we would have labeled as very economically resilient. I look at myself—like, the haircutting business. I would have assumed we always needed to get our hair cut regularly. And if you'd looked at prior recessions, 2009, maybe 2001 or 2002, you would have said like, "Yeah, these came through the recession very well." Now, the pandemic worked out really differently.

So, some of the business models we'd looked at, we really thought of the quality in a pandemic and in a post-pandemic context differently than before. A positive example, for instance, of something we thought more positively in a post-pandemic context were things like e-commerce like Amazon, where we think, "Yeah, this is a great opportunity for them to gain market share, which they might keep over the long run."

So, a lot of movement on the quality and on the valuation axis. So that explains a bit the higher turnover in the first quarter. The first quarter…I wouldn't say there's been any one driver, we always take a look at what the whole Research team at Mawer does. And so in the fourth quarter, there were just a few things that bubbled to the top for us that we thought were really attractive in a global equity context to add to the portfolio. So I would say fourth quarter was a bit different from Q1.

Andrew Johnson: 14:54

Some of those initiations that you're talking about and turnover in the portfolio—it's important for our listeners and our clients to recall that we're operating in a lens that is very long-term in nature when we're making these decisions. We're not making a decision necessarily based on what the economy is going to do 12 to 18 months from now, but more what types of businesses do we want to hold throughout many different market environments and many different economic environments and the ones that will survive and hopefully thrive, as you just illustrated with the e-commerce example.

There are two new holdings in the portfolio that I think would make great illustrations of our philosophy and our process in action. The first is Admiral Group, which is the UK-based insurance business. And then the second one that I wanted to talk about was Novo Nordisk, which is a pharmaceuticals business out of Denmark. Let's start with Admiral Group. So, give me the background on the business, and why it fits into the portfolio.

Christian Deckart: 15:48

Yeah, Admiral is low-cost car insurance provider out of the UK. One could actually also see it with a different angle and say, "Well, they're more an insurance broker because they reinsure most of the insurance they write to clients." Some people might be more familiar with the U.S.-market background, so, with Geico or Progressive. Those are probably similar businesses. And the Buffett fans among our listeners might have heard of Geico obviously in the context of Berkshire Hathaway before. They've [Admiral] tweaked the model of insurance, in the sense that they reinsure a large part of the volume with reinsurance. So, that's why I said earlier the point, one might also think of them simply as a broker. And they've made some very good strategic choices over the decades. So, we think highly of management. That's maybe the Admiral case in a nutshell.

Andrew Johnson: 16:38

And you mentioned reinsurance. Just walk me through how that's a beneficial aspect of their business.

Christian Deckart: 16:44

Well, if you pass on the insurance risk to a reinsurer, you remain more asset-light, so that is a little tweak to the business model.

Andrew Johnson: 16:55

And is there a trade-off there? Do they earn less? Or do they have the potential to earn less, but the trade-off being safety of their business in terms of not putting them at risk?

Christian Deckart: 17:05

Yeah. It's not for free to pass on the risk to anyone else.

Andrew Johnson: 17:08 [Laughter] Oh, so there's no free lunch. I was under the impression that there was.

Christian Deckart: 17:10 There's no free lunch [laughs].

Andrew Johnson: 17:12 Oh, okay. And Novo Nordisk—what was the story behind that business?

Christian Deckart: 17:16 They are the world's largest manufacturer of insulin, so diabetics will know that product. It is truly a non-discretionary item for many people. We like their profitability, we like their long-term thinking. They are, in my opinion, very thoughtful when it comes to thinking of the value they create to society and to patients, versus the price that they charge society. And so seemed a pretty attractive pharmaceutical model to us.

Andrew Johnson: 17:44 With a large business like Novo Nordisk, and you said that they have quite a dominant share in the diabetes market with regards to insulin, I can only imagine that from having that type of position and that scale, there's economies there that they can trickle down through their business. What are some of the benefits of having that kind of scale over the market?

Christian Deckart: 18:04 Surprisingly, even in manufacturing, there is scale here. And then there is scale obviously in R&D, and generally, in focus. If you dedicate yourself to solving one problem, or very few problems, somehow the odds of success are higher than if you try to work on 50 different things. I think some of our listeners might know that from their own life. If you really want to get something done, well, focus on it and don't do 50 things at the same time. So that might also be a reason for the success of Novo Nordisk.

Andrew Johnson: 18:32 Yeah, that's an important point. And it's one that I reflected on when reading up on Novo Nordisk, because there are significant cultural benefits to having that clear, singular purpose. Or at least close to a singular purpose. We're very familiar with that approach, too. We've made decisions after decisions to remain focused as a business in what we do, and remain focused within our investment philosophy as well—not spanning out to different asset classes and products where we may not have the same level of expertise or the same level of experience that we can bring to that. And we've certainly seen the benefits of that with regards to helping our clients over the long-term.

Christian Deckart:	**19:09**	I mean, you're touching on...when we look at a business, I've mentioned wealth creation is very important for us. And for wealth creation, there needs to be a competitive advantage. And I think it's one of the core tenets of competitive analysis, that all competitive advantages tend to be local. So, they don't tend to be generally applicable. Usually, when someone has a competitive advantage, they have it in a narrow region or a narrow segment of the market in some niche where they are protected. So, I think what you touched upon is almost the core of competitive analysis. Competitive advantages are rarely universal, and companies that have tried to test that in the past have usually failed.
Andrew Johnson:	**19:48**	Well, that sounds like another podcast episode that we can bring you back on and we can walk through all of the competitive analysis that you take with regards to the portfolio holdings.
Christian Deckart:	**19:56**	Stay with us. There is more.
Andrew Johnson:	**19:58**	[Laughs] Well, Christian, we always appreciate you coming on to discuss the portfolio and provide some insight and context for our listeners. So, thanks for your time, and again, a belated happy birthday from all of us here on the podcast team!
Christian Deckart:	**20:10**	Thanks. Thanks, everyone.