the art of boring™

EP93 | Playing the plan: Mawer's global small cap 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.
David Fraser:	00:40	Welcome to another episode of the Art of Boring podcast. Thanks for joining us today.
		Today, we're doing a "Playing the Plan" edition with John Wilson, who's the co-manager of the [Mawer] Global Small Cap Fund. John, thanks for joining me today.
John Wilson:	00:54	Thanks Dave.
David Fraser:	00:55	The world looks a little bit different from the last time we had you on, which I double-checked, was October 2019, so, looking forward to hearing your thoughts today.
John Wilson:	01:03	Absolutely. Happy to be here.
David Fraser:	01:05	We're hearing a lot about inflation these days. We've covered this topic on the podcast already, but, in terms of Global Small Cap land, how do you think about that risk and that environment?
John Wilson:	01:17	That's a good question. I think you're seeing a lot of talk of inflation, especially anyone who's thinking about doing a renovation. I think I've seen lumber prices spike, so there's a lot of headlines out there. It's something we spend a lot of time thinking about.
	01:33	In terms of the portfolio, one of the things that we try to do to guard against that, is we're trying to invest in a basket—so, a diversified basket of companies that have pricing power.

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I think that's actually an important attribute that comes out of the businesses that we like to invest into. Companies that have moats. If you have that pricing power, one of the benefits is that as you find your raw materials increase, you're able to eventually pass that through to your customers. It might not happen overnight, there might be a bit of a lag, but eventually, we think that if you have pricing power, you should be able to get that through.

02:07 The one that stands out to me in our portfolio that would fit into this category, and it's one of our larger weights, is Electrocomponents. That's a company based in the UK that's a long tail distributor of components.

John Wilson: **02:21** It's important to note that we're a long tail. That means that they basically have a large swath of inventory—around half a million of different individual SK-User types of parts. That is really a function of the type of demand that they're trying to meet.

02:36 Oftentimes, the customer is in a situation where a machine is broken down, they're sitting around waiting for this one part to basically fix the machine... The customers are highly, highly time sensitive, but not very price sensitive. Instead of charging $50, which is the average basket or average cost per item, you charge $55 or $60. Customers really care.

When we've done scuttlebutt on that company, which is something we do for all our investments, where we try to talk with customers and competitors, one of the customers mentioned to us that they have had instances where they'll send the part down in a taxi cab. So highly, highly, time sensitive, but not very price sensitive. We think investing in those types of businesses, over the long run will help with a lot of the inflation that we're seeing in headlines these days.

David Fraser: **03:23** Yeah, so, crucial parts that they need right away so that the company's able to pass on the increase in costs there.

Is that something that's known in the market? Are we paying a higher price for those types of companies knowing that that is a good benefit of owning a company like that?

John Wilson: 03:39 I don't think so. I think that a lot of people will classify distributors and they'll use a broad brush across that entire category. They might not dig into the minutia or the details around the fact that this is a long tail distributor. So, I think that's one part—they might miss it. I think the other part is, if you think about that business model, it really hasn't encountered a lot of inflation, historically. I think there's a very logical reason on why they have pricing power, and we've gone through the research and trying to understand that better. But I think a lot of times people won't ascribe that value to that until they actually see it. I think that that might be an area where the market might not necessarily appreciate how much pricing power they actually have, because we haven't had an instance like this for 30, 40 years where you're seeing a significant amount of inflation.

David Fraser: 04:33 It sounds like there might be an embedded benefit of our type of investment approach, where we're looking at the fundamentals and really drilling into these companies, perhaps a little bit more than others who look at things from a little bit of a higher level.

John Wilson: 04:47 Absolutely. And I think that that comes back to the time horizon that we have. If you think about it, the stats around the average hold period is, I think, a year. If you're holding a company for a year, are you going to spend time talking to three different customers and go out and try to understand the competitive advantage really deeply? Probably not, because you're going to be selling it within a year. So that investment that you make in that research probably doesn't make a lot of sense for you to do. But for us, when we hold our companies for five, 10+ years, it makes a lot of sense for us to do that research and spend a lot of time trying to understand these moats and this pricing power in a very detailed manner because we're planning on holding it for a very long time.

David Fraser: 05:24 Yeah, absolutely. That's great. That's great insight.

As the world becomes more and more digital, we're seeing more headlines about cybersecurity. How do we assess those types of risks when we look at companies?

John Wilson: 05:37 A lot of headlines around this one. Over especially the last 12 months, you've seen a lot of ransomware attacks or cybersecurity issues. The way we think about that is, we're often thinking about it within our ESG framework. That would be one of the social risks around customer data being leaked. We think that that impacts all of our businesses, but in particular, we think it's particularly impactful for IT-related businesses, IT consultants. We have a business model called the value-added reseller, which you can think of as outsource IT department.

John Wilson: **06:10** We think those business models are even more impacted by it. You can just think about it logically: customers are coming to you to provide advice on cybersecurity, and then you have a breach. That impacts a lot of credibility that you have with the customers. Like, how good is this company if they're giving us advice on cybersecurity and they get compromised?

We spend a lot of time trying to understand, first of all, have they had breaches, historically? Talk about instances in the past. That's more of a output, and then we try to figure out the input. Okay, so you haven't had breaches in the past, let's talk about the process that you have around that. How do you ensure that customer's data is protected?

John Wilson: **06:50** For example, one of the companies we have in the portfolio is a company called Softcat and it fits within that value-added reseller category. It starts with the IT department. What they'll do is they have white hat hackers. They'll basically come in and they will try to penetrate their systems. They'll do that to make sure that if someone was trying to get in with bad intent, they try to find the vulnerabilities and the systems ahead of time before that happens.

So, we think they have a fairly detailed and well-thought-out process around cybersecurity. We think that's becoming more and more important.

David Fraser: **07:21** As we weigh out these risks of certain companies, either inflation or cybersecurity or anything else really, how do we decide how much time to spend on new ideas or new companies that we might want to add to the portfolio or reevaluate holdings that we already have?

John Wilson: **07:37** One of the things that we're trying to do here, and one of the big focuses we have, is on capital preservation. That's where we start, when I think about answering that question. What do I mean by that? That means the companies that we're invested in right now, in the portfolio, we need to do a certain baseline amount of research. We need to make sure that the foundation that we have, the companies that we're invested in, are solid. That's how we've chosen to set the bar. That involves: every year we're doing a refreshed report on that, or we're talking to either competitors or customers, doing risk screens and updating the DCF, putting out a report.

08:11 We think that that is where we start. And once we have that complete, then the remaining time we spend on new idea generation. Fortunately, because of a process that we use called the reverse roadshow, which is effectively meeting a number of companies in a one week time, rather than spreading it out over maybe three months, we'll spend the entire week or two weeks talking to 20-30 companies. That allows us to have a very high throughput on the idea generation on new companies. We find that it's a good balance right now, and that process certainly helps with idea generation.

David Fraser: 08:45 On the reverse roadshow—I believe that you're conducting one at the moment—as you say, you're out there meeting with a lot of companies in a very short amount of time to get a bit of sense of things, have you had any learnings from the most recent version of the reverse roadshow?

John Wilson: 09:00 You're right. We're in a roadshow right now; we're just coming to the tail end of it. One of the things that we like to do is to experiment in these roadshows. We'll trial new types of questions with management teams to see whether we can get new types of insights. I'll give you a couple of examples around that.

09:19 The first one would be... The question is, "if you were to stop investing for growth, how would that impact your margins?" The thought around that, why we're asking that question, is we find that oftentimes the captains haven't kept up with new business models. Historically, you'd make these investments in a big factory, a plant, and that would show up on your balance sheet and you'd spread the cost of that over the life of that asset. Well today, a lot of expenses, a lot of these investments, are actually happening on the income statement. What that means, basically, is your margins are a lot lower than they would be if this was properly accounted for—if it was actually capitalized and amortized over time. That can make a company look like it's actually not bringing that much profit, when in fact it's actually quite profitable. There's a great podcast Justin Anderson did about a year ago, listeners can check out, on this exact topic. That question, effectively, makes sure that we're not missing those opportunities.

10:17 An example of how the company that we had an interest in and an answer to you around that, was a company out of Switzerland that is a broker. They allow customers to buy and sell securities on their platform and they invest a lot in new product development. When we went through the math with them on this question, we think that their operating profit would actually be about 40% higher if they had properly accounted for these investments and actually capitalized them. So, that is actually meaningful. It might look like this is not hurting that much but when you take that into account, you realize, "Wow, that's actually quite attractive." That would be one example of a question we're trialing in this roadshow.

11:03 The other one is, one of the areas that we find can be mispriced in the market is the quality of the management team. If you think about why that might be the case, there is a certain art to assessing management. I think oftentimes if you look at sell-side research—this is research that is available to everyone or a lot of people—they don't spend a lot of time talking about management. They might give a quick background, but not a lot of details. We don't think it's necessarily well-known or something that's focused on a lot. So, one of the questions that we're asking around that is, "what are you doing differently than competitors?" Why is that important? Oftentimes when you're doing something different than competitors, it means that you've probably thought about things from first principles. You started basically from the ground up and thought about, "Okay. What are we trying to accomplish?"

11:48 One of the greatest examples of this, in my opinion—it's not a small cap any longer, it hasn't been for a while—at Costco, they can walk you through the full model. So, rather than use the Walmart approach, which has a number of different items on the shelves, they decided to go with a limited number of products. Why did they do that? Because with each of those suppliers, they have more bargaining power. They start buying more of those products from each of the suppliers, and then they'll tell you, "We're going to have a lower markup than all our other competitors out there." Why'd you do that? "That drives more customers to the store, which gives us even more bargaining power with our suppliers, which then drives more customers." It has this virtuous cycle. So, just by asking that question ("what are you doing differently?"), you can get these really interesting case studies of management teams that have really thought about things from first principles. And that can present a very interesting opportunity.

David Fraser: **12:41** Yeah, absolutely. It seems to me, again, it points to that benefit of having that longer term time horizon. Where, we want to hold these companies effectively into perpetuity if they are solid businesses. That's an added benefit of that approach, where another investor might not want to spend the time drilling that deep to understand the business that well, because it's not worth their time, as you say, over that one year holding period.

John Wilson: **13:04** Absolutely. And the things that drive—if you think about on the management side, culture is a big driver of long-term performance. It probably has next to no impact on the performance of shares over the next 12 months. So, just items that are not focused on by the majority of investors.

David Fraser: **13:20** Obviously, travel is a little bit more difficult these days. I don't think, on our research team we are traveling a lot at all. We used to get out there, we'd see factories, we'd see warehouses, we'd meet with management teams in person, get a good sense of that business from a firsthand approach. How hard is it these days and what have we done differently to try and get that sort of information now that we can't travel as much as we could?

John Wilson: **13:44** You're absolutely right—that's one of the things that we try to do a lot. We call it scuttlebutt, or "on the ground" scuttlebutt. We don't just take management's word for things, but we want to check it out ourselves. In terms of the pandemic, you're right. It has impacted the amount we've been able to get out. What we've been able to do is, we've been able to substitute in other options. Using expert networks is something that we've been finding has helped a lot. This allows you to reach out to customers, suppliers, and prior employees of the company. That can help get you a good sense of the business, the underlying business.

14:21 I think it's also important to note that, when we think of our edge or advantage in the market, what we're talking about right now is informational edge. We're talking about something where we have information that is unique or gives us an advantage over our competitors. I think there is a certain amount of weight and importance to that. Other edges or other areas that I think also matter equally, if not more, is that there's a behavioural component. Part of that is patience; focusing on companies that might have a short-term issue. Again, that one-year time horizon investor just not interested in taking that risk over that shares maybe down over the next 12 months. Well, we're very interested in doing that if we think the long-term outlook looks good.

15:03 You can also see it from an analytical standpoint. We fit the pieces of the puzzle together, maybe a bit different than other people. Probably, again, pleading the time horizon, as well as some of the tools we have internally. Whether it's how we frame decisions in terms of The Matrix. Whether it's the database we have of—we call it M42—all past company notes from not just within in this case, Global Small Cap, but across the entire platform.

There're these other areas that can give us an edge over the others in the market we think that they're equally, if not more, important than that informational side.

David Fraser: 15:37 Yeah, absolutely. Speaking of edge, from all of this research, are we seeing any mispricing in the market? Where we're taking advantage of things? Anywhere in particular?

John Wilson: 15:46 I would point out three general patterns. One I just mentioned, around short-term concern. A company we invested in, around that, is a car dealership out of Sweden called Bilia. What happened in November of last year, November 2020, was they have a large contract with Volvo, for selling Volvo cars. And Volvo effectively gave them notice that, "Hey, over the next two years, we'd like to sunset that contract. Terminate the contract." And so the shares were down a significant amount and I think that created some uncertainty. What we did was, we actually dug into the contract to try to understand what that actually involves, what that actually means.

16:27 What ended up happening at the end of the day was, that contract is only for new cars and new cars actually have a much lower margin than used cars. And then on the used car side of things and on the service side, servicing Volvos and selling used Volvos, that's something where Volvo would actually not be able to take that away from them. That's something that they actually don't have the ability to do, given the legislation in the region. So, that was one where, after we did our research, we thought there's probably an impact on profitability, but given the size of the sell-off and the valuation at the time, we thought it was attractively priced. That's something where there is this short-term uncertainty.

17:07 The other one that comes to mind around that is a company that we own in Japan called Broadleaf. That is a company that has this ERP software for garages there. So, the garage needs to be able to manage their accounting system and manage their ordering system. That's what Broadleaf does. They're switching from a license-base where they get all these fees out front. If you think back in the 1990s, you buy your Microsoft 95 CD-ROM and you pay that upfront fee to Microsoft, well today, you pay this recurring fee. What's important to note is that when you go from getting all that revenue upfront to spreading it over time, you get an initial revenue hit where your revenue is down and impacted by that. But over the long run, it doesn't matter, it's a wash. So, we think that that is something that over the next couple of years they're probably going to face pressure and difficulties, but over the long run, we think this is absolutely the right area and right decision for the company.

John Wilson: 18:03 A few other areas that we find that there's some mispricing—the first one is just around the overall runway that some companies have. Oftentimes when people talk about valuation—I'm talking about sell-side valuations—oftentimes they might do a forecast for two or three, maybe five years, and then they'll stop forecasting and they'll do either a terminal multiple or some sort of terminal calculation. Basically, what that does is it only captures a short amount of a company's runway.

18:35 Now, this doesn't apply for all companies—some companies there's a lot of uncertainty around growth. But certainly, this mispricing does apply for companies that we think have cookie-cutter growth. (That's growth that is very high probability that they're successful in capturing.) The one that comes to mind there is 4imprint. That's a company that has promotional products. So, if you think about buying a pen or a water bottle (I have this lovely mug that says "Mawer" on it), that would be what 4imprint does. It's run by a fantastic management team there. They might have 3% of the overall market, but they've been gaining share against largely a collection of small competitors that don't have the resources to invest in their websites and sales process. So we think they are a very long runway; we anticipate they might be mispriced by others looking at the company.

19:23 The final one I'll just touch upon briefly, is what we call owner-operators or engaged owners. The idea there is, there's a management team in place that is also a large shareholder in the company. And a great way I've heard someone describe this recently was, when the toast falls off the table when you have an owner-operator, it always falls butter side up. When something happens, they're able to mitigate risks before they happen and actually capture optionality. So, when there's an opportunity to jump on it and we think about why that is, they have 90% of their net worth tied up in the company. They spent a lot of time thinking about these things. I think that that is also an important pattern that might be mispriced.

David Fraser: 20:04 That's great. Thanks for pointing out those areas where we might be able to find an edge. I appreciate that that requires a lot of hard work as well.

Teamwork is a big part of what we do and doing that type of research. As you work with new hires and summer interns, can you talk about the process involved in incorporating them into the team?

John Wilson: 20:24 That's a big area of focus for Global Small Cap and something that we really have a passion around. So, when people start [at] Mawer, they start in Global Small Cap, on the Global Small Cap team. Right away, they're assigned a coach. That coach meets with them on a weekly basis to help them get up the learning curve, answer any questions that they have.

20:44 Oftentimes there's coaching around particular mental models that we use in investing. “What is customer stickiness? Let's talk about the attributes of that. What questions can you ask to assess that?” Things like that. They get assigned a coach. On top of that, all of the research that they put out, we have them write research immediately. We think that that is important. That if you're training to do something, you should actually get reps on doing that thing right away—you shouldn't just sit around and read books or do these theoretical things—we think you should get your hands dirty. All of the research that they write, we'll get feedback from all the portfolio managers on the fund. So, they're getting multiple sets of feedback on each one of their reports.

21:25 One of the key things and one of the important things that we focus a lot on in Mawer, is the culture piece. So, making sure that people that are onboarded understand the culture really, really well and live that culture.