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EP 103 | Playing the plan: Mawer's global equity portfolio

Disclaimer:	**00:22**	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.
Rob Campbell:	**00:39**	Dr. Deckart is on the podcast this week. That's our Deputy CIO, Christian. And Christian, you are here to catch us up on our Global Equity portfolio. So, I'm really interested to get your views on markets, the portfolio, and what we've been doing in that regard. We're recording this podcast on February 1st, and we've just come off one of the more, I guess, difficult months in the stock markets since the beginning of the pandemic. And this comes after a quite remarkable 2021 in terms of investment returns for global equity investors. Let's start there. Can you help score that for us? What have you observed casting the net back on...call it the last 13 months or so?
Christian Deckart:	**01:16**	I would say the last two, three, four years have been quite extraordinary just looking back at the returns that investors have gotten in stock markets. Last year I think it was 18% returns in Canadian dollars and the year before it was—the year of the pandemic, right?—when it hit, was 14%. The year before we had roughly a 20% performance.
	01:37	If you think of long-term value creation for equities around the world, there's between 6% and 7% annualized. The last three years all have returned twice to three times what would be a "normal" annual return. So we're coming from extremely profitable period for equity investors...really going back to the financial crisis 2008/2009. But then, that does change human behaviour. Profitable phases do change human behaviour. So that's something I would say I've observed.
Rob Campbell:	**02:07**	Can you expand on that a little bit? In terms of how that behaviour's changed.

Christian Deckart:	**02:11**	I think the market has become increasingly risk-off as crisis situations—drawdowns—become further removed in everyone's memory. The market participants have ventured into longer duration. Equities have taken more risk because quite frankly, taking more risk has been rewarded [laugh] over the last few years in the markets. It's almost frustrating for us because if you did risk management, well that hasn't paid in the last few years.
	02:41	So, if you think back about our motto as a firm, "Be Boring. Make Money.™" Well, the "Be Boring" thing comes first, right? To me, the "Be Boring" stands for manage your risk well.
	02:51	Now, in a time when the market was as enthusiastic as you can see in the returns I've mentioned earlier, the market isn't that focused on risk management. The market put meme stocks and whatever other things we had here in the last few years to new highs. And so one of the things I've observed is that risk management is something that hasn't paid in the past. It should pay over the mid-term and in the long-run, and we think it's very important, but when the market becomes braver and braver, then risk management in the short run seems to be a useless exercise, almost.
Rob Campbell:	**03:23**	That's interesting. And I know you're commenting about the market at large...I'm curious whether you've noticed those same tendencies within our Research team. And if so, what have we done, or how have we managed them as a group?
Christian Deckart:	**03:34**	Well, we're humans! So, we are not immune from the performance of our own stocks, portfolios—from the news flow we see in the world. So, I think it's just everywhere. And how do we manage that as a team? Well, one of our approaches has always been cognitive diversity. We've built a team that has many different backgrounds, comes from many different countries, speaks many different languages. And where we have a relationship of trust so that we can challenge each other, point out maybe weaknesses in our arguing, or quite frankly, just point out hubris [laugh] without getting aggressive or unfriendly. And I think that is a very important feature of a team—almost like in a marriage, when one partner sees the other partner, I don't know, let the kids run over the street (I see you smiling now because you have small kids as well, Rob)—

Christian Deckart:	**04:19**	—When one partner lets kids run over the street in a dangerous fashion, then you need that relationship of trust so that you, as a husband, Rob, can come up and speak and say, "Hey, this is too dangerous. Let's be a bit more careful here." While when that relationship of trust isn't there, you may not be willing to take that step. To call out and say, "Hey, I think this is too dangerous. Let's talk about that." So, I think that culture of trust, alignment, accountability, that is what we use or try to use against that risk of hubris and that risk that people go too far out the risk spectrum.
Rob Campbell:	**04:51**	It's rare that I have a conversation with you Christian where you don't impart some marriage advice, so I sort of expected or saw that one coming.
	04:58	This is about as far into a podcast as I've been in the last 12 months before the word "inflation" has been mentioned. And just as you think about the way the market shifted in the last couple of months, I'm curious to get your thoughts on just...risks that you're seeing out there, and perhaps what's caused some of the risk-off sentiments as we start thinking about the [Mawer] Global Equity portfolio itself.
Christian Deckart:	**05:18**	One risk obviously from inflation is to real purchasing power of you, me, our clients. Inflation means that your money's getting worth less and it's an impairment of real purchasing power. Let's remind ourselves that part of the reason why people invest money is to preserve purchasing power—ideally, of course, to increase it over time. If we invest in wealth-creating businesses and so on, the purchasing power goes up, so inflation is and has always been very key to what we do. It's also partly—that idea of inflation hedge is partly embedded in our philosophy. When we say the first criteria for picking investments on the equity side or for picking stocks, it has to be a wealth-creating business—i.e., one that has a competitive advantage—and often, we see these competitive advantages through pricing power. Now, that pricing power is exactly an inflation offset.
	06:07	It's the idea that if your business is confronted with increasing input costs, you can have the power to pass on those price increases to your customers. So, yeah, inflation always [has] been, I think, a core part of our thinking—although one that's maybe not been needed [laughs] in the last decade. But yeah, it seems we might be at a point where this turns. Now, what does inflation do? Some of you will know I'm originally German, so, I'll quote a central banker here [Dr. Karl Otto Pöhl] who I think 30 years ago or something made the comparison: inflation is a bit like toothpaste, that when you push on the tube and at first nothing happens, and then you think you've stopped pushing, but then it comes out all of a sudden, and then the problem is you don't get it back in again.

Christian Deckart:	**06:47**	So, inflation, in my opinion has a bit of self-reinforcing mechanism. You see now that producer prices have gone up, employees will want more money, and that might change the momentum of the overall devaluation of money.
	07:03	So, I think it might be a more structural shift. We'll see. And then why are people worried about inflation? Well, first of all, because of what I've mentioned—we all want to preserve purchasing power. But secondly, the investments we've bought, their current value is always determined by discounting future cash flows and the higher your interest rate, the higher you discount rate, the lower the present value of your investments is. So it's a risk that goes across, I would say, all income producing assets, whether it's real estate, bonds, stocks, private equity, and so on. They're more or less exposed, but generally, they're all exposed.
Rob Campbell:	**07:36**	So, paint us a picture then of the Global Equity portfolio and how perhaps with things shifting, like you said—[a] tremendous couple years of returns, inflation perhaps at greater risk today than it was a few years ago—what are the trends that you've seen in the portfolio and how you and the team have been positioning it?
Christian Deckart:	**07:52**	One of our other mottos is "prepare, don't predict." We do aim to build resilient portfolios whatever the outcome of the world is. Why? We [do] non-predictive decision making. We try to take the decisions on the portfolio without trying to predict the future. Why? Because it's really hard to predict the future [laughs]. I would even say it's impossible. Think back just two years and two weeks ago when the World Health Organization tweeted that according to Chinese sources, there's no evidence for human-to-human transmission of the novel coronavirus. These things hit out of nowhere! And usually the risks that really get us are the ones we haven't seen before.
	08:32	So, our view is it's impossible to predict these events, but what is possible is to prepare. So, it's a bit like when you go out on the ocean with your boat—you [don't] know where the big waves hit or when the storms [will] hit, but what you do know is that one day they're going to hit, which-direction-ever the storm comes from, whatever the reason that there's a storm. But one day the storm's going to be there, and your boat better be ship-shape then, be in good condition. So, at Mawer, we aim to build diversified and balanced portfolios to deal with this inherent uncertainty of the world.
Rob Campbell:	**09:06**	Can you help us better understand how you evaluate that balance, or things you've done to help adjust and achieve better balance over the last little while?

Christian Deckart: **09:15** So, how to evaluate that balance... The first step always is to look at what's obvious superficially, so you would bucket your portfolios in terms of which regions are the equities in; which industries are they in; are they longer duration, are they shorted duration (to be balanced from a duration perspective) to minimize the impact of potential interest rate changes as far as you can [manage]? But then usually the trick is in the non-obvious groupings. So, recently I've gone through a grouping and checked, "Where do the management teams have skin in the game?" If things got tougher, one of the risks we have as investors is that, well, we've committed our capital in a company but an employee and usually CEOs, CFOs—they're just employees of the companies. They might just jump ship! They might get a headhunter call and they go somewhere else.

10:01 That, of course, is less likely if they have skin in the game. And historical evidence—or at least my experience in my career—is yeah, when times get tougher, that's often when people with less skin in the game are willing to jump ship. So, that is something where I've gone through the whole portfolio and bucketed that. We might go through a[nother] bucketing exercise: "Hey, how much of the portfolio is really recurring revenues versus how much is 1x revenues?" And so on. Might go through the portfolio with [the following]: economically sensitive, relatively not sensitive, or insensitive.

10:29 So, bucketing exercises like that is usually what helps in preparing for scenarios whichever way they unfold, so that the mind is really prepared when something hits.

Rob Campbell: **10:41** May I ask you about just some specific bucketing? I know in my position I'm often asked by clients...so, one just being China and perhaps emerging markets more generally. How is the portfolio positioned and how are you thinking about the investability of those markets?

Christian Deckart: **10:56** So, we don't view emerging markets or China differently from any other regions in which we invest—in the sense that we come from a bottom-up approach. We look security by security. And then we compare the quality we get in terms of quality of management, business model risks, and compare that to the return potential that we can get. And obviously we want the best combination of those two factors: quality and price. And when we put all our potential investments we could buy on a map, then what we have discovered in the Global Equity team is that often all else equal the emerging market version seems a bit less attractive than the developed market version.

Christian Deckart: 11:35 That's at least true for the current environment. So, right now The [Mawer] Global Equity Fund has roughly a 4% weight in emerging markets. And to give you a sense what that means, well, call it a third of the benchmark. The benchmark is at 11%. So, we're benchmark agnostic, but sometimes we do look at it to get a sense where do we stand in comparison to the market?

11:55 And so we're lower, but that is not something that's fixed. I do remember times when the emerging markets weight...maybe five years ago was a lot closer to the 10% level because at that time, yeah, we thought when we looked company by company, we found that there were very good opportunities in emerging markets and we thought, "these companies deserve a place in the Global Equity portfolio." Of course, our company-by-company work hits its limits when it comes to risk management. So if we thought, "Oh, there's all these attractively priced great companies." And we find out, "Oh, they're all in emerging markets." Well, then we would realize that, no, this is not the risk proposition that the global equity investors in the Mawer Global Equity strategy are after. So there are limits to how far we would go with our bottom-up investing, but these are to manage risks. But the first step is to look at the merits of each individual security.

Rob Campbell: 12:48 Perhaps less potential for things to be out of balance just given the current position in those markets. Maybe an area where we have a little more exposure...just curious to get your thoughts as I scan through, call it the top 10 companies, a number of them that, whether they're technology related or otherwise, might have been involved in speculation with respect to antitrust, and that being a risk to some of those businesses. Thinking Google or Microsoft, even Aon, for example, was in the news last year. And I'm just thinking, how do you think about that balance? What is so attractive about those businesses and how do you manage the risks associated with them?

Christian Deckart: 13:22 That brings us back to something we've talked about a bit earlier, Rob, with the wealth creation of these businesses. So, wealth creation means high returns on capital. And high returns on capital need a competitive moat, a competitive advantage to protect them from competition. So the fine line, if you will, that you walk as an investor is yes, you want companies that are protected from competition and that other companies don't eat our company's lunch—can pass on good returns to our unit holders, to our investors.

Christian Deckart: **13:52** But if it's too good to be true [laugh], so if the competitive advantages are too large or the competition becomes too unfair between some companies and their competitors, well then society as a whole and personified through the antitrust regulation might say at your company, "This is too good to be true, and you have to change something about the way you do business." People remember twenty-something years ago, antitrust went against Microsoft and so on because it seemed very good for them at the time.

14:18 So this is a fine line we walk, and I would say for many of these businesses, yeah, that is one of the highest risks. So we do spend a lot of time thinking about that, thinking about where the barriers boundaries might run.

Rob Campbell: **14:34** Why are those particular businesses, or why is the risk worthwhile in specific [terms]?

Christian Deckart: **14:38** As I've mentioned, it's the two axes, right? We try to compare quality, which is made up of the quality of business model management and the risks and the regulatory risk—antitrust risk would fall in there. So, that quality axis and the return potential access. And so regulatory risk can be offset by higher return potential. Better growth would go into the higher return potential because it will give you, all else equal, better net present value. Good management can be an offset to some regulatory risk because even when the regulator comes and says, "Well, you can't do this anymore," then good management teams might find something else to do.

15:10 Most things in investing, Rob, are not binary. The way I think about them more is like on a scale, where something goes on one side of the scale and then something else has to come on the other side of the scale. Or the mental model of communicating vessels: where, while if the water level drops in one part, it's going to drop in the other part as well. I think often the news present things as very binary, like, "Regulatory risk—yes or no!" But I think we always have to see it in the context of going into Game Theory. If one happened, what would happen, then second step, next.

Rob Campbell: **15:41** That's actually a great intro to my next question, which is just managing those tensions. Like you said, we own a lot of very high-quality businesses with extremely recurring cash flows that we have high confidence in going forwards.

15:52 Those companies often tend to come with higher multiples... maybe more exposed to interest rate risk, just given the discounting mechanism that you referred to earlier. And so just curious how you're managing that tension or contradiction; that two sides of the balance in that regard with respect to the portfolio.

Christian Deckart: **16:10** Duration is a topic that's very much en vogue these days. I would say in the Research team we've talked about this at least since the first what I would call, small "taper tantrum" in the fourth quarter [of] I think it was 2018. We've debated how to measure duration, how to measure that interest rate sensitivity and risk. We value businesses on a Monte Carlo simulation that we put on top of a discounted cash flow model. And so with a discounted cash flow model, going out many years you can mathematically very precisely measure duration of an equity security. But of course, that's based on estimates. So we can do that, but with the model uncertainty.

16:50 One other way to look at duration very simpl[y], is to look at current dividend share buyback yield, or to look at the current "P" [current stock price]. And in that sense, I would say the [Mawer] Global Equity portfolio is reasonably balanced. And what I mean with balanced is, yes, we have companies that are longer duration, we've companies that are in line with the market average, and we've companies that are significantly shorter duration than the market average. Two larger positions that we have in the portfolio that come to mind when we talk about shorter duration securities—I'm wondering Rob, are you more interested in Japanese mobile phones or in fast cars?

Rob Campbell: **17:28** [Laughs] I'm interested in both!

Christian Deckart: **17:29** Well, let's start with KDDI, our investment in the second largest mobile phone operator in Japan. To quote some simple stats, they have a roughly 3.5% dividend yield buyback stock, which is really extraordinary [and] exceptional for Japan. Company trades on, very simple multiples here, but roughly 12xP [current stock price]. I'm just quoting the "P" here so that you get some confidence here, Rob, that yeah, the DCF don't have too crazy assumptions in them. So that would be an example of a shorter duration stock. Obviously we all use mobile phones, we all have our contracts here in Canada—maybe with Rogers or Bell. And so we all know that's a subscription business. Customers tend to be around for a while, so it's more a recurring sale than a one-time sale.

Christian Deckart: **18:11** And yeah, recurring revenues have some nice features to them in terms of economic resiliency. Fast cars, Rob, I think you know what I meant there [laugh]. I, of course, was playing with BMW. (That's a car manufacturer—most of you know.) I hope some have the pleasure of driving and supporting your Global Equity portfolio by driving a BMW, whether through a one-time purchase or your biweekly lease payments. That is a company that trades on roughly six times earnings. And very different features maybe from other car manufacturers such as Tesla. BMW is launching many electrical vehicles these days, but of course have the legacy internal combustion engine, but are really doing well in that transition in our opinion. So that would be a shorter duration security.

Rob Campbell: **18:54** You made a comment the other day I found was so interesting just with respect to management quality and just how BMW's been dealing with supply chain problems. Wondering if you can share that with our listeners.

Christian Deckart: **19:06** [Laughs] I'll bring it back to marriage, or to raising kids, Rob. Often from the outside, we can't micromanage what other people around us do, but we can make sure they have the right incentive. We can make sure that as a family, we're a loving group and we care for each other. And then you don't need to micromanage how your kids speak to each other, right? [After] giving them the right models of loving and caring for each other. And I think that is something as a public investor that also counts. We're not there in the office every day, especially in Munich in that case, when they order their semiconductor chips from wherever they order them or when they need to purchase some raw materials one or two years out. We're not there. But what we can do is we can look at the incentives that the people that are in charge have.

19:45 And if the people have incentives that are aligned with the unit holders, with the shareholders of the business—if that alignment is there—I think there's less need to second-guess what these people are doing. And in the case of BMW, it's our opinion that the incentives and alignment are very good. And so yeah, BMW has come, I think, very well through these supply chain issues. And one might analyze now and say, "Well, they were just luckier because they happened to order an appropriate amount of parts just in time, or, oh, they were better at reacting." But I think if you zoom out of it, we might come to the conclusion yeah, it's because people have better incentives than maybe at other places.

Rob Campbell:	**20:21**	The two examples KDDI, BMW like you mentioned, perhaps on a multiple basis, "cheaper stocks" that we've been adding to the portfolio…has that been the general trend in activity, as you look back over the past year within Global Equity? Or how else would you characterize some of the adjustments that you've made to the portfolio over the past year?
Christian Deckart:	**20:40**	I would say we aim for balance in everything we do. And I've given those two examples because you asked me for shorter duration stocks. We've also added I would say, mid-duration and maybe even a bit longer duration at some parts, but the portfolio is always a journey. The portfolio is never constant. And stock prices move every day. So we try to react to that. The general match plan we have is when stocks on our matrix—again, that's the combination of quality on one axis and the return potential on the other axis—when they get from more attractive, so, better company at a cheaper price; when they move away from that and become maybe more either medium-quality company or higher priced, then we try to recycle that cash and put it back into better companies at better valuations. And that trade-off happens all the time and I'm not sure I would bring it down to just lower duration. I think there's been many moving parts.
Rob Campbell:	**21:31**	I've often heard and I've never quite understood myself this notion that, "volatility is great for stock pickers." The reason I've always sort of rejected it myself is there's an assumption in there that you are a "good" stock picker; that you could take advantage of the volatility. Just curious for your opinions on that just given the volatility we've seen, the inventory list that we have. Have you found yourself more active? Are you more excited about opportunities today than you were a few months ago? How are you feeling about stock picking today?
Christian Deckart:	**21:59**	So, I agree with you because volatility in and of itself may not provide any opportunity. Imagine all stocks were up 5% today and all stocks were down 5% tomorrow. That would be volatility, but at a correlation of 1.0. So [laughs] what we need is a breakdown of correlation and an increase of dispersion. In simple terms what I mean [is] we need one stock to go up and the other stock to go down. Only then [do] we get an opportunity to pick and choose depending on the underlying relationship of quality to price for any security. But often volatility and [the] dispersion breakdown of correlation tend to correlate. So, often when there's volatility, yeah, then stocks start moving in different directions.

Christian Deckart: 22:41

So, I'm with you on the theoretical concept, but I think in practice, often when volatility happens also we see dispersion. Have I found ourselves more active? Well, we try to be balanced and level-headed. There is definitely more to look at, in my opinion. We are very busy looking at new ideas. I'm quoting [Charlie] Munger when I say, "Don't confuse action with progress." So, we do look at many things. Do we do a lot more than usual? Yeah, maybe a little bit, but it's not a difference like night and day. I mean there's more on the menu in terms of different features. All of a sudden, you can now talk to companies whose stock prices down 70% over the past 12 months. There wasn't much like that in 2019 [laughs]. So the menu has expanded, I would say, of things one can look at. And that's—for people who are passionate about this, like us here—that is a very satisfying time, in a way.

Rob Campbell: 23:36

Christian, I'm curious: if you could go back in time a year ago and speak to your former self and provide some advice or inputs or things that you've learned over the past year—aside from which way stock prices might have moved [laughs]—what is it that you've learned over the past year that you wish you'd known a year ago? Or better appreciated?

Christian Deckart: 23:53

A year is maybe a short timeframe because if you think of a matrix between process and proceeds, what you really want to learn only from is if a good process has led to a good result or when a bad process has led to a bad result. And then there's all this noise in between where yeah, you had a good process, but it led to a bad result.

Rob Campbell: 24:11

Yeah, this is the idea that you can get dealt two Aces in poker and you can still lose. Doesn't mean you shouldn't play the hand.

Christian Deckart: 24:17

Exactly. And so the lesson that would've been most profitable but it's not one I should have learned would've been like, "Don't try to manage risk. Don't sell your expensive stocks because they will become more expensive" [laughs]. So I would say if one did this purely by the math, and if I was purely a statistician, I would look at this and say, yeah, don't manage risk. But I think that falls under the "that's not repeatable" [approach] so that's not a lesson I would learn. The other learning, and yes, that's a learning from 2021 but it's one that I keep relearning throughout my career (i.e., I may never learn it [laugh] but I'm really trying) is this thought—sometimes my brain tells me, "Oh, Christian, it is too late. If you had just found that idea a year or two ago when it was less discovered."

Christian Deckart: **25:02** And there are some companies I've observed for more than decades now, and where all the factors for great wealth creation, [an] excellent management team, everything was in place—but what held me back was the idea that "we haven't discovered this early enough. Maybe there was some people that were earlier than us." So maybe it's almost a pioneer thinking where I felt like, "Oh, we need to pioneer an idea to really make it worthwhile and to make money off it."

25:25 And in reality, no, you don't need to be a pioneer. You don't need to be the first person on an idea. Also, as a second or third person on an idea. In simple terms: Google probably wasn't the first search engine [laughs], but they didn't need to be the first search engine! It was still a good idea that Larry [Page] and Sergey [Brin] went down that route. So yeah, I have a few stocks that I followed my whole investing career in between sometimes even owning them, but often I've just thought, "Oh, it's too late and this idea has probably run its theme already, and I keep seeing them compounding."

25:53 So, one learning is when you find a great compounder, great wealth creation, great management team, then don't fall in the trap of thinking, "I wish I'd discovered this five years earlier and am therefore not buying it." All we can do is compare today's price and today's value, and then act accordingly.

26:07 More a personal learning from last year is around playfulness. I have a friend who used to be a professional hockey player, and in his times as a pro (when I was still at university), he always said, "Look good, feel good, play good." And I always laughed about it and kept repeating it partly as a joke, but partly because I liked it. And last year I realized that no, there's a lot to it. We talk about area of genius a lot here at Mawer. So, we try to all work at something which really is joy for us, where we're significantly better than others. And it's division of labour in a team that allows everyone to work in their area of genius.

Christian Deckart:	**26:46**	And when you work in your area of genius, well then you feel good and then you play good. I.e., you bring better results. The original quote by the way, is as our trader Jeff Wilson mentioned to me, from Deion Sanders. I looked up that guy after Jeff Wilson mentioned it. So he's impressive because he was a baseball pro and an NFL pro at the same time. So, read his Wikipedia article, that's his quote. And during the height of the lockdowns in 2021, market volatility, a lot of work, I've realized that yeah, it's important that we have fun; that we work together as a team; that we trust each other; that we enjoy each other's presence because otherwise, this vocation that we have, this job we have, can become a real grind. And I think when people have that playfulness, that trust, that humour at work; when they can joke, maybe not in person, even, but over the screen; when that playfulness is there, it's just so much easier and productive to get our job done.
Rob Campbell:	**27:41**	Thanks again Christian, for coming on the podcast.
Christian Deckart:	**27:43**	Thank you, Rob.