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EP 211 | U.S. Equities: Software, Security, and Shifting Regimes

[0:00] Andrew Johnson The U.S., in terms of its place in the world these days, seems to be following a strategy of everything, everywhere, all at once. As global investors, it's impossible for us to avoid the impact that the U.S. has on the world's political, economic, and market environments. But what's it like investing only in U.S. stocks?

Does that lens alter the perception of the waves of change emanating from the shores of America? To find out, I talk with Grayson Witcher, Lead Portfolio Manager of our U.S. equity strategy. Grayson provides insights on everything from trying to find the signal within the political noise, to the shifting ground beneath software business models in the age of AI, to the potentially structural changes to how nations do business with each other.

Here's my conversation with Grayson Witcher.

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[1:05] Andrew Johnson Hey, Grayson, welcome back to the podcast.

[1:08] Grayson Witcher Yeah, great to be here, Andrew. Thanks for having me.

[1:10] Andrew Johnson Yeah, of course. It's been a little while. I was just thinking about the last few podcasts that we've been putting out there, and we've talked about the U.S. on some of these recent podcasts, but it's been with other asset classes, and it's been within the context of the U.S. influencing their investable universe.

So I'm happy to have you here and talk with someone who is investing exclusively within the borders of the U.S. At the risk of stating the obvious, there's been a fair amount of political volatility from the U.S. We both know that's typically noise when we're viewing things through the lens of long-term investing, but the shift in things like global security or the domestic industrial policy, those changes are potentially structural.

And so when you're operating within that type of environment, how do you distinguish between what could just be a political headline that may create either a short-term buying or selling opportunity versus a policy shift that actually breaks a company's thesis or provides a long-term tailwind to another one?

[2:15] Grayson Witcher Yeah, there has been some policy shift, Andrew, and I think that's really the key for us is to figure out how it impacts things, try to step back to understand what matters and what's noise. It seems like the U.S. has more of a short-term focus now, more focused on harvesting and extracting that mentality. So they used to be a bit more long-term focused, supporting capitalism globally, the captain of team democracy or team capitalism, promoting global trade.

So all these things benefited the U.S., of course, it wasn't just altruistic that they were trying to push these, but benefited the citizens from deflationary prices, essentially. So if you lived in the U.S., and the U.S. is a consumption economy, you could buy more stuff for better prices because it was made in China at lower cost labor than it would be if it was made in the U.S. So it was a pretty good tailwind for many decades.

You've seen companies shorten their time horizon in the U.S. too. And so I think there's been that shift where they're more focused on shorter term issues too. So a bit more of that harvesting mentality.

And you see that with firms like private equity that are the poster child of this. And the government's doing the same. You've seen the government shift from their R&D spending as a percent of GDP that was close to 2%, 1.9% back in the 60s. And now it's 0.6%. So it's fallen by two thirds. The businesses have offset a bit of that, but the government and companies become a little more short-term focused on that. And that's just being exacerbated recently.

So why is that happening? Well, globalization seemed to have enriched China, like it enriched the U.S. when it shifted from Europe and the UK to the U.S. one hundred plus years ago. It seems to be benefiting China now.

And so I think the U.S. is thinking about: how do we change this to shift the balance of power a little bit. They're becoming a bit more short-term greedy, trying to trade short-term earnings from potentially diminished long-term competitiveness.

I think there are two things that are happening. One, they're trying to extract more. So they're trying to capture more of the economics out there. You're seeing that with things like tariffs, for example, and they're trying to minimize risk.

That's things like moving critical manufacturing back to the U.S., whether it's steel, semiconductors, these kinds of things. I think there are two risks for the U.S. For a private equity company, you have a risk that you increase prices of the good you're selling massively to front end load a lot of the economics.

The risk is that growth diminishes in the future and you often put a lot of interest onto that company. And so you have high interest payments and you extract a lot of the wealth early on. And then the people that own in the future suffer because they have lower returns.

And you're seeing anomalies in the U.S. with that where they're trying to extract more of those economics shorter term. And the risk could be some of their trading partners look elsewhere with agreements in the future or try to become more self sufficient or more resourceful.

There's that contrast between the U.S. becoming more short term and trying to extract more immediate wealth and countries like China who are essentially doing the opposite in many ways where they're saying, “Hey, we can take advantage of this by having a real long term view and become industry leaders globally over the next 20, 40 or 50 years at the detriment of the next few years. But we gladly take that trade-off of being a huge leader in 20 years.”

And so you have those battles right now between those two mentalities that are seemingly shifting in opposite directions.

So how do we invest in that environment? Well, I think the first thing is to just be more aware that the world has changed. And you want to align yourself with companies that benefit from that extraction mentality.

A lot of those are U.S. companies, of course, as they're trying to benefit their own companies and citizens. And so as a U.S. equity portfolio, you're generally aligned with that. If you're exposed to industries that are competing with the U.S., you might be in trouble.

For example, if you're in the Canadian auto industry, it could be tough when they're trying to bring all the automotive manufacturing back to the U.S. Or if you're growing crops, you could be in trouble there too, if they want to grow those themselves. So it’s just being aware of that.

And then finding companies that are less skewed to the old world, I think. The old world was globalization. There was a huge push towards that for decades.

And the new world seems to be more regionalization, potentially more aggression and conflict. Therefore you may want to be less aligned with companies that are highly reliant on globalization, whether it's manufacturing in different parts of the world, or it's selling your goods to different parts of the world. And you may want to be more aligned with companies that are okay in a more regionalized world.

It could be companies like defense companies, domestic services, where you're locked within the borders, could be domestic products where you make them and sell them in the same country, or it could be growth companies. Of course, there are some growth companies that always benefit from those. So those are some thoughts on companies that could be less at risk and more at risk.

[7:18] Andrew Johnson You mentioned just the lens in which the two superpowers of today, China and the U.S. are viewing this. It is going to be fascinating to see how this unfolds over the next 5, 10, 20 years. Again, with China taking a much longer view, not only how they conduct their affairs, but who is in power over a longer period of time in China versus the typical election cycle and administration changes that we see in the U.S.

So I would imagine a lot of this has to be tempered as well as you move forward, because you don't know which policies may reverse or change course in the next election cycle.

I do want to dig into some of the themes, some of which you mentioned, but that are unfolding both in the market and in the portfolio, just to get a better sense as to how this thinking that you just outlined is showing up. And one of the drivers of portfolio performance lately has been what we don't own.

One example is within the software space. You and the team made the call to exit some longer term winners like Adobe as well as Intuit last year. Just talk us through how things like valuation, management, assessment, or perhaps even just software's place in this age of AI factored into those decisions.

[8:30] Grayson Witcher That [industry is] something we've certainly followed for many, many years, of course. We dug into it a little bit deeper over the past year or so, both to monitor some of these portfolio holdings like the ones you mentioned, as well as others, but also to better understand what was changing in the environment. So a number of people on the team spoke with many different people in the ecosystem to better understand this.

What did we learn from that? Well, I think there are a few things. One is competition, two is penetration, and three is sentiment.

For competition, we think this is being a bit underestimated by the market. When you look back at the software transition, the first phase in more recent times was really the shift from legacy technology to the cloud. And maybe the technology was better in the cloud—maybe it's not—but what you saw was some of those legacy companies would disappear, but in many instances they didn't.

And so if you think about an industry like the payroll industry that we had been invested in, there are historical payroll companies like the ADPs of the world or Paychex that people might be familiar with. They evolved and released cloud products, but then there are a bunch of new companies that also came in. These are the Paylocities, Paycoms, and many more.

What you've seen over the last decade or two is that there's been a big increase in the number of competitors there that are offering pretty similar products. And the new cloud companies are starting to get big enough where they're really becoming tougher competitors now. And so I think that's a bit of what you're seeing there as being underestimated.

And then now you've got the second phase of that, which is the AI angle, which there's perhaps another competitor or multiple competitors added to the mix—more of a general purpose competitor than a niche competitor. But you saw that with companies like Adobe, which we exited. Adobe, of course, is great at doing things like Photoshop that people are aware of.

But the risk was that AI was actually pretty good at doing it too, especially more simplistically, which could benefit some small businesses. For example, if you've got a small business online, you could certainly create some ads or graphics that you could use to sell your products online with AI in the near term. So that's the first phase, that competition, both from more players, including the cloud players, and now you're getting even more players with AI that are doing the same thing. So that's tough.

The second angle is the penetration. Our view is that's a little bit higher than you think. Think about software like CRM, Customer Relationship Management. So many people be familiar with companies like Salesforce, which has been a massive company out there. They were founded in 1999, I believe, about 25 years ago.

I think that's emblematic of how they've been able to go from nothing to being just massive, where there are many, many, companies have Salesforce in their organization, especially large sized ones.

And smaller ones also have something similar that they've implemented too. I think you're hitting a point with many of these technologies where a lot of people have implemented them and it's not as easy to grow anymore.

You're also seeing that with things like e-commerce, of course, many people order tons of things online now. And so it's not as easy to grow that ecosystem or digital ads. And people are seeing digital ads on platforms like YouTube, all these places now that are just much more common. It's a much bigger universe than it used to be 10 or 15 years ago. So it’s just tougher to grow for those companies.

And then thirdly, I think there's a bit of a bifurcation—or there was at least in the sentiment. Therefore we sold into it, Adobe, Paychex, at different times in the past, because we saw that the valuations didn't reflect some of this risk, whether it's risk from AI, risk from other software companies, risk from competition.

And those were great decisions and as they haven't performed great. There were some others that avoided these risks. They were perceived as the winners out there.

I’m thinking of ones like Service Now, where when we were speaking with people last year, it was universally loved by everyone you spoke with. And of course they do many things right. But you've seen this sentiment shift, even for those perceived winners now, where a lot of those are down 15, 25, 35% over the past number of months on fears of AI, competition, et cetera.

So that's what we're seeing that I think the market's realizing some of this and starting to reflect it in

stock prices. And they're just not sure where the bottom is, because you can certainly imagine that with heightened competition and then perhaps even a new, even tougher competitor with AI, it's hard to know when the time is to get back in. And we're in that camp too right now.

We're certainly monitoring a lot of these companies closely, but it's not clear that today is the time to change a view and start investing in a bunch of these software companies.

[13:19] Andrew Johnson And I did want to dig a little bit on AI. For a while, it did feel like any company that mentioned AI on an earnings call just saw its multiple expand.

But as you just mentioned, more recent periods look much more nuanced. In some cases, it appears there's a discerning eye on these stocks now, but you still are seeing some headline driven reactions from time to time as well. So I guess to your comments a little bit further, has the market shifted or is it in the process of shifting from buying the hype to more of a show me the money type of phase?

[13:55] Grayson Witcher Hard to tell, but it seems like there are signs that it has. I was on a quarterly earnings call last week for an insurance broker. And this business has very little to do with AI other than just consuming it like a normal consumer might, and a few other nuances, but very low AI exposure. I bet over half of the questions on the call were somehow tied into AI.

And so it just seems like investors are singularly focused on this theme right now.

But it does seem to be tipping a little bit. We've seen the share price for companies like Nvidia have been flat for around six months. That says something. And I think what people are worried about is they want to see some sort of return on this money.

I mean, you see huge numbers announced for capital spending for some of these big hyperscale companies. Think: Amazon, Google, Microsoft. The big five hyperscalers were roughly a hundred billion dollars in CapEx in 2020. And I think some estimates have them at $500 billion plus and that's a 5X spending in five years, which is huge. And so I think a lot of investors are hitting a point where they want to see some sort of return on this.

You're hearing some comments about uncertainty, whether you're getting the returns you want to get on that money. And you're seeing companies back down a little bit from that. Even Nvidia was talking about their relationship with OpenAI, and they had this co-invest setup and they were saying, well, maybe it's not locked in for sure...we can adjust it over time.

You're also seeing companies adjusting to this and being aware that investors are not as keen about these huge numbers being thrown around anymore, so they're trying to tread carefully too.

It doesn't mean that AI is not going to be used or it's not going to be an ultra powerful tool. I think it's just people saying, well, should CapEx be $500 billion this year or $300 billion? $300 billion is still an

enormous amount of money, but maybe the extra $200 billion is not going to be productively spent this year.

And there seems to be uncertainty right now where the market's unsure. They're not saying it's a bad investment and it's clearly a poor return on investment, but they're not saying it's good. They're in the middle and waffling now. That's where we are in the market. We've shifted, like you say, from awarding anyone who says anything about AI to being in the middle where they're just hedging their bets.

It could be good, it could be bad, but we're not willing to make a huge call on this right now. That seems like a reasonable place to be.

[16:32] Andrew Johnson And certainly the price action that we've seen over the last several years has afforded them that luxury too, because I know a lot of these investors have made a lot of money. They don't need to continue to double down in that space.

Grayson, just before I let you go, one other theme that I noticed is really related to either national security or supply chain security.

While you were trimming back exposure to some of the software businesses that you just talked about, you were also deploying capital into companies that operate in the space of nuclear, defense, robotics. What's the common thread there?

[17:05] Grayson Witcher That's right. We saw an opportunity a number of years ago in defense and nuclear. It seems like the world's become more confrontational, unfortunately.

We saw early signs of this when we first started investing in defense—it was just before the Russian-Ukraine war. It seemed like that sector was highly out of favor at that time. And our take was, this isn't that bad a sector. It's protected. It's going to be supported.

It seemed unlikely that there is going to be no conflict in the world in the future, that you could ramp down defense spending forever. And so our take was it was very low at that point in time and that things were shifting. Therefore, we added to our defense exposure back then.

It worked out very well over the next number of years. We've added with a few different holdings. Initially it was BWX, which is involved in nuclear submarines and nuclear energy, but we've added companies like CACI and Northrop Grumman since then.

What we like about BWX is there are multiple ways to win with a company like that. And so, as you know, Andrew, something we try and lean on is not just trying to forecast the path that’s going to happen for the world or a company. We know there are many paths that could happen and we'd like to be able to benefit from many different scenarios.

And so with BWX, that was one of those companies that had multiple ways to win. If the world becomes more adversarial, and you need to build more submarines, they benefit.

It could also be that we need more energy in the world for more electricity, for things like data centers, AI, heat pumps and ways to warm your house or cool your house with electricity rather than gas. We like that avenue too, where it had different ways to benefit from some of these themes that were happening out there in the world.

And that's been something we've shifted to over the years and it's worked out quite well for us.

Robotics, automation infrastructure has been another one, as you mentioned. What we were thinking about there really was we've seen a huge boom in AI, but what could be the next leg of growth down that path? And our take was, maybe it's using AI in the more physical world.

So AI right now, you plug in something in your computer and get an answer back that tells you information. It could also be used for things like autonomous vehicles so instead of just getting information back, you're using that to move a vehicle around in the world, like you see with companies like Waymo that Google owns. You can also use that in robotics, in manufacturing, as service industry.

And yes, we've been trying to find ways to benefit from that, whether it's investing in companies that supply businesses in the medical industry or healthcare, where you might be using robotic equipment in surgeries for urology, for example, or it could be things like making plants more automated. So thinking about things like an Amazon facility where they're extremely focused on trying to improve the customer experience. And part of that is going from two, three, four-day delivery to next day delivery to next hour delivery. How do you do that?

Well, you have to invest in things like machine vision so that you can have those packages rolled down the line much faster and get them out on the trucks and get the trucks to your house sooner. Or it could be things like investing in robotics that help with pick and pack, where they take those packages from their warehouse and get them into the box faster so they can get the box onto the truck faster.

That can be done with people, but it can also be done with machines, essentially. And so we're looking at companies that supply companies like Amazon to speed up this process.

And so, yes, that's been another theme. Trying to find ways to benefit from automation over the coming decades.

[21:06] Andrew Johnson Excellent. Grayson, always appreciate getting a chance to talk markets and the portfolio with you. So first of all, thanks for coming on.

The first probably month and a half or so of 2026 has packed a lot into it already. So all the best as you navigate the rest of the year.

[21:07] Grayson Witcher Thanks, Andrew.

[21:08] Andrew Johnson Good to chat as always.

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