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EP 182 | U.S. Equity Insights: The Impact of Policy Shifts and AI

[00:00:00] Andrew Johnson: Hi everyone. In this episode, we welcome back Grayson Witcher, lead portfolio manager for our U.S. equity strategy. We check in with him on how the team is navigating the first few months of the new U.S. administration, the practical and not-so-practical elements of tariffs and how that may impact investment decisions. And finally, Grayson shares his thoughts on the potential longer-term implications of the AI boom, as well as some of the recent portfolio changes they've made. Enjoy.

[00:00:30] V/O: 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.

[00:00:47] Andrew Johnson: Hey, Grayson, how are you?

[00:00:49] Grayson Witcher: Good, Andrew. How are you?

[00:00:51] Andrew Johnson: I'm doing well. It's great to have you back on the podcast. There's a few things I want to make sure that we cover today, but let's start with the last time that we had you on the podcast, which was actually way back in September of 2024, and we talked about some of the volatility that comes along with election years in the U.S. and how you manage through those cycles. We fast-forward now about six months, and here we are today where the volatility from the election looks rather quaint in comparison to what we're experiencing in the markets, the economy, and really the world today. So the election's over, we have a new administration in place, and we're seeing those policy shifts in action. How are you and the team processing those changes and what's been the market's reaction so far?

[00:01:34] Grayson Witcher: Yeah, it's been wild. Yeah, it's been a tough market. People were pretty excited at first, and then it's really taken a U-turn lately. Some people are calling it the shift from the Trump bump to the Trump dump, so it's been kind of tough. As you look at the S&P 500, for example, we're now significantly below where we were on election day and also kind of back to mid-September levels where people were starting to kind of foresee that Trump might be the president of the U.S., so the market's kind of really cooled. And if you look at Trump's sidekick, Musk—or maybe Musk's sidekick is Trump, the other way around—but shares of Tesla, which are kind of a good proxy of some of the stocks that have been impacted by the government, they've done the same thing. They've had a real fall—to move up and then back down again—to below pre-election levels. What we've seen is post-election, there are really kind of targeted sectors that people started to worry about. Things like R.F. Kennedy's appointment hurting vaccines and drug-related stocks and scientific research,. And then you kind of saw that move over to DOGE and some of the cuts that Musk has been pushing, hurting many different industries, but some life science companies, government jobs for sure, consulting, defense jobs. It's moved from one-off sectors where those have gotten hit pretty badly in cases and we've seen it just like one after another, after another. I think the shift now that we're seeing—and perhaps why the market's getting a bit more volatile—is that they're just viewing it as being more widespread. It seems like a thinking pattern is, oh, these are just some one-off sectors—not great for that, but the rest of the economy is doing great to now, uh oh, this is becoming a bit more widespread. We can't really shrug it off anymore, so you're seeing a lot more industries impacted

intentionally and unintentionally in some cases. You're seeing spikes in volatility, like the VIX, that I'm sure you're aware of, kind of a popular measure of volatility. That's really spiked up now to the high 20s where it was down in the low teens before. We're at a level that you don't hit that often. We've hit it several times in the past five years. It was above that during COVID, but doesn't get above that level too many times, so it's pretty high. We're seeing inflation worries, of course. We've seen government yields go back up to the 4% range for the 10-year yield, for example, which impacts mortgage costs, credit card borrowing costs, and of course, inflation is impacting a lot of things, like food costs, gasoline costs, and all that. Lately you've seen worries crawl in different parts of the economy. Recently you saw Delta Airlines take down their numbers, which I think is just an indication that people are a little more worried about things. They don't want to travel. They don't want to book big flights or vacations like they did the last few years. Now they want to just hold on to that cash and see what happens, so the negative policy shifts, the impact is spreading.

[00:04:30] Grayson Witcher: One thing to think about is just the resilience of the economy. I think there's been a bit of a shift there too, specifically the resilience of the stock market. If you look over the past decade, for example, you've seen a pretty big increase in the amount of passive investing. That was around 30% of the market a decade ago, and now it's just over half of the market is passive. That tends to be more momentum-driven. As the economy goes up, people put money into passive funds, just buy the same stocks that are going up and push them up more and then people get, as you know, it's just self-fulfilling. People see, "Oh, this is exciting. Let's keep buying this stuff." And it keeps pushing it up. So we'll see what happens. It's great on the way up, especially for these big stocks that are in the indices, but the same thing can happen on the way down. It can really unwind. We'll see what's going to happen, but we've certainly seen volatility spike and a lot more uncertainty over the past few months.

[00:05:23] Andrew Johnson: You mentioned widespread impacts and the breadth of what's going on out there. On that topic, tariffs obviously are front and center for everyone here in Canada, along with the U.S. I'm just curious, and I know our listeners are too: How does something like that impact your investment approach?

[00:05:39] Grayson Witcher: Tariffs impact a home country most directly. Obviously they're intended to inflict some sort of pain or change in behavior on Canada or Mexico or China or other countries. Of course they impact the home country most directly. It's kind of like a tax on the goods, because those goods become more expensive that you're importing. We know markets don't like uncertainty. They don't seem to be loving the indecision that's going on with Trump and the government, the kind of back and forth. It's not great for Canada, and it doesn't seem like it's been that great for the U.S. It seems like they're trying to kind of bully their allies while not putting the U.S. into a recession at the same time. One example: I've heard it estimated that vehicle prices are going to go up something like $4,500 per vehicle as a result of the tariffs. As you know, a lot of things move back and forth between Mexico, Canada, and the U.S. You're going to get lots of parts that are being moved across the border, then they'll be moved back across to be put into a vehicle, then back across again. These tariffs make a pretty big impact on that. When you think about something to the tune of $4,500, that's a lot of money. The average vehicle cost is $50,000 in the States, so that's almost 10% of the cost of the vehicle. The average income of an American is roughly $60,000, so that's 7.5% of your income. That's pretty impactful.

[00:07:01] Grayson Witcher: So why are they doing this, then, when it impacts them as well as other countries? It seems like they're trying to bring some hurt to other countries, but probably the end goal is to bring jobs to the U.S. and try and convince some of these companies to, oh, you're going to open a manufacturing facility in Mexico? Now you're kind of worried. You're just going to open it in the U.S. instead, even though the labor costs are more expensive and land costs might be more expensive and a bunch of other things. They'll just do it anyways to avoid the tariffs for the headache of not knowing what's going to happen there. But some of these changes just aren't that easy, right? When you think about globalization has been going on for 20, 30, 40 years, it's hard to unwind. It's expensive to unwind. It tends to be inflationary, so it may make some sense to bring some critical industries back to the U.S., like semiconductors or steel or vaccine manufacturing, to think, hey, we have to have these and we can't be reliant on China to make a vaccine for us when there's a pandemic. We have to have our own. Some of that could make sense where you're willing to pay at kind of any cost. But especially when unemployment is low in the States, it becomes pretty costly to try and bring some of these jobs back to make stuff. Think about a trip to Canadian Tire or Walmart or Dollar Store. A lot of that stuff comes straight from China, and if it was made in the U.S. or Canada, it's going to be significantly more expensive. What does that mean? It probably means you just buy less stuff. Most consumers aren't going to have a whole lot of extra money that just appears, so it just means you just have less money to buy less stuff.

[00:08:29] Grayson Witcher: What are we doing about it? Well, it's a couple of different stages. One, watching the industries that are most directly impacted. I mentioned autos—that's one that is kind of front and center. So just being careful with those. We generally don't have a lot of auto exposure, so we're avoiding some industries like that. Also avoiding easy targets for governments that are going to put tariffs or countermeasures on. We've seen these a few times with China over the past several years. You never know what the government's going to do. We have a bit of idea what they might try and target. So yeah, we're not invested in wine companies in the U.S. that export to Canada. We're not invested in U.S. companies that export a bunch of goods to China, where those are kind of perfect targets, you know, had U.S. employment and have really no impact. It could be things like premium liquor or something where it's like, if it gets imported or not, it doesn't really matter to China. They don't really care if they get Tennessee whiskey or something. There's lots of other alternatives, so try and avoid business like that. Agriculture has been one that China's gone after a few times too, so we don't have really any significant exposure to that. So that's the kind of direct ones, and we've really tried to monitor that and avoid exposing our clients to that over the past few years.

[00:09:43] Grayson Witcher: The second or third order ones are probably the more critical ones to us longer term, being a long-term investor. We're not just trying to avoid risks in the next quarter or two or three. We're trying to avoid risks over the next few years and then benefit from trends over the next five or ten years. These ones are a little tougher to figure out, right? Because it's the impact of inflation or uncertainty of consumer confidence. The consumer might buy less stuff, and what does that mean? Then there are the unintended consequences. We're seeing things like the Chinese company DeepSeek, who's been in the news lately, where there may be a little bit of a cheating there, where they might have used some of the U.S. AI to kind of train their own AI, but they may have also found ways to run AI with less power usage or less server usage, less chip, GPU usage. Sometimes when you try and cut off exports to a country and really try to hurt them, you end up pushing them to become more innovative and find alternative solutions to this. So while you think you're kind of hurting them and you are in the short-term, you may be helping them long-term. The same might be true for something like EVs, electric vehicles. While the tariffs are enormous on those, which is why you don't see any in Canada or the U.S. right now, even though there's many out there, they're going to go somewhere. They're just going to end up being sold to Africa or South Asia or parts of Europe or Eastern Europe, and so they might just end up replacing cars that GM or Ford might have sold to those parts of the world. Ten years from now, you may see that the Chinese auto industry is powerful and is a huge exporter, and they were more willing to adopt to EVs, whereas some of the U.S. ones push more on old technology, like gasoline engines, and just were kind of leapfrogged. Now you hit a point where even Canadian or American consumers say, “Hey, we'd rather have this Chinese EV for $20,000 than buy a domestic one for $50,000.” Those are going to be tough to predict. But for the U.S., I think the way we're leaning is really the best outcome for them seems to be getting some jobs back to the States, opening a few factories, and opening a few factories in critical industries like semiconductors, and then taking your tariffs off. You claim victory where you got a bunch of jobs back. We didn't push the U.S. economy into a recession or tried not to, didn't increase inflation too much. You can hope to tread that fine line and be able to create some political wins without hurting the economy too much. That's the path it seems the economy is going down.

[00:12:19] Andrew Johnson: Certainly citizens of North America are hoping for at least a neutral outcome to this. While tariffs and all of the other policy changes are getting a lot of air time these days, just picking up on something that you just mentioned previously that the AI and the related infrastructure boom, that theme continues. I'm curious to understand how you and the team are thinking about the medium- and longer-term impact of those developments rather than what's happening right in the near term.

[00:12:45] Grayson Witcher: For sure. So, at big technology shifts, there's probably three ways to have we think about it. One is, is this technology durable? There's a lot of stuff that sounds interesting at the time, of course, and then five years later, it kind of dwindles out and you forget that it was a thing. So we're trying to figure out: One is AI durable? It seems like it probably is. These changes seem like they're relatively impactful now, and we can see the path to being more impactful a year from now, five years from now, 10 years from now. That seems reasonably clear that it's a technology that's here to stay.

[00:13:22] Grayson Witcher: The second part is just trying to understand the life cycle, because often you get a lot of hype early on, and then people realize, oh, it's not quite as ready as people thought. The impact is not going to be as short-term or medium-term as it is going to be long-term. Then people kind of cool on and say, oh, it's not the time, we need to wait. Maybe we spent too much money, put too much capital in this, and then it needs to be some kind of a reset. We've seen that with other technologies too. We even recently think about things like self-driving cars. There is a lot of hype around those for the past five or so years, maybe a bit longer. The timeline was, hey, they'd probably be around now. We'd all be driving self-driving cars right now—and you do see some of them out there in certain jurisdictions—but there's been some roadblocks that have led to slower rollout that some people expected. Same with things like blockchain or Bitcoin. When it first came out, there was a lot of talk about, is this going to change the whole financial system? Everything's going to be running on some sort of blockchain technology. Banks are going to be completely changed. Governments are going to be using this kind of currency and that could still happen, you know, five or 10 or 20 years from now, but it seems like people have kind of cooled on that in the short-term, and it's more of a tool for speculation now or black market, kind of a black market currency. The question is just, hey, how long is it going to take AI to really come to fruition? So yeah, longer-term, well, really long-term is probably not great for humans. Maybe they'll take over and they'll be our overlords. But before that, it seems like there's a lot of big changes in the pipeline that could make a big difference—things like search on steroids could be impactful for Google or Meta or Amazon or Baidue, some of these companies. It certainly could take over things like call centers or prep book publishing for school students, some administrative work. Then medium- to longer-term, it could take over some knowledge-based jobs, things like consulting jobs or legal jobs or radiologists. There's a long list of things that it could impact longer out. So yeah, we're spending a lot of time right now trying to find out who's at risk, who can benefit, and then also trying to find—because as you know, management's a big part of our investment philosophy and spending a bunch of time understanding management teams and how much value they can add to an investment—so we're also trying to find management teams that could benefit from AI.

[00:15:45] Grayson Witcher: The third part is just thinking, is this an attractive investment? Is it here to stay? When is the impact going to happen? And then the kind of valuation is attractive place to invest. You're thinking about past cycles—things like the technology boom in the late '90s or 2000s, where a lot of that stuff was very valuable. They laid a lot of fiber for internet and watching videos and stuff like that, but it took a while for people to use it all, so those industries went through a real tough time for several years. We might be going through the same thing today as you're seeing a huge amount of CapEx from the Mag 7-type companies, hundreds of billions of dollars being spent on deploying AI. So that's the question: Whether that's going to prove to be fruitful over the next five years or whether they're going to have overinvested. We're thinking about what industries are at risk and who's going to benefit and how we can make money longer-term. We've been leaning on some of those companies, but also some where you're not betting on a certain technology, but more just on the broader theme. Companies you've heard many times before like Amphenol, which is going to be making a lot of the connectors behind the scenes that are going to be used in data centers for GPUs, but are also going to be used in devices that use that AI processing power like a self-driving car, for example. That's how we're thinking about the long-term impacts.

[00:17:05] Andrew Johnson: That's a really great overview. Thanks, Grayson. I think it's a good representation of how we're thinking long-term about this and trying not to get caught up in what's happening in the moment. Before we wrap up, we spent a few minutes last time talking about the importance of diversification, just generally speaking. Certainly with the volatility that we've seen lately, it's another good reminder of that importance. How has the portfolio positioning evolved, let's say, in the last six months or so?

[00:17:33] Grayson Witcher: As you are well-aware, we're long-term investors, so our portfolios don't shift too much over a period of a year or two, but we do tweak things on the margin, of course. I'll mention a couple of trims and maybe a new portfolio holding. A couple of trims actually will help to illustrate some of the changes in AI, for example, that we were just talking about. One was a company we used to own called Adobe that most people are probably familiar with. They make the Adobe Acrobat Reader that you look at PDFs on. Maybe people are less familiar with a business called Photoshop that creatives use to edit things like images and videos for things like advertisements, for example. We sold this because we were seeing a lot of progress of AI being able to develop these images and videos with just simple prompts. We saw this being pretty powerful. While it may not be the kind of thing that a huge multinational company uses for a Super Bowl ad or a primetime ad—they're probably not going to chalk it up on an AI quick prompt—it can be pretty impactful for people running a small business, where you have a family business that's selling some stuff and you don't have the budget to be hiring a big ad agency to be coming up with a new campaign for yourself. You just want a quick ad to throw onto an online platform or something to try and get a few more customers in. This would be perfect. It's got a low cost, it's quick, it's good enough for what you're doing to make it work and accomplish what you're looking for. We trimmed that and that's worked out pretty well. It seems like it's been one of those, it's not definitive, but it certainly has seen some pressure in that business on the early stages from AI.

[00:19:14] Grayson Witcher: A second one that we exited was Cognizant. This is a consulting company, and they have a lot of offshore workers in India and other regions where they'll offshore IT work that companies might have to really lower cost labor pools. We were worried in the same way that AI could do some of this work for them where perhaps some simple programming could be done by AI quite quickly rather than sending offshore to India. And some other business processing tasks might be able to be done by AI instead of moving offshore. In one way, you could argue this could be good for a company like that. Hey, if all of a sudden you can pay AI less money than you'd pay the worker to do it, you could expand your margins and capture some of that. But our view is that, hey, this is pretty competitive. Consulting is a pretty competitive industry. It's unlikely that Cognizant is going to be able to grow their margins substantially. It's more likely that someone else will also offer AI services at a fraction of the cost that they were offering them, having a person do them before, and so you just get your revenue and cash flow gets squeezed down rapidly at a company like that, so we ended up trimming that one.

Suppose there's a couple of ones that we trimmed for risk mitigation on the AI front.

[00:20:32] Grayson Witcher: One that we had added that's not related to AI, but is related to some of what's been happening in the economy over the past several months is a company called OSI Systems. OSI is also owned in our U.S. mid-cap portfolio. One of the benefits of a firm like Mawer is that we have the same philosophy and process in all of our strategies, and so we can leverage ideas from other strategies and in a number of portfolios, which is a really nice advantage compared to some others that might have very different process and philosophies in different funds where you cannot easily, that might have different processes and philosophies and different strategies and may not be able to port those. We're able to do that between our different portfolios, which is quite useful. This is one that appears in a couple different portfolios at Mawer. Their primary business is security screening for cargo, airports, and venues. The one you're probably most familiar with is going through an airport. Of course, you go through screeners when you get on a plane. They have that business, and they also have the same business for cargo. As you can imagine, as stuff is coming in through the ports, countries want to make sure that there's not dangerous goods coming in, so they have the same idea for cargo, trying to look for explosives and things like that, that are entering through the ports. OSI makes the hardware and software that they use for these. When you think about the world and how it's becoming a little more combative the last several years, and as we continue down this path of deglobalization, countries want to secure their borders and monitor the cargo that comes through. The opportunities for a company like OSI Systems are inspecting more cargo. Not everything is inspected right now, so you're going to get more cargo screeners coming in to inspect more of the cargo. You're also getting aging airport security screening equipment, so that needs to be replaced to update it to newer technology. They have two primary competitors in the industry, but for both of those, this business is a smaller part of their overall business. Oftentimes, you see that companies like that are slightly less focused on this because they have just bigger priorities to focus on. That's another advantage for a company like OSI: They don't have a ton of competitors and some of those competitors might be a little less focused on this opportunity than they might be. That's an interesting new idea that we found that can benefit from some of this volatility we're seeing in the world these days.

[00:23:02] Andrew Johnson: That might be a great place to wrap things up, Grayson. Great catching up with you. Really appreciate the time and insights on the portfolio and the markets, and of course, looking forward to the next chance to get to do this again. Thanks again.

[00:23:14] Grayson Witcher: Thanks Andrew.

[00:23:16] Andrew Johnson: Hey everyone, Andrew here again. To subscribe to the Art of Boring podcast, go to mawer.com. That's M A W E R dot com forward slash podcast, or wherever you download your podcasts. If you enjoyed this episode, leave a review on iTunes, which will help more people discover the "be boring, make money" philosophy. Thanks for listening.

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