EP 134 | U.S. Equities: ChatGPT, Banks, and Earnings

Anum Siddiqui (00:01):

Hi everyone, on this episode of the podcast, I sit down with Colin Wong, Portfolio Manager for our U.S. Equity strategy. Colin and I start off the conversation chatting about generative AI, and particularly ChatGPT. Recognizing that it is a fast-moving topic in its earlier days, we touch on its current and potential uses, as well as how this type of technological advancement has the ability to impact a variety of businesses and portfolio holdings.

Colin and I also discuss the recent bank collapses; and while the portfolio didn't have exposure to the impacted U.S. regional banks which faltered, we do talk about where the portfolio did have some banking exposure. Aside from that, Colin walks through why the team hasn't come across any energy names that have fit the bill, as well as the background on a recent addition to the portfolio as well as a longer-term holding.

We round out the conversation talking about the dispersion we've seen in corporate earnings and what we keep an eye out for when looking at earnings as a team. A lot of ground is covered in the episode, and I hope you enjoy the conversation.

Disclaimer (01:29):

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Anum Siddiqui (01:46):

Hello everyone, welcome to the podcast. Today, we'll be discussing the [Mawer] U.S. Equity portfolio with Portfolio Manager Colin Wong. Colin, thanks for joining us today.

Colin Wong (01:55):

Thanks for having me.

Anum Siddiqui (01:56):

So, I'll jump right in with our first topic. And it's a topic that has really taken over, I find, many people's minds. Not just investors, but people in general. And that topic is artificial intelligence.

Now, artificial intelligence is definitely not new, but it seems as of late, with the explosion of ChatGPT, that more and more people are talking about what are some of the long-term implications in respect to the use of ChatGPT in terms of how we work and how we live.

Anum Siddiqui (02:28):

As investors, it would be curious to know how we've been thinking about ChatGPT, in respect to how it could impact potential holdings and even opportunities that we're considering as well.

Colin Wong (02:37):

When we talk about ChatGPT, we're really talking about a whole generation of generative AI, and so I think it's very important for us to define what we're talking about before we even talk about the topic. AI and artificial intelligence as it stands right now—they're very task-specific. For example, ChatGPT is very good at writing as we've all learned, but notoriously bad at math. Because it's very good at doing one thing and sometimes very bad at doing other things.

When we talk about generative AI, ChatGPT being one of them, these are AIs that are good at creating things like texts, things like images, things like sound. Things that our human senses can interact with. Over time, if we think about the development of generative AI, there are many potential use cases. One of them, as you pointed out, would be potentially leading to better search results as it pertains to one of our holdings, Alphabet, as well as Microsoft.

Colin Wong (03:38):

Another usage that's often talked about is better ad targeting. If the AI knows that Colin likes the colour blue, it might show me a car when I'm car shopping that are more often blue than they are red. Other things that are interesting that generative AI has been making huge strides on, is making beautiful images. Recently, an AI bot entered a photo contest and in fact won the photo contest amongst other human photographers.

The use case is very far-reaching in the current generation of generative AI. Specific to our holding that is getting the most headlines [is] probably Google or Alphabet. There [are] potential risks out there that the competitor, Microsoft, can gain market share in search by doing things differently using ChatGPT. Specifically, this is a different way to interact with a search engine. Instead of searching something like, "What is the Alberta general election date," you might ask ChatGPT to write a poem.

Colin Wong (04:40):

You've previously probably wouldn't think about asking Google how to write a poem, but you might do that with Bing and ChatGPT.

While there is a threat of substitution, there's actually also an opportunity for significantly expanding the use case of search and really understanding knowledge in the world. One good example would be a recent example that Alphabet has highlighted in their recent conference, which is using a large language model as a way to give purchase recommendations.

One example that comes to mind would be buying an SUV. If you want to find an SUV that fits for your family of five, that has large cargo space and good fuel economy, instead of doing all that search yourself, the large language model might be able to help you get to that decision much quicker.

Over a longer period of time, like many major technological advances, it could impact virtually every holding in our portfolio and the economy as a whole.

Colin Wong (05:41):

This is consistent with the economic development over centuries, which is technological advancement leading to productivity gains and leading to higher wealth in society in general. There will be winners and losers, certainly. So, this is why one major tenet of our investment philosophy is to partner with excellent management teams. The reason why that is important is because the world is ever-changing, and having excellent managers to navigate those changes are ever important.

While we don't know what might happen or what AI will bring next, we certainly have managers that would be able to navigate through many of those changes. And then, secondly, we diversify. We don't put all our holdings in one basket. We don't put all of our portfolio holdings in only one holding for that specific reason, because the future is uncertain as it always has been.

Anum Siddiqui (06:31):

Well, that was a good overview, Colin. I think it is important to recognize that it's still very much early days. We'll continue to monitor and see how things evolve over time and how that could impact potential portfolio decision making.

Shifting gears a little bit, I did want to speak to you about banking within the U.S. equity market. Last year, we did see interest rates increase quite dramatically and there were some casualties, as we saw earlier this year, with some of the U.S. regional banks collapsing.

We didn't have any direct exposure to those banks, but I would be curious to know how your team navigated that period. Were there any thoughts in terms of our indirect exposure?

Colin Wong (07:11):

The U.S. regional banking situations remains very fluid and fast moving. There are new headlines seemingly every day. That serves as a reminder for our team that the banking business model has some significant risks associated with it. Some of these risks include significant counterparty risks. Recently, what came to light was depositor risk as well as borrower risk. Other risks include regulatory risks. We saw that with Credit Suisse being sold, as well as several regional U.S. banks being sold, really, by the regulator's order.

It is also a competitive business. We're seeing banks increasingly competing for a deposit and paying up for those deposits. And all those risks are compounded with the significant use of leverage. This is all to say that the banking sector and the situation, it's very difficult to predict. At the same time, we choose to move away from the prediction game and we try to prepare for what comes next. We own two banks in our portfolio, JPMorgan and State Street. These two banks are distinctly different from many regional banks.

For example, most regional banks would often have 80% plus of the revenue coming from interest income. At JPMorgan, that number is roughly 50%, and at State Street it's close to the 25%. That means, while they are still sensitive to interest rate moves, they're much less directly exposed. They have more ways to offset those negative impacts than many other banks would.

Colin Wong (08:31):

As the events unfolded back in March, the stock price of JPMorgan and State Street actually held up very well. Much better than most. In fact, JPMorgan's stock price today is actually higher than it was back in January 1, 2023.

So, we have taken the opportunity to trim back on both those positions as risks have gone up in the system since the beginning of the year, and we think that the stock price might not be fully reflecting that.

Colin Wong (09:16):

Once again, we're not here to predict that there'll be a big banking system issue or failure, because that's impossible to know. But we can certainly adjust our portfolio as we see the odds changing.

It's very much like going outside on a sunny day, you probably wouldn't bring an umbrella. It wouldn't make too much sense to bring an umbrella. But when you start seeing a lot of dark clouds outside, it probably makes sense to bring an umbrella with you when you go out.

Anum Siddiqui (09:41):

Thanks for that context, Colin. I'm going to shift gears on you again and speak to another area of the market. Listeners of our podcast will know that there are some areas that we typically have less exposure to through the virtue of our investment philosophy. One of those areas, especially in respect to the U.S. equity portfolio as of late, has been the energy sector.

Now, we saw the energy sector and energy companies do quite well through the economic reopening post-COVID in 2021. Over 2022 as well, due to different factors. That's leveled off a little bit so far this year. We'll see how it goes. But my question for you is, has the team been looking at the area? Right now, there is no exposure. But whether it's been more recently or in the more distant past, has the team been looking at the area in respect to certain names that do actually meet our criteria and investment philosophy?

Colin Wong (10:37):

Being bottom-up investors, we never, never exclude any sector. We're always looking. The energy sector is also a sector that we have looked [at]. In fact, we recently did a study on the potential of LNG in North America.

Why don't we own any energy sector companies right now in the [Mawer U.S. equity strategy]? It really goes back to our investment philosophy. First of all, business model.

For many oil and gas companies, it [can] be difficult to assess whether the company is wealth-creating or not. And that's because so much of the revenue comes down to the fuel prices. When oil price was above $90, many E&P companies were very value creating. On the flip side, when [the] oil price is less than $30, almost no company would be considered value creating.

Colin Wong (11:31):

We have seen oil prices or fuel prices go through those bounds many times over the past decade. So, it makes it very difficult for us to assess whether these companies are wealth-creating or not, and decreases our certainty whether these companies are wealth-creating or not, and will continue to stay wealth creating.

The second point is management. There are certainly good managers in the sector. Once again, because of the volatility of the business and the sector, it makes it very difficult for us to assess management competence. A number of years ago, managers who were most aggressive in capital expenditure to drill more wells were hailed as visionaries as the oil price boomed.

Colin Wong (12:16):

That was only to be seen a few years later, where the most prudent managers who had little debt and paid out most of the capital were the superstars of the sector.

So, we've seen the fortune reverse several times back and forth. Once again, making the job of assessing who's the good from the bad much more difficult and much more uncertain. In terms of risks, aside from the cyclical risks that we spoke about of fuel prices, there's also a secular question that we have about energy transition as the world [is] increasingly concerned about environmental issues.

When we look at valuation, we're looking for companies that are trading at a discount to their intrinsic value. That's only one of the things that we look at in terms of valuation. Another thing we look at is we're looking for businesses with limited downside and substantial upside. Once again, driven by fuel prices, many of these companies have a very wide distribution of potential outcomes. And this is reflecting on the stock price. As you alluded to, last year, the energy sector was the best-performing sector in the S&P 500, outperforming the overall index by 70%, 7-0, which is astonishing.

Colin Wong (13:28):

This year, it's actually the worst-performing sector in the whole index. And I think this is just a symptom of the wide distribution of outcomes that's possible given the function of the business.

While we don't have direct exposure now, we're always looking. We have a number of indirect exposures. One of them is AMETEK, a company we've held for over a decade. This company sells many well site testing equipment and various subcomponents for drilling that is being used in many well sites globally.

Anum Siddiqui (14:00):

It's always good to hear about indirect exposure as well. If you compare the U.S. equity market versus something like the Canadian equity or Canadian small cap market, you do have a much broader universe and forest to hunt in. And so, that is the benefit, perhaps.

Anum Siddiqui (14:20):

While we haven't found any good energy names to add to the portfolio, we have found other names. Two that meet our criteria and that have made it into the portfolio. One name that we recently added was BorgWarner. I was wondering if you could speak to our listeners about what the business does and why, perhaps, we decided to initiate a position more recently.

Colin Wong (14:38):

BorgWarner is a company we initiated a position in back in April 2023. Like all of our holdings, we're looking for wealth-creating businesses, run by excellent managers, trading at a discount intrinsic value, and this company fits the bill. In terms of business model, it is a global auto parts manufacturer selling to everyone from Ford to GM to Volkswagen. Some of the products that they sell are turbochargers, transmission components like clutches, and torque converters.

While most of the components are currently sold to make gas-powered vehicles, the company has made a significant investment and shift toward selling components for electric vehicles as well. Some of those components includes inverters, thermal control units, and motors. As one of my colleagues on the team would say, they sell things that "spins fast or get hot."

This company has a handful of competitors globally, and it's a relatively limited market when it comes to competition on a global scale.

Colin Wong (15:45):

That's because the design cycle of a vehicle is very long. It could often take upwards of a decade for a vehicle to be designed. And once these components are spec'd into a new vehicle, it's often very hard to switch, because each component impacts different components. By switching one component, you risk being not compatible with other components in the vehicle after extensive testing.

Reputation is also important. One can only imagine what the automaker would face if they have to recall millions of vehicles because of one faulty component.

Lastly, economies of scale is important in this business. Yes, it is a similar underlying technology being sold multiple times and produced in multiple different countries. The company management has done well navigating through the fast-changing auto industry. Strategically, they have made a significant pivot towards electric vehicles relatively early on and [are] now bearing the fruits of that labour. Operationally, the company has a strong margin compared to several of its peers and has increased its content per vehicle over time.

Colin Wong (16:55):

Financially, the company takes a balanced approach with funding internal and external growth opportunities and not using too much leverage.

Colin Wong (17:05):

Like all investments, there's risk. One of the clear risks is that gas-powered vehicles, which is still the vast majority of the business, might decline faster than expected. Another risk would be the company's failure to make the electrical vehicle transition. Also, overall vehicle sales could go down due to bad economic circumstances. Input costs could increase. Management, execution, and allocation also has risks associated with it.

On another aside, on the ESG front, this company actually scores pretty well, as many of its components actually increases fuel economy within the vehicle. On valuation, the company's trading at the low end of our fair value range. The current stock price doesn't seem to be giving it much credit for its EV transition, which gives it a significant potential for upside if the company were to succeed in this transition.

Anum Siddiqui (18:00):

Just one follow-up in respect to some of the risks that you mentioned. How does the team factor in some of those risks that you highlighted when investing in that company?

Colin Wong (18:12):

Risk is very much core to our investing process. When we choose what weight a certain company goes into our portfolio, one tool we often use is called an investment matrix. One of the key factors within this investment matrix is the risk score. If a company has very, very high risk, it would score very lowly or poorly on this investment matrix risk score. That means that it lowers the overall quality of the business, leading to a lower weight for any investment that we hold.

Specifically, for BorgWarner, this gambit or risk is taken in the context of the management strategy as well as the business that they're in. For example, the first risk I mentioned was gas-powered vehicles declining faster than expected. If the company were not to have pivoted so significantly towards electrical vehicle components, we probably wouldn't be comfortable with that risk, because there was no mitigating factor if gas-powered vehicles were to drop significantly. But they have. And so, this gives us some comfort that even if that scenario happens, there'll be a significant mitigating factor for the company.

Anum Siddiqui (19:24):

Great, thanks for walking through that, Colin. So, BorgWarner was recently added to the portfolio, but it would be nice to spend some time on a name that has been in the portfolio for a longer period. I know one name that has been in the portfolio for some time now, just under a decade, I believe, is Verisk Analytics. Can you speak to why we've been such long-term shareholders of this company?

Colin Wong (19:47):

Verisk Analytics is a company, as you mentioned, we've owned for a long time. What Verisk does is sells data to an insurance company, which then the insurance company uses that data to feed into their risk model to give insurance pricing or a claims' assessment.

Colin Wong (20:00):

This company got started as an industry group, whereby a bunch of insurance companies got together and formed Verisk. The reason why it was formed was because they wanted to report their loss data to regulators, which was a regulatory requirement. Verisk would gather all this data from the different insurance companies, in turn, then report that to the regulators.

Over a few decades of gathering this data, at some point, Verisk started selling that data back to the insurers to help them with their own underwriting and claims' assessment.

Colin Wong (20:41):

As you can tell, with so much data, it's actually very difficult for a new player to replicate the decades of datasets that Verisk has created. It's also very difficult for the customers to switch from using Verisk's data to some other data, because the data might not be compatible. This leads to very sticky customers.

In terms of management, the company recently promoted their previous CFO to the new CEO roughly a year ago. They brought in a new CFO from S&P Global, which is another holding of ours. With the new CEO and CFO, this brought on new energy and direction to the company.

Strategically, the company decided to refocus their business back to its core insurance division by divesting its energy and financial service businesses. Operationally, the company is trying to boost its organic growth through increased innovation and improving its margin through various efficiency measures, such as offshoring some non-core activities, as well as looking for redundancies.

Financially, the company has sharpened its focus on return on investor capital and started returning more capitals to shareholders.

Colin Wong (21:56):

On the valuation front, the stock trades within our fair value range, but the business quality and management execution have improved as I just laid out. There's still significant potential for upside. Recently, with the new management team, we've seen some early results of the improvement that they've laid out, which includes faster growth, better margin, and more traditional usage of capital.

As we saw these earlier signs of improvement, and after speaking with the management team, we added to this company three times over the past year.

In terms of the matrix, the company's score on the management and return potential front both improved, and therefore, we increased our weight accordingly in our portfolio.

Anum Siddiqui (22:42):

It sounds like Verisk is that quintessential, "more boring," holding that we're always looking for. Moving to another topic that has been on top of mind for many investors is that there could be a recession that's looming.

Anum Siddiqui (22:55):

I know we're not in the business of predicting whether or not a recession is coming, but something that has been looked at over the last few quarters is the overall health of the businesses in the market, as well as our own businesses.

As we're recording this, earnings have been rolling in. Earnings have obviously come in for previous quarters. What does the team make of the current earnings? Or the earnings that have come out more recently in respect to the health of the businesses that we own and just the market more broadly?

Colin Wong (23:29):

We certainly have noticed an increasing dispersion when it comes to earnings results. There are companies that are still doing very well. And if you just look at the financial results, it would seem that nothing really has happened in the economy. On the flip side, we have seen some where they're starting to see early signs of deceleration within their earnings and, also, they're seeing an increasing pressure from cost inflation.

When we look for earnings in our businesses, we look for a number of things. Some things include cyclical changes like the ones I just highlighted. Either cost inflation or slowdown in consumer spending. Other times, we also look for secular changes. Many things change over a long period of time, but it's important for us to continue to monitor the progress as those long-term changes happen. Some secular changes would be consumer spending pattern change.

Colin Wong (24:28):

Going into COVID and coming out of COVID, consumers have started to spend money quite differently. And so, we're monitoring those secular changes over a longer period of time. The geopolitical risk changed, as well as things like energy transition, [like] as we talk about BorgWarner with the electrical vehicles from gas-powered vehicles transition. These are many, many changes that we monitor over a very long period of time.

Of course, while we see these changes happening in real time, we're always assessing what management are doing about these changes. Because with change, oftentimes [comes] opportunity as well.

Anum Siddiqui (25:06):

This has been a great discussion. We covered a lot of bases. Thanks so much for joining us today and hope to speak to you soon.

Colin Wong (25:13):

Thanks for having me.