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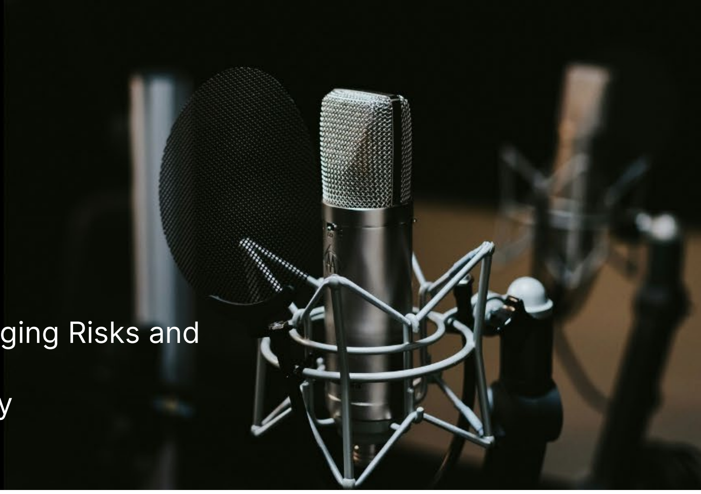
EP 173 | The "S&P 493": Managing Risks and Opportunities in the Global Equity Strategy



[00:00:00] Rob Campbell: Coming up, our chief investment officer, Christian Deckart, and our global equity strategy. Christian runs through some of the more notable vulnerabilities he perceives in the world today, talks through the portfolio's performance experience over the past year. Christian shares his excitement for the S&P 493, and he draws a distinction between companies with AI use cases in their businesses, versus those that are simply benefiting from the AI capex build-out. Enjoy.

[00:00:30] Disclaimer: 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] Rob Campbell: Christian, welcome back to the podcast.

[00:00:49] Christian Deckart: Thanks, Rob. Pleasure to be here with you.

[00:00:51] Rob Campbell: Yes. I'm looking forward to our discussion. Where I'd like to start is on portfolio construction and risk management. As a portfolio manager, as a chief investment officer, you're looking at your portfolio, you're looking across the platform and other portfolios. As you're thinking about risk, at the most basic level, can we start with what's the risk that you are principally concerned about? Is it absolute risk? Is it relative risk to an index or a benchmark, some kind of tracking error, or is it something else entirely?

[00:01:18] Christian Deckart: Principally, primarily it's absolute risk. I personally think that if you worry about absolute risk all the time, then in the long run, you're likely to do well relatively, too. However, turning this around, if you worry short term about relative risk, then long term, in my opinion, your absolute is likely to be in danger. Not blind to either of the one of them, but if in doubt, I would say the absolute is what I'm more concerned about.

[00:01:51] Rob Campbell: What are the types of things that you look at, Christian?

[00:01:54] Christian Deckart: When you think about risk management in general more, you would start by thinking about the decision-making environment. You'd start to think about our culture, the firm ownership, how the alignment is of people. Really, that environment where best ideas win, not hierarchy, a system of clear accountability, so the decision-making environment. Then in the next step, you would worry about individual securities, you would see if the process has been followed while that's been done, the research has been done properly. You would worry on the portfolio level about concentration risks, about interaction risks between positions, between sorts of exposures, and then you'd worry about a systemic review, if there's any unwanted biases that you want to check and have checked usually by other people.

[00:02:39] Rob Campbell: Can I ask you to—we're recording this the week after the U.S. election—so a chance to have a real live view of what risk management and responding to new information looks like. I think we learned yesterday, it sounds like it's going to be a red wave across the Senate, the House, and the presidency. What's that conversation or thought process look like with the global equity strategy, with this new information, with a clean sweep for the Republicans?

[00:03:01] Christian Deckart: 2016 was maybe a bit of a shock. There was Brexit and then there was Trump 1, as

I would call it, and then there was COVID. All these things already had increased trade barriers, nearshoring trends, had made people aware of the vulnerabilities of global supply chains. I would say the newness of some of these things has worn off a bit. Because as something goes from a probability to a certainty, there is of course decisions you can now make with a different mindset. We have made some minor adjustments in the portfolio following that outlook for change political environment in the U.S., but generally I'd say it's very important to keep in mind, at Mawer, we try to be prepared for our outcomes to be probabilistically positioned—so, not betting on any one outcome, but that doesn't mean being totally blind to what's happening in the world around us.

[00:03:48] Rob Campbell: Christian, as you think about vulnerabilities that you see out there, either in the portfolio or in the market at large, what are some of the ones that you're looking at more closely, whether it's having to do with the election outcome or just otherwise?

[00:04:00] Christian Deckart: There's many of those, but let me start with one that's probably very topical right now: debt levels of governments and the possible resurgence of the—I don't know how you pronounce it in English—bond vigilantes?

[00:04:11] Rob Campbell: Yes, yes.

[00:04:12] Christian Deckart: Bond vigilantes, right? Look at what the Fed has done in the U.S. over the last, say, two months, lowering rates. The bond market has decided, no, long-term rates should be higher. So governments have gotten a lot into debt over the last, well, basically forever, but over the last decade, very quickly. This is not a new phenomenon. That vulnerability of a risk to shock to interest rates is not new. By the way, I do remember around 2008 financial crisis, I always joked with a colleague like, ‘Hey, these banks are getting rescued, that person is getting rescued, but who will rescue the rescuers?’ That question—who will rescue the rescuers?—that is still open. It's not clear how this path continues with government rates and what it means for interest rates, and interest rates are really important for the valuation of all financial assets, whether that's bonds, obviously stocks, private assets, alternative assets. In the end, everything that's income-producing is very likely to be linked to interest rates.

Second one I would have is: I think a lot of investors have given up the protection they had for mark to market. Investors like to go to assets where they don't have a mark to market, people tasked to run money are now also tasked to value these assets, which is not what we have obviously in public markets. The market values our assets on a daily basis, but you can think of that conflict of interest when someone who runs the money actually also values it. I think there's probably a place for that, but the amount of that we have in today's markets, I think that comes with some risks as valuation adjustments may not be as quick as in public markets, in my opinion.

Linked to that, there's examples now of hidden losses, for instance, in some real estate. The question to me is, who owns this? If there's losses in real estate and maybe some loans are written down, you can read that in the Financial Times and Wall Street Journal, so that first-level knowledge probably isn't worth much that commercial real estate often sells for discount to the previous value.

[00:06:03] Rob Campbell: We had a podcast on that earlier this year with Curtis.

[00:06:06] Christian Deckart: OK, but the question to me is who owns it, who's taking the loss and what does that mean? In the global equity strategy, you will have seen that we have almost no banking exposure. We think that's just a vulnerability that we want to avoid because we don't think we're compensated for it adequately. But the funny thing is, if you say this is a risk that I don't think I'm compensated for adequately, we can't measure that risk, and what's funny and surprised me when I first heard it 20, 25 years ago and started to think about it, is that even after the fact, right, you can't really measure risk.

[00:06:38] Rob Campbell: Meaning that there's only been one version of the world. You don't really know what your riskiness was at the time, just because you ended up in a certain place?

[00:06:45] Christian Deckart: Exactly. The world has billions of iterations it could take from any given moment—billions is probably not even enough. The universe just unfolds in one certain way. That's just the way it works. I had an old colleague who gave me this mental model. Probably around 2008, he said something like, "Christian, you can close your eyes and cross a four-lane highway, and you may get safely to the other side, but you're still an idiot", i.e., this example is now very obvious, right? "Hey, I made it to the other side." But it doesn't show you what risks I took. Even the outcome—that one outcome where it worked—that doesn't tell you something about the risk we took, or I took in this case. I think that's always important to keep in mind what the risks are, what companies are taking, investors are taking, and so on to get to certain results. I think there is a, maybe vulnerabilities of roles in the global economy that have become too specialized and that might link back to the Trump election and what we might see there in terms of tariffs, if it does happen indeed. The country where I'm from originally, Germany, the business model seems to have been over the last 20 years, you sell to China, you get the energy to do that from Russia, cheap energy, and then you don't spend too much on defense because you really rely on the U.S. to protect you. That probably has been a vulnerability all throughout that time, and it's one that's becoming more obvious now. So that's a vulnerability that probably in a world that was very fast-moving towards globalization in the '90s, 2000s. Some countries, some regions may have become too specialized and too reliant on others. That has, of course, impact on the companies we look at, we can invest in, so that is something we do think about less in abstract ways, but more, how could it affect the companies we invest in?

[00:08:26] Rob Campbell: I love that last one, because like you said, it's been 30 years of that or almost 40 years of that and yet, despite the fact that that vulnerability was always there, it seems to be a lot more top of mind today, just given the way that the world is. Fantastic. Thanks for giving us that tour. Any more vulnerabilities that you want to share either with respect to investors' mindsets or just the market at large?

[00:08:46] Christian Deckart: We always say the biggest risk is us, right? I think as investors, the biggest risk is us. It's psychology, it's fear and greed. Right now, obviously it's greed—that's in my opinion—dominating out there, or if you want to use the word fear, the fear of missing out, the fear that the neighbor gets richer faster. I think that creates a large vulnerability because my impression is that in parts of the markets, normal risk management gets thrown overboard. Maybe people are more willing to forego diversification. They're foregoing alignment, maybe foregoing a long-term horizon. These are all things that we really try to avoid.

[00:09:25] Rob Campbell: Transitioning back to the portfolio, recognizing some of these vulnerabilities out there, or just maybe to the work that you and the team have done over the last little while. Any recent activity you think is worthwhile highlighting for clients?

[00:09:37] Christian Deckart: Yeah, I would start that by making an observation on the market in general. Often you read in the news about the Magnificent Seven, and that's sort of put in almost in a negative context, like that the market is narrow and all that. I would say the positive side of that is that, hey, there is an S&P 493, as I would call it: the companies that aren't that much in the spotlight. In the positive spotlight today, we have everything that is AI infrastructure and maybe the semiconductor capex stocks, so stocks that benefit from semiconductor capital investment. Mood seems very positive there. But that has the positive side that yeah, a lot of other things aren't getting that much attention or love. I think the number is five of our last seven initiations in global equity have been U.S. companies that are U.S.-listed, and I think two of those seven are U.S.-listed, and then you can debate whether they're really U.S. companies, because part of their business is elsewhere, large part of the business is elsewhere. I think these are examples that there are opportunities in the U.S. if you open yourself a bit

up from that concentrated world. I cannot recall a time actually where in global equity, we had such a densification of new U.S. ideas, where many U.S. companies in a row that we think fit our investment criteria at a price that we thought was, on a probabilistic basis, very reasonable.

[00:10:57] Rob Campbell: Outside of initiations though, Christian, have you also been adding or taking away from existing, or making adjustments to existing, positions in the portfolio?

[00:11:04] Christian Deckart: Yeah, I would say we've added to a few companies that we think are off creating businesses, excellent management teams, and that we felt the valuation was attractive. Two examples would be Booking and Publicis. Booking is a website where you can go and book hotel rooms and flights. They're the largest an online travel agency. They're the largest online travel agency globally. While Publicis is actually right now our largest holding in the global equity strategy, they're the second largest ad agency in the world. In ads, there's a lot of digital and IT in there. Booking and Publicis do have interesting applications for AI, for artificial intelligence, or for machine learning, if you want to call it that. They're not AI infrastructure companies. These are two where we thought, yeah, they might have a positive long-term effect for the business, from things that are happening on the IT or maybe the AI side.

[00:11:57] Rob Campbell: Actually, I was going to ask you more about that because as I look at many of the largest constituents in the universe, so the top companies in the MSCI ACWI, a fair number of them do seem to be tied to this theme of AI infrastructure or capital expenditures, whereas it seems to me that a theme of some of our top holdings is less on the capex side, more on the applications or usage of AI.

[00:12:19] Christian Deckart: I would like to say it's a fair assessment because it's my opinion as well, but I mean, time will tell. But yes, what can Booking—because I've talked about that one already—what can they do with AI? There are some regions now where they've launched, you can book travels with an AI assistant. You can put in preferences for hotels and so on, and AI is going to help you. Find that and then they've discovered that, well, if they have an AI assistant in the app, some people prefer to actually change their hotel bookings or the flight bookings through an AI chat, rather than calling a call center. I can actually imagine that that would be true for me when I travel, because often when you travel and need to change something, you're in a cab, you're on the fly, you're between meetings, right? A call is more detrimental. Apart from that, by the way, there's an angle for Booking that it saves them the cost, too. That would be one example. Publicis, I think in the ad agency world, there is a lot that might change with more IT and with artificial intelligence. The question always to us is right, because we want high returns on capital, higher than the cost of capital, a durable competitive advantage: Well, how could AI lead to a competitive advantage? I think a theme we have with many of our companies is that they tend to be market leaders. Publicis is the second largest ad agency in the world. Booking is the largest OTA in the world. Imagine Rob and Christian had an ad agency, R&C Advertising, you and I probably couldn't invest in a big AI engine. It would be harder for us. It would be very expensive. While Publicis can scale that over, that cost over big business, if you and I wanted to start a website where people can book hotels, well, it might be quite tough for us to have the data with which to feed that AI engine. Short story is, I think the data that these businesses like Publicis, like Booking have collected, that has a good chance of being actually the valuable asset once we're sort of past the first AI capex build-out and then we're in a more steady, be boring, make money environment. That's just my opinion.

[00:14:11] Rob Campbell: To push you a bit further on that assessment, clearly over the last year or two, the market is really valuing more of the capex, the infrastructure, the money that's legitimately being spent there. But at least if I'm hearing you correctly, long term, perhaps undervaluing some of the ways in which great businesses and management teams that have good proprietary data can actually roll this out and benefit their businesses.

Why do you think that is? Is it just less certain what the use cases will be versus the sheer dollars that are being spent on NVIDIA chips, for example? Or why might that be?

[00:14:43] Christian Deckart: The short answer is I do not know. What I do, however, what I can speculate, although maybe I shouldn't, is that if you have an infrastructure build-out, the growth rates at first are very impressive, while use cases will come up more slowly. Use cases will come up more slowly over time. It's going to take time. If we stay on that mental model that, hey, the biggest companies that possess the data—let's take Publicis or Booking, for example, keep these companies in your head—if we believe that AI can help and make the business better for customers and take out cost within the business, then you would expect that to play out over decades, so it's nothing to get excited about overnight. It's more be boring, make money. I also think, that's my opinion, that it has to do with investor psychology right now. There is mainly the fear of missing out.

[00:15:11] Rob Campbell: Let's talk about that: performance of the global equity strategy year to date, at least, pretty good in absolute terms, but certainly for those who are comparing against a global benchmark, relative performance has been a bit more challenged. I assume we've already talked a bit about this on your comments on the infrastructure versus the usage, but just any more thoughts that you have on the relative performance experience in 2024.

[00:15:50] Christian Deckart: Outside of this podcast, I should let listeners know, Rob and I looked just recently at the index composition versus the global equity composition. We've always said we're index-agnostic. We still are, so the portfolio does look very different from the index. That would explain generally why our performance experience can be different from the index. Yeah, I think that AI theme usage maybe versus infrastructure is one, and then I shouldn't just say AI infrastructure, capex infrastructure. I should also say semiconductors, right? This plays into semiconductors. We always say, be boring, make money, but I would put an asterisk. It's a firm motto for those not aware, but we should put an asterisk behind that and say like, be boring does not make money all the time. There are times when exciting makes more money. We had a blog out, I assume, 10 years ago that said flying on an airplane shouldn't be exciting, it should be boring. Heart surgery should be, should be boring. There's times when boring really isn't what excites people.

[00:16:47] Rob Campbell: I might add an asterisk to your asterisk: Be boring. It has made money. It just hasn't made as much money.

[00:16:55] Christian Deckart: That is how you started this question with yes, absolute performance this year isn't bad at all. I think if we made that every year, I personally would be quite happy. It's the relative that is clearly lagging. That's a reasonable assessment. There are companies—you and I looked at the performance slides this morning—so there are companies in our portfolio, UnitedHealth, FedEx, Novo Nordisk, as large positions come to mind that yeah, they have done just fine, but not as well as the benchmark. They've made money, but others have made more money.

[00:17:23] Rob Campbell: Presumably, there are some that we've been disappointed in as well.

[00:17:25] Christian Deckart: I would differentiate between disappointing performance and disappointing things that have happened. Sometimes the two correlate, sometimes they don't. In the short term, in my opinion, stock prices are more random and the media will always tell stories why a stock is up or down. I think people have a tendency, as humans, we have a tendency to confuse correlation and causation. I do have two companies in mind where I think I have a pretty good grasp of why stocks have done what they've done. Again, that's difficult in the short term. Couche-Tard is one top position that I think this year has actually, not done great because there's consumer headwinds. When people have to tighten the belt, think of it yourself. If you have a, I don't know, a loss in income or things are getting tougher, inflation, are you really going to grab that $3 Snickers at a Circle K or

you're going to postpone that? A colleague mentioned to me the example of, Hey, really, you're going to drive two blocks to get a Coke from Circle K or are you maybe willing to drive two extra blocks to a supermarket and get a Coke at maybe a better price? There is that consumer headwind, and then there's some M&A concerns. We'll see, by the time this podcast might be out, that the world may look different there, but there's some M&A noise around Couche-Tard. I think also is affecting the share price, or I think there's a good chance that it affects the share price.

Another example is KDDI, our Japanese mobile phone provider. While there are some company-specific things maybe, but the large one for me is that there are times when boring, stable businesses are viewed very favorably by the market, and there's times when they're more viewed as dead money, and obviously the stock doesn't do that well. I think KDDI is one of the larger holdings in that bucket.

There's one other factor, Rob. We manage a global equity strategy, so we try to be well-diversified and around the world really. The indexes aren't that diversified anymore. I think the U.S. is in the 60s or maybe now even low 70s of the benchmark, depending on what benchmark you take, and we're more in the 50, 55 percent range. Given that the U.S. market has done so much better over the last few years in a very concentrated fashion, in my opinion, but still the market overall, therefore has done better. Our more diversified approach to global investing, I think, has hurt us in terms of returns. My personal opinion is that this also meant less risk, but as we established before, we don't really know what risk we took. So to summarize, Rob, maybe the three things I'd highlight is yeah, AI: I think we're more in the recurring and stable business be boring, make money part of that; have good bunch of companies that can benefit if data becomes more valuable.

I think the second factor is that market sentiment is in my opinion quite positive these days. Be boring, make money is not the flavor of the month.

Maybe the final one is, shall I say, almost traditional diversification across the world and that's broader diversified than the benchmark maybe, which is a lot more U.S.-focused and the U.S. market has done better than the rest of the world.

[00:20:17] Rob Campbell: It's pretty evident to me when you look at the top 10 benchmark constituents for your ACWI, your MSCI worlds, the majority of them, if not all of them are U.S. companies, tons of representation from the technology sectors. It's certain that concentration is quite evident. That summary, Christian, is really helpful. Shifting to a last question, just looking ahead, we talked a lot about portfolio construction, some recent activity, but just generally speaking as an investor, what is most exciting? What are you most excited about today?

[00:20:42] Christian Deckart: As an investor, I'm most excited about the opportunities we're seeing on a company-by-company basis. There's dispersion between, we just said, between regional markets, between companies. I mentioned the S&P 493, as I'd label it. For people who look at opportunities one by one, that brings up a lot of things to look at, to examine, and ultimately with the goal to differentiate ourselves from the crowd, from the index, from the average. But this doesn't happen overnight. I spoke to an investor friend this week who said something which deeply resonated with me, and it made me smile because he was saying that obviously we're not talking about which companies we're looking at, but he said, he's looking at all these things right now. He's thinking whether these are good ideas. Well, we'll see in three, four, or five years, but he's quite optimistic about it. I was thinking, yeah, that's a good summary. How I feel about things.

[00:21:29] Rob Campbell: Well, a sentiment, I think, not just of you, Christian, but speaking to other members of our research team and everybody who contributes to the global equity strategy, I know that's a sentiment that's shared widely across the team. Thank you so much, Christian, for joining us today and hope to see you on the podcast again soon.

[00:21:45] Christian Deckart: Thank you. It's been fun.

[00:21:48] Rob Campbell: Hi, everyone, Rob 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.