the art of boring™

EP 176 | Why Invest Outside of the U.S.? The Benefits of EAFE Large Cap

[00:00:00] Rob Campbell: This week, Ian Turnbull on the Art of Boring. Ian's an analyst on our EAFE Large Cap team, focusing on investments in developed markets outside of North America. And we kick things off with a pretty big question. Why invest outside of the U. S. at all? From there, we dive into two-minute drills, exploring five of the portfolio's holdings. By the end of the podcast, I hope you'll have a better understanding of why we're so enthusiastic about these businesses, each elevating our investment philosophy and process. Plus you'll hear how they all work together in terms of portfolio construction and risk management. And as this is the final podcast of 2024, I'd like to take a moment to thank all of you who have tuned in over the past year. Special thanks to those who've sent feedback to podcast@mawer.com. You're probably familiar with our mantra, Be Boring, Make Money. And so, for the holidays, I'll leave you with this. Be Jolly, Make Memories. See you next year.

[00:00:21] Rob Campbell: Ian, welcome to the podcast.

[00:00:23] Ian Turnbull: Thanks, Rob. Glad to be here.

[00:00:25] Rob Campbell: Well, I'm so glad to have you, another first-time guest on The Art of Boring. Can you give us a little bit on your background and how you got to Mawer?

[00:00:34] Ian Turnbull: I've been at Mawer just over four years now. I joined in November 2020. I started out, I went to Laurier. I had studied finance, was in Toronto working for another firm there, doing healthcare and a bit of consumer work as a specialist, so it was a little bit different as a kind of sector specialist-type role, doing mostly global healthcare. What attracted me to Mawer was the investment success they'd had, a lot of really good investors here to learn from, and the opportunity to be a generalist, take my learnings in a couple of sectors and try to apply them around the world, across all sectors. So, it's been a fun transition moving to Calgary as well. It's been awesome. I really enjoyed it.

[00:01:13] Rob Campbell: Fantastic. You joined our EAFE large cap team, and we're here to talk about that portfolio. I ask this half-facetiously, but also half-seriously: U.S. equities have just trounced other regions in the world over the last 10, 15, 20 years. We're talking substantial outperformance. Genuine question: Why even have an EAFE portfolio in your asset mix? Why not all U.S. stocks?

[00:02:15] Ian Turnbull: It's a good question because doing that historically would have worked pretty well. To start: it is kind of bottom-up. We are finding great companies that fit our investment philosophy really well in EAFE today. We have a lot of those in the portfolio, and we've got a really deep inventory list—dream list—things you would love to own at some point. It has kind of answered a lot of questions of like, maybe why do you have more exposure here or there? It often comes to the bottom up, what we're seeing on the ground, company by company. There can be lower-quality areas in our universe, and so I think our win-by-not-losing strategy can work well. We’re agnostic about the benchmark. There are areas that we won't own much of and areas that we'll own a lot of.

I think to the U.S., if you think of a 100% U.S. portfolio, there are two big risks there. One would be just concentration risk. The U.S. is one country. It's very diverse, but it is one country. It's had its historical volatilities and fragilities and even with geopolitics, it can be unique to it. The other one would be valuation risk. Right now, the S&P forward price-to-earnings ratio is about 65% above the equivalent in Europe. Historically the last 20 years has been about 10 or 20% premium, quite possibly deserves a premium, but the last, especially five years, we've seen that premium blow out substantially. I think their performance has been that more than half the last 10 years has come from multiple expansion. So the U.S. has done really well with great companies, but there is a valuation, maybe fragility risk there as well.

One thing too is, when we think of the EAFE universe, there are 21 countries and there are some really good ones here. There are some issues that grabbed the headlines, but I think, especially on the smaller country side, there are a lot of really attractive situations. If you think of the Nordics, there's five countries there that are all generally doing really well. Also in Europe, Switzerland is doing really well. Ireland has emerged as a really bit of a powerhouse. Poland, particularly the ASML, has done great. Looking over at Asia, Singapore looks extremely attractive. Australia, some characteristics just like Canada, but some really great countries there as well. When you look at some of the smaller countries, there are really attractive opportunities.

[00:04:11] Rob Campbell: When you say attractive opportunities in these countries, I think I know the answer, but you're not saying that somehow these are economic powerhouses that are domestic plays. You're suggesting that for whatever reason—cultural happenstance, density, whatever—these smaller countries tend to punch above their weight in terms of producing global leaders that compete against the very best U.S. companies too.

[00:04:35] Ian Turnbull: Yeah, we see a lot of that. I think one deductive reason could be small home markets, so they have to look abroad to export. I’ll point to Sweden, Denmark, the Nordics, Switzerland for that reason. They couldn't just stay within their own borders like a lot of U.S. companies do and for good reasons. If we think of Denmark with Novo Nordisk with GLP-1 and insulin, they've always been an exporter of that, always focused abroad internationally. If you think of Sweden, a lot of really strong industrial businesses have been around for a long period of time, where the home market is 1 or 2% of their revenue and they're extremely international, very good at localizing things. Being a world leader, Switzerland as well, great pharmaceuticals, medical devices, leadership, various industrial niches, and consumer brands from chocolate to luxury. Even Japan, which maybe has some of its problems, but really good exporting companies, often with almost a 100% market share and very little niches that they've iterated on for generations. And the employees don't leave, so you get them throughout their life. There's a lot of learning that is very unique versus the U.S.

One more part I'd touch on too is just Mawer’s abilities internationally. We're kind of an offshoot of our international team, which has a really long track record of success and process for investing internationally. And we think EAFE large cap, we fully overlap with international and global, so there are a lot of eyes looking at these companies. From the analyst perspective, it's great because I get a lot of perspectives and debates. We have a lot of people traveling through these countries frequently, a lot of languages that we speak within the team. Our Singapore office is awesome for getting local insights there and working in that time zone. So, I think the team and the process is really set up well to be successful in these geographies too.

[00:06:17] Rob Campbell: You mentioned it, but one of the aspects of this portfolio compared to perhaps other international portfolios or global portfolios that we manage is the distinct focus on developed markets and the distinct focus on larger cap. How are you defining larger cap, and why does that make for a good universe?

[00:06:35] Ian Turnbull: So for us, large cap is the top two-thirds of the MSCI EAFE Index. The index is only 800 companies, where about 550 are within our index.

[00:06:44] Rob Campbell: Market cap wise, like what would be the bottom end of your range?

[00:06:46] Ian Turnbull: It's about 11 billion USD right now. That's kind of where we cut off the bottom. I think within this, there's always going to be pros and cons, but you have a lot of historical resiliency, it's been around for a while, been through cycles, been through wars. I'd have to have proven moats because of this. One risk with some newer industries and companies within the U.S. is just high growth, but maybe no moat. It hasn't been proven yet. You haven't tested it. You haven't had new entrants in periods of weak demand to kind of test that out. These companies have often, some have been around for over a hundred years, tons of cycles. There is more proof of that moat and the ability to create value. Large cap, you have more economies of scale, more resiliency often with these businesses, the ability to be world leaders in what they do. Countries kind of graduate into it. Once a country's doing well, MSCI will put them into the developed market category. If a company is doing well, they grow into our size range, so there could be positive selection bias would be one way I think about that too.

[00:07:38] Rob Campbell: I'd love to hear a little bit more flavor on the portfolio. I thought the way that we do this is just go through some of the more significant holdings, get a sense for what these companies are, what they do, how we came across them, why they deserve a place in our portfolio. Through that, just get a sense for the general flavor of the portfolio too. Can we start with what I believe is the number one holding? Wolters Kluwer. Who are they?

[00:07:59] Ian Turnbull: Growing into our top holding, good performance, and it's been a very long-term one as well for us. They provide workflow solutions for professionals, so lawyers, accountants, tax professionals, healthcare professionals, doctors, nurses, all use their information solution software tools to make decisions, to reference case law, tax laws, best practices in healthcare. They provide these solutions to customers. When our international team invested a long time ago, this was kind of going through a print to digital conversion, and we had a long-term perspective. We felt the manager team were excellent and capable of executing this. The risk was it went the way of the Yellow Pages, but the benefit here was it was really successful, turned into higher margin, more recurring business. It's really able to drive a lot of value for customers, automating things, making the professionals faster, what they do more accurate. The Spanish hospital system uses their up-to-date healthcare tool for all of their hospitals around the country. They've been doing that for over a decade. It's also a bit of a play on AI as well. They have the data of customers. They have really deep relations with these customers, so they can take the AI tools, sell them into the customer base. It's another way to create value, share with customers, keep some for themselves. This is just a very steady, reasonable grower with good margin expansion. It's been a good story for us.

[00:09:22] Rob Campbell: Sounds like pretty sticky customers, pretty highly recurring revenue.

[00:09:25] Ian Turnbull: Definitely really high recurring revenue. But even with, especially the transition to software, we've seen that recurring piece grow more, the stickiness get tighter. It's very flat market shares. It's the kind of thing where you're trained on some software tool, a lot of your employees, you don't really want to switch off. There's not much of an impetus to. They've done a good job of just maintaining that customer relationship. You're creating value for the customer as you're developing new tools and charging a bit more for it as well.

[00:09:47] Rob Campbell: Reference information for lawyers. It sounds like a beautifully boring business. Can we move to one that might be perhaps a little more exciting? Another company in our top five is BAE.

[00:09:57] Ian Turnbull: This was an investment we made in EAFE just before the Ukraine war. That wasn't our base case. What we liked here was one, it is a wealth-creating company. It's quite asset light. The government's often funding your CapEx and often your R&D. So even if you have a relatively low margin, you have a really high

return on capital. It had had its struggles historically, but a new management team was really focused on improving profitability and risk mitigation and kind of the contracts they're willing to sign and avoiding a lot of fixed price that had been an issue historically. It's a defense contractor, so they make defense products. It's very broad. It's UK-based, but they have a very large U.S. and European business as well. I think one thing we really liked about it was the portfolio considerations. Its growth is very idiosyncratic. In the rest of the economy, defense spending is pretty stable. It's not a different cycle in the economy. They had a bit of a pension liability, and we saw rates were going up at the time, so that is actually going to benefit the pension as well, but it's obviously a pretty good hedge on conflicts. It's been a good one, and we see now with the impetus to spend more defense, Trump pushing countries to meet their targets, there's a lot of momentum behind defense spending, and this is one industry that Europe is probably going to be much higher growth than the U.S. We've added other defense companies as well since, and it's still very reasonably priced for the quality we see.

[00:11:11] Rob Campbell: With a Trump presidency, what does that mean, if anything at all, with respect to those U.S. government revenues that BAE has? Is there a risk to them, or is it a pretty strong relationship?

[00:11:20] Ian Turnbull: We'll see what they do with spending, what areas they look to cut. There are very high barriers to entry for these programs. BAE will often work with a prime, larger customer in the U.S. to develop programs. Jets can take over 10 years to develop, very high barriers to entry. We definitely are seeing more new entrants that have different business models, might be a little bit faster, starting to win some business, but it is high barriers to entry. Defense spending is a big priority. It's bipartisan in most places and in the U.S. today. So I think they'll be selective with what they look to reduce. Definitely the U.S. may spend less internationally, and they may not be willing to fund a lot of Europe's defense, and that's an opportunity for BAE for these countries to spend more themselves.

[00:12:01] Rob Campbell: Can we shift from Europe to Japan? I'd love to hear more about Chugai. Perhaps this goes to your roots before more as a healthcare analyst.

[00:12:08] Ian Turnbull: Yeah, Chugai is a fun one. For background, Roche bought a controlling stake in Chugai back in 2002, and Chugai has acted as Roche's Japan subsidiary since, so they distribute all products for Roche in Japan. It's a very efficient commercial structure, and Roche commercializes and develops stuff for Chugai outside of Japan. Historically, that's what Chugai was. They're a very good distributor, not much innovation, but really over the last 10, 15 years, they've become Roche's R&D engine in a lot of ways. I noticed a lot of the high-quality Roche products coming from Chugai. About two years ago, went there, met with the whole management team, was impressed with how they thought about the relationship, the scale benefits they get, the R&D, and innovation that they've been able to develop has been really awesome. You often see Japanese companies that are good at R&D, bad at commercial, and even worse, internationally. This allows Chugai to focus on what they're great at: discovering, developing things, commercializing in Japan and letting Roche do it outside. And we've seen great results. Hemlibra is one product which they've developed. It's half the hemophilia market now. It was a very complex molecule at the time.

The one we're excited about for kind of early next year is their GLP-1. This was actually partnered with Eli Lilly because Roche chose to pass on it back in 2018. It's an oral GLP-1, so it's different from the injectables that are currently on the market. It's going to be highly competitive. We think it might open up a new market segment that doesn't want to have the injection. They have a great commercial partner with Lilly, and Chugai gets a nice royalty. So it's actually a pretty good upside opportunity on that.

[00:13:35] Rob Campbell: So this positions them as a rival in some ways to Novo Nordisk, another portfolio holding.

[00:13:39] Ian Turnbull: It does. Novo has done a great job with GLP-1, with innovation over the really long term. One concern is just the level of competition entering there. As you kind of pared back Novo, I think Chugai been a nice portfolio offset as one of the new entrants that might disrupt or change the market dynamics a little bit. But Novo has been a great company, very well-run, really spearheaded the GLP-1 revolution and believed in the obesity opportunity five, seven, eight years ago when no one else did.

[00:14:06] Rob Campbell: Can we stick with Chugai on a couple of following questions that are either specific to Chugai or just healthcare more broadly? AI and pharma or R&D. How should we think about that going forward? I would imagine that so much more might be possible. I would imagine that it reduces the barriers to entry, makes it easier for subscale competitors to do more. Am I right in thinking of those two things? Or how would you think about the impact of AI in the healthcare space?

[00:14:31] Ian Turnbull: Within healthcare, if we focus on R&D, it has broad implications, of course, like any industry. We often think of R&D, it's really hard to define who's the best at R&D and why, but there's something special in the culture that's how they do things, so I think the best R&D cultures will integrate AI well. We're seeing that with our companies, we're talking to them frequently. It's a great tool for the discovery process, which often involves looking at thousands of different molecules to see what might fit the best at the preclinical stage. A lot of stuff fails. Only about 10% of stuff you bring into Phase 1 gets through Phase 3. The cost to develop drugs is continually going up. It's well above a billion dollars at this point. The promise of AI is you get faster, you get to look at more drugs, find a more optimal one early on, possibly do more optimizations before going to the clinic. You end up with hopefully something better, going faster at that stage, but there will still be the clinical stages. It's very regulated, so there are kind of limits with how fast technology can penetrate healthcare. I had a lot of people disappointed, but I think there was a good opportunity for the best at R&D to get better, to lower the cost curve, maybe get higher return on their investment, so it's an exciting time for pharma, and I think we'll see a lot more innovation with that.

[00:15:36] Rob Campbell: Connected to exciting times, I want to ask you about valuation, whether it's Chugai, Novo Nordisk, maybe even outside of your area, an Eli Lilly. With, like you said, potentially more competition, obviously GLP-1s being such a huge success, presumably everyone's trying to catch up or do something in that regard. How do you think about valuation in this space, maybe Chugai specifically?

[00:15:56] Ian Turnbull: It's a different way to approach it. Historically, these markets for pharma would kind of define how many cancer patients there are. You can do a model that's pretty tight. Here with obesity, it's very broad. We kind of ran market models for how penetrating it could be, what the price point might be, something that comes down to more competition than the market share for your product, but always putting a really wide range of the assumptions there with our Monte Carlo. It's difficult. You're always looking out for a pharma company. In 15 years, most products will be off-patent, so you're modeling something out there, but you don't know what's going to be there then. Assuming a return on their R&D is something I'll often do in my model or kind of bespoke for each company. But when you look at it, Chugai, that's generated very high returns on R&D, I can assume that comes down quite a bit and still get to a pretty reasonable valuation today. I would say with the GLP-1s, people have got excited. It's no longer an easy free call option like it was once for Novo. You've got to think of the competition side too, but it's definitely an attractive market, and there can be a lot of value creation for the company and for society, I think, with it.

[00:16:53] Rob Campbell: Another company I wanted to ask you about was Haleon. I imagine the ranges in the DCF are a bit narrower for this one, but correct me if I'm wrong.

[00:16:59] Ian Turnbull: Much narrower. Haleon's a consumer healthcare company. They are brands you might

know in pharmacies such as Advil for pain, Centrum for vitamins, Sensodyne for toothpaste.

[00:17:10] Rob Campbell: OK, we're back to very boring.

[00:17:12] Ian Turnbull: We're back to very boring, yeah. The range is much tighter. You think of the fair value and the assumptions you can get much more confident in. These brands have been around for a long period of time, and they grow within a pretty narrow range, but it definitely serves its role of a foil. It was spun off from GSK and Pfizer about two years ago. I followed it for over 10 years, kind of on the healthcare side. It was always the best part of GSK, but not perfectly run. Often the pharma side had some dis-synergies with it. With the spinoff, I think initially the excitement is cost-cutting. They reduced some of the pharma excessive overheads and whatnot. But I think longer term, the opportunity to improve the speed and the culture is exciting. I talked to a lot of former employees before we made the investment, and the consensus was great company, great brands, but just a little bit slow. One example was the compliance required to talk to a dental hygienist about toothpaste was the same to talk to an oncologist about chemotherapy. So that's going to change. They have a CEO here is from PNG. He's brought a lot of PNG people over. They have the chief marketing officer from L'Oreal on the board. So trying to get faster for what's a very good underlying business and tighter ranges than a Chugai.

[00:18:15] Rob Campbell: The last one I wanted to ask you about more, because I think you just visited with them, is Lonza in Switzerland.

[00:18:20] Ian Turnbull: Yeah, Lonza's a contract manufacturer of biologic and, think of it as, complex pharmaceuticals. They do this for pharma companies on an outsourced basis. Their end markets have really nice growth, biologics themselves. Then you tack on the outsourcing trend that's happening in the industry. Lonza's done a really good job of capitalizing on this.

[00:18:38] Rob Campbell: What's driving that trend? Is it just that it costs that much more to develop a drug? It's that much more complex such that the economics are better to outsource versus developing that expertise internally?

[00:18:48] Ian Turnbull: It would depend on the area. There are some where it's so complex to manufacture, Lonza is the best at it. Antibody drug conjugates are like three different molecules pieced into one, and Lonza is the best at it in the world. They have well over half this market. That's the complexity side. I think on the other piece is just financially it can be more attractive for customers to outsource to Lonza. They have three times the scale of any pharma company for manufacturing, and they can spread the cost over more customers. They can build, have capacity ready for customers that have a launch, maybe uncertain on the demand. If a customer builds a lot of capacity and demand isn't there, that's a big risk for the customer. There's a trend of biotechs are about half Lonza's business and they often don't have the physical infrastructure, raising capital will be more difficult. So you're turning a CapEx into an OpEx with a really trusted partner. Lonza serves customers very well, great on the being on the forefront of innovation where customers need to be. I visited them in Switzerland a few months ago and was really impressed with what they're doing. There's a small town in Switzerland called Visp where they have basically half the workforces for Lonza and just learnings iterated over decades.

[00:19:50] Rob Campbell: You mentioned it a bit with BAE, but just thinking through the names that we've talked about in the portfolio, the companies and what they do, any material portfolio considerations as you guys as an EAFE large cap team get together and obviously talk about individual companies, clearly a bottom-up process, but how they stitch together? What are you discussing or debating most with respect to that composition today?

[00:20:14] Ian Turnbull: We want to make sure the portfolio is resilient. We think about risks—and there's hundreds, thousands to debate, discuss—that we're aware of, not trying to put a probability necessarily on them,

but just awareness of them. If this happened, what would the portfolio look like? What would the impact be? Ideally we have contradictions, so if this unknowable future event unfolds, these companies might do well and these companies might suffer, so there are some nice offsets there. We think about themes that are happening in the world today. We think of pharma innovation, which we talked about, the GLP-1s, AI, electrification, defense as being a big theme now as well. Do we have the right exposures to those themes to make sure that we have some nice tailwinds from that? But ideally, yeah, finding contradictions in the portfolio. BAE is a nice example where it's a very different cycle than the rest of things. Haleon's one where it's just very stable, but then having some more upside opportunities too with maybe a Chugai that you could see as having more upside, and thinking with our evaluation approach and process, I think is pretty good to kind of stretching out what could be those upside cases, as well as the downside. It's blending all that.

[00:21:17] Rob Campbell: Are there any themes you're talking about that you feel are under the radar? We hear a lot about GLP-1s and obesity, but this being an EAFE portfolio, where are the sharper exposures with respect to geopolitics or tariffs? We spoke about BAE, but are there other angles in the portfolio that you're mindful of today, either from a winning perspective or where there might be more risk?

[00:21:40] Ian Turnbull: It's kind of like we had higher inflation. We think about the business model quality. If a tariff comes into place, do they have price and power? Can they pass that on to customers over a period of time? Often, if they're differentiated products, pretty captive customers, they're able to. Are they on an equal playing field with competitors also phasing this? That can often work out quite well. We do have a lot of companies that have very local U.S. operations that might benefit from more localization in the U.S., more construction spending there. I think too, with the geopolitics, which are very unpredictable, some nice hedges there on the defense side, but that's definitely already getting more and more attention, and we think about a lot.

[00:22:16] Rob Campbell: Appreciate the tour, appreciate the deep dive on a few of the top holdings. Thanks for coming on the pod.

[00:22:22] Ian Turnbull: Thanks Rob.

[00:22:23] Rob Campbell: Hey, 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.