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EP 105 | Playing the plan: Mawer's U.S. equity portfolio

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Andrew Johnson: **00:40** Welcome back everyone to another edition of "Playing the Plan." Today, we are joined by Grayson Witcher and Colin Wong, the co-managers of our U.S. equity strategy. Happy to have you here, guys. Thanks for joining us.

Colin Wong: **00:52** Thanks for having us.

Grayson Witcher: **00:53** Yeah, great to be here.

Andrew Johnson: **00:54** Don't know who wants to kick things off first, but the last time we talked about the U.S. portfolio was with you Colin, back in May of 2021. Can you summarize any notable observations since we last spoke?

Colin Wong: **01:06** Yes Andrew, it's good to be back. So, it's been roughly 12 months and it's been an interesting 12 months to say the least. As you know, we look at things on a bottom-up basis, so maybe some notes on the sectors we looked at one level down—bottom up—on the company level. So, the last 12 months has really been two different tales: up until 2022, the market, the S&P 500 has been up roughly 20%, with every sector being up double digits. So, it's pretty typical bull market up until 2022. And starting this year, the market has been down over 10% with large divergence across the different sectors. We have energy being up 30% roughly, and the IT sectors being down over 15%. So that's a pretty significant divergence versus what we saw last year.

Colin Wong: **02:05** On a much more bottom-up basis, on a company basis, we saw significant deceleration of revenue growth starting a year ago, really, pretty soon after we spoke. And in the first half of last year, the economy was still benefitting from fiscal stimulus, monetary stimulus, and reopening benefits. Fast forward to now, we're seeing a lot of those forces reversing. We have the Federal Reserve now starting to lift rates, the U.S. federal government has been pulling back on the budget a little bit, and actually, we saw the first budget surplus since 2019 from the U.S. government. Then some of the reopening benefits [have] been maturing.

02:52 We add all those factors with supply chain issues that we read so much about, labour shortages and pull forward demand for certain sectors. All those factors had really dampened revenue growth.

03:05 Then we flipped over on the expense side. Companies are now experiencing higher raw material costs (as what we've seen ourselves at the pump), labour wages [have] been increasing, and higher shipping costs. Many of our companies are working hard to counter those inflationary forces with everything from price increases to changing their service offering, package sizes, to cost cutting. And lastly, this all boils down to the stock valuation, which are now adjusting to this new reality of lower growth and potentially more volatile margin. So, when we look at relative value, the gap between traditionally considered high-quality and growth stocks, and lower quality value stocks, [has] closed significantly. As you know, our portfolio[s] tend to focus on value-creating businesses with strong management team[s], and so we have missed out on some of the rally that we've heard so much about on the energy and commodity sectors and that has hurt our performance on a relative basis.

Andrew Johnson: **04:11** Clearly a lot going on. And I guess, to be fair, there's always a lot going on when it comes to the economy and markets. Perhaps some new inflection points are emerging here, but one of the tools that we have in our toolbox at Mawer is the matrix meeting, which is this opportunity to discuss and debate the individual merits of the businesses we own, and where in the portfolio they ultimately fit. So, with so much noise and macro events playing out and things affecting at the micro level as well and all of the subsequent price volatility that we've seen, what have those conversations been like more recently?

Colin Wong: **04:46** So Andrew, once again, we look at things on a bottom-up basis like you mentioned, and so we judge [a] company on a case-by-case basis, so it's very difficult to have a broad stroke comment on this. At the same time, actually, this case-by-case method that we use is a big part of the power of our Matrix, because it forces us to look at each company we own, each business model we own, each management team we work with, and the valuation on an individual basis and independently. To be clear, companies don't operate in a vacuum. High energy prices feed into higher input costs in the whole range of businesses we own. But higher energy prices [don't] have the same magnitude of impact on all the businesses we own. And the strength of the businesses and the ability to pass through pricing also differs significantly from one company to another.

05:41 Management's reaction to those shocks are very different and what the stock valuation reflects also differs based on different times.

05:50 So, like any other major shock reveals to us much new information that we wouldn't know otherwise, the current environment is a good test-case to see if our analys[e]s, previously, are correct, when we believe a company is resilient or their management team is adaptive. We all know this is when the rubber hits the road—and I think Grayson [has] a few good examples of this case-by-case method in action recently.

Grayson Witcher: **06:17** Yeah, absolutely, I can give a couple examples, Colin, of companies that we've looked at as part of our matrix process and part of our reviews we call delta reports or initiation reports. One would be a company called Intuit. We've owned this company for quite a while, but late 2020, Justin, one of our colleagues who spends a good amount of time looking at tech companies in the U.S. and globally, did the delta report on that, trying to understand what [had] changed. This is a current holding at the time of the [Mawer] U.S. Equity Fund.

06:50 What came out of that was that the business had been getting stronger and was underpriced in our opinion, and so when we compared it via the Matrix to other holdings, we thought it warranted a higher weight, and so we added to the position in late 2020. Then you could see over time that shifted through the Matrix, so the stock did quite well, and as a result, it's position in the Matrix shifted. It became less attractive on a valuation basis, and so we started trimming in late 2021, because the Matrix told us that there were other better options available out there. And so that worked out quite well for us; you've seen over the last couple months the share price of that one has fallen a bit more than markets, so that analysis from the Matrix and from the delta report turned out quite well.

Grayson Witcher	**07:37**	A second example would be McCormick. That's the company we added to the portfolio recently. From a Matrix perspective, this is one where we decided to add to this company at the same time that we exited some other holdings like Ecolab and Ansys. And this was really from our bottom-up analysis. From looking at the Matrix, we determined that when you look at the range of risk-adjusted outcomes from McCormick versus some of the others in the portfolio, it appeared that McCormick had better skew to it and added a better range of outcomes.
	08:12	So we added that to the portfolio and trimmed or exited a few other holdings. Those would be a couple examples of ones where the Matrix has helped us make better informed decisions.
Andrew Johnson:	**08:21**	Yeah, that's a great overview and two great illustrations. Before we move on and talk about some other things here, more specifically, with what's happening in the world and in particular Russia's invasion of Ukraine, is there anything differently that takes place on the team or in your conversations in a crisis like that?
Colin Wong:	**08:36**	I don't think so, Andrew. Our risk management process has stayed fairly consistent and just a recap: the basis of our decision-making risk management process is the decision-making framework, which comes down to people, process, and culture. We're constantly auditing that and we're constantly challenging one another on our viewpoints and how we do things. Then the next level up is security selection, which is adhering to our philosophy of buying wealth-creating businesses with excellent managers trading at a discount.
	09:10	Then one step up is on the portfolio level, which is trying to identify sharp edges of, really, any risk factor under the sun and trying to understand what the magnitudes and probability are, and what our exposure is, and that's where a lot of the work you mentioned would come in if we're talking about a big macro event like geopolitical risk. On the ultimate level, the highest level, would be systemic risks. These are risks that are almost impossible to get away from, so our approach is really to make sure our exposures are correct so even if those risks happen, we are down, but not out. As well, we build contradictions [into] the portfolio. For example, for interest rate shocks we have a number of banks, as well as a few interest rate exchanges that would benefit if interest rate[s go] up—even though it will hurt almost every single one of our holdings. So that's how we think about these macro approach[es]. Recently we have undergone a pretty significant risk management review that Grayson spearheaded, so maybe he can tell us more about it.

Grayson Witcher: **10:20** Like Colin said, we're thinking about risk and downside protection all the time, so it's not just in response to big geopolitical events like this. We did an exercise last fall where we looked at the micro risk for the portfolio. So we looked at— I don't know— 30 or 40 different risks that we thought could impact the portfolio.

10:42 We looked at them for each company on a spreadsheet. Across the top, we had 30 or 40 risks, on the vertical axis, we had all the companies in the portfolio. And then we'd plot our exposure that those companies had to those risks and then we'd aggregate that to determine, "Hey, maybe do we have more risk than we thought? More exposure than we thought to a certain kind of risk?" This could be examples of risk that we were looking at. There's many things like companies that could be hurt by inflation, companies with a lot of tech exposure, companies that are exposed to rising input costs or pandemic beneficiaries, geopolitical tension.

11:16 The good news was that, after looking at that, we were pretty happy that our portfolio was diversified and quite resilient. That was the good news was that the portfolio, we thought, was well diversified and resilient. But we still did make some changes. In response to that exercise, we added a little bit to some healthcare companies like UnitedHealth, which got hurt a little by COVID. We thought they could benefit as the U.S. emerges from the pandemic, and the business is pretty steady in all environments—of course, people don't get sick more often when the economy's strong or weak. So that was one.

11:51 Another one would be RPM, which is a company that sells paint and coatings, stuff you might buy at Home Depot or a place like that. They're exposed to raw material prices, so if oil prices go up, their input costs rise. We saw that as a bit of risk, so we trimmed that position a little bit late last year. Then lastly, we trimmed some of our tech exposure such as Intuit and Ansys; we just found there's better alternatives out there. And so we wanted to make sure we were managing our exposure to those type of companies, and so we found better investments out there. Those would be examples of some changes we made to focus on risk-adjusted returns and manage risk as part of that continuous risk management process.

Andrew Johnson: **12:38** Yeah, so it sounds like to me, as much as things change around us—there's obviously an importance of situational awareness for the macro environment—but also the focus remains on doing the work that needs to be done to ensure the portfolio is resilient through time. What form has some of that work taken more recently? Grayson you already alluded to some of it, but you mentioned some delta reports that you've done. Anything else that comes to mind?

Grayson Witcher:	**12:59**	One of the things that we did relatively recently was we looked at the utility industry. As you know, [we have these things called reverse roadshows] that we've been doing for many years now, where instead of going out, meeting with companies, travelling all over the U.S. to meet with them face to face, we'll do it at our office and [it's] just a more efficient process. So, our latest iteration was looking at utility companies. We hadn't owned utility companies in the U.S. portfolio for at least 15 years, and that was a good decision over that period. That industry had underperformed the benchmark over that period, so that worked out quite well for us, but we thought it was worth a revisit. Reason being that the fundamentals had changed in our mind. We'd seen some things that were leading to the industry being more attractive.
	13:44	Some of those changes were the push into green energy. So, utilities are investing in projects with attractive returns, things like solar farms, wind farms. Secondly, grid resilience. So, we've all seen how with climate change things like forest fires, hurricanes, those can impact the electrical grid in the States and it can be pretty disastrous for people. So, a lot of these utilities [companies] are reinvesting and upgrading their grids so that they can be more resilient in these situations. That was another shift. Then you're seeing some changes like electric vehicles, and so obviously as you shift from vehicles that are powered by gasoline to ones that are powered by electricity, but electricity has to come from somewhere and it comes through your electrical grid, so there's more of a strain on the grid.
	14:35	We saw some of these changing fundamentals as a possible reason to invest and so that's why we dug into the industry. So what did we do? Well, we spoke with nine different companies over a short period of time, had several meetings with sell-side analysts, and then did a bunch of in-depth research looking at publications from the EIA or EPAs—big U.S. organizations that publish research.
	14:59	They have a lot of data on [the] utilities industry, and those were quite helpful as well. We took all that together, did a big deep dive, and put a report out on that. And the result was that we invested in two utilities in mid 2021. The good news is those have outperformed since then, so over a relatively short period of time, that decision's panned out well. But yeah, we think as one of these exercises that had led to some interesting ideas in the portfolio that are, especially, on a risk-adjusted basis, we think these are pretty attractive addition to the portfolio.
Andrew Johnson:	**15:31**	And I can imagine when you're doing a more broad-based research approach like that, do you tap into the power of the broader research team, not just the U.S. team?

Grayson Witcher: **15:40** Absolutely. I mean, that's a huge benefit of having one philosophy and process—you can think of a ton of different examples over the last many years where we've owned similar companies in different portfolios at the firm. That's a huge plus. I mean, one example I can give that has panned out pretty well and it benefitted from that knowledge and the different parts of our research team, was a company called Ryan's Specialty [Group]. It IPO'd last year; I guess it highlights both the team dynamic and a number of other factors.

16:12 One was that we knew the industry well, we've looked at the industry before. It's an insurance broker, so if you're a commercial company trying to buy insurance, you're not sure what to buy, you may be a dry cleaner, or you might be a pizza restaurant or something. You're running a business, you don't really know what you need for insurance, you need to go to a broker that could help you out to avoid some of those risks that might come with owning a business. So, these insurance brokers help you there.

16:35 We know the industry well because we've owned several of these companies in the past. Ones like Marsh McLennan, Gallagher, Willis [Towers Watson], and we've owned ones like Aon in the [Mawer International Equity] Fund, so that's where that knowledge really helps on different teams. The other factor with this investment that helped was that the founder of Ryan's Specialty led Aon for many, many years. He was really the leader of that company, the president of that company, and he brought it from a real, smaller business to global powerhouse over many, many years. That relationship really helped us in a situation where we're trying to get shares and IPO and understand the business better. The CEO of Ryan, who was the CEO of Aon, was well aware of our relationship with these businesses. That helped us as well.

17:18 Then, of course, the reputation that the firm has garnered over the years was quite helpful, in that investment banks that are selling these shares and the companies themselves that are trying to go public, I think, are becoming more aware of Mawer's reputation as being a long-term investor and someone who's looking to own shares for 10+ years—not trying to quickly flip shares or to make a quick profit or speculate over short-term news.

Grayson Witcher **17:42** So, companies really like that. Management team really like to have those type of investors. That was another factor that really helped us get a position with this company. It's performed very well, so I think it's overall a great experience and added significant value for Mawer's clients.

Andrew Johnson:	**17:55**	Well, that might be a really good segue into the last question that I had for both of you, which is (just before we wrap up)—are there any other examples of businesses that you can point to that, in your mind, showcase our philosophy or process in action, just like you did there Grayson?
Grayson Witcher:	**18:09**	Well, I could give one more, it comes to mind. A company called McCormick. I alluded to it earlier on. Many of you're probably familiar with McCormick; they sell spices. So, you go into the grocery store, and you can see one of the aisles has a bunch of different spices. So we've been following this business for many, many years. Actually—I remember the U.S. team did a report on McCormick, probably 15 years ago—we didn't end up buying it at that point in time, but we did the report on it, and then I was looking through M42, which is our proprietary database where we keep notes on management meetings, on news, on interactions with companies, scuttlebutt, things like that, and I can see here that we spoke with management seven years ago as well. We've had many interactions over the past number of years.
	18:54	What we like about this business is they've got a strong management team, in our opinion. It's an attractive area of the food industry; they benefit from this trend of people shifting towards healthier living or healthier eating. When you think about some packaged food companies that are selling more processed food or more sugary food, that would not be the case with McCormick. McCormick's selling spices—and a lot of times, if you're cooking some fresh food at home, you've bought some meat or vegetables or whatever it is, you're going to add some spices to it, so they benefit from that healthy.
	19:28	As well, we see there being an attractive upside in that they are shifting more into the flavours business. We know the flavours business fairly well because we, in the past, invested in a number of flavours companies, one in the U.S. being International Flavors & Fragrances. And Andrew, as you know, we've also (in other funds) looked at and invested in those peers. Specifically, the European companies in the flavours business. So, this is again an industry we know quite well, so we feel like we have an advantage.
	19:56	When we saw that McCormick was moving a little bit more into the flavours business, we thought that was an attractive area of upside that wasn't quite being priced in by the market. One of the reasons this is attractive is you see themes like more "natural" flavours versus artificial flavours, so that is a benefit for flavours companies because you can charge higher prices for them. Or you see more plant-based food, for example—if you see plant-based burgers and foods like that; you're seeing more in different restaurants or even in fast food chains. Those tend to have more flavours in them as well. So there's some nice themes behind that business.

Grayson Witcher:	**20:36**	And there's attractive downside protection in times like these. I know you mentioned the volatility in the markets these days —we really like companies like McCormick where we believe there's some upside potential and growth but that's also balanced with some downside protection, where in rocky times, the business still continues to do well—because people keep eating. In many cases they may eat out less and eat at their house more, so you might want to buy more flavours because you're cooking more food on your own. So, that's another example of one that we came across and invested in recently where we thought the business was attractive on a risk-adjusted return.
Andrew Johnson:	**21:10**	Yeah, that's a great example. In the name of due diligence, do you have a favourite spice that McCormick makes?
Grayson Witcher:	**21:15**	Oh of course. I'm a big cinnamon fan. I like having breakfast in the morning with the kids. A little bit of cinnamon raisin toast is one of my favorites. I think they do a great job at their cinnamon.
Andrew Johnson:	**21:26**	[Laughs] It's delicious. Sounds good. All right. Well that's a great spot to wrap things up. Thanks to both of you for joining the podcast once again. Looking forward to getting a chance to sit down again in the future and recapping just how much has changed and how much has stayed the same at that point. So thanks guys.
Colin Wong:	**21:45**	Thank you for having us.
Grayson Witcher:	**21:45**	Thanks Andrew. Always good to talk to you.