the art of boring™

EP 145 | EAFE Equities: Japan, Interest Rates, and Managing Volatility

[00:00] Rob Campbell: Today on the Art of Boring, we've got Portfolio Manager Dave Ragan. We talk Japan, rising markets, companies like Chugai, Adyen, Novo Nordisk, and all that in under 15 minutes.

[00:32] 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.

[00:49] Rob Campbell: Welcome back. Today, I'm speaking with Dave Ragan, co-manager for our EAFE large-cap strategy. And Dave, despite your having been on the podcast many times before, and I've certainly hosted a bunch of them, I actually think this is our first one together.

[01:02] David Ragan: Yeah, it might be. It's definitely been a little while. Thank you for finally having me back.

[01:06] Rob Campbell: Awesome. Let's get into it. Actually, where I want to start dates back to your very first appearance on our podcast. I looked this up—it was episode nine, it was more than five years ago, and it was dedicated to your posture in Japan. As I remember it, the tone overall wasn't terribly enthusiastic.

But more recently, I've been reading and hearing from clients a lot more optimistic things with respect to Japan's prospects and progress with structural reforms. And so I wonder, can we start there? What's underpinned some of the challenges that you've seen historically, and do you share the view of many others that things are changing for the better?

[01:41] David Ragan: Well, historically, there's a lot going on. I mean, Japan was an absolute powerhouse expected to take over the world about 40 years ago now, but then it really came to light that it probably wasn't. There [were] lots of problems in the country; asset valuations were way too high, and then they started suffering decades of deflation. Population remains a challenge. It's a very old population; not growing and shrinking now. And the other issues that we have, now the valuations of the stocks have gotten more reasonable after decades of underperformance, is capital allocation.

It's a small island. It used to be very isolated. It still is somewhat isolated. So, the companies would reinvest into businesses maybe not necessarily tied to areas where they have competitive advantages, areas of genius, basically. So, the capital allocation would be in new areas where they might not get a good return. Or, and this is a very common problem currently, just massive amounts of cash in the balance sheet, which is very inefficient.

[02:41] Rob Campbell: That's the history. I think in the other strategy that you've worked on for a long time, international equity, we've had a pretty persistent underweight in Japanese companies. But bring us up to speed to today. I mean, I'm hearing a lot more about, "Hey, maybe these cash balances are coming down. Maybe there is a reform to introduce more independence within the boards of Japanese companies, more buybacks, and a little bit more focus on return on invested capital." Are we indeed turning the corner? Have things gotten better? And if so, are you guys in the EAFE strategy finding opportunities there?

[03:11] David Ragan: Well, luckily, we looked at the bottom up. So, we're just looking for individual companies, looking for a few diamonds in the rough. And it's a big market, so we're definitely finding some ideas, but honestly, en masse, I don't think so. I don't think there's been massive changes. There's still very large cash balances. The payout ratios might be going up, but from incredibly low levels, where they're growing the cash hoard rapidly to, still, moderate to low levels, where the cash hoard might still be growing or maybe just staying the same.

There [are] some examples of improved capital allocation. There are also cross holdings where one company will own shares of another one because they're customers or suppliers. Again, that's an inefficient way to run a balance sheet. Some of the companies are reducing that.

If you look for examples, you'll find examples of improvements, but I think en masse, I haven't seen a whole lot, which results in us continuing to have an underweight in the market because it is a very large market, somewhat inflated by all the cash holdings. And one that we can't find enough high-quality companies, good management teams, with shares trading at a reasonable price.

[04:17] Rob Campbell: So, a bit more cautious with respect to some of the optimism out there. How do you go about tackling it? It's a big part of the EAFE universe. We've spoken generally about Japan, but presumably, there are individual gems that are there. How do you guys as a team go about tackling that part of your universe?

[04:31] David Ragan: I mean, it is a big universe, and you just tackle it one company at a time. Japan is no different than any other market aside from the language. We have been covering it for years, though we did add a new person to the team a few years back, Asim, who's actually fluent in Japanese and Korean.

So, I mean, the big difference there is he's able to do management interviews in Japanese, which are much more value add than a translated meeting, which greatly reduces not only the time you actually have to ask questions, where you basically have half the time in English asking questions, but also just the nuances that you lose in translation. So that's helped. He's gone through a lot of the universe—as we have in the past. It hasn't really resulted in a big shift in a lot more names, but it's good to make sure that we're confirming our thesis on some of these companies. We'll probably find some more names, but I don't think there's going to be a massive change.

[05:24] Rob Campbell: I noticed one that was added to the portfolio this year, and that's Chugai.

[05:27] David Ragan: Yeah, Chugai is a pharmaceutical company based in Japan. The reason we like them is they seem to have a very strong research franchise, which is obviously the most important thing when you're a pharmaceutical company—you have to discover new drugs and then be able to market them.

And one of the roads that led us to this idea as well, was long-time holding Roche. They're a majority owner in this company, and they obviously saw the potential. And saw the benefits of not only having access to their drugs and marketing Chugai's drugs internationally, which they do, but also having Chugai as the marketer of Roche's drugs within Japan, where Chugai is obviously very strong.

So yeah, that one on a bottom-up [basis] is a good company, strong research-based pharmaceutical company, good returns. It's in Japan. I mean, that's not necessarily... it's a positive from a portfolio construction basis, but that wasn't a core part of the thesis.

[06:21] Rob Campbell: And in having a parent or at least a large investor like Roche with a controlling interest, does that mean that some of those corporate government aspects are just better at Chugai compared to the rest of the Japanese market?

[06:31] David Ragan: To some degree, I'd say that it is better. Roche, we've always appreciated. It is also a pharmaceutical company that's very much focused on value add. Reasonable capital allocation. They've identified great research houses around the world and in another bought part in the case of Chugai, or all in the case of Genentech, and then allowed them independence to be a very creative, highly productive research facility. So, yeah, I think that's definitely helped with Chugai as well.

[06:58] Rob Campbell: Let's shift gears a bit. I want to talk about how the portfolio has done so far this year. We are recording this at the end of November. It's been a particularly good month, I think, for just markets in general, but thinking of the year so far, I mean, the portfolio has done even better than its benchmark.

[07:13] David Ragan: The biggest influence on returns—and this is this year and the last, honestly, decade almost—is the interest rates. The government 10-year risk free interest rates. We've gone through a very painful period when they were going up rapidly and materially relative to being very low, basically getting up to 5 percent in the U.S., to where it looks like we've peaked. And it looks like the central banks will start reducing short rates and long rates have followed. This is always the one number that I would love if I had a crystal ball to find out what is that 10-year number, 3, 6 months.

[07:47] Rob Campbell: You and many others.

[07:49] David Ragan: Yeah, it'll tell you probably what the market's doing. I guess the other thing that is very positive right now is the likelihood of a soft landing, cutting inflation without really having a bad recession. Maybe just an economic slowing. We might be getting that. I mean, that's basically a financial unicorn. 19 times out of 20 when this happens, it's a recession. It may still happen. It may not. But, I mean, those two factors are the real reason why we've had such positive markets, and we'll see how the actual economics turn out.

But, you know, as long as we're near the peak and we're going to look to 2024 to see those central banks starting to reduce—it does set us up for a pretty good equity market and has been priced in.

[08:29] Rob Campbell: I mentioned November's; I think, with the latest inflation prints, to your point, has really driven the markets. A comment I heard you mention maybe going a month back was just that, "hey, it's still quite a volatile market, meaning that when companies miss, they do tend to get really punished and also really rewarded." I'm wondering if you can take us inside the discussion that the team has when you get big reactions or stock price movements. How do you react? What does the decision making look like on the day or in the coming days after those movements?

[08:56] David Ragan: The first nine months of the year, it seemed like basically you did great on your results, and your stocks stayed the same. You did poorly or even average, your shares are dropping 5 to 15 percent or more. The first reaction is look at the results. We figure out what people don't like, what's changed. We're thinking about, does this matter to the fundamental, intrinsic value of this company? There's short-term little blips, but then there's long term structural changes.

And we're also very humble, I would say, where we know that the market is very efficient. Again, nine times out of ten, the right move is made by the market. It should be worth slightly less. We're doing all that. We may talk to management, we'll maybe talk to an analyst, and then we're looking at competitors. Competitors are often another good way to tell if this is something specific, a specific problem to a company, or something more broadly happening in the industry, or maybe it was a short-term blip, and the competitor who is announcing results a month or two later is saying things are looking better.

It's really a lot of fact finding, understanding, "does this matter to the intrinsic value of the company? Is it a great opportunity?" But most of the time, it's just, there is no opportunity. We keep our holding, wait for more information, wait for things to start to improve.

[10:15] Rob Campbell: Do you have any particular examples? And I'm sure the ones that come to mind might be the ones that sting or they've gone down, but there are some that have done pretty well, too. I'm thinking like Novo Nordisk, which has had some pretty tremendous days this year. And is it the same on the upside, I guess? Do you tend to let it go because the market gets it right or tends to be efficient?

[10:30] David Ragan: Generally, it works on the upside and downside. The market is generally right. Novo Nordisk... historically diabetes company that has come out with an anti-obesity drug that's having some amazing, positive health impacts and the end market for this drug is looking massive. So it's very positive. It's done incredibly well. And that's the same sort of situation where, yeah, we're evaluating, "Okay, well, this is great news. They're going to make a lot more money, but is the market getting too excited by this? Should we be trimming?" And we have trimmed the position back a little bit. It did exceptionally well. It became a large position and at a higher valuation than that position warranted. So, we did trim it on the downside.

We've had some challenges with Adyen, [a] payments company, where it did drop materially. And the review of that position as well, the competitive position is a lot more intense than we thought. It has come back a fair bit as, again, the market is learning more about this as we are, as I see what competitors are doing and see growth expectations. So, yeah, it's been a very volatile time. I mean, the first nine months it seemed all negative, but I would say again, that a sign of positivity in the market is we are actually seeing those jump-ups, where Adyen was one of those examples where they had good results, they had good comments, and it jumped up. I don't think that would have happened in the first nine months of this year. So again, this highlights to me a little bit more positive investor sentiment.

[11:59] Rob Campbell: What is most top of mind for you and Jim and the rest of the EAFE large cap team when thinking about the portfolio? I actually think it's kind of interesting that Novo Nordisk and some of the ramifications of what it's treatments might mean for the world going forward may actually figure it into risk management, but I'm curious what other things are you guys looking at and that you think are really important for investors to think about today.

[12:22] David Ragan: That's step number one. And then step number two is, well, don't lose too much money at any given point. So that's why we have rules and limits on the sizing of individual companies. And that's why we have conversations about what's our overall weight exposed to this one driver, where the driver could be something broad like oil prices, but it could be something very specific, like a regulatory change that is potentially going to happen in one country.

And we're really looking for that resilient portfolio; real diversification, lots of different drivers we're exposed to. And fundamentally, hopefully, that diversifies out a lot of that risk that happens, so we get really just a lot more focused exposure to good quality companies with management teams that are in control of their future.

[13:07] Rob Campbell: It does sound quite consistent with episode nine and some of the thinking that you had back then. And so Dave, really appreciate your thoughts on the EAFE strategy and really happy we finally got to do this together [laughs].

[13:17] David Ragan: Yeah, absolutely. Thanks so much. Great to chat, as always, Rob.