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EP 150 | Playing the plan: Mawer's International equity portfolio

[00:00:00] Rob Campbell: Hi everyone. I'm your host, Rob Campbell, and welcome to The Art of Boring, the podcast where we dive deeper into Mawer's investment philosophy and thinking in order to make you, our listeners, more informed investors. Ultimately, we hope to connect you with the people at Mawer who find excitement in "Be Boring. Make Money."

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[00:01:03] Rob Campbell: Well, Peter, welcome back to the podcast.

[00:01:06] Peter Lampert: Thanks for having me. It's great to be back.

[00:01:07] Rob Campbell: I could see from your background that you are in our Calgary office. I was thinking maybe you'd be in our Singapore office. You were visiting them recently, were you not?

[00:01:14] Peter Lampert: Yeah, I spent two weeks visiting our Singapore office. And as you know, I lived there for a couple of years. That takes me back. That was 10 years ago, but it was great to be back and catch up with the team and we also had a lot of management meetings and talking to companies in Asia as well. It was a well spent two weeks.

[00:01:30] Rob Campbell: Awesome. Were you just in Singapore, or did you travel around the region any more than that?

[00:01:35] Peter Lampert: I stayed in Singapore, so I spent a lot of time with the team in the office there. And we met a number of companies in Singapore, either based in Singapore or companies that were traveling through Singapore, or even having calls with other companies in Asia. You know, it's a lot easier in the same time zone.

[00:01:50] Rob Campbell: I can imagine. So you're jet-lagged in other words. One place I wanted to start with, Peter, we just announced that we were reopening our International Equity strategy to new institutional clients. I'm wondering if you could take us back. When did it close? Why did we close it? And why are we reopening now?

[00:02:08] Peter Lampert: Sure. Yeah, we're excited that we'll now be able to welcome new institutional investors into our International Equity strategy. For background, this strategy is one of the longest running International Equity strategies. In Canada, it was launched in 1987 and we closed it at the end of December 2020 at that time we had about 15 billion in AUM and our first priority is always to look out for our existing investors who have entrusted their money with us.

So we need to ensure that we keep assets at an appropriate level to ensure we can continue to implement our strategy. And there's pros and cons. There's benefits to having a larger asset size and benefits to having a smaller asset size. Some of the. benefits with larger size are, as we got larger, we are able to participate in IPOs, which we didn't have access to before.

We are a larger shareholder in many of the companies in which we invest. So, you know, by no means are we activists, but when we do have suggestions or opportunities for improvement, we do have more of a voice with the companies. But on the other hand, there's benefits to smaller size. Especially for us as an all-cap strategy with a smaller AUM, it does make it easier to invest in small and mid-cap companies.

We want to protect that ability. We want to make sure we can continue to invest in small and mid-cap companies. And that's why we implemented the closure to new institutional clients, but remained open to existing clients when we made that change at the end of 2020.

[00:03:33] Rob Campbell: And so fast forward three years or so, what's changed?

[00:03:37] Peter Lampert: If you look back at the time, it was a good decision to close at the end of 2020. We had 15 billion in AUM, but we were getting consistent inflows. We were forward-looking. We wanted to maintain the ability for our existing investors to increase their investment. We were expecting strong inflows to continue and we were correct in that.

So our expectations were correct. Our AUM continued to increase to 20 billion. And fortunately, because we had closed to new clients, when we did, we were able to still comfortably accommodate that AUM increase and implement our strategy. Since then, our AUM has declined, it's back to about 15 billion, and we do an annual assessment on our capacity.

In the past year, our annual assessment was that we now do have room to reopen based on current market conditions. So the key inputs that we do in that assessment is really, like I said, the bottleneck is on small and mid-cap, so we want to ensure we have the continued ability to invest there. And we look at four key variables that dictate our ability to invest in smaller companies.

The first is the market cap of our target companies that we want to invest in. So we're not investing in micro caps under a billion AUM, but if we want to invest in a three, four or five billion market cap company, that's the first input.

Second input is what percentage of the company are we willing to own? In many cases, we own up to five or ten percent of the company. But we would be uncomfortable getting up to 20 percent or higher because that reduces our liquidity and increases risk for our clients.

The third one is the weight in the portfolio. So with just under 60 names, an average weight is somewhere between one and a half and 2% in this portfolio.

And the fourth variable is the overlap with other strategies. A number of the stocks held in this strategy are also in other strategies, whether global equity or EAFE large cap strategies. And we want to accommodate for that as well. So when we ran through the process, we make estimates around all four of those variables.

We run through a Monte Carlo simulation approach, not dissimilar from the approach we use when we do our discounted cashflow valuations to value stocks. And we come up with a range, an estimated capacity range. And in this case, 15 billion was at the low end of the range. Our AUM today shows we do have room to increase our assets.

And as a result, we're happy if we can continue to serve our existing investors extremely well, and also welcome new investors into the strategy.

[00:06:02] Rob Campbell: Well, great. That's great news. A footnote, I think, Peter, you've been speaking in U.S. Dollar terms in terms of the capacity assessment, right?

[00:06:06] Peter Lampert: Yes.

[00:06:08] Rob Campbell: Well, thanks for that context. Let's shift gears and shift from decisions that we've made to decisions that some of the management teams of the companies that we own have made. And there were two that caught my eye in the most recent period. One was quite head scratching, an acquisition made by KDDI. I wonder if you can share some perspective on that.

[00:06:28] Peter Lampert: The North Star for us in every investment we make is we want to invest in companies that create value for shareholders. And so that's what we're looking at when our companies make investments. They're investing money on behalf of shareholders and our North Star is: do we expect that to be a value-creating investment.

KDDI, which is one of the major telecom companies in Japan and a portfolio holding. bought Lawson, one of the major convenience store chains in Japan. Now we had a more negative view on this acquisition, for a variety of reasons. In this case, we didn't have a problem with the underlying business.

Lawson is actually a pretty good business. In fact, we previously owned it and it did well for us. And the price too. Sometimes with management teams, we think they overpaid too much for an asset. In this case, the price was also reasonable. So no problem with the business or the price they paid. But like you said, it is head-scratching.

The strategic fit we think is a bit of a stretch. Their idea is that they can cross-sell some of their services through the convenience store locations. One of their main competitors has a tie-up as well with a convenience store chain. It seemed like they're perhaps trying to replicate that strategy. To be honest, I don't think we've seen a lot of success even from their competitors.

So we're skeptical that they'll create value through this while Lawson's a good business, investors like ourselves could own it on the public markets if we so chose. So we don't see the benefit of having it as part of KDDI and we're skeptical that it will create value for shareholders and in fact could end up being more of a distraction for the management team than anything else.

Which, if that's the case, could distract them from the core business and end up destroying value that way.

[00:08:03] Rob Campbell: Got it. And this would represent a pretty small proportion of KDDI's market cap, am I right?

[00:08:08] Peter Lampert: Yes, that's the good news. It's a large company. They didn't bet the farm here. So we haven't made any portfolio changes.

If we were more concerned, if it was a major bet, we would probably be reducing our position. But that's the silver lining here.

[00:08:22] Rob Campbell: What about another acquisition that I saw recently? I don't think it was made specifically by Novo Nordisk, but rather by the controlling entity of Novo Nordisk. So wondering if you can share just a little bit about that and contrast it to the one made by KDDI.

[00:08:35] Peter Lampert: Sure. You're right. It was a bit of a complex transaction, but Novo Nordisk, the pharmaceutical company that everyone sees in the headlines for their Ozempic and Wegovy drugs, which are super popular because they help with weight loss, they structured a transaction in which they ended up acquiring three manufacturing plants that manufacture these drugs from an outsourced manufacturer. And it was structured through a holding company. The holding company bought more assets and then in turn sold three of the plants to Novo Nordisk, the listed company in which we are shareholders. The end result is now that instead of outsourcing the manufacturing to a third party, Novo Nordisk can take it in house.

There were many issues, quality control issues, that were limiting the supply at these plants. And we expect most of Novo Nordisk's production has been in-house. They are experts at manufacturing in-house. We expect they'll be able to get the quality up to their in-house standards and, as a result, increase their production volumes.

Now, it looks like on the surface that they paid,—if you just looked at it through purely a financial lens—that they paid maybe a high price for the assets, and perhaps it would have been cheaper to build the assets themselves, but that would have taken a number of years. And in the meantime, they cannot meet demand.

So this really allows them to save a lot of time, save a few years and meet that extra demand in the meantime. And when you look at it through that lens, this looks like a smart acquisition. We expect them to create value in finance terms, NPV positive, or create a positive net present value through the acquisition by comparing the upfront cost of acquiring the plants to the incremental demand that we think they can meet.

It's especially important in pharmaceuticals where when you have a popular drug like this, we do expect copycats and others to emerge and there are many large pharmaceutical companies chasing this market now. Novo Nordisk has a head start along with Eli Lilly. They're the two far ahead of everyone else.

So if they can maintain that head start and get doctors and patients using their drugs before others catch up, this could not only allow them to capture that incremental demand in the next few years, but also position them more strongly over the longer term as well.

[00:10:40] Rob Campbell: I have a sense for what your answer might be, but I presume this all else equal improves the investment case for Novo Nordisk, which was already quite a good one.

And yet I think we've been on balance, trimming our weight in Novo Nordisk over the last year or two, just as the prices skyrocketed. Can you just walk through, what's the decision-making [in regards to] that? And I presume in matrix terms, we've got like an up and to the left shift on the matrix as news comes out.

[00:11:08] Peter Lampert: Sure. Every incremental news that we've seen, including this acquisition, highlights just how strong of a business it is and what a fantastic job the management team has done in the way they've built the business.—as they do. a few things, but they do them very well. They're very focused on the types of drugs that they're willing to target.

Like I said, they're very good at manufacturing them in-house. This does strengthen the investment case, but like you said, there has been a lot of excitement and that's been reflected in a skyrocketing share price. And as a result, the weight has gotten higher than where we would have liked it in the portfolio just for risk management purposes.

The valuation has moved higher in our fair value range. So for those two reasons, we have trimmed it back, kept the position, what we think is a reasonable weight to reflect the risk reward. But certainly that often is the case when you have everything going well for a company. In this case, the obesity drugs are much more popular and the potential market size is much larger than anyone would have expected a few years ago.

And now there's some debate about how large that market will be in the future, how much market share Novo Nordisk will ultimately be able to retain once new entrants catch up. So it does introduce more uncertainty and we come up with a wider fair value range. That's why we always have to come back to our process, go back to our DCF models, update the assumptions, update the [inputs] and see what we think the current risk/reward is and reflect that in the current weight of the portfolio and which is why we have been reducing it.

[00:12:31] Rob Campbell: I want to come back to your comment from the top, which is you've spent a bunch of time speaking to a number of management teams. Have there been any interesting themes that came out of that? And one of them might be just Novo Nordisk's impact on broader companies, but I don't want to lead you with that. What have you picked up that you think some of our clients might find really interesting to hear through your conversations with management?

[00:12:53] Peter Lampert: If you sat in on one of our management meetings, you'd find it's 90% bottom-up. We're talking about the specific business, the specific industry, not really looking for big top-down themes that we can apply more generally.

You know, sometimes we're doing some scuttlebutt, speaking with one company to understand more about the industry or the value chain that we can apply to other companies. But usually it's quite focused and specific. So you know, we were just talking about Novo Nordisk and in those meetings, we're really trying to understand their R&D approach and with pharmaceutical companies, we think that's how companies can have a sustainable competitive advantage that ultimately leads to wealth creation. So how do they think about their R&D philosophy? What types of drugs are they trying to create? How do they decide which drug trials to fund? And ultimately, do we think that makes sense and is likely to lead to future value creation?

I mentioned being in Singapore—being in Asia—there are a lot of real estate companies. So companies that own and operate or invest in real estate. And so the big question for them was how they are coping with higher interest rates.

And in that case, we can read their disclosures, see what they're doing, but we really want to understand how management's thinking about it. With higher interest rates, that presents more risk. They made many investments. They bought real estate when cost of debt was low. They used leverage. They bought these assets.

And now with higher interest rates, the real estate property prices should be falling. Their cost of debt is increasing. Their profits should be declining. What are they doing in that situation? And you see some companies are looking to sell assets and reduce their debt load as interest costs have gone up.

Other companies might be more contrarian and be looking to buy in a weaker market as asset prices come down. But what we found was actually most companies are just frozen and in wait and see mode, not wanting to transact, hoping that interest rates will fall, which would benefit them. As you can imagine, we don't think hope is a great strategy. We didn't end up investing in any of these companies.

If you really look for themes across management companies...I said it's 90% bottom up in our conversations...but the one big theme that is pretty consistent is almost all companies, except maybe the real estate companies, are talking about AI.

And how that might impact their business—even the real estate companies to some extent— because they want to invest in data centers and everyone is trying to position themselves as AI beneficiaries. There's a lot of hype around this, so I think our default position is generally to be skeptical if a company starts talking about the benefits of AI on its business. We don't want to be dismissive and we need to maintain that balance. We'll look through the hype, but also keep our eyes out for genuine opportunities and companies that can benefit from technological change, and this is certainly one.

[00:15:40] Rob Campbell: Not surprised to hear that AI is a very popular topic, it certainly is with our clients as well. Peter, thanks for coming on the podcast. We will let you get some sleep.

[00:15:50] Peter Lampert: Thanks a lot Rob.

[13:21] Rob Campbell: Hi everyone. Rob here again. To subscribe to the Art of Boring podcast, go to mawer.com – that's https://www.mawer.com/podcast. Or wherever you download your podcasts. If you enjoyed this episode, please leave a review on iTunes, which will help more people discover the Be Boring, Make Money philosophy. Thanks for listening.