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EP 154 | A deep dive into the psychological approach to finding opportunity

[00:00:00] Kevin Minas: This is Kevin Minas, and in this episode, I sit down with Samir Taghiyev, Portfolio Manager on our Canadian small-cap strategy. For this conversation, we do a deep dive on several frameworks the team uses in their research process. We start with two mental models for assessing the quality of management and the level of impact their actions have on the company's operations.

We then cover the S curve of the corporate lifecycle and why it's so important for companies to find the right balance between a focused business model and a willingness to explore new ideas and ways of operating. Next, we talk about a few key levers management teams can pull to generate that next phase of growth. We finish up with some key learnings and improvements from the Canadian small-cap team in 2023, including a new reflection-focused exercise that they call their “look-back” process.

[Disclaimer]

[00:01:10] Kevin Minas: As a reminder for our listeners, we've got three key pillars to the investment philosophy here at Mawer. We're looking for wealth-creating businesses run by excellent management teams that trade at a discount to intrinsic value. So if we focus a little bit more on the management evaluation aspect of the process, one dimension of our assessment is around judging how good management is at thinking and acting strategically.

So you were sharing with me earlier an interesting mental model that the Canadian small-cap team likes to use that relates to assessing management's strategic approach. It'd be great if you could share that mental model for our listeners.

[00:01:46] Samir Taghiyev: Management is actually one of the more fascinating parts of managing a small-cap portfolio. One of my predecessors, Martin Ferguson, had this neat framework of looking at management—whether they grow revenues, whether they control costs, and whether they control the risks—and judging management from that perspective. I really like that framework. We also apply that framework on top of other frameworks when talking to management teams.

It's important because smaller companies tend to be smaller than all of the opportunities ahead of them, but it also means that they're more fragile. But there's still enough resiliency in the businesses that you see in the large caps, and, as a result, management evaluation is extremely important. Related to that framework of seeing whether management teams are able to grow revenues, control costs, control risks is this framework of exploration and exploitation that comes from resource-based companies. So back in the day, oil companies would do this wildcat character exploration out there. Some of the wells would come successful; a lot of them would come out dry. Then they would start drilling, exploiting the area that they found to be successful.

That mindset is not just applicable to the oil and gas companies or resource companies out there. I think it's very applicable to other types of companies. In fact, it relates to this mental model of growing revenues. How are you going to grow revenues? Are you exploring out there for opportunities to grow revenues? While you're doing that, are you controlling costs and risks enough? Because if you don't do that, you might create damage to the company by overextending yourself.

I think it's a very general mental model as well. As I look back at my first time in Canada, coming to university, I thought that I wanted to be an economics PhD because my father came from that background, but I had a suspicion already in the back of my mind that I'm quite still young, and I shouldn't be 100% sure of sticking to one area. So I started going to different clubs. I remember going to an anthropology class just for fun, just to see how it is out there, even though I didn't have much of an interest in anthropology.

One of the clubs was an investing club, and that was close enough to economics, but it was also fascinating. And here we are. If not for that exploration out of the set boundaries that I had in mind, we wouldn't have even had this conversation. I think about doing that later in life, changing your career after you're 50. Some people have rediscovered themselves, but it's a much riskier proposition. Being curious and exploring what is out there is very important earlier on. Once you have found that, exploiting that and sticking to that and not getting distracted by anything else but also still keeping an open mind that—hey, the environment might change, so I might as well be curious, read books, or learn about the world, talk to people and do incremental changes. I think that's the mindset that everyone should choose both for their careers but also for running a business or more generally.

[00:05:27] Kevin Minas: So as it relates to a management team, the model is: Find what you're good at, find what works, and then make sure to pursue that aggressively and try not to get too distracted. But to your point at the end, there does need to be some acknowledgment that things can change, the market can change, and the back option chance that you need to remain curious.

So how do you think about balancing, when you're evaluating management, a level of focus but also that more creative, curious aspect? How do you think of that when you're interviewing them?

[00:05:54] Samir Taghiyev: That's the balance that a lot of companies are not able to strike correctly. So a lot of times we see examples of one extreme or not. On one extreme, it would be companies completely cutting out all of the exploration and seeing that as a waste of dollars. A lot of times that results in very high current earnings, but as a result of all of these cutbacks, in the future—in five, 10, 20 years—the product becomes stale. The company starts losing market share, the [cost cutting] becomes a value-destructive activity.

On the other side of things, companies sometimes get too curious and destroy a lot of wealth, investing too much into exploring out there. And what it results in is distraction by the management teams, not being able to focus on their current businesses and doing a good job of it. But also putting too much of resources and risking too much of the company on that a lot of times that results in very big acquisitions in completely different industries or very tangential to the current industry. As a result, the balance sheet gets very much stretched. Resources get wasted trying to integrate these companies. There is a cultural integration issue, financial integration issue, and distraction of management, which doesn't end well. Striking the golden middle is very, very hard.

[00:07:28] Kevin Minas: Absolutely. I really like that mental model. Thinking about another framework that the team likes to use, and this time looking more at the business model as opposed to the management, we really look for having a focused attention on specific parts of the S curve of the corporate lifecycle. So before we dig too much into that, can you start by walking us through what this S curve is, and what it means in this context?

[00:07:51] Samir Taghiyev: The S curve in this context means just the lifecycle of a company. Think about time on the X axis and revenues or profits of a company on Y axis. And there are multiple parts of this company lifecycle. At the very beginning of the company, there is not much in terms of revenue. It just started out. These companies – pretty much startups – are trying to figure themselves out. They're trying to see what they can make that is better than the competition, given that they don't have anything yet, that will stick in the market and will fit their customers' needs.

A lot of times, it's also some kind of a strategy that they're trying to figure out— for example, the inquisitorial strategy—but they haven't fully nailed it. As a result, there's a lot of exploration going on. And that part of the business lifecycle is very hard to navigate. That is the riskiest part of the company's life cycle because you have very low wealth resources. And we have tended to stay away from those parts of the corporate lifecycle. We have stayed away from investing into concept stocks and unproven management teams or business models. Interestingly, a lot of times, those types of companies also capture the imagination of the market. The markets behave in collective hallucinations. They think in images, and a lot of times, those companies also tend to be very overvalued compared to their potential.

The next stage is this growth part of that S curve, where they have figured something out that seems to be working. There's some kind of attraction happening. And that is the sweet spot of investing, where you have figured something out. The competition hasn't caught up with you yet. There's an opportunity of X years for some companies, a very short period of time. For some companies, that can be a very sustainable way of creating a lot of value by just sticking to that, what we call internally the algorithm of wealth creation.

So, in the earlier stage, they were trying to figure out that algorithm of wealth creation, and in the growth stage, it is all about applying it without being distracted. And the last part, before we shift topics over to another question, Kevin, is the maturity or the decline stage, once you have completely exhausted your runway. And there's a potential for declines in the business. And that is why it's very important to always explore in the background in a very mindful way. Because once you get in there and if you haven't explored enough, then you don't even have the muscle to find what the customers really want, to find new market opportunities. And that's when the companies, a lot of times, get very anxious by doing large acquisitions or valid destructive deals or overstretching their balance sheet.

[00:11:19] Kevin Minas: Okay. Samir, you've mentioned that it sounds like there are four phases. There's the startup phase, growth, maturity, and then decline. We're not really focused on that first phase, and the sweet spot is the second. Do we focus on the maturity – and presumably not on decline – but what are we focused on? What phases and why are we focused on those particular phases?

[00:11:38] Samir Taghiyev: We do not focus on the companies in the first—the unproven technology or unproven product or strategy—part of the corporate lifecycle. And we're not focused on the last cycle in the corporate life cycle; that is quite obvious. We don't want to get into the decline mode of the business while theoretically one can manage the cash flows and do a good job of extracting the capital that is remaining in the business and dividend it out to turn it back to the shareholders. In reality, it is extremely tough to do that while there are uncertainties of the how many years a business has.

As a result, we do focus on the second and third phases, which are the growth phase and the maturity phase. Even within the maturity stage, one needs to be very vigilant of the ability of the business to keep its position market and straightaway all the competitors that are vying to take a piece of their business and not to cut back too much of the expenses and the names of the financial optimization. The short-term incentives of the management might have then cut back from the necessary investments that the business needs to make to be viable.

[00:13:10] Kevin Minas: Are there any examples of companies that we own that are in that maturity phase? Or an example of a company that moved to the maturity phase and then, through exploration, was able to reboot that next phase of growth by moving back to the growth phase?

[00:13:23] Samir Taghiyev: Those are my favorite examples. Those are the examples of the companies that were able to reinvent themselves through one way or another. People thought that it was a mature business, and they were able to find some kind of a growth runway. Some management teams are really good at that. At least they've shown a track record of doing that.

One example that comes to mind is Trisura. It's an insurance company focusing on the specialty insurance segment of this very large space. They pride themselves on listening to the brokers on what kind of insurance their clients ask for. They're able to create new products by implementing those suggestions. Not all of them but being very mindful of which areas would they have a potential competitive advantage in and doing a small product offering. If that works, then they would allocate more resources toward that.

So an example of that was Trisura venturing out of Canada into the U.S. because they felt that the internal team could underwrite similar insurance, and they have relationships in the U.S. they can use. They also found some people who wanted to start a so-called fronting business model. So they allocated some resources toward that, not betting the house for it. As it started working out, they started allocating more people, more financial resources, and more capital toward that area.

Another example is TerraVest, which is one of the larger holdings in our portfolio as well. TerraVest is in multiple different businesses, but one unified characteristic for many of those businesses is steel. So they make propane tanks or heating oil tanks or some kind of other industrial gas tanks that will use a lot of steel and they use their purchasing power with the steel mills to get efficiencies in that business. Each of these markets is very mature, perhaps even declining, but they were able to buy the businesses in each of these industries and get the efficiencies from them.

Once they have consolidated the particular market, they look into what their customers need but also what kind of smaller businesses haven't they paid much attention to in the businesses that they acquired, that they have, that perhaps might be a nice tangent to start getting into allocating more resources. They do it very incrementally; incrementalism is very important when it comes to exploration versus exploitation because it strikes the balance of spending enough resources to de-risk that random opportunity but also to learn. Just in case if it doesn't work out, you can always come back versus the mistakes that happen when people go for one large idea, one large acquisition, and it stretches out all their resources internally.

[00:16:55] Kevin Minas: Absolutely. I really like that. It maps quite similarly to how you guys think about even portfolio construction, where there's a balance between a sufficient amount of diversification to spread out the risk in the portfolio and make sure we don't have any sharp edges, but at the same time, we don't want to diversify away the alpha that you're trying to generate with too many stocks. So I think there are a lot of parallels to even our own business and how you guys run the portfolios.

[00:17:17] Samir Taghiyev: That’s why we are on the lookout for new ideas, but we don't put all of our capital into a new idea. We want to see the management team proving itself, while we get more comfortable with the business model, learn it a little bit more, and build our position from there.

I think it was Buffett's nice mental model of watering your flowers and trimming your weeds. That is exactly it. That is exactly the kind of approach we want to employ for our portfolio but also, we want that approach to be employed by the businesses that we own as well. To plant the seeds, water their flowers, and trim the weeds.

[00:17:59] Kevin Minas: So if we hone in a little bit on the growth phase, you've just sketched that out for us what it is and why we're focused there. Are there a few common levers that you typically would see management pull to generate that next phase of growth? Are there any other ways that they can generate that growth that you're looking for?

[00:18:18] Samir Taghiyev: Typically, companies either grow organically or inorganically through acquisition, and those are very different. Organically is typically longer in capital intensity. It is easier to do for some businesses out there that have figured out a way of introducing new products, but it can be hard to swallow if you don't do it right because you will end up with this huge portfolio of products that did not gain traction or people that now you employ and there's bureaucracy now on top of that.

Then there's acquisitory growth as well, which is a very different way of growing. It is chunkier. There's a lot more integration work that needs to be done. Again, some companies do a really good job of that. And some companies—a lot of companies—can destroy wealth by pursuing those acquisitory strategies as well.

[00:19:18] Kevin Minas: Are there any examples on the point for those two different phases of growth or even a company that's done both well?

[00:19:24] Samir Taghiyev: One that comes to mind would be Stella-Jones. Under the leadership of Brian McManus, it was a very successful acquisitory growth company and served as a very small collection of treatment plants that would make utility poles and rally ties, very boring businesses that make money. Again, very mature industries, each of them, but as a result of the consolidation opportunity and the synergies they would get from this very piecemeal acquisitory strategy, they were able to create a lot of wealth. And it was one of the best-performing companies on the TSX over a very long stretch. So time horizons.

Once they have finished the consolidation opportunity—because there's only so much market share and so many competitors you can buy—the attention has gone inwards. What are the areas of the business that offer organic growth opportunities? For them, it turned out that, luckily, one of the bigger businesses that they had in utility poles is showing signs of a renaissance, as a lot of the utility poles were constructed or were put in place 50-60 years ago, and they're coming toward the end of their lifecycles.

On top, there are these very strong secular tailwinds of electrification, electric vehicles, and utilities needing to invest more in strengthening their grids. That created an opportunity, and it's a very different opportunity because you need to invest in capacity organically of expanding your towing capacity to satisfy customers' needs. They've done quite a good job of it because they very much employed the same mindset as they have with the acquisitory strategy, which is a very return-on-investment-focused mindset that has helped them to shift away from the acquisitory strategy to an organic strategy quite successfully.

[00:21:43] Kevin Minas: So as a preamble to the question, at the start of every year, we like to conduct a learning- and reflection-focused exercise that we call the postmortem at the firm. So the research team all sits down and shares their learnings, best practices, things that we could improve. In fact, we recently recorded a whole podcast episode on the postmortem, which I'd suggest listeners go and check out.

Since I've got you here, perhaps we can dig a little deeper into some of the learnings that were specific to the Canadian small-cap team that you'd like to share.

[00:22:12] Samir Taghiyev: Speaking of the exploration and exploitation, we do apply that internally within Mawer and within the Canadian small-cap fund as well to what we can do, not just on new company ideas or new holding ideas but also in terms of processes that we can employ to achieve our goals and using the same philosophy that we have.

One of the innovations in 2023 was this "look back." The fund has been around for a very long time—for decades—and we have internal notes on different companies. We are able to now, about once a month, look back on a particular company, which is a very arduous process of going through all of the notes that we've had to see what kind of thoughts we've had on the companies and looking at their financial performance and stock performance as well.

We do one case study at a time, one look back at a time. And that has resulted in a lot of interesting learnings.

The more you do that, the more statistically significant these learnings become, the less hindsight bias you'll have, and the more generalized these learnings will be. One of the learnings was what we call “trust but verify,” meaning that we like to talk to management and we would like to get the insights on the business from them. But if you do not verify that through the third-party sources, whether it is talking to the competitors, customers, suppliers, or ex-employees, it would be very hard to judge management teams that market their company very well to the investors versus no—a lot of the things that management's saying aren’t correct about the opportunity that they have.

As a result of that, another innovation in the process was now every time we do a Delta review of a company—which we do every single year, looking at how the performance of this company has changed—we also take this as an opportunity to talk to independent third parties to verify what management has told us; to make sure that the industry is great, not declining, even though management is marketing the company as a growing company; that their position is very good in the marketplace; their competitive intensity is not increasing. We have done that historically, but I think the learning was to do that more. And we're employing that now at Canadian small cap.

[00:25:00] Kevin Minas: Awesome. Well, I love all these mental models. I find them fascinating. It's always really helpful to hear how they're applied, how you guys think through when you're evaluating companies and management, and ultimately how stocks end up in the portfolio. It's nice to get some color on a lot of these frameworks that we have. Thanks a lot for speaking with me today, Samir. I really enjoyed it.

[00:25:17] Samir Taghiyev: Thanks a lot. Good. I enjoyed it very much as well.

[00:25:19] Kevin Minas: Hey everyone. Kevin 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, be sure to leave a review on iTunes, which helps more people discover the “be boring, make money” philosophy. Thanks for listening.