the art of boring™

EP 166 | The U.S. Equity Landscape: Inflation, Artificial Intelligence, and Elections

[00:00:00] Andrew Johnson: Coming up in this episode is Grayson Witcher, the lead manager on our U.S. equity strategy. We looked at what's driving the strong returns in U.S. markets and what's happening under the surface. We also discussed how Grayson navigates election cycles and their impact on his portfolio management. And we couldn't resist talking about the importance of diversification. I know, boring, right? Finally, Grayson explained how he and his team manage executive turnover within the companies they invest in. Enjoy.

[00:00:32] 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.

[00:00:49] Andrew Johnson: Hey, Grayson, how are you?

[00:00:50] Grayson Witcher: I'm doing well, Andrew. Thank you. How are you?

[00:00:52] Andrew Johnson: I'm doing well. Great to have you back on the podcast. It's been a while since you and I have chatted on here, but it hasn't actually been that long since talking about the U.S. equity portfolio. Our last episode on the U.S. was back in May this year. At that time, we talked about the strong market performance in the U.S. to that point, which has obviously continued its ascent, albeit at a slower pace than the first half of the year. Let's start there and give our listeners a feel for what the market has been doing under the surface of the strong returns so far this year.

[00:01:21] Grayson Witcher: I'd say there have been three big themes driving the U.S. market over the past six months but even longer. Interest rates and inflation, artificial intelligence (AI), and more recently, the election. Let's talk about those three. First, inflation and interest rates. Over the pandemic, we saw food, energy, and goods inflation rise, things like basketball hoops, ping pong tables, and lumber for decks. So that has really subsided over the past six months or year, which is not surprising. People have enough of that stuff. A lot of them have spent their COVID savings or their government checks.

What we are seeing stick around a little bit longer is service inflation. It has been falling very slowly, but it's still fairly high at around 3%. This includes a lot of items that are pretty sticky, things that you might not see relief for in the short term. Think about things like rent, home insurance, car insurance, education, and medical services. You probably sign a lease for your apartment for a year and same with insurance or education. You're not going to see those costs come down until you renew your lease and maybe not even then.

Wage inflation has been reasonably strong as well. You're seeing real wage inflation of 1-2%. People are still making more money, and you combine that with unemployment being pretty low. It's below where it was in 2000 and 2007 and just above where it was in 2019. If you have a job and you're making money, it's usually a pretty good setup. You can get squeezed in the short term if costs rise faster than your earnings, but it's usually pretty decent.

Now, it's a little bit different for low-income families. Their discretionary income is already fairly low, so if food costs go up 15% or your rent or car insurance goes up, you really start to see the squeeze. We've seen a little bit

of that over the past six to nine months, with stores like Target or dollar stores calling out lower-income families as being in a pretty tough spot. If unemployment starts to rise, we could run into problems. And since we're long-term investors, what's the long-term outlook for inflation? It may be subsiding in some ways right now, but a lot of the drivers of longer-term inflation are still out there. De-globalization still seems to be a problem, as do tariffs and war. So that's inflation.

The second big theme that's impacting the U.S. this year is AI, specifically NVIDIA. NVIDIA is kind of the poster child of artificial intelligence, and it's really been driving the market since ChatGPT was released. NVIDIA is up nearly 10 times from late 2022, and it's pulled up the S&P 500 Index in that time as well. The S&P 500 is up about 60% since then. Now, since about mid-year 2024, we've seen NVIDIA start to yo-yo a bit. It's been down anywhere from 5% to 30% over that period.

The real question now is, "Is AI a real trend?" Probably is the answer. We've gone through the initial hype stage, where people are super excited about a paradigm-shifting technology. But that hype often outruns reality in the short term. Think about things like e-commerce back in the 90s with companies like Amazon. Amazon took decades for its stock price to get back to where it was in the late nineties. It was a great theme, and everybody could see that e-commerce was going to be a theme that stuck around, but does it mean that the stock did well over that period?

Same with internet fiber back in the nineties. More recently, you've seen it with themes like blockchain and Bitcoin, which have been really hyped up, or self-driving cars. These technologies are likely going to be critically important in the future. It's just maybe not quite yet. So that's the question with AI: is it overhyped, or is it not? You can see when you look at a company like NVIDIA, where you have to pay 55 times earnings for a nearly $3 trillion company, that it's not super cheap on the surface. We'll see what happens, but it seems like the market is a little bit less certain about that than it was six months ago.

The third theme is the election. This one has a bigger impact than some people believe. It really seems like democracy is on the ballot this year. When you look at the two candidates, some of the stuff that Trump is talking about – massive tariffs on Chinese goods, halting immigration, perhaps even putting opponents in jail, and a big increase in spending – these are all really inflationary changes to the economy. Harris's agenda is also pretty inflationary but in different ways. We could see a lot more uncertainty with the upcoming election, even than what you normally see in an election cycle.

The good news is that the U.S. has survived a lot of challenges before, and democracy has prevailed. Hopefully it does this time, too. So those are the three big shifts, Andrew. AI, inflation, and the upcoming election.

[00:06:14] Andrew Johnson: Since you mentioned it, clients and listeners are always curious about the impacts of the election in the U.S. I don't mean to make a comment on your age here, but you've been at this through several presidential changes at this point. How do you manage through election cycles and the potential for changing leadership every four years?

[00:06:14] Grayson Witcher: I know you've heard this before, and many listeners have probably also heard this before. It's really about preparing and not predicting. It's really hard to predict the outcome of an election. Even pollsters get it wrong, and that's their full-time job. Of course, you need to forecast what will happen if a certain person gets elected, and what will happen after they get elected. What kind of policies will they implement? How will the markets react to those policies? It's really tough to know what to do.

What do we do? Two things come to mind. One, avoid sharp edges, and two, diversify. How do we avoid sharp edges? We avoid industries and companies that are highly dependent on one outcome. This could be things like

companies that import goods from China that could get crushed by tariffs. This could also be companies that export goods to China that could be hurt by a retaliatory backlash. A couple of things come to mind. If you look at big exports to China from the U.S., one of them is soybeans. About 60% of soybeans that are exported from the U.S. go to China. You'd want to be careful if you invest in soybeans, for example. Vehicles could be another one. About 20% of vehicles that get exported out of the U.S. go to China. If you're investing in a vehicle manufacturer, you'd want to check that out as well.

The second is to diversify. You could invest in a pipeline owner or a supplier to a pipeline; winning or losing is going to be highly dependent on who gets brought into power in the election, but we would rather buy companies that are diversified. Healthcare is often an industry that comes up in election discussions, and we've decided to invest in healthcare companies that are highly diversified. Think about ones like United Health. They have a top-tier management team enabling them to adjust and benefit from any changes that might happen. They have a highly diverse side business model.

Of course, many of our U.S. holdings are globally diversified. Ones that come to mind would be Procter and Gamble, which owns brands like Tide and Pampers diapers. Over half of their sales are outside of the U.S. Microsoft would be another one. Nearly half of their sales are outside the U.S. Even businesses like futures exchanges that are less consumer-facing. We own a company called CME. When you look at the different asset classes that they run, about a third to a half of the volumes are from outside of the U.S. for those futures exchanges. Diversification is really important, and the ways we've done it is risk management through avoiding sharp edges and risk management through diversification.

[00:09:04] Andrew Johnson: Let's stay on the topic of diversification. It's obviously one of the most important lines of defense for an investment portfolio. What does that look like in a so-called single geographic asset class like the U.S. portfolio?

[00:09:16] Grayson Witcher: Lucky for us, the U.S. is highly diversified for a single country. There are two big drivers to this diversification. One, diversification by geography. At first, that sounds kind of funny because it's just one geography, as you mentioned, but the U.S. is fortunate in that it has a ton of multinational companies. Their strength of product and brand allows them to sell globally. Companies like Nike, Amazon, Pepsi, and, of course, there's smaller ones that have smaller brands too.

Companies in our portfolio like Ametek would sell all their high-speed cameras globally. Or companies like ITT would be selling brakes for automobiles and pumps for industrial uses globally. While it seems like it's not diversified by geography, it really is due to the products and the brands that come out of the U.S. The second is diversification by industry or even sub-industry. The U.S. is in a great position because they have an unparalleled breadth of companies and industries.

Smaller economies often tend to lean heavily on a small number of industries to generate much of their gross domestic product (GDP). For example, our home country of Canada is pretty resource-intensive, so it leans on a lot of commodity industries as well as the banking sector. But the U.S. has far more options. Even for small industries like materials, for example, there's impressive diversification in materials. We could buy oil and gas exploration companies, but in the past, we've also bought companies that make software that helps manage refineries.

We currently own an aggregate company that would fall under the materials umbrella that produces rock that goes into infrastructure and buildings. The U.S. also has diversification through industries like healthcare and technology. These industries tend to be a lot smaller in a lot of countries globally. Healthcare could include companies like pharmaceutical companies like AbbVie or companies like Abbott that make medical devices such

as continuous glucose monitoring devices for diabetes or could include drug distributors like Cencora or needle manufacturers like Becton. Even within that one sector in the U.S. equity strategy, there is a wide diversification of companies.

[00:11:30] Andrew Johnson: Diversification is clearly an important aspect contributing to attractive long-term, risk-adjusted returns. As we talked about earlier, it can be an antidote to volatility through different periods, like elections. Building on the theme of changes at the executive level, when you're looking at the portfolio or out in the broader market, I know that you and the team have an alert that lets you know there have been changes in the C-suite of companies within your investable universe.

How does that help you? And ultimately, how do you factor in the leadership changes when evaluating a company's long-term prospects?

[00:12:04] Grayson Witcher: We created an alert system that notifies us of many things, including management changes. So why is that important? Well, for long-term investors like us, management and culture drive a significant amount of value for two key reasons. One, the management team reinvests the cash flows generated by these businesses. As you know, we focus on highly cash-generative businesses, so there's typically a lot of cash to invest. The management team has to decide to either give that back to shareholders through buybacks or dividends or to grow the business.

So that's going to be really important over the five- or 10-year time period. They also help to manage risk. Having a good management team can help the business adjust to competitive changes. It could help the business manage its costs, especially in tough environments like a recession, and it can help in managing leverage on the balance sheet. Why do we monitor these changes? Some people are better than others, frankly, and there are different people that have different priorities.

When we look down our portfolio, we think we have a lot of top-tier management teams; ones like Amphenol, Ametek, Gallagher, Accenture, and Texas Instruments come to mind. But when key parts of that management team change, we want to make sure our thesis on the management team is intact. That's partly because we might have to adjust our management score in our proprietary matrix. If we change our score, that can impact the weight in our portfolio. Depending on the significance of the change, we will often speak to the CEO and the CFO.

We'll listen to them on conference calls or presentations just to get a sense of how they think about things. We might talk to former colleagues of theirs to see how they rate them, and what their interactions were like. We're really trying to find out how much value this person and this team are going to add over the next five years. Management is clearly a very important driver of the value of a company, so we think it's important to monitor the quality and the motivations of the management team. If you look over the past five years, the Mawer research team has spoken with nearly 1500 U.S. management teams over that time period. We think we have an edge and understanding management teams, so it's important to monitor that on a real-time basis.

[00:14:14] Andrew Johnson: Yes. Management can certainly make or break the long-term success of an investment. Just before I let you go, one stock that is relevant to highlight today because it hits on some of the themes that you've discussed already is AJ Gallagher, which is involved in both insurance as well as risk management. Tell us more about that holding.

[00:14:30] Grayson Witcher: AJ Gallager's a great business with a great management team, and we think it trades at an attractive price. How is it a great business? Well, they're an insurance broker; they're trying to help businesses find the best insurance for their needs. This is a great business because you can benefit from the characteristics of the insurance industry without having to take balance sheet risks. If you think about an

insurance company, they're on the hook to pay out claims, but brokers aren't. Brokers are able to benefit from some of the macro shifts we're seeing. Climate change, for example, you see more forest fires and floods. Things like this lead to higher insurance premiums because the money has to come from somewhere, so you have to pay more money for your insurance, and then the claims paid out are higher.

General inflation – you're seeing rising labor costs; you're seeing building material costs go up; you're seeing a more litigious society in general. All these factors lead to higher insurance premiums. For a company like AJ Gallagher, their revenue is based on insurance premiums, so some of these changes are good for them. The insurance cycle is also a different cycle than the economic cycle. This is very helpful for the resiliency of our portfolios.

Second, how is the management team? Gallagher has a pretty unique culture. They have a strong sales culture, and they have a cultural credo. They like to call the "Gallagher Way." They're also excellent at capital allocation. They've done a lot of savvy acquisitions over the years. These have primarily been smaller ones, which lowers the risk to them, but there have also been some larger ones. They recently did a Willis reacquisition where they're able to take advantage of the failed acquisition between Aon and Willis and snag an excellent asset at a pretty attractive price. We believe they have a great management team.

Lastly, it's great that they have an excellent management team and an excellent business, but we want to make sure we pay the right price for that. We've run it through a detailed discounted cash flow analysis DCF model, and that's helped us determine the price that we want to pay for an asset like this. Looking at the price that's traded out over the past several years, we don't think that price has properly reflected the quality of the business and the quality of the management team. So that's why we've been happy owners of AJ Gallagher for the past five years.

[00:16:54] Andrew Johnson: Well, I always like ending on a note talking about the bottom-up process and the holdings that make up our portfolio. So let's wrap it up there. Grayson, always great catching up with you. Thanks for taking the time to come on and chat about the portfolio.

[00:17:05] Grayson Witcher: Thanks, Andrew. It was fun.

[00:17:07] Andrew Johnson: Hey everyone. Andrew 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.