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Who's on Your Equities Watch List?

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And, more importantly, how might they fit and function in your overall portfolio? This PM and his team relentlessly search for the answers.

A global equities strategy is only as good as the businesses it invests in, which is why **Darren McKiernan** and the Global Equity and Income team at Mackenzie Investments spend so much time identifying and honing the list of names that make up their watch list of compounder companies. McKiernan, SVP and Lead Portfolio Manager, and his colleagues are on a constant lookout for companies that fit specific criteria. II recently spoke with McKiernan about what makes a company stand out to his team, and how those companies fit into the portfolio.

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– Darren McKiernan, SVP and Lead Portfolio Manager, Global Equity and Income, Mackenzie Investments

What attracts you to a business initially?

We're trying to find businesses that are advantaged relative to their sector – and we are looking across all sectors for names as high up the value chain as possible. Typically, what jumps out is the durability and the duration of their cash flows, and their business model. From a style standpoint, we are agnostic, meaning we own companies that trade at 30 times earnings and companies that trade at single digit multiples. We're not necessarily growth investors or value investors. We own names across the valuation continuum, and it's all about establishing and paying the appropriate price for them.

As you're evaluating businesses you are presumably also considering how they'd fit into the portfolio?

Over time you learn that it's not just about looking at single stock securities, but rather how a recommendation might affect the portfolio and the role that each individual security should play. As a result, we run a fairly diversified portfolio with an active share that is consistently above 80%. In the context of portfolio construction, we think about risks from the top-down standpoint, and as a result, we always have a minimum amount of sector exposure, and guard rails around maximum weights of position sizes, sector exposures, and geographic allocation. So, even though the portfolio has a high active share and distinct characteristics, as an investor you aren't going to wake up some day and suddenly realize you're in a technology strategy or a Japan strategy. No matter how much we love a specific company, you're never going to see a position above 6% of cost. We protect the investor against hubris and portfolio manager pride, because in the end it's about risk-adjusted returns for the investor, not just raw returns.

You place an emphasis on including compounder companies in the portfolio. Is every company in the portfolio or under consideration a compounder?

We think of compounders as infinite duration bonds with rising coupons, and we have a compounder watch list of just under 400 names that fit that description to some degree. These are companies that we've been looking at for many, many years, even if we haven't owned them all. So, we have what you might call our high-level compounders, and our watch list of companies. A watch list company, for example, is one we may have owned in the past and is a known quantity to some extent. While still a very high-quality business, however, it's growth algorithm, valuation, or economic moat on the margin might not be quite as attractive as the compounders we hold in the portfolio.

What is a Compounder Company?

- Highly cash generative with a proven track record of generating high returns on capital and reinvesting retained earnings at similarly high rates of return.
- High up in its respective value chains and supported by a powerful intangible or tangible asset; a strong brand, exclusive patent, advantaged distribution, or proprietary technology, that is very difficult for competitors to replicate.
- Provides relatively recurring revenue stream supporting high free cash-flow generation and durable organic growth.
- Tends to carry manageable financial or business risk, and because of its inherent strength, are rarely cheap in the traditional sense. However, these businesses are often ignored by a short-sighted market fixated on quick gains and sell-side analyst models that assume zero terminal growth, which overly discounts growth prospects that are more than a few years out.

That focused compounder list must come in handy during severe market turbulence.

There are times when you have to act fairly quickly to take advantage of market volatility. We're managing through one of those periods now as markets react in real time to different potential outcomes of the coronavirus pandemic – some less extreme and some potentially catastrophic. During periods of market dislocation like this, we don't want to be in the position where we're running around like a chicken without its head, so our day-to-day research throughout the year is really focused on making sure our compounder watch list is up to date, and that we're only looking at what we consider to be the very best companies.

The world changes, and there's a big difference in what constitutes a compounder in, say, a Materials or an Energy company versus a software business. We're constantly revisiting that list. There were companies on the list five years ago that no longer are – for example, we no longer think advertising agencies are investible businesses. It's our job to look at a company and ask the hard questions about how the business fits into our investment philosophy in terms of compounding and its ability to grow its cash flows over the next 10 to 15 years.

With respect to the coronavirus and its current impact on global markets, it is our view that the world will get through this and adapt, as it has always done. It may take months, or it may take the rest of the year and beyond. While that feels like a lifetime from now, it is not. In the meantime, besides doing our part as members of society to stay safe and help those in need, we will do our best to position the strategy for when the clouds part and the sun comes out.

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Are there any businesses in the portfolio that might not immediately leap to mind as compounders?

In terms of long-term holdings, stock exchanges are our biggest sub-sector exposure. They check all the boxes – extremely high return businesses, extremely high margin, very little capital requirement, highly regulated, and there are long-term tailwinds. They don't just benefit from one competitive advantage – they benefit from network effects, such as every incremental customer that goes into an exchange adds to the liquidity pool and helps to reduce spreads, which is to everyone's benefit. We consider exchanges to be growth utilities in a lot of ways because they're the financial plumbing of the capital markets. These companies are classic compounders in the sense that they don't require excessive capital, and they aren't allowed to take on very much debt because of the important role they play in the smooth functioning of capital markets around the world. Think about stock exchanges 25 years ago – a bunch of people in a pit with colored jackets yelling at a screen – and today they are basically servers and software, with very little capital required and, as a result, they have very progressive dividend policies. Not only do they generally have very good payout ratios, but many of them end up paying out special dividends over time because the amount of money they need to invest to keep the business growing at above average rates is very, very little.

You mentioned the self-imposed guard rails of portfolio construction a little earlier. Why are they important?

The world's a pretty unknowable place, and that's reflected in certain maximum position sizes. No matter how much work you've done on a company, how well you think you know management, or how well you think you understand the business, you can still get it wrong. Three months ago, no matter how well you understood any travel-related business, you likely weren't modeling in the potential impact of the coronavirus. We're fundamental investors, and we pride ourselves on understanding companies, but things can and do come out of the blue that you've never experienced. And when they do you have to make sure that your ego hasn't gotten in the way of making the right decision. The same goes for sector and geographic allocations.

You and your colleagues seem to really fit the true definition of a team, with a lot cohesion and trust. What's the secret?

Many of us worked together previously in our careers before joining Mackenzie Investments, and we know each other's strengths and blind spots. And there is a trust between us when it comes to getting each of our jobs done consistently and well. We're proud of the track record built over our time together. And when you're looking at the underlying quality of the portfolio and its metrics, whether it's return on equity, return on invested capital, or operating margins, it has consistently been at a significant premium to the underlying benchmark. Despite this premium, I like to think each of us are still very thoughtful about what we pay for the businesses in the portfolio. It's consistently traded at a slightly higher multiple than the market, but not an unreasonable one given its quality. We have all always been on the same page when it comes to striking that balance.

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