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Investments

Simple but not easy: The global search for mispriced great businesses

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The Global Equity & Income team at Mackenzie Investments seeks to identify great business models wherever they exist around the world. Whether it's a company in one geography replicating what we know has worked in another region, or an emerging market business model that leapfrogs a western model due to a lack of legacy assets, we endeavour to find them.

The essence of our process is simple. A great business is defined by us as one with sustainable high returns on invested capital and growth. The team analyzes the returns on capital rigorously, first by examining an industry's barriers to entry. We then analyze the competitive advantages that drive a company's competitive position within that industry. These are differentiation or a cost advantage. The best businesses have both in our view. We avoid businesses we don't fully understand. We also believe high free cash flow conversion is critical. Once that cash has been generated, an important question is: how does the management then deploy it? It's a simple question, but not easy in practise. After this analysis is complete, the portfolio is constructed from the best opportunities we see within that universe of companies identified.

Team Lead Darren McKiernan often points out that "It's tough to put us into a style box. We're not growth investors; we're not value investors." Core to us means the team goes where the opportunities are – some opportunities may look like growth, while others may look like value. The definitions of value and growth styles are highly academic and can be too simplistic at times. They are based on accounting and thus suffer accounting's shortcomings. Accounting is a record of the past, and it must balance (debits and credits, assets and liabilities). Valuation is about future cash flows. Here is an example to illustrate: Imagine Company A acquires Company B for $1 billion at a valuation multiple of 20x enterprise value (EV) to earnings before interest and taxes (EBIT), and 5x price to book (P/B). An investment made at 20x EBIT and 5x book is widely considered to be a growth investment. The day after the transaction, Company B is held on Company A's books for $1 billion. If Company A partially listed Company B two days after the transaction, at the same valuation it paid, Company B would then trade for 1x book. Now, assume that Company A improved the profitability of Company B in a short period because the latter was grossly underearning its assets, making its effective acquisition cost just 5x the post-integration EBIT. Consider that 1x book and 5x EBIT, along with the concept of "what would a private owner pay for the business" are trademarks of the conservative value investor. So was Company B a value investment or a growth investment?

This is nothing new. Attractive returns accrue when assets are mispriced, to the buyer's advantage. We are therefore keen to analyze value on a company by company basis and take advantage of mispricing – whether the origin of that mispricing is micro or macro in nature.

In the above example, the mispricing of Company B was micro in nature. A macro example is what we believe to be the systematic discounting of China in the West, reflecting a bias that could form the basis of behavioural finance research. Some illustrations:

Accounting

"One cannot trust the accounting of Chinese companies" is something that is often said, and more often implied. Yet when Warren Buffett invested $488 million in PetroChina between 2002 and 2003, he specifically cited that the accounting was the same as that of all the oil majors, and so he was certain of what he was getting: a fungible barrel of oil for a fraction of the cost implied by peer valuations. Needless to say, Buffett understands accounting (he made a tidy $3.5 billion profit on that investment).

Fraud is different than bad accounting standards. There was a period between 2010 and 2012 with high levels of fraudulent Chinese listings on US markets, this is where the reputation comes from. However, we would point to Enron, Bernie Madoff and Theranos as the largest frauds of their kind in history, and these happened in North America. General Electric, once America's most successful company, was famously rewarded by investors for dishonest accounting – among many things, managed earnings through cookie jar accounting at GE Capital. If the "best" company in America does this, can US companies be trusted? Of course, they can. Wirecard and Steinhoff are examples of recent German corporate frauds; Alstom earned a special place in history for how it hoodwinked GE, which bought the French company for $10.1 billion, only to subsequently write it down by $22 billion – that doesn't happen without grossly misleading accounting. Accounting is a starting point for investor due diligence; usually fairly reflecting a business' economics. Fairly does not mean perfectly – but sometimes accounting does not even fairly represent a business' economics at all. The bias against China is unwarranted in our view.

Pandemic

For most of Western society, the COVID-19 pandemic began in early March. For those who do not discount China, the pandemic began earlier, and its severity was already notable. Investor Bill Ackman famously isolated in February and began shorting the market. Tesla CEO Elon Musk criticized the Californian government's protocols for Tesla's factory, saying "we've dealt with this in our Chinese factories. We didn't have a single case due to the precautions we took, even when there was COVID-19 locally." To paraphrase, he was saying: "You don't know what you're doing; it's uncoordinated and ineffective; you should call the Chinese."

The bottom line is that these biases can translate into extraordinary investment opportunities. On finding a great business model being replicated in a different geography – the team bought Kweichou Moutai, a spirit brand with more goodwill than Johnnie Walker or any single western brand (it survived communism as one of the most valuable brands in the world), for less than the liquidation value of its inventory in 2014. It has not been uncommon to find companies growing revenue at over 20%, yet available for 5% or 6% free cash flow yields, where US or Western equivalents offer 2% free cash flow yields with less growth.

Our team's approach incorporates risk management through portfolio construction a priori. In the recent COVID-19 crisis, that key element of portfolio construction paid off not just in performance, but also in allowing the team to focus aggressively on the opportunities available with an aim to embed returns for the next three-to-five years, rather than playing defense.

We pursued many opportunities in the crisis, driving the highest turnover since the inception of the strategy. Our actions fall broadly into our taking advantage of either accelerating or interrupted structural trends.

An example of the former is our longstanding investment in semiconductors. This includes companies such as Texas Instruments, Taiwan Semiconductors, Avago and ASML. Their growth is underpinned by many drivers: data centers, high performance computing, 5G and the Internet of Things, as examples. E-commerce has had a particularly strong impact. We believe one of the next big sources of growth is the electrification of vehicles, where semiconductors as a percentage of a car's bill of materials will become significant.

The second category are trends on pause. An example here is travel, which can be both necessary and discretionary. Transportation is necessary for the function of the economy. Business requires it, such as the consultant who travels every Monday to be on a clients' site, or the production manager traveling to establish a new facility. But travel is also discretionary, it taps into Abraham Maslow's hierarchy of needs as a psychological need. The aspirations of the middle class are timeless. The team seeks to invest in the most attractive parts of the aerospace value chain, with companies such as Safran (a duopoly in narrow body jet engines) and Amadeus (a strong oligopoly in global travel distribution systems), which we believe are best positioned to survive and prosper in the long run – despite the challenges facing the industry.

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