Active Insights Podcast – Altrinsic Global Advisors: Searching for Undervalued Companies with a Long-Term Perspective

Diane Merritt:

Welcome to North Square Investments' Active Insights Podcast. North Square Investments is dedicated to bringing differentiated active investment strategies to financial advisors and investors through our multi-boutique asset management platform.

Today Mark Goodwin, Chief Executive Officer of North Square Investments, will discuss international equities and building high conviction equity portfolios with John Hock, Chief Investment Officer with Altrinsic Global Advisors. Altrinsic is a partner firm in the North Square platform, and sub-advisor to North Square Altrinsic International Equity Fund.

Mark and John, we look forward to your discussion.

Mark Goodwin:

Thanks Diane. As you mentioned, at North Square we seek out best-in-class active managers for our platform, and our partners at Altrinsic have a long history of success with their fundamental approach to equity investing across global markets. First John, I want to thank you for joining me today. It's always great to speak with you.

John Hock:

Thank you, Mark. Great to be here.

Mark Goodwin:

John, Altrinsic has managed equity portfolios for over 20 years, primarily for institutional investors. So perhaps some financial advisors and retail individual investors may not be familiar with the firm. Could you give us some background on the firm and your investment team?

John Hock:

Sure. So Mark, we started the firm in the year 2000, in an environment that wasn't too dissimilar from that which we recently experienced. It was amidst the fallout from the TMT (technology, media and telecoms) bubble, during which the media and the sirens were pronouncing the death of value investing, the death of active investing. There were many great value investors who were merging out of weakness or closing down. So for us at the time we said, "what better time to stick the flag in the ground and launch a global equity boutique." So that was the year 2000.

You might ask what gave us the confidence to do that at the time, particularly given how young we were? And really central, a few reasons. First, my early partner, John DeVita and I were just incredibly lucky, in that we entered this industry in 1990 as the Berlin Wall was coming down, developed markets in China, Russia, India were all opening up. And at that time there was a relatively small number of international investors. So John DeVita entered the industry at that time and trained under a great investor Jean-Marie Eveillard at the First Eagle Funds before joining me 10 years later. I also entered the industry in 1990 as a sell side analyst at Merrill Lynch and spent much of those early years, my first six years in Eastern Europe, Russia, China, India, and South America as an equity analyst as those markets were opening up.

And then six years later was approached by the President of the Templeton organization to form a global equity boutique, which we did. Learned a lot of what to do, learned a lot of what not to do, and ultimately left in 2000 amidst that environment I described up front to launch Altrinsic. So Mark, I guess essentially what I'm saying is that we were just incredibly lucky. We were early in building our networks and developing our perspective. We were fortunate to work alongside a lot of great investors where we could draw upon and bring the best practices from the firms and people you worked with over time. And since then at a very disciplined and measured pace just added to the team. Never compromising culture and did so in a very, I guess deliberate, measured way that results in our offering today.

Mark Goodwin:

Thank you, John. Your investment approach is very research-intensive with a strong focus on stock selection. Can you talk about the core investment philosophy of the firm and managing equity portfolios? I know as we've spoken in the past you've referenced buying a business as opposed to a company, or investing in a company as a hallmark. But if you could just talk about the fundamental underpinnings?

John Hock:

Sure. So we search for undervalued companies from a long-term perspective. And as you said, we analyze them as if we were to buy them outright with our own capital. So much of what we do would be not dissimilar from what your client's relationships would do if they were to buy businesses, whether it be in Des Moines or in Calcutta for that matter. So effectively we're applying what we call a private equity approach to public equities. So if you think about the universe of publicly traded equities in the world, there's a wide range of quality among the businesses that present themselves across companies. There's also a wide range of prices being paid or valuations for those businesses. These valuations often overshoot, whether it be because of greed, or fear, macro or micro factors, policy to name a few. So essentially what we're looking for are the best risk-adjusted investment propositions amongst this opportunity set.

For example, sometimes in an economic or macro environment you might find the value presents itself in higher quality compounding companies, and other environments, particularly during recessions, you might still find value in more cyclical-related businesses. So rather than being confined to a narrow segment we'll be flexible, we'll be opportunistic, and we'll go to wherever absolute value presents itself. So to do that, Mark, what we'll do is construct a mosaic around the business that we're considering. And that involves first evaluating the long-term historical drivers of a company's fundamental operating performance. Think its sales, its margins, its working capital requirements, its debt covenants when times are good and when times are bad. Next, we'll engage with management teams while drawing upon our own network to get additional perspective and nuance around the leadership, the culture, and the overall business, competitive opportunities, and threats. And then thirdly we'll quantify the long-term threats and opportunities at the margin level, the revenue level from a perspective of capital allocation and overall long-term profitability.

And within this mosaic then what we'll do is value that business and consider it for inclusion in the portfolio. We can unpack the process in a little bit if you'd like to probe into more detail. But that investment process and the approach to risk, what it results in for our clients is a fairly concentrated portfolio; currently we have about 67 company-specific investments. Our turnover is quite low, it's generally been between 15% and 35%. But the key thing, Mark, is that it’s overwhelmingly, over time, been company-specific and/or idiosyncratic factors that are the drivers of performance, not macro bets (intended or unintended) or other thematic stories; it's really company-specific dislocations.

Mark Goodwin:

Thanks, John. No pun intended, but the world truly is your oyster in terms of looking at opportunities. How do you work through the vast universe of global equities to identify ideas to consider for further research, and what's the vetting process or funnel for ultimately getting a stock to be considered for a position in your equity portfolio?

John Hock:

Sure. So it begins with a clear objective. So for each member of the team we want the clear objective to be to identify a handful of high conviction opportunities, as if we were to buy them out right with our own capital. This number, this objective, it's tangible, it's measurable, and provides more than an ample idea flow considering the concentrated nature of our portfolios and the long-term low turnover nature of the portfolio. So, with this objective in mind, we'll first approach the vast universe of publicly traded companies through parallel processes. First of all, being certain quantitative tools that really focus on price to normalized earnings measure, but really encapsulate a whole host of valuation profitability and leverage factors.

But that quantitative approach really supplements or compliments the second source, which is the most fertile source of finding the pearl in the oyster so to speak, and that's really just drawing upon our network and our farm teams. So what I'm talking about here is our analysts, each member of our team, including myself, is first charged with being engaged in their industry food chain globally. So if you're looking at financial industry, you're engaged with banks, insurers, non-life insurers, insurance brokerage, FinTech disruptors, new venture capital companies. Just to paint that mosaic of that ecosystem, be incredibly networked and engaged.

And in each of these industry food chains we have our farm teams, which would be 50 to 100 companies that would include the companies that we believe are best-in-class, could be companies that might be worst-in-class but they're at critical intersections of these industry food chains and give us lateral perspective, and/or companies that come up through screens or other sources. So it's through that combination of quantitative tools which complement that more nuanced approach that drum up the ideas. And it's the interplay of these tools and that good old fashioned curious investigative work that is really the fun part of the business, but also leads to nuanced opportunities that lead to further due diligence.

Mark Goodwin:

So as you work through processing those best ideas that did bubble up for inclusion in the portfolio, how do you think about portfolio construction in risk management to make sure at the end of the day you don't have an overweight of say, telecom companies in France, or banks in Asia, or whatever the concentration bubble might look like?

John Hock:

Right. The answer to that stems from one thing I mentioned earlier, taking some of the best practices of the firms we came from, but also leaving some of the worst practices. Even though we're bottom-up investors, we recognize that it's like baking a cake. These individual ingredients might taste very distinctive but when you put them together they result in something very different. And oftentimes with bottom-up investment portfolios an unintended consequence is you might have improving concentrations, whether it be in super low-quality businesses, or in a certain sector you alluded to.

So for us once we get to the portfolio construction process later on in our investment process, we put alongside of that certain risk guidelines that limit our exposure to major sectors or regions to 2x aggregate benchmark rates or 15 percentage points above that. And the whole goal of this that we've been employing and refining over 20 years is to seek to ensure that it's that company-specific idiosyncratic thesis or edge that we bring to the table is a driver of performance. And when we're not necessarily performing and limit the propensity for, what you allude to, and these unintended factors to overwhelm that.

Mark Goodwin:

So as an outgrowth of that would you say that most of the positive performance attribution would attribute to security selection as opposed to sector weights?

John Hock:

Without a doubt, pretty much consistently over time. So in recent years up until the last few months this has not been the ideal environment for value investors many say. Yet despite that we've been able to outperform in that environment, and the main reason why is exactly what you alluded to, the companies that we've been able to identify have really had distinctive theses behind them that were not predicated upon a booming economy or a weak economy. And they were able to execute on them and see improvements from depressed levels in their profitability and get re-rated—I'm happy to give examples if you like—or are companies that were also targets of private equity or M&A, because most private equity or strategics are looking for companies with the same characteristics that we're looking for.

Mark Goodwin:

Thanks, John. Yes, obviously having a concentrated portfolio is desirous by many end investors, and you described very well the process of getting individual securities into the portfolio. Can you talk a bit about sell-discipline and what are the typical means by which an individual security leaves the portfolio?

John Hock:

Right. I skipped over quite a few elements already in terms of getting it into the portfolio, I framed it out from a big picture perspective. But I should mention that the determination of whether a company gets in the portfolio stock by stock first stems from its research process, that basically takes the key elements I described earlier, but then involves distilling that into a research report that is disseminated to the entire investment team. I mentioned upfront how we put a lot of value on diversity of team because of diversity perspectives, and we think in this world where information is ubiquitous one of the key sources of differentiation as an investor, are just the different backgrounds, experiences, and perspectives of the team filtering and evaluating that information. So once that idea is vetted and approved, then it becomes a candidate for inclusion in the portfolio. And then the primary determination of whether that security goes in is its base case discount to intrinsic value; that is the overwhelming factor.

And it's at that point where the broad overall portfolio construction guidelines that I mentioned earlier come into play. So sell discipline, the high-class way, Mark, is when your thesis works and the share price appreciates, the value erodes and you're happily selling it off to someone else who's chasing momentum or is less value conscious. That's the high-class way. We also sell an idea if a better idea comes about. You never want to get wed to an investment. Each day is a clean sheet of paper, we want to put the best ideas on the field. The less glamorous way is when things don't work out. So, if there's new information that enters and a stock price is reacting accordingly, we will unemotionally recalibrate, go back to the thesis and the assumptions included in our research report, re-underwrite the idea, and then make an objective decision.

We also trigger automatic reviews; upon a 20% adverse change we will do that same re-underwriting of the investment idea. If there's no material change we will be the liquidity provider and be in the market as the aggressive buyer. If things have changed we may have to recalibrate and sell. But where there's debt involved is where we'll typically just blow it out immediately and revisit. Time again where value investors, including, frankly us in our early formative years, got burned a lot as having this naive notion that if you like a company at 10, you got to love it at six, and if it goes to two it's dirt cheap. Well, it may be, but it may be more expensive at two than it was at 10 depending upon the capital structure of that business. So clean sheet of paper, fresh perspective, when there's debt involved revisit it, take that action and revisit it another day.

Mark Goodwin:

Thank you, John. US equity markets have had a great run but less so for many international markets. And as we look out into the remainder of 2021 we've got a post-pandemic recovery, inflation starting to pick up in some arenas, clearly an out-performance of value versus growth in Q1 for the first time in a long number of Q1s. Can you give us some perspective on where you see the global equity markets currently and what your outlook is for 2021 broadly?

John Hock:

Sure. So I think the most important point is that a long overdue transition appears to be underway. And I wouldn't characterize that transition as the one that's popular in the media and the financial press being this growth/value story, I think these labels have kind of taken a life of their own. Then I think it's a little bit more nuanced, the transition to this Mark, is first, we've had narrow leadership by a small group of highly valued, fifteen, twenty growth stocks for over a decade. Great companies, they just got too extended and too highly priced. Transition was long overdue and the catalyst for that to unwind as we saw it was competition amongst them, changes in interest rate regime, introduction of regulatory pressures, et cetera with the idea that it wouldn't necessarily disrupt them, it would just lead to a broadening out.

And those factors were underway but the key catalyst for the transition that we've begun to see late last year was the vaccine development and the reopening trade. Because what that did is it caused the companies at the one extreme of the last 10 years, that narrow leadership of FANG type stocks give way to companies at the opposite end of the quality spectrum. The lowest quality, most highly levered, deep cyclical businesses; many of which happened to be labeled value stocks, but we'd argue that would just be a small set of the broader value opportunity. So those companies have been the early beneficiary of this transition because the vaccine was the catalyst. We'd argue the greatest sources of opportunity in the next stage of the transition broadening out are companies between these two extremes that have done fine, they just offer much better propositions concerning the quality of the businesses, the sustainability of the growth profiles, and the prices you're paying for them. As opposed to the companies that led in the first quarter, which are again, those highly levered, most cyclical businesses.

And again, not those that led the last decade, which are still highly valued. They're probably going through a digestive phase, kind of like Cisco did post the original TMT bubble. And Cisco was around for a decade, but it took a decade for the earnings to catch up with the high valuations. So I guess first point is broadly transition underway, broadening out. That's not to say those leaders the last year will be horrible, but the playing field is more fair for other areas. As it pertains to the international versus US consideration, is that's the key one too because as you know, US equities have far outpaced international equities for that same 10-year period or more, and that's begun to give way.

And the value case for international is well-documented, so I want to expand upon that by pretty much any factor, any measures, the situation overseas is more favorable. So that's nothing particularly new. However, what is a bit less documented is the difference in expectations. Very high expectations set for many US companies to achieve where the bar is still quite high, while the bar is set much lower overseas. But the real story, Mark, is really down in the trenches where there's a growing number of companies in Japan, in emerging markets, parts of Europe, increasingly embracing measures of financial productivity, which has really served US companies so well, it's just slow to catch on overseas.

Also a greater prioritization of shareholder value with you and I as minority investors moving up the priority list of these companies, and their management teams and boards. And this will continue to unleash value. And the evidence of this is further reflected and you’re seeing each day, and the meaningful acceleration in private equity activity and increased M&A activity in these international areas. So it's tough to make a broad generalization about markets, but transition, broadening out, and favoring international versus US.

Mark Goodwin:

Those are great insights, John. Changing gears for a minute, passive investment strategies have increased their share of investors' wallets for the past several years for equity exposure, as well as fixed income, but in particular equities. Does Altrinsic's particular style of active management provide advantages over passive strategies, particularly in the current market environment?

John Hock:

Yes. Now there's always room for passive, and if one believes that the next 5 - 10 years from an economic market environment are going to be a repeat of the last 5 - 10 years, then passive will be the only place to be. But that's highly unlikely, highly unlikely. If you think about the pro-cyclicality of flows into these products, of the resulting impact on index composition, it's led to a much higher embedded risk in these traditional benchmarks and strategies than many perceive. So that's the concern I have just as a citizen in the world. But as has been the case for us in the last 20 years, what to expect from us is we're going to beat to our own drum, it's going to be those company-specific factors, job performance. So I guess what I'm saying, Mark is if the financial advisor and investor looking for a tight tracking error index-oriented manager, we are definitely not the best fit.

Mark Goodwin:

That's great, John. As I mentioned earlier, US equities have had strong performance now for so many years that investors are starting to look abroad for new opportunities. Based upon your recent research can you think of particular sectors of the equity market, or specific regions of the world, or countries where you're finding particularly good opportunities for investors with a medium to longer-term horizon?

John Hock:

Sure. Certainly opportunities present themselves wherever there's change, where there's uncertainty, innovation, disruption. These create the dislocations that lead to opportunities, and risks for that matter, but the opportunities is what we're looking for. So we see many of these emerging among financial companies, heavy investments in financials, but mostly non-bank financials. It's important to make that distinction because a lot of value investors have a secular weddedness to banks. And there have been episodes where we've had lots of banks, but generally we see a lot of negative disruption in that space.

We see more opportunities in areas of non-bank financials, be it insurance, insurance related, exchanges. We can expand upon those if you'd like, healthcare, consumer, and increasingly in technology. Markets are fluid and volatile so this can change, but just to give you a little bit more color on that, Mark, financials, non-life insurers are benefiting from the combination of strongest competitive environment we've seen in decades. We've seen increased demand for these risk reduction products. A lot of them are exercising cost control to our benefit. And to the extent we do see improvement in economic activity that will be additive as well. But we also have a lot of exchanges.

Over time we've had meaningful investments in stock exchanges, because we like companies that might be perceived in a certain light, but the real transition underway in the business is different than that, which it is perceived. So, these exchanges, like in our case like Euronext or Singapore Exchange, have sustainable competitive moats, and importantly they're shifting their business mix away from traditional trading activity where there are fees off of that, to more proprietary high-margin products like data and clearing services. So improvement in business quality coupled with re-rating embedded in them.

And healthcare, everyone talks about the excitement and innovation in technology, which is great, but on a five- to 10-year view we'd argue that the investment opportunities tied to innovation are more likely to appear in the healthcare related areas, given the sequencing of the human genome, the increased computer processing power, and the impact that this is having on the whole food chain of healthcare. So not only depressed valuations in many companies, take Astellas out of Japan, even GlaxoSmithKline out of the UK, investing heavily in innovation but shifting their business models in our favor as well.

Third, I'd say consumer franchises. Diageo, Heineken are a couple of examples. They're often seen as more defensive businesses, and they do have defensive attributes which can be a very good thing in certain episodes, which people sometimes lose sight of, but in our view they also offer several avenues for growth including improving category mix, improving capital allocation, and tailwinds from reopening for consumers. And then lastly I've just mentioned even technology. To generalize about technology in general, but companies like Checkpoint and SAP out of Europe, they're transitioning to stickier more recurring business models.

And now you are going to see an uptake in demand as companies seek to reduce risk and lower costs and become more digital. So the good thing is the world's a big place, international is a vast area. These are four sectorial areas of concentration. From a regional perspective, the way I'll frame it up for you, Mark, is you see a lot in continental Europe, about 50% of our investments are in continental Europe. While many of those are businesses that just really happen to be domiciled there, be it for tax reasons or legacy issues, but they might operate businesses in other areas or on a global basis. About 16% of the United Kingdom, about 14% in Japan, 11% in emerging markets where we see a growing opportunity set as well.

Mark Goodwin:

Thank you, John. A quick side question, we keep hearing about inflation raising its head and is it transitory or not? Do you think about that within your overall investment framework? And do you have a view as to whether it is transitory or more systemic cyclical returning, and does it really change your investment thesis at all?

John Hock:

Sure, we think about it a lot, but we think about it a lot with the realization that nobody knows how the hell it's going to play out. What we do know is pretty much everything we've studied in university about inflation dynamics, you can pretty much throw it out the window as we're kind of entering a new arena and new policies that have previously been unheard of. So I guess a couple of things. From a long-term view, on one hand we have this massive amount of debt in the world, and a lot of related issues with that. And that can and should be deflationary. Excessive debt results in deflation is how people prioritize paying down debt or companies' governance prioritize paying down debt.

But on the other hand, you got these policies, including monetary policies that are incredibly inflationary, just throwing money on the fire. And the interplay of these two assets should lead to a continuation of what we've begun to see, which is a greater volatility in rates. And since all assets are valued in reference to interest rates, that should lead to greater volatility in stock markets. Not necessarily a bad thing, it's just something to be prepared for. Now that was a big long-term thought. Now let's just bring it down to what everybody's talking about in the media, which is the fact that you, and I, and everybody on this podcast is realizing if you want to make an addition on your house or go on a trip, everything we spend money on is skyrocketing, experience in price. In fact, we ordered some chicken sandwiches today at lunch and we were talking about how the chicken on your sandwich is getting to be a smaller and smaller portion, like people are experiencing this.

So right now it's transitory. So, if I were to speculate, and again discount this because I'm not a macro guy, I think in the next two to four months probably peaking out by the end of this year it will be kind of peak inflationary concerns. At which time maybe you get whips in the other direction with people beginning to recognize some of the more deflationary or other consequences out there. If not deflationary, the fact that something else was at play, Mark. I hope I'm not over complicating this but these things all connect. So what I'm talking about here is if we approach that period of peak concerns about inflation, activity, monetary issues, liquidity, towards the end of this year I think you're going to begin to hear more and more people realize that, hey, all this stimulus that we've benefited from this far, is thus effectively been growth that would have otherwise happened next year, and the year after that, and in the year and year after that, it's just been brought forward.

So, people need to look through this bridge or over this valley and say, okay, once we kind of settle in what is that new normal as Mohamed El-Erian puts it? So I'm rambling on a little bit here, but my point is, is it transitory? It's a bit more than transitory because of the enormity of the policy issues, it's largely unpredictable, but it's going to oscillate and it's going to lead to volatility and gyrations in asset prices.

Mark Goodwin:

That's very helpful, John, thank you. As we mentioned earlier, you sub-advise the North Square Altrinsic International Equity Fund, ticker NSIVX. Can you tell us about your approach with the fund and what is your current investment strategy and portfolio allocation for the fund, as opposed to some of your other institutional clients?

John Hock:

So, Mark, as a boutique every person and every resource in our firm is solely focused on what we're talking about on this call. So the fund is the same portfolio that we run for some of the largest pension plans in the United States and around the world. We're one team, one process. So the fund embodies, all the principles and approach that we discussed earlier, that we apply for all the institutional clients. And importantly, as meaningful investors alongside our clients, we approach it with the same alignment responsibility that you should expect. Just to add that the positioning I briefly elaborated on earlier is a function of what opportunities and risks we see overwhelming at the company-specific level. But when you aggregate these holdings, the positioning is one where the risk is below that in the market. So below market risk is a function of the type of margin of safety that the companies which we are investing offer, and the nature of their businesses.

I would also add that whereas many investors, particularly many in the value camp have and are continuing to invest in this reopening trade and deep cyclical businesses, well we look at them objectively. We just don't see value in that space. Yes, they can continue to, there's such powerful earnings momentum behind them, but they're already discounting earnings expectations next year that are well beyond that which were pre-COVID levels. So the bar is set quite high. So instead we see the greater value beyond those two extremes that I mentioned on the quality spectrum between those super deep cyclical and the higher quality compounder type ideas.

And then I guess last point on that is, I guess I should say that the portfolio, it's the economy... So many of your clients and relationships are making a macro call, and their true view is that we are in the roaring '20s and we're going to have 6%, 7% GDP for the next three years. We'll do fine in that environment. We'll probably not distinguish ourselves against certain others, but our companies where we see the greatest opportunities at right now are companies that if the economy just muddles along, that's where these portfolio holdings can really shine because the company specific levers can release themselves and you'll get those re-ratings.

So from a macro environment it gives you a sensitivity there, and I'd emphasize that margin of safety. And the end result is, as I mentioned earlier very diverse, 16% the UK, 50% / 51% in Europe, 14% Japan, 11% emerging markets, with the greatest source of new idea flow coming from emerging markets. Now the general emerging markets has been disappointing performance for quite some time, and in the emerging markets, which in many ways is a structurally flawed asset class given how concentrated the index is in a few countries and in a few sectors, we are just seeing a lot of emotion in these markets leading to greater value propositions. More in kind of upper mid and lower large cap related companies.

Mark Goodwin:

Great. Thank you, John. A final question, we know that diversification and asset allocation are critical elements for any investment process. How do you see an actively managed high conviction international equity strategy being best positioned in the diversified portfolio of an individual investor or an institutional investor?

John Hock:

Right. So I might not be the best person to ask that because for us we eat our own cooking. So I think the real answer to your question is it's situational, and that really depends upon the advisor's appraisal, a client's risk tolerance, et cetera, et cetera. So essentially someone has an equity allocation, total equity allocation of pick it, 50% in a portfolio, I would think that international, including portfolios such as the one we run, it should be anywhere between 20% to 50% of that if one's taking a truly long-term perspective.

Mark Goodwin:

That's great, John, thank you so much for joining me today. It's been a great conversation as always.

John Hock:

Thanks, Mark. Looking forward to chatting with you again soon.

Diane Merritt:

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