Portfolio Manager Update – Empire Life's International Equity Fund

By David Mann, Portfolio Manager, International Equities
June 5, 2020

This is my inaugural letter since becoming Portfolio Manager of the International Equity Fund in September of 2019. In this update I intend to discuss our approach to portfolio construction and the types of businesses we are investing in. I will then provide a brief overview of some impacts from COVID-19 and how we have navigated through these turbulent markets.

A significant portion of any portfolio manager's role is to adjust the level of risk, or beta, of a portfolio to the outlook for equity markets. While we are stock pickers by nature, the overall direction of equity markets will undoubtedly have a significant impact on our underlying investments. Beyond looking at the actual beta of the Fund alongside our geographical and sector allocation, we have a three-tiered strategy to manage the desired level of risk in the portfolio. Before moving onto the tiering strategy we want to mention that we are willing to have material underweights and/or overweights in countries and sectors based on the opportunities that we see. For example, we have no allocation to energy or utilities while having overweight positions in technology and healthcare. Similarly, when looking from a geographical lens we have had no allocation to Hong Kong while being overweight the U.K.

Our three tier portfolio structure is instrumental in how we manage the portfolio and if anyone has heard us present it has been discussed at great lengths. While I am going to describe the different attributes that result in companies being categorized as tier 1, 2 or 3 companies, there are two characteristics that the vast majority of our investments share: Strong management and low debt levels. During times of crisis, this is of increased importance. Well managed businesses with low leverage will with high likelihood emerge from this crisis better positioned than poorly managed businesses with high debt levels.

Tier 1 businesses are the most stable companies. They are usually large capitalization, "blue chip" equities with diverse revenue streams, strong market positions, high returns on equity and often have a history of paying a growing dividend stream. These characteristics usually result in tier 1 equities having the lowest volatility of the three tiers. A great example of a tier 1 business is Nestle – it mainly sells food, but many varieties of food in most geographies globally. It also has strong and increasing return on equity and one of the most bankable dividends globally. At any given time tier 1 businesses will cumulatively comprise 40-60% of the invested assets in the portfolio. There are two key differences between tier 1 and tier 2 businesses. First, tier 2 companies will generally have higher levels of revenue growth, and second, they will often have geographical concentration and/or be tied to the revenues stream from a single product. Nintendo is an example of a tier 2 company. Its revenue growth, while diversified by geography is mostly reliant on a single console – the Nintendo Switch. Tier 2 businesses typically range from 20-40% of the portfolio. Tier 3 businesses most often offer the highest growth in the portfolio and can often be emerging market companies. Cumulatively, tier 3 businesses can be up to 20% of the portfolio. If we have a more bullish view of markets we tilt the portfolio to having higher weights in tier 2 and tier 3 businesses, while conversely if we are more cautious we tilt to portfolio to tier 1 companies.

2020 has insofar seen high levels of volatility. Prior to the global emergence of COVID-19, the year was broadly characterized by steadily rising equity markets and modestly elevated valuations. We had a slightly defensive tilt to the portfolio which was broadly attributed to "end of cycle" risks. The onset of COVID-19 resulted in high volatility and significant market declines. During this turmoil, on a year-to-date basis Tier 1 businesses in the portfolio were the most resilient while, as expected, tier 3 companies together declined the most. This is reassuring and further instills our belief that our tiering approach is a highly effective tool for us to help manage the levels of risk in the portfolio.

COVID-19 related market volatility created an opportunity to invest in businesses that we have otherwise been valuation restrained on. An example of such a business is Nihon M&A, a Japanese M&A advisory boutique that in our opinion one of the best managed businesses in Japan. It is a company that through the years has built up a vast database of small and medium sized businesses on one side and potential buyers on the other hand. Due to several factors including labour shortages and succession issues there are many business owners in Japan looking to sell their companies. Nihon M&A matches those sellers to buyers and collects a fee. Their market position and consistent execution alongside a "scarcity premium" has resulted in a high valuation historically. We believe the medium term earnings power of the company has not changed and invested in it following a near 35% contraction in the price/earnings multiple.

Like all crises, COVID-19 has caused management teams and investors to re-think some assumptions that were previously seen as the norm. Top of mind for many is working from home, which has quite quickly been abbreviated as WFH. Here at Empire Life I always had a 5+ day work week. Naturally, when we first transitioned to a WFH environment there was some questions around corporate access, internal/external communication and what we would generally classify as technology. There were some small bumps on the technology side that were more of an annoyance than anything but productivity is now the same if not higher than working from an office. I say higher simply because our already strong corporate access capabilities have improved because of virtual management meetings. We are certainly not the only company to notice these efficiencies and this has led some management teams to re-think their footprint and maintain a more hybrid employment model. Just this one potential consequence of COVID-19 might have a clearly negative impact on not only the commercial real estate market, but also caterers and restaurants, toll road, transit and parking lot operators as well as certain retailers. Alongside this damage, opportunities are being created as well and some business models are being further strengthened. There are early signs of what types of companies these are (i.e. delivery companies, online retailers) but it will only be some time after global "re-opening" that we will have a clearer picture of which businesses benefit on more of a structural basis versus those that saw a short term demand boost.

One area that we think will change the investing landscape, internationally at least, for a reasonable time period are the higher debt levels that governments have taken on to help support their respective economies as well as lower interest rates. The higher debt levels extend beyond the country level and into corporates and households as well. Part of the aforementioned fiscal spend are direct rent and wage subsidies. In some countries (i.e. U.K.), countries have attached restrictions to the bailout schemes, of which limiting dividend payments is top of mind. There are bound to be far reaching long term impacts from increased debt levels, record deficits and low interest rates globally. A more immediate consequence is continued uncertainty. We think companies that pay a steadily growing dividend stream will become an increasingly attractive sub-asset class and will over-time be awarded with a higher multiple. Prior to COVID many businesses in the International Portfolio would have had this characteristic, but more than ever this is an area of focus for us. As always, we continue to incorporate new information as we invest Fund assets. This discussion linking higher debt levels and lower interests to an increasing focus on dividend paying equities is just one example.

We have high confidence in the management teams we have invested in and similarly we thank you for your trust and ongoing support.

The Empire Life Insurance Company
259 King Street East, Kingston, ON K7L 3A8
Insurance & Investments – Simple. Fast. Easy.®
www.empire.ca info@empire.ca 1 877 548-1881