

TRANSCRIPT: EPISODE 315

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[INTRODUCTION]

Staci West (SW): Welcome back to the Investing on the go podcast brought to you by FundCalibre. We're joined this week by a contrarian multi-asset investor who tells us about the "four horseman of the stock apocalypse" and why he thrives in a murky environment.

Chris Salih (CS): I'm Chris Salih and today we're joined by Alec Cutler, manager of the Elite Rated Orbis Global Balanced fund. Alec, thanks for coming all the way over to the UK to see us.

Alec Cutler (AC): Oh, thanks for having me and putting me in this beautiful room.

CS: Yes, indeed - on a lovely day where it's raining outside!

[INTERVIEW]

CS: I want to start with markets at the moment because there's a lot of analogies and people have been using various ways of describing what's going on. I saw somewhere where you said "the sun is setting on Venus" [AC: Yes] ...and it takes a hundred days. Maybe you could start by explaining what's going on and why, and your sort of take on it, really.

AC: Yeah. I think we're trying to use different creative approaches to get across to people that the environment that they've been used to for the last 10 years or so is not a normal environment. It's a wonderful environment for producing high nominal returns on investments, but the sun does set and we could be in for tougher sledding over the next 10-15 years. So perhaps clients and investors should get used to lower returns in a more difficult backdrop.

CS: You mentioned that backdrop in how awkward it is at the moment as a contrarian investor: is it like a sweet shop? Are you seeing lots of opportunities at the moment? How does it go in your world where it's a bit different to lots of others who've been so happy in the last, you know, till 2022 for the best part, 15 years before that and now it's sort of much more murkier and there must be plenty of opportunities out there for someone like yourself?

AC: I think we kind of thrive in the murk and we thrive in difficult environments. We're happiest when we're being given opportunities because the market's puking them out! The kind of pinnacle

TRANSCRIPT: EPISODE 315

of the puking phase would've been in 2020, 2021, beginning of 2022, where we were able to buy fantastic companies at very, very cheap multiples. Right now, we're in a phase where some of those cheap companies are starting to re-appreciate in value but we're still continuing to find replacements for them when they get too expensive for us to own.

CS: Are you coming out of the sweet spot for your style of investing - how would you see it? Would you say a lot of the market is now sort of fairly valued? Maybe talk about a couple of areas where you see the opportunities still.

AC: Yeah, I mean, the global market looks fairly valued. The US market looks overvalued, but that overvaluation is coming from a concentration of a small number of names so it's still a target-rich environment for us.

And from an investing style standpoint, what we're seeing - this inflection of relative performance that we're seeing, we think is indicative of the sun setting on Venus. And that is that we're going into an environment that many investors who have been crowded into the most popular stocks or long duration assets may find more difficult but we find a more level playing ground of fairness and interest in valuation around names.

That gives us the ability to allow the portfolio to appreciate because our names are being appreciated for what they deliver to the economy or to earnings growth, and other names are being kicked out at the same time that we can invest in them.

CS: I wanted to focus on two specific areas firstly, because we're here, the UK obviously, that's an area where things are looking a little bit brighter - not that much brighter, but a bit brighter. And then also Japan, where things have turned around perhaps to a greater degree. Maybe we can take one in turn, start with the UK and just your view on that. Are you invested heavily in the UK to any degree?

AC: So, the Balanced fund is invested heavily in the UK and I think it's a good representation of the kind of environment that we thrive in. In order to thrive from a returns standpoint, we need to be able to invest into high pessimism. And I think the UK listener will be able to relate to that pessimism if they've held UK stocks. They would've seen, you know, 10 years of water torture. But that provided us [with] the opportunity to accumulate really, really good companies, some of these are excellent world-beating companies at valuations that we find once in an investing lifetime. And now we're just starting to, as you say, we're just starting to see glimmers of those names start to appreciate and for the market at all to appreciate what they bring to the table from an investment standpoint.

CS: I guess patience is the biggest part of your role in as a contrarian investor. You just have to wait for that opportunity to rise. I mean, Japan probably stands out as somewhere for years where there's been false dawns mentioned, et cetera, et cetera - is the case still strong there? Have we had most of

TRANSCRIPT: EPISODE 315

the appreciation on that side that you were expecting to see or is the story still going to grow from here?

AC: Well, I think patience is the watch word, not only for us as the investors controlling the portfolio, but also our clients, because they need to understand what we're doing and understand that it sometimes is a waiting game.

And as you say, Japan was a very long wait. And just when you think it's never going to come to fruition, the Japanese government turns around and says, you know what? We can't have this, we can't have our equity culture be so poorly rated by the rest of the world. We need to see appreciation in the value of our companies, we need to get to global standard market valuations. So they passed some regulations and laws and the Tokyo Stock Exchange followed up on those to really put pressure on Japanese managements to make their companies appreciate value. So, that's been a great catalyst for us. We've rotated within the Japanese market, we continue to have around the same weighting. We've moved some of those assets to the UK where it's been a bit later in that process, they haven't appreciated in value. Or Korea, which is kind of eyeballing Japan and saying, you know, we can do that too.

CS: Okay. I want to sort of take a step back and focus on the murky world again. I mean, when we talked in, I think it was November last year, you talked about the four horsemen of the stock apocalypse.

AC: Yes.

CS: Are you as worried now as you were then, or more so or less so? Could you just give us a bit of a view from that perspective please?

AC: Yeah. So, just the same because nothing has changed. Despite the fact that we had this period of enthusiasm where the Fed was winking and nodding that they were going to cut interest rates and and that, you know, everyone should run out and buy long duration bonds, those fabled six interest rate cuts in 2024 now look like it's going to be zero. Inflation hasn't rolled over. But if you, just looking at the four horsemen of the stock apocalypse: the New Cold War coming out of the 1989-2022 peace dividend era, that's now done, I think that's increasingly understood by the market. Those defence names have appreciated, but from an inflation standpoint, all that defence spending that's ramping up is inflationary because tanks don't make anything, they're non-productive.

If you look at labour power, the next horseman, labour power peaked in 1981 when Reagan broke the [US National] Air Traffic Controllers Union, in 1985 when Margaret Thatcher broke the coal miners' union [National Union of Mineworkers] in the UK, labour has been on its back foot until about a year, year and a half ago. Now, with very low unemployment rates and ageing population,

TRANSCRIPT: EPISODE 315

labour has a lot more power, and we're re-shoring everything back to the Western world. All that is inflationary.

The third one I just mentioned — re-shoring. So, globalisation really kicked off, and the offshoring of a dirty industry or expensive industry to China, kicked off when China joined the WTO [World Trade Organisation] in 2001. Now, I think if you surveyed, you'd find that many people thought that was a mistake, we shouldn't have done that, and they're bringing industry back. If it was deflationary and a depressant on inflation to send your industry to China, bringing it back can't be deflationary as well. It has to be inflationary. That's the third.

The fourth is a decision that we've made, it's not a cycle. It is the decision to decarbonise the economy, industry and from a consumer standpoint. So it's everything from driving to EVs [electric vehicles] or driving cement manufacturers to switch from natural gas to electricity. The cement manufacturer - everyone can understand the EVs, [but] the cement manufacturers may be a little bit more difficult to understand, but if you tell a cement manufacturer they have to switch to electricity to burn limestone and to make concrete, they have to spend \$2 billion to rebuild their plant, to change what they're burning. So, they have to amortise the cost of that over the next 20 years, say, through every 50 pound bag of cement. It's more expensive to make cement from electricity than it is from natural gas, otherwise, they would've done it from electricity to begin with. So, now it's more expensive from a variable cost standpoint; that has to be put through price increases. That's inflationary. So any of the green spending that we talk about, or the electrification - that is all inflationary.

So, those four things are not going away, they're real. So, between November of last year and now, those are just as real as they've ever been.

CS: Just wanted to pick up a couple of things then. So obviously, as a contrarian, you hold gold, and it's one of your largest single investment at the moment, I believe? [**AC:** Yes.] Is gold still a contrarian play?

AC: It's tough to tell. Interestingly, so the price of gold has been going up quite nicely. It's being driven by the Chinese and the Indians accumulating gold. So, you might want to wonder why they're doing that. We can get to that if you'd like. But the ETFs, the Western ETFs have actually been seeing outflows from gold. So, the Americans, the Brits and the Europeans haven't really bought into the movement in gold. So, if you look at the total corpus of investment money out there, I still think it's out of favour just looking at where the money flows are going.

CS: Okay. And then also just on inflation, you mentioned, I think when we talked, you said the inflation isn't going away anytime soon. It's quite low here and in Europe versus the US. How does that come into your focus [for] your portfolio at the moment? Do you sort of see that as an anomaly or an opportunity, or how does that play out for a fund like yours?

TRANSCRIPT: EPISODE 315

AC: Yeah. I think in general it's super hard to try and predict what something like inflation or any macro variable is going to do on a six month or one year or even a two-year basis. Anything we talked about, those long-term drivers and impulses for inflation or deflation, those are 20 year views. So, we can't make guesses on six month or one year views and make differentiates be between two countries. The economic stats and CPI themselves are quite volatile between two countries, and they're volatile over time. The Fed is constantly tinkering with and reassessing what CPI is, always seemingly to reduce the inflation rate, but it does change over time.

CS: I just wanted to, before we wrap up, a couple of stocks in particular, obviously [you're] big fan of Burford [Capital], the company. Maybe first you could tell the listeners about that because that's quite an interesting company that you talked to us about before, please.

AC: Yeah. So, one of the things that we love to have in the portfolio somewhere is something that's completely idiosyncratic. And if you were to look up the definition in the dictionary 'idiosyncratic investment', Burford would be the example. It is a litigation finance company. And from a diversification standpoint, the drivers of a litigation finance company are completely unrelated to the economy or interest rates or currency or anything. There's also never been a down year in litigation anywhere in the world, so it's also a nice growth industry. Burford invented the litigation finance industry.

So first, what they don't do: they don't fund mass tort claims where it's class action [law]suits, they're not ambulance chasers. They look at typically corporate lawsuits where the plaintiff has a really good case but they're running out of money. And one of the ways that a defendant - a big corporate defendant - wins is they just outspend the plaintiff and they run out of money. Burford steps in and funds the rest, the remaining portion of the lawsuit for a percentage of the win. And their skill is around identifying lawsuits to back their IRR - their rate of return on their investments - that they have made. So they invest in lawsuits. Their IRR is 29%, historically over 14 years. So not only is it diversifying for us, but in a way it's us outsourcing a portion of the portfolio to someone who has an investment return that's better than ours.

CS: Okay. And then just switching tack for a minute, obviously AI is the biggest thing going on in the markets at the moment. You've talked a bit about beyond AI and some of the companies that can take advantage of that. For example, Nvidia can't grow without some of the semiconductors growing as well. [**AC:** Yeah.] Maybe just talk a bit more about some of those companies behind the frontline of AI that are also, you know, set to grow, based on that theme.

AC: Yeah. So, all the press around AI is sort of focused on the big winners from AI or supposedly: Microsoft, Amazon, Google [Alphabet], Meta, Apple. The way we look at that is they actually see this as a existential event. Internally, they're looking at AI and they're saying, we have this golden goose, this moat [sustainable competitive advantage], you know, search for Google or social media for Meta. Those are now under threat by AI. We need to spend to defend, and we need to win; we need to become the winner of AI out of these five, there may be going to be two winners.

TRANSCRIPT: EPISODE 315

So picking which of those five are going to be one of the two winners, we just aren't equipped to do that at Orbis. What we are equipped to do is assess the entire situation and say, where can we win? Where's the highest probability winner from this? And when you break that down, you see this as a five-way cage match fight between these titans that have unlimited cash flows and unlimited ability to invest, they're all investing like crazy to try and beat the other one. We want to be in the ammunition providers.

The biggest name out there in an ammunition provider is Nvidia. So people who agree with that way of investing say, okay, I'll invest in Nvidia. Nvidia's very expensive, but what does Nvidia depend on? 100% of Nvidia's chips aren't made by them, they don't make anything, they design chips that are made by Taiwan Semiconductor [TSMC]. So, that's the obvious reasonable valuation stock that we can play. It's a mid-teens multiple, Nvidia is sort of a 60 multiple. So, it's a very attractive, fairly-valued to lowly-valued way for us to play that.

Also, the memory semiconductors: an Nvidia chip or an AMD chip or a Google processor, any AI processor is surrounded by lots and lots of very expensive DRAM memory [dynamic random-access memory] to allow tons of information to get in and out really, really fast so that processor can process all that information and send the information back out. So, we are invested in Micron and Samsung.

CS: Are you surprised that the PEs are as low as they are for the semiconductors?

AC: Yes, yes. I don't think they're...

CS: ...you'd think there might be more of a consensus focus on that, given that they're not exactly not well talked about, are they?

AC: I mean, the history is that foundry is kind of the backwater of semiconductors and the sexy stuff is all happening in the design, but it's also incredibly consolidated. So, Taiwan Semiconductor can do leading edge semiconductors, which AI needs. But Samsung is the only other player that can manufacture leading edge. So it's a very narrow oligopoly; they can really charge whatever they want and Nvidia's going to pay for it, otherwise they're not going to have anything to show clients.

On the DRAM side, it's been a history of a volatile commodity. And what investors are missing is, while it has been a volatile commodity, the industry's consolidated from 27 players when I started out in this business to three, so it's a global oligopoly. The investment requirement's gone way up, so these fabs no longer cost a billion dollars, they cost \$15 - \$20 billion, and the nature of DRAM has become much more ubiquitous. So that need to get data in and out of a processor has become more and more important in almost every part of our daily lives. It's super, super important for AI, which is now the new big growing, it's super important for cell phones and it's super important for any kind of computing device. So DRAM's more important, more valuable in the system, its

TRANSCRIPT: EPISODE 315

supplier base is more concentrated but we're still able to buy these things at 10 times forward earnings.

CS: Okay. I wanted to finish on ESG. Now, I believe there was a research report recently which found a couple of years ago that almost two thirds of people were considering ESG as a factor when they were selecting a fund. That's now fallen to almost half. I am old enough to remember the credit crunch and when well, not ESG, but SRI sort of fell off a little bit as growth sort of waned. And I think you used to run an SRI fund back in the day. [**AC:** I did, yes.]

So, maybe tell us, you are quoted as saying you feel ESG's failing again. Maybe you can give us a bit of insight in what context it is failing and where you sort of feel it can still succeed.

AC: Sure. So I have some training in ESG. SRI - Socially Responsible Investing - was the first version of ESG, that was in the late nineties. I did run an SRI fund. And what happens, this will sound very reminiscent for what we've been seeing.

SRI was started by the Quakers in and around Philadelphia. And it became popular because it was outperforming. The thought was it was outperforming because doing good, you can make money by doing good or you can outperform by doing good. That was kind of the sales pitch that grew out of it. The reality was that it forced you to concentrate into growth stocks and growth stocks were in favour. So, it was misconstrued that SRI investing would outperform because you were investing in companies that did good or didn't do bad. The reality was it was just catching a growth wave. And then it failed because growth investing went out of favour and value investing came into favour. SRI underperformed and all the tourists that were there because it was outperforming left, and you had this great bulge of assets in SRI and then you had a great sell off in SRI and it kind of dwindled down to nothing into the GFC [Great Financial Crisis] and out of the GFC. And then it's been sort of resurrected, rebranded as ESG.

My concern in saying that, you know, this is not on a solid foundation, was because I saw our industry beginning to sell it as the same thing as it was sold for when it was SRI, which is you're going to outperform by buying these names that rank highly in an ESG metric that they've come up with.

Anytime you restrict the universe - investment universe - in theory, you're going to have a more difficult time to perform well, not an easier time to perform well. And my concern at that time was, we're just going to see the same thing happen again. And I wasn't anti-ESG — I know I was labeled anti-ESG at one point — it's a misnomer. I'm looking at some of the things that ESG was trying to accomplish, and I was all for them. And I was worried that they weren't going to happen.

So I'm not a big fan of tobacco, I'm not a big fan of coal. As ESG is waning now because it's underperforming, my concern was we lose the momentum around trying to shut coal down or trying to shut tobacco down because investment money is running away from it. So, where I've had issues

TRANSCRIPT: EPISODE 315

is our industry's reaction to the movement and how they've sold products related to ESG and how that's impacted the movement itself and the good things it was trying to accomplish.

CS: So I guess you would expect some consolidation perhaps in the space, or..?

AC: That would be the SRI playbook from back in the early 2000s. I wouldn't be surprised to see that.

CS: On that note, I'm going to wrap it up there. Thank you very much for joining us again, Alec.

AC: Thank you.

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