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investing ON THE go

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[INTRODUCTION]

Staci West (SW): Welcome back to the Investing on the go podcast brought to you by FundCalibre. Quality investing has faced an unusually difficult year, as AI disruption, shifting valuations and sharp style rotations have challenged traditional approaches. This interview looks at why some of the world's strongest businesses are currently trading at surprising valuations.

James Yardley (JY): I'm James Yardley, and today I'm joined by Mark Ellis, the fund manager of the Nutshell Growth fund. Hello, Mark. Thanks for joining us today.

Mark Ellis (ME): Hi, James. Thanks for having me.

[INTERVIEW]

JY: So, Mark, it's been a really interesting year. Lots going on in markets as always. How are you seeing the world at the moment?

ME: Yeah, I mean, I would agree. It's been a fascinating year. We've had many different themes throughout the year. I mean, I would say as a quality growth investor, we've had a real headwind of quality underperformance, especially in Q1. We had probably the worst underperformance relative to the market as a whole since the late '90s.

So, yeah, challenging environment, basically on the back of AI disruption to a lot of these highly motive businesses. But yeah, we had that Q1, and then since then, that has turned around somewhat. And then on top of that, there was kind of style dispersion between kind of AI winners and losers. We've also had geopolitical risk with Iran. We've had the Fed raising rates. We've had higher inflation, more stimulus inflation. So kind of a lot to get your process and mind round, but lots of opportunity as well.

JY: Yeah. I mean, it's really interesting, isn't it? I mean, it's been a very tough time for quality investors. I mean, a lot of funds have, quality funds have massively underperformed. Not so much yours, I think, which is still holding its own in the last three years, to be fair.

I'm just wondering, has your view of quality changed? I mean, a lot of other quality managers sort of tend to have this buy and hold approach. I know that's not your approach. You're much more willing to trade things. And it's interesting, what does quality mean for you today? Because I mean, traditionally, I guess quality, I mean, people have their different definitions, but you'd usually start from this point of this competitive advantage or moat which protects the business. And as you say, AI has been so disruptive for your traditional quality plays, particularly in software, but also in places like consumer staples with GLP-1s. It feels like those moats have been knocked down or certainly weakened.

So where are we with quality today? I mean, it feels like a very different world to where we were 10 years ago with 0% rates. I mean, has your definition of quality adapted and changed? And what are you seeing as quality investments today?

ME: Yeah. I mean, a really good question. I mean, like a lot of quality investors, we probably, we… I mean, our process, we look at over 40 different characteristics of companies, and the majority of those are quality characteristics.

So we look at high margins, high return on invested capital, motive businesses, but also we really look at stability of those numbers as well. So we like a long track record of stable margins, stable high margins, stable high return on investor capital. But unlike a lot of my peers who kind of buy and hold forever, we have a big emphasis on valuation and expected return. So with all this volatility, these stocks are moving up and down 10, 20% interim month, and we're managing to capture those changes in valuation, changes in expected return.

And if you look at what happened in the first quarter of the year, you were getting, say, semis versus, semiconductors versus software, that pair, virtually every other day, one semiconductors will be up 5% and software will down 5%.

And we will be able to capitalise on those intraday movements as the expected returns and the price changed. And we trade around those positions around our target weights. We change our target weights due to new information, which comes intraday even. So we trade maybe 10, 15 times a day on some of our core holdings, and to try and capitalise those small bits of alpha, which are thrown off by this volatility, which our peers don't do. And that generally gives us an edge over a kind of pretty poor market environment for a quality investor.

JY: And so that, is that buying weakness and selling strength simply?

ME: Typically. So in our process, it's kind of two regimes. So in the short run, intraday or daily is to do with price action and expect a return on valuation. So as free cash flow yields drops, as PA ratios expand, we will take profit on those kind of companies and add to ones which are becoming cheaper.

But then when we get new real information via earnings or some kind of exogenous announcement from a company, then we will make a structural shift to the way we look at a company and the way we score a company. And that will be more longer, medium to longer term.

So it's… Well, I would say where our real edge is, is being able to capture these short-term movements. And again, it's to do with my background. I was a trader in the city for 25 years, so I'm very comfortable at going from new information to trade within seconds, with no investment committee or external research or any of that stuff, which slows everyone else down.

JY: Yeah, very interesting. And I mean, I was having a look at your top 10 and you seem to have a bit of a sort of barbell approach going on because, I mean, you've got the likes of Adobe and Booking Holdings who are at least perhaps considered some of the potential AI losers as their businesses have been disrupted a bit. For example, being able to replicate Adobe software and things with these open source things.

But then on the other side, you've also got, you know, ASML, Broadcom, NVIDIA, TSMC. So you seem to be playing the AI trade there. I mean, I'm just curious as to how you've built the portfolio like that. Is that an element of risk management in what you're talking about in terms of the way the extreme moves we're seeing in markets with, you know, one day that the AI losers do very well, then the next day the AI winners do very well and vice versa?

ME: What I would say is our process is all bottom up. So what we try and do is compare like for like across the globe and generally get the biggest allocation to the quality characteristics we really like and look for for the cheapest possible price.

So actually, we recalibrated the portfolio from scratch yesterday, and the portfolio now looks very different to it did in kind of March, April, May time. I would say at that time, we were probably a lot higher allocation to software and AI losers. But recently, the last one will save outperformed and more of the AI winners, the kind of semiconductors, those kind of names, have underperformed recently.

I know the semiconductor index is probably down 20% from its recent highs. So now those companies have got more attractive to us. So we've actually got a number one, our number one position at the moment from yesterday, is ASML. And that's not NVIDIA for our number one position which has been number one for a while now. So again, we've also added a new company, Celestica, Electronic Components, which is involved in the kind of hyperscaler build out into the port, into our top 10 recently. And again, that's had really explosive growth and it's really cheaply valued. It's on a P of around 14 for next year and it's growing at 90%. I think the management came out last night and indicated 90% growth over the next 12 months.

So the portfolio is a blend of, a bottom up blend of great companies at reasonable valuations for the quality characteristics they exhibit. Yeah. And as those kind of valuations move around, the portfolio moves around.

JY: Yeah, and that strong valuation discipline is a feature of your fund, isn't it?

ME: Yeah, I mean, what's quite incredible at the moment is for what… A very rare kind of period this year, we've been able to create a portfolio as a whole with really high quality, quality characteristics and a discount to the market.

So if you look at our portfolio from yesterday's recalibration, we've got a return on equity of around 67%, which is three times the index. We've got a net margin of 34%, which is about double the index in SAI world. We've got a return on invested capital of 48%, and we've got an expected growth rate of over 30%.

And yet, the portfolio is traded at a discount to the index if you look at PE ratio or free cashflow yield. So in my mind, it's like buying a Bentley for the price of a Monday.

It really doesn't make any sense that you're getting these great companies, the best, most highest quality companies on the planet for a discount to the market. And it's the first time we've seen… I mean, this year is the first time we've seen this dislocation where it's actually trading at a discount rather than a premium. So a very interesting time if you're a patient quality investor.

JY: Yeah, no, fascinating. I mean, and we have seen very strong earnings growth coming through in the US in particular, I guess, this year. And I guess that has meant that valuations, if anything, have actually been coming down for a lot of stocks. I mean, do you have a strong outlook of, a strong view of where this is all going? Or do you just let the earnings come through and kind of?

ME: I mean, I try not to get distracted by the macro headlines, whether it's kind of oil price or the Fed or kind of funding, funding levels of AI financing or whatever that latest story is, because look, I started in the city in '95 and it's just been one long time series of reasons why not to invest. So there's always something brewing which makes you a little bit nervous. But in the long run, we all know equity investing is a very profitable business.

And look, for me, I was lucky enough to spend a bit of time in the hedge fund investment community and I did quite a lot of work on seasonality and the US midterm or the US election cycle is a very strong seasonal pattern where Q4 midterm is a start of a three-quarter period where seasonally you get very strong returns.

So I think the recent weakness has been a really good opportunity to add to equity allocations to run into next summer. And once this event of the US midterm clears, if history is any guide, equity markets generally do really well. And on top of that, we've got a fund which is invested in quality, a discount to the market, and some really compelling companies with compelling growth stories going forward. So we think here's quite a nice sweet spot to allocate to this space.

JY: Excellent. So you're clearly happy with how you're positioned at the moment and the outlook is strong. I mean, are there any risks or anything which you would be worried about? I mean, do you think there's any truth to this talk about AI bubbles and things, or do you think that's been overplayed or…

ME: Yeah, I mean, I think the AI kind of talk is overplayed. It reminds me a little bit of Alan Greenspan's irrational exuberance where in '97 he was waving the flag about the tech valuations. He had another three years to pan out, and that feels probably about the same here.

What I would say is that the other good thing about being a quality investor, if you were to look at our portfolio as a whole, we really do have a big allocation to the profitability factor and really highly profitable companies.

And if we do get an exogenous shock, be it kind of global geopolitical risk or some kind of escalation in the Middle East, what you generally get is a flight to quality, and quality companies do really well in that environment relative to the index.

Whether that's a COVID type scenario or Liberation Day, what you generally find with our portfolio is the drawdowns is significantly less than the index, but also that gives us this great optionality of being able to deploy to areas because of our style, which have overshot the downside. So, I mean, a great example is Liberation Day. If you look at our drawdown into that period, we actually were more muted than a lot of funds, but then we came out at a faster rate. So, yeah, we don't mind the short-term volatility to give us opportunities to redeploy and switch our allocations around.

JY: Fantastic. Well, it's been great to get your thoughts today, Mark. Thank you very much for joining us.

ME: Thank you very much, James.

SW: A high-conviction, concentrated, pragmatic fund investing in exceptional growth companies. Nutshell Growth is a truly innovative fund, which makes use of a heavy quantitative input. We like the fund's nimbleness and its ability to quickly reposition. As such, the fund has a much higher turnover of holdings than its quality growth peers. To learn more about the Nutshell Growth fund, please visit fundcalibre.com and don't forget to subscribe to the Investing on the go podcast, available wherever you get your podcasts.