MACKENZIE Investments

Growth & Value: Your questions, our answers

Core investing: The "just right" porridge

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Over the last decade, growth outperformed value. With the recent resurgence of value investing, should investors be tilting their portfolios towards value?

Darren McKiernan, Head of the Mackenzie Global Equity & Income Team, believes economic growth coming out of the pandemic could beat consensus expectations, an environment where value investing has historically been rewarded. We chatted with Darren to learn how he strikes a balance between growth and value in his portfolios, and why he believes a core, bottom-up investment style is the key to investors succeeding through a variety of market environments.

Q | We've seen a rotation to value that started at the end of 2020 and has persisted well into 2021. Do you think this rotation has legs?

Nobody can really say for sure how long this rotation might last, including myself and the team. Very high valuations have been afforded to the fastest growing companies over the last few years, but this recent boom in higher growth companies is unlike the tech bubble of 1999, when tens of billions of market cap was being ascribed to money-losing operations with questionable business models.

Today's market leaders are fabulously profitable. They are generating tremendous free cash flow at high margins and significant return on investment. That said, the bulk of a high-growth company's intrinsic value comes from the cash flows it will generate far into the future, and its estimated terminal value cash flow. These future cash flows are susceptible to higher interest rates, which brings us to the environment we may be in now. As economies reopen, unemployment comes back down and some semblance of normalcy begins to return to people's lives, inflationary pressures could lead to even a 1% or 2% move in rates.

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That would make those far-off free cash flow coupons and terminal values of the most expensive companies less valuable. It would also make the near-term cash flows being generated by banks, industrial manufacturers, travel and leisure companies, and commodity extraction operators more attractive. And these have traditionally been viewed as the more value-oriented segments of the market.

We are generally wary about agreeing with consensus forecasts, and typically err on the side of caution – we are more inclined to discount consensus growth projections. With that in mind, while most economists are forecasting a strong expansion of global GDP this year, we are taking the rare view (for us) that the consensus forecasts are conversative and are positioning the portfolio accordingly.

Q | You employ a core investment style while searching for the best companies around the world. What does managing with a core style mean to you?

We're really trying to offer our investors exposure to what we believe are the best companies in any geography and sector, without a value or growth style focus. We like to call ourselves "agnostics" when it comes to categorizing our investment style. We're always trying to strike a balance between offense and defense, depending on the circumstances. What's working today won't necessarily be what will work tomorrow. The market can discount pretty quickly what it doesn't think will be working 12 months forward and so we're fortunate as core managers that we can own, for instance, fast-growing technology companies while also owning consumer staples with strong brands and attractive pricing power that typically grow more in line with GDP.

We can tilt our portfolios a little more towards value, or we can tilt our portfolio a little more towards faster growing parts of the market. But don't mistake that for us making major macro calls. We are bottom-up focused, first and foremost, looking for the best companies anywhere in the world with durable business models. Only then do we evaluate factor exposures, including style, as a secondary input to our overall portfolio construction. The only style factor that we're "all-in" on is quality. So that's what core means to us.

> **We do know that what worked going into the pandemic is not likely what's going to work coming out, and we have calibrated towards more pro-cyclical businesses and what one might refer to as 'reopening' themes as a result.**

Q | How have you positioned the portfolio?

As always, changes we make to portfolio construction are done in a prudent, and typically incremental, way. That's part of our DNA as core-style managers. We're never swinging for the fences at any point in the cycle – we liken that to flipping a coin. But we do know that what worked going into the pandemic is not likely what's going to work coming out, and we have calibrated towards more pro-cyclical businesses and what one might refer to as "reopening" themes as a result. Of course, the economy – and the market – is a highly complex and unpredictable organism that doesn't always neatly fit into a technocrat's model, let alone a fund manager's.

At the very least, better economic data coupled with seemingly unlimited central bank liquidity and real-world confirmation through the companies we own and follow gives us comfort that our current positioning is on the right track. But don't mistake a confident view for hubris: we are well aware our thoughts on GDP growth and inflation could be wrong. Alas, we are in the judgement business, and while we are sticking to our knitting – the fund remains a collection of upper echelon quality businesses with strong competitive positions, cash generative economics and sound long-term growth prospects – we are tilting the portfolio to better reflect an acceleration of global GDP growth. For now.

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Q | How do you balance a focus on quality with tilting the portfolio towards more pro-cyclical businesses?

We feel there are companies that can offer both exposures to investors. We own companies like Diageo, Heineken and Coca-Cola, three beverage companies that were able to weather the pandemic rather well despite a good chunk of their revenues being impacted, as drink consumption in bars, restaurants, hotels and stadiums all took a hit. We believe they will benefit from all the pent-up demand that's coming once the economies reopen.

Disney took the opportunity to accelerate the rollout of their direct-to-consumer division (known as Disney+) and also invest in their parks' infrastructure while the world went on lockdown. They will be nearing full capacity by early next year with a full content slate being put through their streaming service by then as well.

Hotel and airline reservation booking software company Amadeus will be coming out of the pandemic with a lower cost structure and an even better competitive position.

And while we have been long-term holders of JP Morgan, we have also added to what we consider to be leading banking franchises such as US Bancorp (which has a recovering merchant processing business) and Bank of America, the biggest and most profitable consumer banking arm in the US. These are just some examples of how the portfolio strikes a balance between quality and cyclicality.

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