AORIS INVESTMENT MANAGEMENT

Dealing with 'overheated markets'

Managing Director and CIO of Aoris Investment Management, Stephen Arnold, gives his view on the market & arguments for investing in traditional value stocks.

Stephen Arnold
Founder & CIO

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Alan Kohler, 2 Feb 2021, Eureka Report

Stephen Arnold is the founder and the portfolio manager at Aoris Investment Management. They’re a pretty traditional value manager. They didn’t do well in 2020 because the stocks that they don’t own, the big growth stocks like Afterpay and Tesla and so on, are the ones that have underpinned the market’s performance and they don’t own them. They own fairly solid what they call market leadership companies like Louis Vuitton and L’Oréal and so on, so that’s what they do and it’s always worth listening to Stephen Arnold’s views on things.

Here he is, Stephen Arnold, Managing Director and CIO of Aoris Investment Management.

Well, Stephen, a lot of people are saying the market’s overheated, the latest evidence of that being the GameStop situation in the US but also Tesla and Afterpay in Australia and so on. What’s your overall view about where the market now sits?

Well, Alan, I think there’s a lot of indicators that I would say are suggestive of effervescent or overheated markets, the ones that you referenced, the Teslas. As well as just the number of businesses that are coming to market without any earnings with a short operating history, the valuation that the market has accorded those businesses with not a lot to show for their business in terms of profitability or durability. We don’t think about markets in aggregate, we don’t buy the market. But I think the way that I would interpret those signs is there are even more reasons why one should steer their investments towards businesses that have been around a long time that aren’t vulnerable.

If we had some of this effervescence come out of the hot parts of the market and I think where the vulnerability lies in those newly created exciting markets where you’ve got loss-making businesses. I think if one can avoid those, then you’re already in a better place.

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Yes. But I mean, although you don't buy the market, if the market corrects, the stocks you do own will also come down, right?

Yeah. I think the correlation among individual businesses is higher, the shorter the time period. If you take it to a day most things move in the same direction. But the longer you stretch your time horizon, the lower those correlations are, and the longer those time horizons, the more the fundamentals matter. And that's where investors should always be thinking is longer term, and that's very much how we think. So if you steer clear of businesses where the valuation or the durability of the business is not well underpinned by fundamentals and that the most important one being, of course, profitability and you extend your time horizon, then you're going to do yourself a couple of favours as an individual investor.

How did you go in 2020? It turned out to be not as bad a year, obviously as was expected. What was your 2020 performance like?

Yeah, you're right. It's a remarkable year, both in terms of share price performance, but also for international investors, the other relevant performance was the currency and the strength of the Australian dollar took us by surprise and the weakness of the US dollar. So international markets benchmarked to the MSCI in Australian dollars last year, up about 6 per cent. Our performance was up about half a percent, so marginally positive and a fair bit behind the broader market. The way I think about that is if I think 2020 served as an accelerator for a lot of new technology businesses as well as the effervescence and enthusiasm that we spoke of a few minutes ago, being reflected in the valuations of those cloud-based and new disruptive technology businesses and as investors, that's not our sweet spot.

We steer ourselves always towards durable businesses that have leadership positions in established markets that have been around a long time. On that dimension 2020 was not a great year for our performance. The other way to slice and dice the market is I think it was an amplifier for leadership businesses. We always like to own businesses that are strongest in their market, we own L'Oréal, which is by far and away, the world's strongest beauty company. We own Nike, we own Accenture and the operating performance of those leadership businesses also surprised us positively where they gained share at a rate even faster than a normal year. Now, the interesting thing to us is that wasn't always reflected in share price performance, but those businesses entered 2021 with a lot of operating momentum. Those leadership businesses have strengthened those number one positions, proved more profitable than many of their peers, and start this year in great shape. So that's what we own and it's why we feel very optimistic about the year ahead.

Right. But if those companies did okay last year, how come you didn't? Your performance was so far behind.

Well, the share price performance doesn't always match the operating performance, particularly over periods as short as a year and the heat of the market was really captured in an unusually narrow way in those newer technology businesses. In fact, you can measure in a number of different ways, but of the 2-3,000 companies that make up the MSCI International Index, a smaller portion of them outperformed the market than in any year, in the last 15 years. The market was unusually narrow and the performance was really made up by a remarkably small part of the market, which as I said, is not how we define our sweet spot. It was new, exciting, disruptive businesses and we go for leadership, established, profitable businesses.

The trouble is that a lot of these new, exciting growth businesses will turn into leadership businesses that are in your sweet spot at some point?

Yes, some, they will. I think one of the characteristics of new exciting markets is firstly, the way those markets are regulated hasn't been established. The buy now, pay later, I think is a good example of that. As with things like electric vehicles, it takes some years for regulation to catch up and how that influences the market, which may be very important through the fullness of time, is not yet set in stone. The second thing is in those new markets, the competitive structure is not established in an early market, like buy now, pay later. One business might look miles ahead, but it's a bit like the Tour de France, you know, there's more than a dozen stages and the rider that wins the first stage may be nowhere by the time you get to the finish line or, you know, mile one after a marathon.

We like businesses where the leading business has already been established. And if we think back to say Accenture or Nike, you can wind back five or even 10 years and they were already at that time the number one player in those markets. So to own them five or 10 years ago, you didn't have to make any heroic assumptions about who will be the number one IT outsourcing consulting business, or who will be the number one athletic apparel and shoe company and you can buy them knowing that you own the leader and that's where we like to own. Because the risk, if you buy today's leader and they end up being displaced by someone else in these fast-changing markets or regulation gets in the way and makes a material impact on profitability, it can be devastating for share price performance.

So, you know, with our conservative investor hat on we're willing to let those opportunities pass us by which really was where a lot of excitement was last year and steer our capital to these established leaders, like, as I said, the L'Oréal's and Costco is another one by far the leading retailer in their part of the retail market, we don't have to make any heroic assumptions about who's going to be tomorrow's winner.

What are some of the stocks you've been buying lately? And I'm thinking of Ryobi, I think Louis Vuitton you've bought again, Milwaukee, AEG, Hoover. Tell us about some of the things you've been buying?

Yeah, well, we repurchased LVMH the luxury goods business for the portfolio, having sold it back in April, really for risk reasons as the COVID period last April was really getting underway, we were wary of owning a business that at the time depended a lot on people travelling, on luxury goods. It depended a lot on its own stores for which it pays rent as opposed to selling through supermarkets or department stores where rent is someone else's issue. So that's why we sold it and not for price reasons, but through the second half of last year, we could see that the performance, the operating performance of the business was surpassing our expectations. The business was proving far more resilient than we expected, so we repurchased it for the portfolio in January. A couple of weeks after that the company reported their December quarter and full year 2020 results, which were excellent, consistent with what I said earlier about leading businesses, strengthening those leadership positions, strong, getting stronger.

You could see that through the market share gains in brands like Hennessy Cognac, Dior, Louis Vuitton, Bulgari, all had great years. So that's back in our portfolio and we couldn't be more pleased with what we saw from the operating performance. The other business you've touched on in terms of power tools, a Hong Kong-based business called Techtronic.

But it's very much a global business with the bulk of their shares happening in the United States. They own two primary battery-operated power tool businesses, Ryobi and Milwaukee tools, the former serving primarily the DIY market and the latter serving the pro market. And both of those businesses have gained consistent market share or consistently gain market share over the last decade. And a key part of that has been that both of them have a single battery platform such that I can own five different Ryobi battery-operated power tools, all of which use the same battery. And so I can interchange my one battery between the five tools. It means that when I'm purchasing a new tool, I don't have to buy another battery and it significantly lowers the cost of ownership for the purchaser.

Same is true of the Milwaukee tools in the pro market. They've got very effective, powerful, long lasting batteries and all their tools use the same battery platform. And as the market's moved from petrol or AC power to battery-operated then the Techtronic brands Ryobi and Milwaukee have been big winners. We see them very well positioned to continue to grow and gain market share.

So that's a Hong Kong company, you said?

The business was founded in Hong Kong and remains listed in Hong Kong, but the bulk of their sales are in North America. They also have a very strong business in Australia. We'd all be familiar with the Ryobi brand and a smaller contribution to sales from other parts of the world.

Do you own any of the big technology leaders, Facebook or even Microsoft?

No. None of the ones that you mentioned. We own other technology businesses. We own a small company called Jack Henry that provides software for small banks and credit unions in the United States. And we own Accenture, of course, in IT outsourcing and consulting, Amphenol that provides connectors. Whenever there's power, including electric vehicles, mobile phones, cars, then Amphenol's connectors have a role to play. So that's our participation in technology, but not the big FAANGs and trillion-dollar businesses that people will be more familiar with.

You also bought apparently S&P Global and then sold it again after they made a big acquisition. Don't you like acquisitions?

Well, the larger they are, the less we like them because it's a very, very strong correlation between the size of an acquisition relative to the acquiring company size and the future problems. That's not to say that things never turn out well. But the odds are increasingly small as that size gets larger. And in the case of S&P we loved the business pre-acquisition, they've got very strong positions in equity indexes, as well as research services, credit ratings. Many people would be familiar with the S&P ratings. But what they're buying is a business that we believe is not as good as what they are themselves, in IHS Global, is the name of the business they're merging or acquiring. And the challenges of bringing those two businesses together effectively can be enormous.

Of course, the acquiring company always tells a good story about synergies and, and future plans, but we know that it can suck huge energy out of an organisation when you're trying to make an acquisition of this size work. S&P Global's best people will be diverted from what they're doing today to integrating that acquisition because of course, it's important to make the acquisition work. But the opportunity cost comes because they're not doing tomorrow what they are doing today well, and those leadership positions get left vacant. There aren't the best people talking to their customers. There aren't the best people managing their own IT infrastructure. There's a lot of energy that gets pulled out of making the existing business work well. There's a lot of disruption. There's a lot of politics, and so we'd much rather sit on the sidelines. If it all works well then in five years' time, we'll take a fresh look. But we know that the odds are strongly against this all working as planned and we'd rather move our capital elsewhere where we can feel much more confident about not only the growth in the value of the business, but you know, the absence of these risks that so often come with large acquisitions.

Great to talk to you, Stephen. Thanks.

Right. Thanks, Alan.

That was Stephen Arnold, Managing Director and CIO of Aoris Investment Management.