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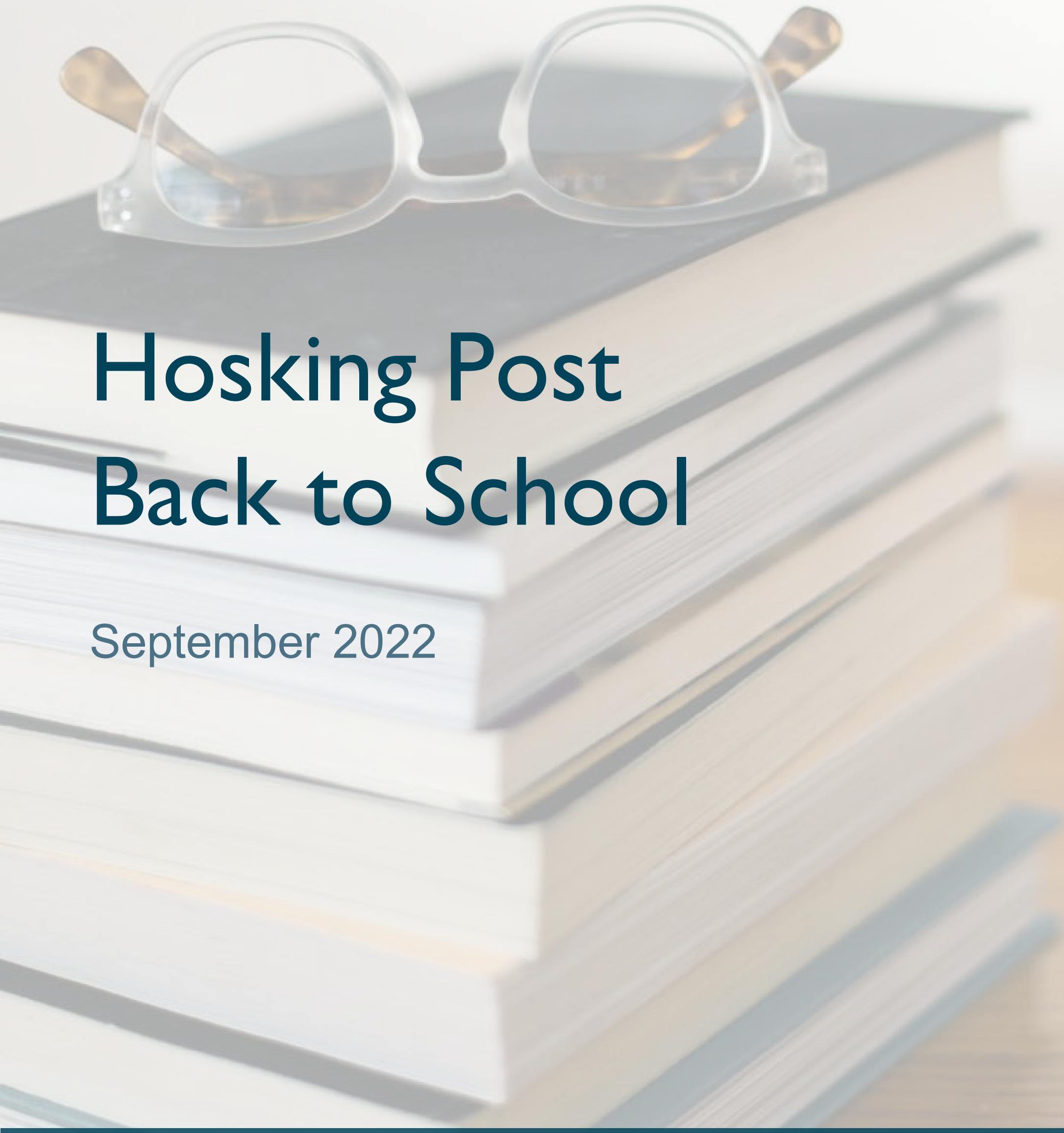

Hosking Post
Back to School

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BACK TO SCHOOL

"I never teach my pupils, I only provide the conditions in which they can learn"

Albert Einstein

I joined Hosking Partners in June this year, alongside Chris and Omar from whom you will hear and hopefully meet in the coming months. We are at the start of what is effectively a three-year postgraduate course in the Hosking Partners way of investing. However, we are not conventional postgraduates – between us we have many years investment experience under our belt, in my case 12 years, mostly as a global generalist. During the next three years, each of us three analysts will shadow a portfolio manager (or a pair of them) for six months at a time, using those portfolio managers' individual sleeves of the Hosking Partners portfolio as the basis for learning the Hosking Partners way. I have started by working with Jeremy and Jules, and the purpose of this blog is to share my experience of getting to grips with a contrarian and diversified portfolio with a multi-year investment horizon.

I guessed from the idiosyncratic individuals I met through the lengthy interview process that Hosking Partners was likely to be a quirky environment, but until my feet were under the table it was difficult to appreciate how different. The Hosking Partners structure has a heavy emphasis on portfolio manager autonomy, but in practice this is "autonomy with Hosking characteristics", these being a fundamental belief in the capital cycle approach to investment, and a transparent and open environment where debate is encouraged. The breadth of the Hosking Partners portfolio is huge, with potential investments analysed in all corners of the globe and in all sizes. I have been tasked with looking at opportunities arising from the increasing amount of activism in Japan, and potential bargains emerging from the recent wreckage of the IT sector and Chinese share market. At the same time, I have been getting up to speed with the tail of smaller positions in the portfolio, a key feature of Hosking Partners' contrarian and unconstrained approach, with the purpose of reviewing whether to size up or down. There are no investment silos at Hosking Partners.

Given high valuations of IT companies in recent years, this is an area Hosking Partners has only selectively looked at, but recent weakness may have offered up some gems at low valuations. Peter Lynch said "behind every stock, is a company. Find out what it is doing", so Jules has put me (and himself) on a crash course reading, meeting, analysing and then discussing and presenting various software, semiconductor and hardware companies. We have been struck by the egregious stock-based compensation that many companies have handed their management teams, as well as by the docile acceptance by the analyst community of the companies' use of "non-GAAP" adjustments. Companies like Salesforce, Autodesk, ServiceNow and Shopify award 10-35% of revenues in stock-based compensation each year, which seems to us a compensation structure better suited to a workers cooperative than a capitalist enterprise owned by external shareholders.

Among these companies, however, we have unearthed some gems with deep moats, strong capital allocation records and (increasingly) attractive valuations. Qualcomm's stranglehold on CDMA (code division multiple access) technology has represented a toll-booth for the mobile phone industry for many years, but it is now shifting the balance of its profits away from its dominant licensing business by growing its manufacturing division which offer chips across a number of applications. We view Qualcomm's record as a capital allocator favourably, which contrasts with our assessment of many in the sector. Market perceptions of the semiconductor testing company Teradyne seem not to have adjusted for the consolidation of the industry and the recently introduced "profit first, market share second" behaviour of its Japanese competitor, alongside whom it exists in a cosy duopoly. Autodesk enjoys dominance in many of its end markets and offers an essential product which architect and designer firms rely on for a subscription price which is a low percentage of their labour cost. However, the strength of its business model and the decline in its valuation need to be offset by a generous 11% of revenues paid in stock compensation; perhaps we should be mindful of the old maxim that the best is the enemy of the good. The ability of some of these licensing models to resist the volatility of business cycles has highlighted other companies such as MSCI, FICO, the rating agencies, NASDAQ and Euronext, and we are doing work on all of these to assess whether recent lower valuations offer a sufficiently attractive margin of safety.

This year's dramatic weakening of the yen against the dollar has brought the value of assets in Japan into sharp relief, but we have equally been struck by changes in corporate governance in Japan and their potential to unlock significant returns. Historically, Japanese companies have been less accountable to their shareholders than their peers overseas, with the result that the valuation spread between good and bad businesses in Japan is extreme. On my last visit to the country in 2018 I saw how attitudes to corporate governance and shareholder rights were beginning to change, although it was hard to perceive as it was my first investor trip to the country. While investigating the Third

Arrow of Abenomics (structural reform of the economy, named after the lamentably late prime minister Abe), Jeremy and I have gone from lukewarm to positively tepid on value investment prospects in the region.

Like prospectors for gold, as we have dug down into the deepening vein of Japanese activist situations we have come across nuggets of new ideas. While it is not our primary intention to initiate an activist campaign ourselves, we have nevertheless met like-minded investors with whom we can join forces to encourage change. It is clear we are adding force to a door that has already begun to be prised open. A number of Japanese stocks could return investors many multiples of their money if governance changes led to corporate practice and capital allocation that was merely average, let alone best-in-class. The potential of the opportunity is illustrated by some companies actually having negative enterprise values. We are working on a diverse range of prospects which are already engaged with their activist investors to a greater or lesser degree.

In Japan, investors' efforts to challenge poor corporate governance has been encouraged by the government as it tries to change attitudes and unlock value for society as a whole. Whereas in the Chinese politico-economy, it is the other way around. That country's leading technology companies are finding the terms of their licence to operate become increasingly reliant on greater cooperation with the communist regime. My last trip to China was in 2019 when the US trade war was at its peak: despite assuring me that US sanctions changed nothing, the following day Huawei fired most of its western coders. Share prices in Chinese tech companies have since collapsed and the risk/reward equation is markedly different. We have applied the slide rule and an open-mind to a swath of Chinese technology companies and concluded the range of outcomes remains extremely wide. Given such difficult-to-price risks we have set ourselves a high hurdle but feel that, for example, NetEase's valuation is excessively discounted. The opportunity for gaming companies which create domestic IP and are able to export it internationally is large and, at this juncture, undervalued by the market. One significant and positive difference in the case of NetEase is that it pays a consistent dividend, unlike most other Chinese technology companies.

Many of the valuation anomalies that draw our eye at the moment are linked, one way or another, to the market adapting to inflation. With this in mind I wrote a review of Anglo American exploring the valuation implications of a range of macro-economic scenarios against the backdrop of long-term mining cycles. Anglo's balance sheet is well capitalised to weather (and even take advantage of) near-term economic headwinds, and at the same time the stock is undervalued in light of underinvestment in the mining industry for almost a decade so far and the elongated period of elevated returns this should stimulate.

The Hosking Partners portfolio is characterised by a head of large positions and a tail of smaller positions, and I have also spent time on this tail. One approach I have taken is to apply a series of accounting tests and screens for risk factors as a starting point for investigation. The extent to which issues are discounted in the valuation of the stocks is not a trivial question to answer, because a portfolio as diversified as Hosking Partners' can accommodate more idiosyncratic single-stock risk than those of more concentrated competitors. This journey through one end of the portfolio has led us to re-underwriting the investment case for various portfolio holdings.

The coming months will see us dig deeper into some Japanese companies as we build familiarity with a number of special situations. In the US we are likely to build on the work we have already done in tech. Following an encouraging meeting with an American biotech company, and in light of valuation spreads and share price weakness, we are casting a beady eye over pharmaceuticals and biotech. Separately we are assessing the Chinese A-share market, where our supply-focused approach should be an advantage as we hunt for unappreciated capital cycles.

Chris, Omar and I will soon be joining Jeremy and Django at Harvard University for the three-day course on Investment Decisions and Behavioral Finance; a refresher for Jeremy and Django and an induction for Chris, Omar and myself. That will provide a forum for us to take a step back and reflect on our individual experiences as generalists, interrogate our thought processes. By sharing our ideas and challenging our biases we will grow a little.

An investor never stops learning and I personally look forward to sharing my thoughts with you over the coming years.

STEVE CHAMBERS
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