Investment Insights

Investment Deep Dive: A Roundtable With Bessemer's Equity Portfolio Managers

Peter Langas
Chief Portfolio Strategist

Alex Christie
Portfolio Manager

John Hall
Portfolio Manager

Michael Morrisroe
Portfolio Manager

Jeff Rutledge
Portfolio Manager

Highlights

- As we emerge from the worst of the COVID-19 pandemic in the U.S., internal equity mandates remain focused on investing over a long-term horizon.
- Bessemer's portfolio managers continue to seek companies with strong management teams, balance sheets, and cash flow generation potential.
- Bessemer's internally managed equity portfolios reflect the view that certain trends have been accelerated by the pandemic and that structural shifts may occur in some sectors.
- With greater confirmation of a positive path forward for the economy, Bessemer's equity portfolio managers have increased exposure to cyclical-oriented stocks.

Overview

Chief Portfolio Strategist Peter Langas recently hosted a roundtable discussion with Bessemer equity portfolio managers to delve deeper into how they are navigating the current market environment. He posed a number of questions to them, including how they are thinking about current holdings, earnings, valuations, and distressed sectors, and what themes and trends are emerging as we move forward in a post-pandemic world. This Investment Insights provides a summary of their conversation.

PL: Can you give an overview of the different equity strategies that you manage?

John Hall (U.S. Select)

A focus on quality is a unifying theme across all of our internal teams. Cash flow, competitive advantage, good balance sheets, and strong management teams — these are the hallmarks for companies that we aspire to own for long periods of time.

Implementation of our quality focus is expressed differently in the different portfolios: Mike Morrisroe and the SMID core team focus on small and mid-cap companies with a market capitalization of $25 billion dollars or below. It's a highly concentrated strategy. All other internally managed portfolios focus exclusively on large companies.

For Jeff Rutledge and the global team, half or more of the assets are located outside the U.S., and they have a fair amount of emerging markets exposure. It's also the largest portion of the Large Cap Strategies Mandate.

The second-largest portion is U.S. Select, which I and my team manage; it's exclusively focused on the U.S., and it also targets a dividend yield that has at least a 25% premium over the S&P 500. This dividend focus means we are structurally limited in terms of how much exposure we have to the faster-growing (and non-dividend-paying) companies in the marketplace.

Alex Christie and the Large Cap Core team don't have these limitations. They have a higher exposure to "growthier" companies as a part of their process and philosophy. They are mostly focused on the U.S., but they have a license to hold a material amount of non-U.S. companies and currently own seven great companies outside U.S.

PL: Cyclical and growth issues have been top of mind in recent months. Can you comment on positioning and portfolio moves toward more cyclical holdings?

Jeff Rutledge (Large Cap Global Equities)

We've seen an enormous run of high-quality, compounding stocks for the past decade; to the extent that they have been weaker lately, I would caution against drawing a strict parallel to the technology bubble burst. These are successful, competitive companies, and they generate a significant amount of cash flow — a key difference from the tech bubble. Valuations might move around, but we don't believe these companies will wane dramatically over time as we saw a decade ago.

With that said, we do believe the economy will rebound, and a number of factors suggest we could capture some upside opportunities in more cyclical companies' stocks.

Within Large Cap Global, we have made several changes to capture more of the cyclical upside. We trimmed our weightings in consumer staples, healthcare, and utilities — all defensive sectors. We also trimmed exposure to large technology stocks such as Facebook, Amazon, Apple, Google, and Microsoft, although not materially; we're still overweight these stocks and have maintained our sector exposure by adding to other names within the space.

We have added to economically sensitive sectors — energy, financials, and industrials (our largest increase in sectoral weight). And, along regional lines, we have added to emerging markets (with some semiconductor and other companies) and to Japan.

We do have to be careful about the more economically sensitive parts of the market, where companies tend not to be terrific long-term compounders. The challenge is finding companies that we can get comfortable with in terms of a long-term thesis. This often means looking for industrial or cyclical companies that have a structural reorganization or another internal factor that we believe will allow the company to do much better than simply buying beta.

PL: Can you give examples of companies that you would categorize as cyclical? What qualifies them as cyclical?

John Hall (U.S. Select)

It is important to distinguish among the various types of cyclical companies. We generally avoid boom/bust types of cyclical companies and instead seek high-quality companies with attractive visibility. Some ebbs and flows in the upside and downside of their earnings trajectories are inevitable, but we don't want to own companies that will lose money on the down cycle.

In U.S. Select, we reduced a substantial overweight to consumer staples and wanted more exposure to businesses that can benefit from reopening and stimulus, and what we expect will be a cyclical expansion in the economy. A few examples: Union Pacific Corporation, since railroads will benefit as we ship more goods, and Bank of America, a large and well-run bank, since faster economic growth will lead to high interest rates, which is good for banks. We added to Anthem, a large health insurer, since more workers mean more health insurance. We also added to Waste Management Inc., a very steady business that is more profitable because of its commercial (rather than residential) business. We sold our defensive REIT, Public Storage, a sleepy, slow grinder, and took a bit more risk out on the spectrum by investing in Simon Property Group Inc., which just acquired one of its largest competitors. The company is the largest mall operator in the U.S. It has a strong balance sheet and is exposed not only to reopening but also to the pent-up demand of consumers wanting to get out and go into stores.

Michael Morrisroe (Small & Mid Cap)

Typically, coming out of an economic downturn, you would buy some deep cyclicals, but the combination of a global pandemic and economic shutdown is anything but typical. For this recovery, it is important to make the distinction between true cyclical companies and durable companies that may have behaved like cyclicals as a result of the shutdown. A number of durable companies that we own went down materially in this period, and we expect them to recover this year due to pent-up demand.

For instance, we own a contact lens manufacturer, Cooper Companies Inc., and its business was impacted because people were not able (and then were reluctant) to go in for contact lens fittings. We also own a food distribution company, US Foods Holding Corporation, that primarily serves the restaurant industry, which in aggregate, is a pretty resilient industry. Not last year. It was hit hard as a result of the pandemic. That recovery is now starting, and it will produce meaningful earnings growth into next year. We believe these companies will have earnings trajectories more emblematic of cyclicals, but in reality, they are resilient franchises that we think will be in much better shape post 2022.

PL: How much further will we go with this? Are you adding more cyclical reopening types of stocks?

Alex Christie (Large Cap Core)

We evaluate this on a case by case basis. Some companies will have pent-up demand, some won't, and a lot has been priced in. We recently trimmed a reopening story, IQVIA, which does drug trials. When the pandemic started, it had to shut down, so the stock went down. We were confident that drug trials would resume, so we added to it last May — and then again in November and December — for more reopening exposure. The stock worked, and it became our largest active weight. Now, it's back to a normal story with no pent-up demand, so we trimmed and also trimmed Home Depot, another recovery beneficiary, and put the proceeds into Vulcan Materials, an aggregates (basically crushed stone) company. Aggregates are really low price-to-weight items, so they're not shipped into competing areas, and no one can start a new quarry because of NIMBY (the not in my backyard phenomenon), so you'll get regional monopolies with a ton of pricing power. With these purchases, we think we've found a high-quality way to play the midcycle economic expansion and a potential housing cycle — and even gain a free option on infrastructure.

PL: We're well into the first-quarter earnings reports. Can you characterize what you're seeing and provide any broad macro market themes that you may be gleaning from company comments?

Jeff Rutledge (Large Cap Global Equities)

Given the unprecedented events of the past year, establishing first-quarter estimates was particularly challenging for everyone. That said, most of the reports were good. Unfortunately, this was not true for the pharmaceutical companies. There were some beats and some raises, but mostly they missed estimates. There was a massive amount of stocking of their products in the first quarter of 2020, and this is what they blamed for many of their misses. They did hold their guidance for the full year, however, which suggests they're going to make up their shortfalls.

Tech reports were strong across the board, but valuations were high, and so in many cases tech stocks sold off even on very strong reports. Is that because people were worried about tech fundamentals, or were they worried about rising interest rates causing multiple compression? I would say it's the latter.

Now, the economically sensitive sectors — consumer discretionary, industrials, materials, banks — that's where you probably have the most confounding assumptions to make insofar as earnings drivers, and so ranges of estimates were wide. Nonetheless, we saw a lot of beats.

Banks are starting to report better earnings, but a lot of that has to do with the release of provisioning, or the building of reserves for potential losses that occurred last year. We're still not seeing terrific loan growth, although we suspect this will improve as the economy ramps up. Bank earnings could continue to be reasonably strong. The shape of the yield curve is going to have a large effect on that as well.

More broadly, I took away three things — and possibly a fourth that is not yet completely clear — from earnings.

First, companies are starting to give guidance after a year-long hiatus. That's really positive, and it lessens the uncertainty. Whether it reduces market volatility is not certain at this time.

Second, the semiconductor shortage seems to be a little more acute than we reasonably thought it was going to be, and it seems to be hitting autos particularly hard.

Third, we're starting to hear about labor supply shortages, and that seems to be most pronounced in some of the service industries — restaurants and some of the areas of the economy that shut down completely and where the alternative to working is to receive a stimulus check and opt not to return.

And the fourth thing — which is becoming evident, but it's not yet clear whether it's good or bad — is inflation. Companies are beginning to talk about inflation, wage rates, and raw material cost increases. Inflation in and of itself is not necessarily a bad thing. I think the important issue is how aggressive it is — how much it goes up and how rapidly it goes up.

PL: Speaking of inflation, John, can you share what you're seeing and hearing from companies about inflation and its impact on their businesses?

John Hall (U.S. Select)

I just read that mentions of inflation on earnings calls jumped 800% year over year this quarter. For myself, I can say that companies are talking about inflation more than at any other time I can remember in my 23 years at Bessemer. Companies are seeing wage pressures, labor availability pressures, commodity price pressures, and rising transportation costs. The situation was complicated by the winter storms that happened across the Midwest and Texas as well as the Suez Canal fiasco; there are delays on everything — some might be transitory, but some might linger.

On the commodity side, Mike and Alex would say that high prices cure high prices, so we'll likely see more supply come on in some of the commodity areas eventually. And don't forget that commodities in general are a small component of the cost structure for most of our companies. Over time, in fact, they've been quite deflationary, and there are secular deflationary forces at work.

Finally, I would say not to underestimate the companies we own, and even the companies we don't own. There are some great companies out there in terms of their ability to manage costs — deploying technology and automation, reorienting their businesses and supply chains to capture incremental cost savings, or even by making acquisitions. There are many things these companies can do in their defense, but yes, there are inflationary pressures, and companies are talking about raising prices pretty much across the board.

PL: How do you think about inflation when it comes to evaluating potential investments?

Michael Morrisroe (Small & Mid Cap)

We're all looking for "quality companies." Within SMID, we use a quality score composite of 10 different criteria. The top criterion is pricing power because we feel that that allows a company to derive value for its product. Often, that's related to its competitive advantage, and that can be because of its product — maybe it's hard to substitute because it's integrated into the workflows of the customer. Sometimes it can just be because of the competitive nature and dynamics of an industry. Consolidated industries, for instance, are generally more conducive to pricing power. One example within our portfolio is A.O. Smith, a leading water heater company in the U.S. The business is an oligopoly; essentially, three companies serve the North American market. Steel is the primary component of water heaters, and some grades of steel are up over 100% this year. A.O. Smith has enabled itself to put through price increases of over 30% this year, which will preserve its margin structures; importantly, when raw materials prices decline, the water heater prices often prove to be stickier, and there are margin enhancements. It's a great business.

PL: What about valuations? Is the overall market becoming overheated?

Alex Christie (Large Cap Core)

I think the market is pretty fairly valued. As soon as we get past the easy comps from the pandemic and we're able to grow at historical earnings growth rates of 5%-7% with a 2.0%-2.5% risk free rate and a 5% or 6%

equity risk premium, the dividend discount model tells us we should be paying 21x-23x, and that's where we are. There are some spots where valuations are tricky — some of the retail stocks, some of the thematic stocks, where we don't really know what the future holds and they don't earn any money — but the market has priced a lot in. Some of the defensive names seem like they're a bit undervalued and unloved. And some areas of the market appear to be betting on a cyclical recovery; banks, for instance, are at all-time-high multiples, so if we don't see a recovery and rates rise, they're overvalued, but we are expecting a recovery.

PL: How do valuations look for specific sectors?

John Hall (U.S. Select)

I'm going to echo some of Alex's comments about the overall market looking fairly valued. But there are always going to be areas of the market that look cheap, and they certainly look cheap for a reason. Just look at some of the energy companies. On a trailing basis, maybe they look unattractive; on a forward basis, maybe they look cheap, and they may also look cheap on price/book value. But there's a reason they're cheap: Their financial returns are not very good. If you look at FAANGM, on the surface, they look a little expensive, but if you look at the financial profile of these companies, they are some of the greatest financial engines that have ever existed. Their returns are astronomical, and their growth rates are mind blowing. The question is, how sustainable is it? It's not about cheapness. If you believe their growth rates are sustainable, then you buy them and never look back. That said, Netflix might be expensive, but Google and Facebook are not, in my view.

When I look at the U.S. Select portfolio, we have broad-based investments across all sectors. On a forward basis, we're trading at less than 20x, and we have a high degree of confidence that, on average, these companies are going to compound at double digits and throw off a 1.8% dividend yield. That seems very attractive. I would add that we're not struggling to find new ideas.

PL: I know we build our portfolios one stock at a time from the bottom up. When you put together all these different stocks that you like, what themes emerge?

Alex Christie (Large Cap Core)

We build portfolios from the bottom up, and we are not thematic investors, but we do have a bias for quality, growth, and pricing power, and these types of names tend to cluster in certain parts of the market and benefit from certain themes.

Cloud computing and digital transformation is a big theme across all the portfolios. In consumer, we have exposure to e-commerce. And within consumer discretionary, we're finding a lot of recovery plays — retailers, restaurants, and hotels. Another theme here is the Chinese consumer, where we're expecting years of double-digit growth.

A few more examples: digital advertising, beneficiaries of the increase in drug trials, payments (the move toward digital banking and neo banking), and — this is an important theme in all of our portfolios — the penetration of semiconductors into everything.

PL: Let's continue with semiconductors. The semiconductor shortage is currently a big issue. How is it affecting companies, and what do you see for the future?

Jeff Rutledge (Large Cap Global Equities)

For a host of reasons, semiconductor supply has fallen short of ever-expanding semiconductor chip demand. The automotive industry has been particularly impacted by the shortage as it found itself on the bottom of the priority list for semiconductor deliveries at the time of reopening. It's not alone; many industries are feeling the pinch.

Essentially, the list of products that demand semiconductors continues to grow. We call this the silicon intensity of the economy, and it's increasing. If your device or product or whatever it is you're holding, riding in, or living in has a plug or a battery, chances are it has a semiconductor inside it somewhere.

We own five semiconductor-related companies in our portfolios — one is a software designer, two are semiconductor companies, and two are semiconductor capital equipment companies. We believe they are among the highest-quality and most technologically sophisticated companies and are therefore protected throughout the industry.

PL: Finally, individual stocks. Please choose a specific stock to highlight and why you own it.

Michael Morrisroe (Small & Mid Cap)

We're looking for opportunities where the market is either overlooking some aspect of the story or overly discounting some short-term noise.

The stock I would highlight in this regard is Domino's Pizza. A few years ago, we'd looked at it and were concerned about valuation and the aggregators (DoorDash, Uber Eats, etc.) and what they would mean for pizza delivery. Then the pandemic happened, and that's been a huge windfall for pizza in general, and Domino's in particular. However, this has created concerns around the reopening and the next two or three quarters not looking so great in comparison. The stock has suffered, and when we purchased it, it was selling at a decade low relative to itself and to the market. Basically, the market gave us an opportunity, and looking out past the next few quarters, we believe Domino's should be able to compound in the low teens for the foreseeable future.

John Hall (U.S. Select)

I'm going to stick with the semiconductor theme and focus on Broadcom, a large semiconductor company and a clear leader in networking, broadband, and wireless. They also have a growing enterprise software business that we think is underappreciated because it grows slower than some of its other enterprise areas. They have a visionary leader, attractive margins and cash flow, pay a large dividend, and right now, the stock trades at a little over 15x earnings.

Jeff Rutledge (Large Cap Global Equities)

I'd like to highlight Siemens, a German industrial automation company. For a number of years, Siemens was generally considered to be lower quality compared with the other major industrials in Europe — largely because it had a robust energy-related business that put permanent pressure on the valuation. There were also concerns about poor management. But about eight months ago, Siemens spun off its energy-related businesses, eliminating its lower-return franchises. Over the past few years, Siemens has been building its portfolio by buying industrial internet-of-things types of software businesses, and they are in effect going to bring digital transformation to the factory floor (automotive manufacturing in particular). When we started looking at this stock, it was cheap at roughly 17x earnings vs. peers in the mid-20s. We also saw a company that was increasing in quality and also had businesses that were going to be accelerating due to an economic expansion and a few specific businesses that appeared particularly attractive. This is one of those cyclical companies where we had to get really comfortable with a long-term thesis, as opposed to just buying cyclical beta. We think we found that in Siemens, and it's one of our largest active-weight positions.

Conclusion

One of the most important concepts to be successful in investing over time is having a disciplined process and sticking with it over the long term. Based on our conversation today, it is clear that we have a strong discipline that we believe ultimately benefits our clients.

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