FINANCIAL REVIEW

Building a portfolio of inflation, recession-proof stocks

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The stunning recovery rally on Wall Street over the past month has reignited concerns that stock valuations look inflated, particularly as war rages on in Ukraine and the Federal Reserve kicks off its most aggressive tightening campaign in decades to tackle inflation.

But for Nick Markiewicz, who spearheads Lanyon Asset Management's global equity strategy, finding value in the recent bull market is all about digging beneath the surface.

"The view across our calls with companies last year was that inflation is here to stay, and that wasn't consistent with owning the expensive parts of the market," Nick Markiewicz says. ***Ben Searcy***

"The US market as a whole in aggregate is the most expensive it's ever been by a huge margin, but if you look at it by market cap weightings, it's really the top third of the market that has actually seen a significant re-rate," he says.

“On a simple measure, like price to book, the bottom two thirds of the market isn’t that different in terms of valuations compared to 10, 15, 20 years ago. So, there’s still a heap of small to mid-cap stocks that are trading at incredibly cheap valuations.”

The abundance of opportunities towards the smaller end of the market is why Markiewicz scaled down the Lanyon Global Value Fund’s historically high cash holding from around 55 per cent when he was appointed portfolio manager in September, to now sit around 30 per cent.

The decision to become more heavily invested but maintain some cash helped limit the fund’s net loss to 1.8 per cent in the month to February 28, compared to a 5.4 per cent drop by the MSCI All-Country World Index (ACWI).

Since Markiewicz officially took charge of the fund in October, following a five-year stint at Platinum Asset Management, the portfolio has returned 4.1 per cent against the MSCI ACWI’s 1.6 per cent loss.

While the global value portfolio can invest in companies of all sizes, Markiewicz describes the perfect stock as having a market capitalisation of $2 billion to $10 billion given they often fly under the radar of brokers.

“We are, unashamedly, value investors, which for us doesn’t just mean buying stocks on a low PE, it’s about buying stocks cheap relative to cumulative cash flows,” he says.

“The businesses we invest in are all very profitable, have great balance sheets, return a lot of capital to shareholders, and we aim not to pay too much for them, and hold them for a long period of time.”

Sticky inflation

Lanyon’s house view that inflation would not be transitory contributed to Markiewicz equipping the fund with companies that perform well in an environment of rising consumer prices which includes gold and oil stocks.

The fund's top holding at the beginning of March was Barrick, the world's second largest gold producer, with a 6 per cent weighting, while oil producers Shell and ConocoPhillips were also among its top 10 exposures.

The decision to invest heavily in oil stocks was also backed by a structural thesis, Markiewicz says.

"The ESG movement of the last five years has meant that a lot of these major oil and gas explorers and producers have spent less on expanding production and more on just running down and maintaining their existing assets," he says.

"We think there's probably half a trillion dollars of capital expenditure missing in the coming five to seven years, and so we're going to see very constrained output."

With a third of the fund exposed to Europe, it has experienced some volatility in the aftermath of Russia's invasion of Ukraine but Markiewicz notes that it didn't own any eastern European or Russian assets.

The fund instead has exposure to European banks which Markiewicz expects will benefit from an inflationary environment and rising interest rates. This includes a 4 per cent weighting in Bank of Ireland.

One of the holdings that was hit hardest by the war in Ukraine is BMW, due to the damage inflicted on the company's supply chain. But Lanyon has added to its position given Markiewicz describes it as the most compelling stock in the portfolio.

China temptation

While some global fund managers have chosen to avoid China altogether, 5 per cent of the global value portfolio is invested in the world's second largest economy, primarily through the megacap tech stocks.

And Markiewicz has been topping up the fund's position in Alibaba and Tencent in recent weeks.

"With Chinese stocks, you've got an obvious pocket of the market which is totally out of favour, and sentiment is as bad as I've ever seen, so valuations are at historic lows," Markiewicz says.

"But I think the government has recognised that these businesses are consequential to the economy, living standards and wealth of China, and I think the market got a bit spooked by the systematic sell down in these companies."

"When you get a hated sector at trough multiples and trough earnings, not much needs to change to make really good money."

The fund's growing position in China forms part of its exposure to Asia, which makes up around 28 per cent of the total portfolio, and also includes holdings in Japan and Australia.

While Lanyon also has a separate Australian Value Fund, which holds the majority of the firm's $740 million in funds under management, Markiewicz says he's happy to own Australian companies provided they have a key asset that is important globally, or the business operates in a global market.

This means the fund will never own an Australian bank, but currently has a position in Woodside as part of its positive outlook on the oil and gas sector.

A typical emerging market exposure for the fund is Mexican airport operator Aeropuertos del Sureste which Markiewicz describes as one of the highest margin businesses he's ever found.

"The company has effectively got software margins, no debt, traffic has already returned above pre-COVID levels, they have an amazing capital return policy to shareholders, and you can buy it on 16 or 17 times earnings," he says.

Starting young

Markiewicz's interest in financial markets began as a teenager around the dinner table where his mum, who worked on the currency desk at Citi, would discuss global news, and his dad, an entrepreneur that floated a business in the early 2000s, would talk about the company he ran.

"Those discussions around the dinner table got the ball rolling. I was always really fascinated by world events, and I just wanted a job where I could be part of what was going on in the world," he says.

After graduating university with an accounting and economics degree in 2008, Markiewicz started an internship at a Swiss bank during the global financial crisis.

"Working at a place that only narrowly survived the GFC, and then went through the European financial crisis straight after, shaped my view on markets and probably made me quite conservative and prudent in how I viewed the world," he says.

Markiewicz then spent three years as an equity research analyst at Credit Suisse, and a further three years at Morgan Stanley in the same role, before deciding he wanted to switch sides and become an investor.

This inspired a move to Platinum Asset Management where he worked as a global equity investor for five years, two of which overlapped with the firm's co-founder Kerr Neilson.

But an introduction to Lanyon's founder and managing director Dave Prescott by a former colleague led to Markiewicz making the switch last year.

"We both recognised this huge opportunity of investing in small to mid-cap companies that the larger funds simply can't touch because they're too big, and they can't get the liquidity, and that was a little frustration of mine," he says.

"It's easy to get access to large cap stocks via ETFs and fund managers, but there isn't really a global small and mid-cap value manager out there because the incremental dollars over the last 10 years have gone into tech funds, or disruption funds."

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