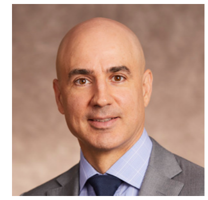
Highlights from Invaluable Insights 2022

PORTFOLIO MANAGER
Viewpoints

March 2022

Daniel J. O'Keefe, lead portfolio manager of the Artisan Partners Global Value Team, recently sat down with a panel of legendary value investors to discuss the current environment and offer perspectives on a wide range of timely topics, from geopolitical risk to inflation, and from valuation to China. We have shared Dan's insights here.



Daniel J. O'Keefe
Portfolio Manager

29 Years Investment Experience

On Russia and energy markets …

The biggest real economic risk is a greater energy shock. The GDP of Russia is effectively irrelevant, as it is a $1.5 trillion economy. For most companies, Russia represents about 1% or less of their revenue and profits, so Russia is not a meaningful GDP driver on the world stage. What is meaningful is that Germany derives 50% of its energy from Russian gas.

If Russia decides to stop selling gas to Europe, Europe will have to buy that gas somewhere else. This will drive prices up and Europe will likely go into a recession. That is the immediate economic risk. I think on the opposite end of that risk is the fact that 50% of Russia's exports are oil and gas and Russia certainly does not want to turn off the taps to Europe, because that is its source of hard currency. That helps handicap the risk of blown-up energy markets sending Europe into a recession.

On inflation…

I think inflation is going to be here for a while. When I talk to companies, not only is there inflation—wage inflation—but there continues to be significant undersupply of labor. If companies are going to incentivize labor to return to the workforce and continue to hire people, there is just going to be more inflation. It is that simple.

In the US, all of the subsidies that serve as extra insurance have already been taken away, at least in the immediate term. Certainly, some benefits like food stamps have not normalized. But I think for the most part, the wage subsidies and the income supports have largely been burned off.

A real shortage of labor is driving the wage inflation. Given how severe the shortages are, I think it will continue.

On companies' ability to manage inflation…

Global, multinational companies with operations in emerging markets may be better equipped than domestic US companies with CEOs who have never managed through inflation. For example, the management of Unilever and Danone is used to dealing with inflation with a lot of experience.

Managers move around, so it is hard to generalize. The CEO of a US company may not seem to know much about inflation, but she or he might have worked in a subsidiary where it did. But the larger point is true. Generally, the ranks of managers are less experienced with inflation than they were in the '70s or '80s.

On labor markets…

In my opinion, one of the reasons for the difference between what has happened in the US versus Europe with respect to what is referred to as the Great Resignation is the way government aid was distributed. In Continental Europe, people kept their jobs; they just went home, and the government picked up their paychecks. When it was time to come back from work, the connection between work and the individual had not been severed and people simply came back to work. In the US, that connection was severed. The subsidies were distributed through the state unemployment systems. Sending money directly severed the link between the person and the employer. As a result of that, an individual has to go out and find a new job. The situation is very different from Europe where that connection was never severed.

On the travel and leisure industry…

If there is inflation in, say, hotel room rates because of labor shortage or just strong demand for travel, that inflation is automatically passed through for OTAs (online travel agencies), which do not have a lot of labor costs because they are technology businesses. In a sense, investors in these companies have built in automatic inflation protection that some of the underlying assets do not necessarily have.

I believe there is a lot of pent-up demand for travel. People are desperate to travel and experience life again as soon as things open up. And with all the savings, particularly in the US, I think the demand could very quickly get past 2019 levels. If there is inflation on top of that, OTAs will benefit through a commission on higher room rates.

On Meta…

Meta was down recently because of a change in Apple's IOS privacy rules. Effectively that meant Meta was not able to track user activity across apps, which made the traceability and therefore the return on investment (ROI) of its customers' advertising spending less measurable.

It does not mean that the ROIs are unattractive; they are less measurable. Meta still grew and has been growing its revenue at a pace similar to Google in the past two years. However, Meta anticipates a slowdown as a result of ad budgets rolling over into this year with those IOS changes.

I do think that in this new IOS world, Meta's business model is less robust than it was in the old world. However, I do not know that it is meaningfully competitively disadvantaged versus a lot of the other advertisers. I think that the ROI presented to the advertising base is still very attractive.

Meta has a three billion user base and advertisers are going to want to access that. The multiple is now around 13 times earnings looking out 18 months. It is very cheap. It is not as great a business as it was prior to the new IOS changes, but it is still an excellent business. Plus, let's not forget the massive investment on the metaverse. If it does not work out, the margins are going to skyrocket as the project tails down. And if it does work out, value will be created out of what is now a capitalized cost into perpetuity.

On Chinese stocks…

There should be a higher risk premium on Chinese stocks. As an example, Alibaba trades at a single-digit multiple of free cash flow and around three to four times EBIT. It is the largest e-commerce company in the world levered to digitization and the expansion of the increasing wealth of the consumers and the middle class in China.

It is probably one of the cheapest companies in the world and one of the cheapest stocks I have ever seen for a business of that quality with that financial strength. The risk premium is through the roof. When you are evaluating it, you have to ask yourself: What has actually happened with regulations in China? What has the Chinese government actually done?

The government has intervened on merchant exclusivity, so it has made platforms more competitive. The government has intervened on payments exclusivity, so it has made payments systems more competitive. And the government has intervened on network exclusivity to make networks more interoperable and more competitive.

None of those things are irrational, and none of them are outside the bounds of what any developed world regulator would like to do but cannot because they have to do it through the legislative process that is more cumbersome and can take longer. Therefore, I do not view what has been done as irrational, albeit it has happened within the context of a command economy that can do whatever it wants.

In the case of Alibaba—which we own and have been buying—I do not see the Chinese government as a hand that is trying to destroy these business models. Rather, I infer the government is encouraging Alibaba to make investments in new areas that benefit certain sectors of the economy, which may also be reasonably viable business models over time. If those investments were excluded, Alibaba's enterprise value and multiple would go down even further because they are consuming 25-30% of profits on some of these areas. Notably, management recently said it is going to start to taper these investments.

Alibaba is an extraordinarily cheap security, in my view, more than discounting the fact that it is in China. I think there is a lot of cyclical pressure on the business as well because of the zero-COVID policy. The business is effectively stalled. But as the Chinese economy recovers, I think that business will come back.

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