Eiswert: Don't Get Lulled to Sleep in the Yield Trade

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Dave Eiswert
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EXECUTIVE SUMMARY

Since Dave Eiswert joined T. Rowe Price in 2003, he has had a worldwide focus—first as a technology analyst, then as portfolio manager of the Global Technology Strategy for almost four years, and now as portfolio manager of the Global Focused Growth Equity Strategy since 2012. In this interview, Dave outlines his views of the global investing landscape and his strategy.

What's your approach to managing a global strategy?

With this strategy, I'm not trying to give you the world. I'm trying to give you the greatest stocks, the best of the best. The strategy's two pillars are opportunity and choice. It's a multi-cap all-country portfolio—so it's the widest opportunity set offered by the firm. The opportunity is sophisticated because the firm has so many analysts and managers around the world feeding ideas. But that alone doesn't generate returns; making difficult choices does. The strategy is selective—with under 85 stocks—so we use a framework to concentrate on the best ideas. Put simply, I want holdings where the economics of the businesses are getting better over time.

What are the drivers of those business improvements?

At various times, they can vary in different regions, sectors, or industries. It could be an election in India, a regulatory change for an industrial firm, a new product cycle for a technology firm, an interest rate cycle for financials, or maybe a corporate management change. I'm looking for something that will drive improving returns on capital, equity, or assets—that will drive greater-than-average growth.

How much do valuations matter?

I look at valuations in multiple dimensions, not just at price-to-earnings or other such ratios but at an asset's strategic value, what it would cost to replace. For example, I own some companies that are under-earning normal profit margins. They look expensive, but they're actually cheap because their margins are going to be much higher in the future. While the price I pay matters, it mostly matters at the extremes, when companies are very expensive or very cheap.

The investment thesis really matters. One cheap stock that I bought two years ago was the generic drug company Hospira, but it also had a strong thesis. It was broken, under-earning, and spending to meet regulations; now it's a leader in biosimilars [drugs from living organisms' DNA], and in my opinion is likely to be a big growth driver in 2016–2017. Similarly, when I sell stocks, sometimes it's when valuations get to an unsustainable point, but mostly it's because the fundamentals have played out.

Is growth hard to find when overall global growth is relatively slow?

Many CEOs and investors have the misperception that we're going to be in a low-growth, low-yield environment forever. It's the "new normal." Many central banks are still infusing liquidity, corporations are conserving cash, investors are chasing yield and want stocks that perform like bonds, and there's an overall deflationary mindset. It's a strong narrative that can persist for years: There's no reason to invest in businesses, we'll never have inflation, and our kids won't want to own homes or cars. I am 100% sure that we are in a yield-chasing bubble right now—just like with the tech and housing bubbles.

However, once something is consensus, distortions start to set in. In reality, this "new normal" is a dialectic already beginning to destroy itself. Not enough investment means business capacities get stretched. So with any demand increase, there can be big product price increases because there's no excess capacity. That can mean tremendous incremental gains in revenue from adding just a bit of capacity—and that, in turn, can drive more investment.

How far down the road is that change?

It's already starting. For example, cement already is sold out in most major U.S. markets until 2016. After years of airline consolidation, seat price increases are outpacing inflation, even without the growth in add-on fees, and at some point the airlines will add planes because the incremental returns will be so high. There're U.S. shortages for 50% of all injectable drugs. In Spain, the number of major banks has dropped in recent years from about 40 to a handful; the same sort of consolidation has happened in Greek banking.

So while people think it's a no-growth world, supply bottlenecks are forming around us now. For example, you suddenly see some competition for bank deposits and loans in Spain, and all of the sudden net margins are expanding. But killing the deflationary mindset will take a long time. We're not there yet. But there're a lot of pockets—particularly in the more flexible, stable markets like the United States and United Kingdom—where price increases are back and incremental returns are fabulous.

As a result, how have you positioned your strategy?

I'm a bottom-up investor but looking at the portfolio top down, the most important sector is financials. I like companies such as J.P. Morgan Chase, Morgan Stanley, State Street, and TD Ameritrade. These stand out in a world where regulation is peaking, interest rates are likely to be rising, and volatility is increasing with the transition to a more inflationary world.

I'm also overweight technology, industrials, and consumer discretionary stocks—areas where there is a lot of change and industry structures and pricing can get better in a hurry. I'm underweight consumer staples; they're overpriced because they've appealed to the deflationary mindset.

Regionally, I've been overweight North America and underweight Europe because the United States has been recovering quicker and the euro was collapsing. But in the third quarter, I began rotating into Europe somewhat as its industrials and exporters corrected with the weaker euro, which should help fundamentals. Over time, as U.S. growth and higher rates weaken the euro, investments in Europe will become more attractive.

In emerging markets, I own Chinese Internet stocks, and have a relatively big position in the United Arab Emirates, in real estate, banks, and the global port company DP World. I also like the political changes in India so we're overweight there. One of my top holdings, Holcim, is a Swiss cement company that gets 25% of earnings in India and more than 50% in emerging markets altogether. I've stayed away from Russia and Eastern Europe.

Last word?

Over the next two to three years there will be a big transition. Don't follow the herd. The worst thing for an investor would be to get lulled to sleep in the yield trade—and then wake up and find out the world has changed.

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