02-08-2019 MoneyLife Interview of Brian Yacktman by Chuck Jaffe Transcript

Chuck: The last time Brian Yacktman was here, it was near the end of 2016. All he's done since then is lead the YCG enhanced fund to two* superior years in drastically different market conditions. Now he's back and ready to talk stocks today in the MoneyLife market call.

Yes, it's the MoneyLife market call. That's where we talk with experienced managers about how they do their jobs. What they look for that makes them say this is how you get the courage to buy something and this is how you get the courage to say its time to get out of it. And once we learn about how they do their jobs, we learn about what they're looking at now, what they like and dislike, and eventually we put them to your test with a little hold it or fold it at the end. I am very happy today, because I love finding money managers who articulate what they do well, and then have the track record to back it up. And my guest certainly does. He is Brian Yacktman. Now if the name rings a bell, well, yeah, Don Yacktman, his father, has been on the show, and Stephen Yacktman, his brother, has been on the show, but they work for the Yacktman Funds. Brian broke away and founded the YCG Funds a couple of years ago. And again, it's YCGEX for the YCG Enhanced Fund, ycgfunds.com for more information on the funds. Ycginvestments.com for more information on the firm. But a superior track record, and what's really interesting in the two years since he was last on the show. In 2017 the market was strong, and his fund was up more than his peers**, to finish near the top of its group, and in 2018 the market finished down, and his fund was down much less than the average in the group, to again finish near the top. That's the kind of thing that I think is interesting. Brian Yacktman, welcome back to MoneyLife!

Brian: Well, thank you. Thanks for having me back.

Chuck: We always start with methodology, and you know, your dad - he's kind of famous, and folks know him as a value guy, but your methodology, well, it's your own. It's not entirely dissimilar, but it's also not entirely similar. So explain how it works. What goes into the things you're looking for?

Brian: Well, in short, we're investing in global champions with enduring pricing power that can grow their volume long term without requiring a lot of capital, and oftentimes where we see high insider ownership so that the incentives are aligned.

Chuck: So, you want global leaders, and enduring pricing power, and all the other things that you just described there. First thing I've got to ask, how important is price in that. Second is, define enduring pricing power, because as a general rule, pricing power is something that doesn't necessarily last for that long. The minute you've got pricing power, everybody else prices to you and you lose it.

Brian: Of course, and so when you bring up price, of course price is a huge element because you need to make sure that the price in which you're buying these global champions is at a price at which we believe will produce attractive long-term returns. But we have to start at the business. Think of like if the stock market were to close down. And what I mean by that is if the stock market is crashing, it's essentially closed down; you want a business you could feel comfortable owning for the long run. And so it has to start with the business, and be a business analyst first, but then once we identify these great businesses, we're looking for the best businesses at the best prices possible. Now, you also asked about pricing power, and where we're coming from here is we have this overarching belief that innovation is going to continue at a relentless pace, things will be made better and get cheaper in real terms, after adjusting for inflation. Or in other words everything is becoming a smaller percentage of someone's budget. And there are very few companies in the world that can buck that trend and maintain a share of our budget, or essentially maintain a share of Gross Domestic Product ("GDP"). So we want a portfolio that's filled with those global champions, that can stem that tide through enduring pricing power, and as I said long term growth opportunities.

Chuck: Help somebody understand. What is a stock, what is a security that has enduring pricing power. But I'm going to ask for something a little more specific than that. I'm hoping it's going to be a stock where folks will see you got enduring pricing power, but you also have competition.

Brian: Well, there is competition in this space, but the one that comes to my mind, you know. One of the clearest examples of pricing power is Moody's. So, Moody's is definitely a global champion. They're essentially the globally networked language to rate bonds across the planet. And, humans don't want to put in all this time to learn multiple languages, not to mention a startup couldn't even replicate all of that rich historical context they have which allows ratings to be comparable across time. So there really only is room for a few of players. There is some competition. There's Moody's, S&P and Fitch. But it's kind of a cozy oligopoly. Many people try to encroach on it, but they've failed. And that's what gives them this enduring pricing power. Like I said, globally networked language, historical context, but also it's a small expense of the companies' budgets. It's only 6 basis points to rate your debt, but there's tremendous value to the consumer that's having their debt rated where it probably is roughly around 30-50 bps it reduces your cost of debt by having the rating on there. There's also this principal-agent problem, where the agents meaning the employees that work on behalf of the owners, the principals, they're not going to take risk on going with some lesser known competitor just because the benefit of saving your company maybe a little money on a startup. It's not going to work out – they're not going to be compensated if they're fired because a deal failed when everyone knows you should've just gotten your debt rated by these big two or three companies. So, the overarching this really fits in that pricing power, but also from a long term growth opportunity standpoint, it's essentially indexed to GDP, so as long as there's businesses that exist on the planet, they're going to issue debt to bring down the cost of capital, and they need to rollover their debt, and they'll use Moody's to rate it. And so as the economy expands over time and does more business, they will basically act like a toll taker on GDP, and they'll actually be even faster than GDP as the capital markets take share from bank lending over time. And the best part is it is so capital light, it allows an enormous amount of cash flow to be returned to shareholders and yet still be able to grow, So very enduring pricing power very long runway for growth, and right now I feel that the fear of rising rates in an over-indebted world has put a lot of pressure on the valuation, much more than is warranted, creating a wonderful buying opportunity.

Chuck: Well and that's Moody's, ticker MCO, and I should point out 'cause I didn't point out in asking, part of my reason for asking is that enduring pricing power is different from what some people would call wide moats. And it's not that you dislike wide moats necessarily, I think most people like it, but Moody's is not really a wide moat kind of company, even as you said - nobody wants to come up with a new language and change it, there's still the competition there, so it's not necessarily the wide moat kind of thing, and I wanted folks to understand that difference.

Brian: Yeah, and so, wide moats can lend to pricing power, but moats can be penetrated and what we're really trying to say is a company that can raise prices over a multi-decade period, because if you look across multiple industries, prices are being driven down relentlessly in real terms, everything is getting cheaper, but there's just a few hundred, two hundred types of business that we look at that say yeah, these guys they have the ability to continue to raise prices for long periods of time.

Chuck: What else stands out to you right now. What's another example of enduring pricing power.

Brian: well, another area that can help is when there's social status involved. So, Richemont is a global champion. They've got brands that have been around for over a hundred years. And by nature, humans are status seeking. Richemont's jewelry and watches – they're essentially used as a signaling mechanism to show to others, hey I'm valuable. I'm worth partnering with. And we believe that the Richemont brand portfolio such as Cartier will continue to convey these status symbols on a global level, which helps it keep that pricing power because it's a globally recognized symbol. And by definition they're able to raise they prices, because if their goods are easily obtainable, then it's no longer a good status symbol filter. And so, with the increasing global wealth over time, there are all these long-term growth volume opportunities. And they're net cash on the balance sheet, and I believe that fears on China are giving it a great valuation right now.

Chuck: And what makes you move away from something. If you find all the right things there, what makes you say time to go?

Brian: Well, a more recent example would be Hershey. They're an extremely profitable business with very high return on tangible assets, they have very strong brands that have shown that pricing power in the past, very small cost, people don't really pay attention or worry if the cost of your Reese's or Kit Kats continues to rise faster than inflation, and so while they're incredibly dominant with 45% market share domestically, we were becoming concerned with their inability to grow volume internationally. We saw they made a poor acquisition in China, and it seems they lack the expertise to tackle different taste preferences around the world. On top of that, we were becoming concerned as things go more online, you begin to lose the impulse buys that occur at the checkout counters and its very inefficient and pricy to ship a bag of chocolates on dry ice through the mail. So, ultimately not really a global champion, and we thought you we were missing out on some long-term growth opportunities, and would've rather played elsewhere.

Chuck: Well, as much as I love chocolate, I've got to say that when you're talking about Hershey, HSY, I have it in my portfolio. Guess I've got to look at it because it's been there for a long time, and it may not be the global champion I thought it was. Now it's time to find out how you feel about some stocks that my audience owns and is interested in.

Chuck: It's hold it or fold it time with Brian Yacktman. He's the founder and president of the YCG Funds. It's ycgfunds.com, ycginvestments.com, and the YCG Enhanced Fund, YCGEX. It gets four stars from Morningstar, and has been a stellar performer. Hold it or fold it, well that's where we put our guests to your test. To test our guests, send us your name, hometown, and the ticker symbols you're interested in. Hopefully you'll get into an interview soon. We're going to start with a request we've got from Richard in Chula Vista, CA for Walt Disney Company, that's DIS.

Brian: Well, one of the hardest things to do is disrupt your own business. But Disney knows that the direct-to-consumer channel is clearly the future, where you own the relationship, and they offer some of the best and most desirable content in the entire world. Their movie studios and parks have created this virtuous cycle, and perpetuates the value in the back catalog of their media franchises. As a result, since 1971, Disney park ticket prices have grown nearly 8% compounded, far in excess of inflation, so talk about some pricing power. In our view, the uncertainty around them switching the business model, disrupting their own business model has really created a buying opportunity in a global champion.

Chuck: That's a buy on Walt Disney Company; ticker symbol DIS. Our next request comes from Tom in Louisville, Kentucky. He wants to know about International Paper Company. That's IP.

Brian: This is a commodity business. Nobody cares whose paper they're buying, there's really no pricing power here. I've read that there are more trees today than when the pilgrims landed, and that forest growth has exceeded harvest since the 1940s. So I'll bet if you look at the price of a ream of paper in real terms, it's declined significantly, not to mention that there are more alternatives towards digital that's surely reducing paper consumption volume. So, here's a super capital intensive, cyclical business that's seen it's stock trade sideways for decades. I'm out.

Chuck: That's a fold on International Paper, ticker IP. Next for Dave in Beaver Dams, NY, it's Marsh & McLennan Companies, ticker MMC.

Brian: Well, if you're a fortune 500 company evaluating your business complex insurance needs, you basically have two choices, AON and Marsh & McLennan. They're both global champions with enduring pricing power, has a small cost to the budget of a firm, but far more efficient than if they tried to do it on their own, allowing them to maintain pricing. And they essentially act as a toll taker on the economic activity, so as long as there's business being conducted in the world, you're going to have insurance needs. And they get a piece of that action with inflation protection built in. And as an added bonus, it's not very capital intensive.

Chuck: That would be a buy on MMC, Marsh & McLennan. Our next request comes from Peter in Beaumont, TX, who wants to know about Lenovo Group. That ADR trades under LNVGY.

Brian: Technology is classically hyper-deflationary. Just consider the cell phone in your pocket, if it kept pace with inflation, all that it's capable of as a mini computer, GPS, music player, video player, etc. it'd cost over a million dollars today. And laptops are no exception, where the price has just been driven down. I wouldn't want to be up against that. It's simply an industry where the odds are stacked against you, so I wouldn't want to invest in it.

Chuck: That's a sell, a fold on Lenovo Group, LNVGY. And last, in the limited time we have left, for Sam in Homes Beach, FL, it's General Mills, Ticker GIS.

Brian: True, General Mills produces disposable goods, which makes this a fairly acyclical, high return on asset business with slow and steady unit growth, which might make you think that we're attracted to it, especially with all the difficulties surround the CPG industry and the valuation, but we question they're in categories with enduring pricing power. I'd much rather play in the cosmetic space with global champions such as L'Oreal or Estee Lauder, where cosmetics as a percent of GDP have actually grown their share of the budget over time. They're products are attractively in that universe desire for increasing attractiveness, and many people view makeup as so important for their self worth that if they fell on bad times, they'd rather eat ramen noodles at home than to show up in public without makeup, giving them enduring pricing power.

Chuck: So it's a sell on General Mills, GIS. But in there you heard about some other potential buys in Estee Lauder and L'Oreal, EL and LRLCY. And unfortunately we've come to the end of our time here with Brian Yacktman, but Brian it is great to have you back, it was two years. I hope it won't take us that long to get you back again. But thanks for the time.

Brian: Well, and thank you. Enjoyed it.

Chuck: Again folks, that's Brian Yacktman. He is the founder and president of the YCG Funds. YCGEX, the ticker symbol on the YCG Enhanced Funds learn more at ycgfunds.com. Learn more about his firm at ycginvestments.com. Now, maybe missed it, but Brian just during hold it fold it just talked about a couple of stocks we discussed with other people this week. I'll tell you whether he agreed or disagreed on some of those picks before we send you home and set you up for next week, right after this message.

Disclosures:

* 2 year returns for YCG Enhanced Fund versus S&P 500 TR USD.

	2017	**2018**
YCG Enhanced Fund (YCGEX)	22.79%	-3.21%
S&P 500 Total Return Index	21.83%	-4.38%

Returns for YCGEX are net of fees.

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Definition:

Basis point - a basis point is a unit of measure used in finance to describe the percentage change in the value or rate of a financial instruments. One basis point is equivalent to 0.01% (1/100th of a percent) or 0.0001 in decimal form.