DODGE & COX®

Podcast Transcript

Charles Pohl and Dana Emery Discuss Their Perspective on These Unprecedented Times

APRIL 2020

Scot Hoffman: Welcome to Dodge & Cox Investment Perspectives, where we take a close look at key themes in our investment portfolios. I'm Scot Hoffman in Communications. In this special edition, we are joined by Charles Pohl, Chairman and Chief Investment Officer, and Dana Emery, CEO and President of Dodge & Cox. Dana and Charles will discuss the market environment surrounding COVID-19 and how the firm's Investment Committees are navigating it by actively managing our investment portfolios, while staying focused on the long term. Dana is a member of both the Dodge & Cox Fixed Income Investment Committees, and Charles is a member of all three of the Dodge & Cox Equity Investment Committees. Welcome, Dana and Charles.

Dana Emery: Thank you.

Charles Pohl: Thank you, Scot.

Scot Hoffman: Dana, let's start with you. COVID-19 is affecting everyone around the world in some way, causing extraordinary disruption of business and the lives of individuals and families. How is Dodge & Cox operating now?

Dana Emery: As you said, Scot, the disruption has truly been extraordinary. First, our hearts go out to the individuals and families who have become sick or have lost loved ones to this virus. We're grateful to those on the front lines, especially healthcare workers treating patients and the researchers working hard to develop tests and vaccines. This has obviously been a very challenging time at a humanistic level with an unprecedented rapid disruption to the global economy. It's truly a black swan event, if you will. From an operating standpoint, Dodge & Cox moved to a work-from-home model in mid-March, doing our best to comply with the shelter-in-place orders in the Bay Area as well as California, and also in our London office. All of our teams are operating pretty well in this environment. We're very grateful to their work and dedication to make the best of a very challenging situation. And then we're also grateful to the confidence our clients have put in Dodge & Cox as we navigate this environment together.

Scot Hoffman: How does the COVID-19 pandemic compare to other periods of distress, if you look back over the five or six major events that you've both experienced over your 35 plus years at Dodge & Cox?

Charles Pohl: My career at Dodge & Cox certainly spans a number of periods of severe market distress: the 1987 crash, the 1998 Asian crisis and collapse of long-term capital, the collapse of the Internet bubble in the early 2000s, the 2008 financial crisis. So we've seen a lot of crises, and in the history of Dodge & Cox, of course, you know, we go back to the Great Depression and World War II. And the firm has navigated through all of these reasonably well. I think the important thing to keep in mind in all these situations is that we maintain a long-term, value-oriented perspective and we try not to get caught up in short-term panics. And in fact, sometimes the panicking of other people, based on their temporary nature, creates significant opportunities for us to outperform longer term. I think that's true of the current panic. COVID-19 is a terrible thing and it's causing terrible loss of life and enormous disruption to the economy, but it is likely to have a finite period of disruption. And by keeping focused on long-term value, I think we can gain some real opportunities here.

Dana Emery: Charles and I, along with several other senior members of our Investment team, have worked together through these many other periods that Charles mentioned. During our long time together at Dodge & Cox, we've navigated all these dislocations relatively well. This one seems different in the sense of the suddenness and the wide-reaching economic impacts of it globally. Social distancing, hygiene measures are currently our best defense to slowing the virus, but this comes at a significant economic cost. And what's different this time is the speed and size also of the central bank and government response to help calm the dislocated markets and to attempt to mitigate the hardships that have been faced by individuals, companies and governments alike. The Federal Reserve was ready in the sense that it was able to quickly implement programs that they developed in the aftermath of the financial crisis. Unfortunately, while the initial actions were decisive and massive by historical context, as the shelter-in-place mandates expand and also lengthen in time we expect that they'll need to pull more levers in the coming weeks to mitigate the challenges.

Scot Hoffman: With that as a backdrop, what steps are the Investment teams taking in this environment? More specifically, have COVID-19 and the oil price war going on at the same time caused our research teams to change their convictions about any of the investments that we hold?

Dana Emery: First, I think before I address that I'd like to just give a little bit of context. As the market reaction has been negative in almost all asset classes, valuations have swung wildly in recent weeks. Volatility measures are three times long-term averages, for example. And as the realization of the seriousness of the virus and the decision to move to a shelter-in-place as the best way to control the contagion, investors started to flee risky assets, often indiscriminately, selling really wherever they could gain liquidity. This was exacerbated by levered investors who were forced to sell to meet collateral calls. And as an example of flight-to-quality, we saw massive outflows from investment-grade bond funds and massive inflows into Treasury money market funds, just to give you a good example there. And the equity markets in the first quarter were down over 20%. Credit yield premium in both investment-grade and high-yield are at multi-year wides. Ten-year Treasuries hit an all-time low of 33 basis points in mid-March, ending the quarter at 68 basis points, and oil prices declined below the cost of production for most producers around the world. EM currencies declined precipitously. There's many more examples, but the bottom line is that in our view, there's significant pessimism imbedded in the current market crisis. As in past crises, depressed valuations often create significant future total return opportunities. We believe that this period will be no exception to that. The current valuations we think are going to offer opportunities for investors that do deep research like Dodge & Cox and embed very careful security selection, long horizons in our decision-making. And as in past periods, we always keep our research focused on the future. We incorporate new information into our models. We evaluate companies and other issuers' ability to weather the downturn, for example, looking at liquidity, access to capital, cost-cutting opportunities, capital cuts, asset sales—very much a credit analysis in many ways. And as always, we use extensive simulations to look at the fundamentals and potential total returns in base, up, and downside cases from these lower starting valuations.

Scot Hoffman: How have our Investment Committees thought about the risks within our portfolios? Charles we'll start with you on that question.

Charles Pohl: Well, you know, there are always risks in the investment markets and those don't necessarily change over time. But there are always things that are unexpected that crop up from time to time. I think the real thing to pay attention to, that we're trying to pay attention to is understand where the long-term values are. Prices have swung wildly for a lot of stocks. There's been a lot of forced liquidations in the market, and this creates some opportunities for us. The key thing that I think we're paying more attention to in this downturn is survivability. It's been very useful to have our credit teams from the fixed income area looking at some of our equity holdings, and we did this in 2008 as well very successfully, to ensure that the companies are survivable over the course of what most likely would be a very severe but relatively short downturn. And then once we establish that they are financially viable through this downturn, try to find the real values where others have maybe panicked and are willing to sell at unreasonably low prices, and try to increase our odds of outperforming in the future.

Scot Hoffman: Dana, what would you add to that?

Dana Emery: Our Investment Committees are actively at work trying to incorporate the new risks that this environment poses to future returns of our investments. Many of the topics that we're actively discussing include one, of course monitoring the COVID-19 cases and mortality rate, just to get a sense for the effectiveness of this social distancing policy. Data out of China and other Asian countries is going to be insightful in this regard, as they've been ahead of the West in addressing the virus and the data coming out of those areas are going to be very important to monitor. We also are utilizing our network of experts in the healthcare field to assess progress from tests, vaccines, potential efficacy of existing and new drugs, and obviously progress on much needed ventilator production. We're really optimistic about the progress that's being made, but probably not as soon as everybody would like to see it happen. We're also discussing the effectiveness of central bank and government responses to support the global economy, and we're also asking ourselves questions about once we're through the current crisis, which we would expect by late second quarter, early third quarter, really what is the new normal going to look like? How will this impact society, the way people live, the way businesses are run? Will there be more permanent changes to how companies finance themselves, allocate capital, what the regulatory response will be like. We're also actively debating oil prices, for example, and what the supply/demand shocks look like, how long we think oil prices will remain depressed at these levels. And we're also discussing future central bank policy. Will these extraordinary policies be unwound and over what pace? Will low rates actually be part of the solution going forward, as we work our way out of the debt that's been incurred during this period? That's massive amounts of debt being incurred by governments and are low rates really part of the solution going forward, as we attempt to pay down those debt levels? Obviously there's no easy answers. This is why we incorporate a wide range of scenarios, constantly try to talk with various experts and rerun our models as we make difficult investment decisions in this environment.

Scot Hoffman: How do our Investment teams stay focused on our long-term five-year investment horizon when you have so much changing around you and a flood of information in the market every day?

Charles Pohl: It's something that we've done throughout our entire history so it's kind of second nature to us, is to always focus on the long term. And if you're in the habit of doing that, it makes it easier, I think, to do in a time of crisis like this. But there certainly is a lot of distracting information coming across people's screens. You've got to sort through that carefully and try to understand if there's anything there that has a longer-term implication or not, and if it doesn't, to set that stuff aside and to focus on the long term.

Dana Emery: I think focus has always been a big part of how we run our firm and how we manage money. I think I'll highlight that we own ourselves. We've been independent throughout our 90-year history and that allows us to make decisions in the long-term best interest of our clients. We only have one business, which is asset management, so we're not spread thin in terms of thinking about a whole range of types of businesses. We also have relatively few investment strategies, all managed with a similar long-term, value-oriented philosophy so we're able to work together and stay focused on finding opportunity in this environment. So we're conducting our research as we always have done, staying in constant contact with companies and other issuers to test their assumptions and share our views on capital allocation and other investment decisions that will impact future returns.

Scot Hoffman: Business continuity planning at Dodge & Cox, like many other firms, is something that we focused on. But it's probably fair to say that we and others did not anticipate a disruption the length of what we've experienced with COVID-19. How have you and other senior members of the firm, our Investment Committees, our analysts, folks across Operations adapted to operating in this remote work environment?

Dana Emery: Remote work capabilities were always part of our business continuity planning, but we never had to put it in place for the entire firm and for such a long period of time. Having said that, it's gone very smoothly and we're very optimistic that we'll be able to operate well throughout this extended shelter at home environment. The biggest thing in this environment is communication. We've been encouraging our people to communicate often, using all the tools that are available to them: video conferencing, emails, chat, direct calls. And all the technology of that seems to be working very well. We're also having more frequent meetings across our Investment and our management teams across the firm. So we're having daily calls, sometimes multiple calls a day. Our view is that constant communication is going to be really key to success as we work in this remote environment. I would also mention that the value of having integrated teams in our investment side has really been highlighted in this environment. Our equity, fixed income, macro analysts and PMs are all working together to truly attempt to understand the risks that are imbedded in the current environment, as well as seek out various opportunities.

Charles Pohl: It's very different running these committees over WebEx or these video calls. But it's actually proven to be quite functional and, you know, we can have conversations using WebEx or Zoom or conference calls, much as we would have in our policy room. We're not physically next to each other but the process is functioning really quite well, I would say.

Scot Hoffman: How is the firm doing financially?

Dana Emery: The firm is in a very strong financial position. We've always run our firm conservatively, and we have strong liquidity, no debt. We have a small number of investment strategies, so we have low fixed costs that allow us to weather this environment well. Our independence is also a key advantage, as it allows us to stay focused on managing the assets entrusted to us and serving our clients well throughout this period.

Scot Hoffman: For our final question, we know the markets have the potential to deliver disappointing returns potentially for this year and beyond. Why are each of you optimistic as long-term investors?

Charles Pohl: I think from the point of view of our equity investments, if you look at this in a long-term context, we're coming off of a decade that is arguably the worst for value investing in history. And we are also at a point where valuation spreads are very close to their widest level ever. If we look at subsequent performance by value stocks compared to points where you had this level of valuation spread in the marketplace, performance of value stocks has been extraordinarily good. There's also a lot of opportunities that are being created, I think, by all the disruption in the market and we're evaluating those on a case-by-case basis, trying to pay strong attention to fundamentals, including, of course, the near-term liquidity situation of these companies, but staying focused on the long-term fundamentals. And we think that the combination of a great starting point for being a value investor plus the opportunities being caused by the disruption in this market potentially could yield very attractive returns going forward.

Dana Emery: I'm optimistic because starting valuation matters a great deal to future returns. In the fixed income markets, for example, we've experienced significant new issue volumes, very sizable price concessions and depressed valuations in the credit markets during this period. Given the contractual nature of fixed income, investment-grade yields often have a strong mean reversion tendency. So if we do our credit work correctly, we believe that this environment will be no exception and strong total returns are possible from these very depressed levels.

Scot Hoffman: Thank you, Dana and Charles.

Dana Emery: Thank you.

Charles Pohl: Thanks, Scot.

Scot Hoffman: And thank you for listening. This podcast was posted in April 2020. Statements in this podcast represent the opinions of the speakers expressed at the time the podcast was recorded, are not a complete analysis of every material fact concerning any market, industry or investment, and may change based on market and other conditions without notice. The statements are not intended to forecast or guarantee future events or results for any product or service or serve as investment advice or a recommendation to buy, sell or hold any security. Any securities identified are subject to change without notice and do not represent a fund's entire holdings. This podcast should not be copied, distributed, published or reproduced in whole or in part without express permission of Dodge & Cox. Before investing in any Dodge & Cox Fund, you should carefully consider the Fund's investment objectives, risks and charges and expenses. To obtain a Fund's prospectus and summary prospectus, which contain this and other important information, or for current month and performance figures, visit dodgeandcox.com or call 1-800-621-3979. Please read the prospectus and summary prospectus carefully before investing.