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Podcast Transcript

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Scot Hoffman: Welcome to Dodge & Cox Investment Perspectives, where we take a close look at key themes in our investment portfolios and other topics of interest to our clients. I'm Scot Hoffman in Communications. In this edition, we are joined by Dana Emery, CEO and President of Dodge & Cox and Charles Pohl, our Chairman and Chief Investment Officer. We'll talk with Dana and Charles about their thoughts on where we are one year into the COVID-19 pandemic. We'll look at the investment environment and rotation into value stocks in particular. We'll also touch on several important themes within our industry—including Diversity, Equity, and Inclusion, and ESG integration. And we'll wrap up with an update on a few strategic initiatives underway here at Dodge & Cox—notably our China research capability and our soon-to-be launched Emerging Markets Equity Strategy. Welcome to the conversation, Dana and Charles.

Dana Emery: Thank you.

Charles Pohl: Thank you, Scot.

Scot Hoffman: Dana, it's hard to believe that we recently eclipsed the one year mark when the CDC declared COVID-19 a global pandemic and one year of working from home. We'll be continuing in this work-from-home model through at least early September. Why are we extending it?

Dana Emery: Well, let me start by saying that this has been an extraordinary period—one truly unprecedented in Charles' and my careers at Dodge & Cox, and we're grateful to our clients for their continued confidence in our firm. We believe in the power of in-person collaboration and communication, and we are optimistic about vaccine rollouts and the prospect of herd immunity allowing us to be back together in the office later this year. But to your question, we've decided to extend our work-from-home model to early September because our primary consideration is the safety and well-being of our colleagues. In addition, clients and management teams of the companies and issuers we own in our investment portfolios have expressed their own sense of caution about not resuming in-person meetings too quickly. And overall, we're pleased with how this remote model has worked. We, like everyone, have had our challenges, but I think it's a real testament to the strength of our culture and the fortitude, flexibility, and focus of our colleagues across the firm that it's worked so well.

Scot Hoffman: Dana, what would we consider bringing forward into our operating model when we return to the office?

Dana Emery: Going forward, we're evaluating flexibility options within our working model—both to help continue to increase efficiencies in how we work and to help our own teams balance the needs of our firm with their outside interests. We're looking at three key areas: meeting effectiveness, hybrid structures in terms of where people work, and, thirdly, how they work. We're doing this analysis across the firm and at the job function level, and any changes will likely not be one size fits all. We also continue to talk with clients about their expectations in terms of meetings—whether more of those would be held virtually versus in person. And we're in the middle of this evaluation process now, and we plan to share any decisions we make later this year.

Scot Hoffman: Let's turn to the investment environment. Charles, Dana mentioned our optimism surrounding the rollout of vaccines and the prospect of herd immunity. What's your current assessment of the investment environment?

Charles Pohl: As Dana said, we are in the early stages but we are starting to benefit from a coordinated effort in the U.S. to get the vaccine into the arms of more people. But the picture is much more muddled around the world, especially in Europe where logistical setbacks have compounded with medical concerns to slow down vaccine rollouts. We're also starting to see a roll back of stay-at-home orders in the U.S. and in other regions, buoyed by the decline in new cases. Economic activity is already picking up in the U.S., although the data increasingly suggests the economic recovery will be uneven around the world—mirroring the differences in the size and scope of policy support measures. With recent fiscal stimulus, pent up demand, and household savings, we expect to see very strong economic growth post COVID-19. This should continue to benefit a number of sectors and strong companies within them. One example is banks with strong balance sheets, like those we own across our portfolios. They are also benefiting from steeper yield curves. Another is energy companies, some of which are well positioned to capitalize on the recovery in energy prices and expectations for an increase in demand for oil and other energy sources well into the future. A third example is companies in emerging markets, which suffered enormous dislocations due to the pandemic. Some emerging market economies are likely to stage impressive rebounds based on their unique characteristics. This should help fuel the profitability of a wide array of emerging market companies that still trade at significant discounts. And a fourth would be non-cyclicals like pharmaceutical companies. For example, in the first half of last year we trimmed pharma positions based on their high valuations and redeployed the proceeds into segments of the market that were trading at compelling valuations because of the pandemic. Fast forward to today, and relative valuations for certain pharma companies now look attractive again. It's also important to remember that Energy, Finance, and Emerging Markets were out of favor a year ago, amid fears of a prolonged economic downturn. However, we stuck to the principles of patience and persistence when our analysis of the companies we own in these sectors showed an extraordinary markdown of their valuations despite the underlying strength of their businesses.

Scot Hoffman: Charles, another major theme is the rotation towards value and away from growth stocks that's driven by continued quantitative easing and other factors. Where do you see the opportunities for value investors when you look out into the future?

Charles Pohl: That's right, Scot. For more than a decade, value stocks significantly underperformed growth stocks on a global basis. That divide really widened over the last three years, and many value stocks were marked down even further to exceptionally low levels surrounding worries about COVID-19. Since the vaccine announcements this past November, we have seen what appears to be more sustained appreciation for so-called value stocks. The market has turned against the high-growth companies, like high-priced technology companies that are attracting regulatory scrutiny due to their size, and begun to recognize the fundamental value in companies like banks and energy producers. Put another way, investors who were once willing to pay for substantial multiples for future earnings growth are now less willing to give these growth companies the benefit of the doubt. We believe the odds are stacked in value's favor on a relative basis versus growth when it comes to future earnings growth, capital returns, dividend yield, and valuation. But that does not mean you should simply own what is in the value index. Many companies trade at a discount for good reason, but that's why fundamental analysis is so important. Our Funds are well positioned, especially with the valuation gap between value and growth stocks as wide as it still is today.

Scot Hoffman: Dana, you sit on all our Fixed Income Investment Committees, and I know we have grappled with the issue of low interest rates since the global financial crisis. But in the last several weeks, we've seen rising yields and rates despite expectations of lower for longer rates. What's driving this, and how are we thinking about the opportunity for both U.S. and global fixed income investors?

Dana Emery: The recent steepening of the U.S. yield curve has been primarily driven by improved growth prospects and inflation expectations. The larger context is highly stimulative policies, pent-up savings, and the gradual unwinding of economic lockdowns. The growth forecasts have been revised upward, especially following the passage of the recent fiscal stimulus measures worth $1.9 trillion in the U.S. In addition, the Federal Reserve's commitment to low rates, quantitative easing, and its new average-inflation-targeting framework, have also contributed to rising inflation expectations. The result is that long-end yields have risen, but they remain low by historic standards and they offer negative inflation-adjusted rates. Curves of other developed markets have also steepened, albeit to a lesser extent. Our cautious duration approach has paid off in this environment, especially given how quickly rates have risen. In addition our funds have a high exposure to spread products—both in corporate credit and structured products which help build yield in the total return potential of our strategies. And our Global Bond Fund adds exposure to a set of carefully selected international securities, which we believe offer attractive yields and/or currency appreciation potential. So all in, based on careful research, we continue to find attractive risk-reward opportunities in fixed income over our three- to five- year investment horizon.

Scot Hoffman: Dana, let me follow up on one aspect of that. We've historically focused on absolute return in the way we construct our fixed income portfolios. Have we made any changes to our approach, and why should investors hold bonds in an environment like this one?

Dana Emery: That's right, our philosophy has always been to position our portfolios with the potential to perform well in a variety of scenarios over an extended time period. We do that by sticking to our valuation discipline, having a long-term investment horizon, and a total return mindset. This often leads us to take positions in securities, sectors, or interest rate exposures that are substantially different than our performance benchmarks. To put that in current context, the steepening of the yield curve has been fueled by "good news," but we are cognizant of two-sided risks to that outlook. Long-end yields could decline again if the virus reignites, vaccine rollouts fail, or the Fed expands its easing. Or they could rise further if the market perceives that the Fed is behind the curve facing possibly stronger reflation dynamics, or if the Fed changes its tack. So we are also looking at the developments in other large economies that reverberate across the fixed income markets. For example, the ECB recently decided to ramp up its asset purchases to fight off a tightening of fiscal conditions as yields have risen. This and other major central bank actions could tilt the balance of global risks around growth and inflation, or open roads of economic divergence. So we believe our active management style helps us navigate those cross-currents effectively for the benefit of our clients. We can be agile in terms of responding to the change in circumstances, while keeping our eyes firmly focused on the long run. This is key to generating satisfactory returns for our bond investors in the face of headwinds imposed by rising yields, which causes price declines in fixed income securities. It helps us find exposure to income potential, as I mentioned earlier, while preserving some protection against rising rates. And this is a delicate balancing act, but we're confident that our approach will continue to help us deliver good results for our clients over the long run.

Scot Hoffman: Dana and Charles, this is a question for both of you. We've continued to make and really deliver on key decisions for the firm over the last year. Many of these are focused on building on the investments we've been making over the last several decades to enhance our investment research capability. Would both of you walk us through the highlights of this journey? And let's start with you, Charles.

Charles Pohl: I would start by saying that we approach investing with the same focus that we always have: we use fundamental research to find equity and fixed income securities of solid business franchises or other issuers that we believe are undervalued and create long-term return opportunities for our clients. We have enhanced the way we do that over time. First, we have strengthened our global research and investment capabilities as U.S. companies became multinationals over the past several decades. In turn, this has enabled us to build our knowledge base and expand our investment strategies from U.S. equities and fixed income to becoming a global manager. Second, we have beefed up our approach to risk management. We have hired PhDs and investment professionals with quantitative expertise. Across equity and fixed income, our teams have integrated a lot of work on risk modeling, portfolio analytics, ESG data, and decision-making inputs. The benefits of using quantitative tools and quantitative experts is that we are better able to measure risk across a bigger universe of individual securities and at the portfolio level. Third, we have improved our decision-making processes to reduce behavioral biases. We want our Investment Committees to arrive at conclusions with clear independent thinking after vigorous debate. Our use of double-blind voting and a designated devil's advocate on each investment idea our analysts present minimizes groupthink and underpins a hallmark of our firm: effective team decision-making.

Scot Hoffman: Thank you Charles. Dana, what would you highlight in addition to what Charles said?

Dana Emery: We've also built out a very robust macro team with data and model development expertise that has deepened and broadened our understanding of the global markets, sovereign economic, political, policy environments, rates, and currencies. We incorporate the views of this team into our projections of the range of outcomes our equity and fixed income could achieve, and that helps us construct portfolios with even greater confidence. This expertise has also led us to launch our global fixed income strategy over five years ago now. In addition, I would highlight that we've integrated material environmental, social, and governance, or ESG, factors into our investment process as a long-term owner of companies and fixed income securities. We believe that we have a responsibility to conduct thorough research on ESG variables, to look for those material factors that could impact investment outcomes, and to engage with company managements teams and Boards, as appropriate, as active owners on behalf of our shareholders and clients. Recently, we formalized our process by creating an ESG Research Steering Committee to evaluate expanding data sources and to deepen our analytic tools that support this work. Steve Voorhis, who has assumed the Director of Research role in anticipation of Bryan Cameron's retirement, has oversight responsibility of the Committee.

Scot Hoffman: Dana, increasingly, we're receiving questions about our own diversity and sustainability initiatives at Dodge & Cox. What are the key takeaways that you would emphasize?

Dana Emery: We're a team-oriented firm that has recognized the importance of diversity of thought and inclusiveness in our decision making throughout our history. For the last several years, we have embarked on a journey to formalize a more intentional focus on diversity, equity, and inclusion, which is also referred to as DE&I. To guide this work, we created a DE&I Committee comprised of a team of individuals across the firm. I join the committee meetings on a quarterly basis to review the progress we are making on our key priorities—both internally and externally.

Scot Hoffman: What are the priorities of this Committee?

Dana Emery: The first is all aspects of employee engagement from education to training on this important topic. The second is focused on recruiting—from building our recruiting pipeline to enhancing our interview process. For many years, we've had a robust summer internship program which allows us to get to know candidates really well. To attract diverse candidates to our internship program and our full-time positions, we've developed a strong partnership with organizations like Girls Who Invest and the Ron Brown Scholar Program, aimed at creating greater opportunities within investment management and the financial services industry overall for women and African American students, respectively. The third initiative centers on our efforts outside the firm, both engagement with clients and consultants and the leadership role we've taken within the industry by participating in key industry groups on this topic and sponsoring and speaking at conferences. The fourth initiative is driving greater alignment of our charitable giving with our DE&I initiatives. Our firm's commitment to community goes back to our very founding and the instrumental role our founders played in establishing what subsequently became the United Way of the Bay Area. And today, our focus areas include providing educational access and opportunities for minorities and young women interested in careers in finance, as well as social justice initiatives. In terms of our firm's sustainability efforts, our Sustainability Committee is focused on our role as stewards of the environment with a number of initiatives designed to reduce our carbon footprint as a firm.

Scot Hoffman: Charles, we've received some specific questions regarding the portfolio director role for our strategies. Can you speak to what this role entails?

Charles Pohl: Sure. We've recognized the need to drive even greater focus and coordination around the priorities of the Investment Committees, so we have introduced the concept of a portfolio director among the members of each Committee. These individuals—we have one for each investment strategy—coordinate agendas and the focus areas the Committee may want to explore in its management of the portfolio. While this is a coordination role, decision making for the portfolio is the responsibility of the Investment Committee as it has been throughout our history.

Scot Hoffman: Charles, let's turn to another topic: China is one of several areas where we have incrementally built out our research expertise. How has that led to new investment opportunities for our clients, even as we've had to curtail research trips because of the pandemic?

Charles Pohl: Over the past several decades, we have closely followed China's emergence as the second largest economy and the second largest stock market in the world. We have invested successfully in some of the country's largest companies through the International Stock Fund and the Global Stock Fund. And we have augmented our global research team with Global Industry Analysts and Research Associates who are Chinese nationals—bringing important language skills and cultural understanding to our firm. Today, China accounts for approximately 40% of the value of the MSCI Emerging Markets Index, or half the Index when taking into account the number of companies represented. Over the next two decades, we believe that China will become further integrated into the global capital markets and economists predict that China will emerge as the largest economy in the world. Taken together, these factors create significant long-term investment opportunities for our clients through our International and Global Equity, Global Fixed Income, and soon-to-be-launched Emerging Markets Equity strategy.

Scot Hoffman: Dana, we've also submitted an application to operate a research office there, in China. Yet we've also emphasized one single investment office in San Francisco as really important. Two questions for you: What led us to make this decision, and how will we integrate the new office into our research effort?

Dana Emery: Upon obtaining the license, we're establishing this office in Shanghai to capitalize on the opportunities that Charles mentioned and to further deepen our China expertise. We believe that having a local presence should provide even more direct access to company management teams, enable us to foster relationships with Chinese regulators, and, ultimately, build the brand recognition of Dodge & Cox in China. To your question about operating the office, this team will be fully integrated into our research efforts across the firm, augmenting the existing team Charles referenced earlier. Before the pandemic, many of our Global Industry Analysts and Investment Commitment members made frequent research trips to China and an office there will us help facilitate extended trips, augment our due diligence, and deepen our knowledge sharing.

Scot Hoffman: Charles, we recently announced to our clients that we will be launching an Emerging Market Stock Fund this year. Why is now the right time to do this and what's the long-term opportunity that we are playing for?

Charles Pohl: Well, let me start by laying out some context. Over the last several decades, the globalization of capital markets, trade, and emerging economies has created significant long-term investment opportunities for our clients. We have built out our team to respond to those opportunities and gained substantial knowledge and expertise investing across emerging markets. Over the past three years, we have drawn on this strong foundation of global research and investment expertise to launch and manage a private Emerging Market Equity Fund. This work has affirmed our belief that emerging markets offer some of the world's most compelling equity investment opportunities. Why do we believe that? These companies are often exposed to stronger underlying growth and often offer a valuation discount for a variety of reasons. Many of them are also under-researched and therefore underappreciated. We believe our research can uncover more opportunities to benefit our clients through a dedicated emerging market strategy—one that will be grounded in the same long-term, value-oriented investment philosophy that continues to guide our firm 90 years after our founding.

Scot Hoffman: What closing thoughts would each of you like to share as we wrap up? Dana, let's start with you.

Dana Emery: Thank you, Scot. This last year has been extraordinary in the way that the pandemic has affected the lives of individuals and families, the way businesses operate around the world, and in the capital markets. We've experienced tremendous volatility in the equity and fixed income markets, but this has created significant opportunities for long-term, value-oriented investors, like Dodge & Cox. I also want to take this moment to thank our clients for your patience, persistence, and confidence in Dodge & Cox.

Scot Hoffman: Charles, what would you add?

Charles Pohl: I would like to echo Dana's thanks for our clients and emphasize how optimistic I am about the future of value investing. I continue to believe that the long-term opportunity for value investors is compelling.

Scot Hoffman: Thank you, Dana and Charles, for this great discussion. And we want to thank all of you for listening. If you have any questions or comments, we encourage you to reach out to your Client Service contact.

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