Dan Davidowitz (Polen Capital) – Compounding Made Simple

Tom Yeowart: Dan, welcome to the podcast. Thank you very much for coming on. Thank you for having me. So, I believe you studied Public Health at university in the States, and I'd just love to understand a bit about how you chose public health as a subject, but then also how you pivoted to investment.

Dan Davidowitz: Like a lot of things in my life, Tom, there wasn't a well thought out plan that happened here. I originally wanted to be a physician. I wanted to be a doctor, probably because my parents had some expectation that that might be something that I would do. But I quickly realized that some of the aptitude and science and mathematics I was going to struggle with. And so, I started to think, you know, maybe that wasn't the path. And then I thought maybe I'd be kind of interested in business. And then I found at Rutgers University, which is where I went, they had a Major, like you said, called Public Health and Public Health had two different concentrations. There was a concentration in epidemiology, which is somewhat interesting. And if I had known a global pandemic would come years later, might have been a great way to go, or hospital administration. And so that was interesting to me because it took that interest in healthcare, the interest in business and kind of blended it into one.

And so that was the idea, was to work in hospitals as a hospital administrator, which I actually did after I graduated. I worked at Sloan Kettering Cancer Center in New York City for five years, not really hospital administration. I wasn't at that level, obviously right out of school. I was more of an analyst, almost like a business analyst for the hospital and the physicians that work for the hospital. The pivot happened to investing in the late 1990s, and as we know, that was when the tech bubble was happening, and so I was attracted to all thing's investments at the time, not really smartly, not for the right reasons. I was in graduate school at the time, part time, while I was still working at the hospital. And that's really what kind of changed my interest. But again, it wasn't like a well thought out plan. It definitely wasn't for the right reasons. But I started to kind of figure out a little bit about investing and how I could do research around that time. So, it took it took a while, honestly, for me to figure it out.

Tom Yeowart: Has your experience in hospital administration at all informed the way you invest in healthcare?

Dan Davidowitz: Long before I got to Polen Capital, I think we were already kind of aligned in finding great health care businesses that had kind of a safety element to them. And growth too.

What I have probably is a little bit of bias in me about health care. I know how difficult the healthcare industry is from the inside. I know that there are certain businesses that are very, very difficult to have sustainable profitability. And for a long time, there was a decent sized cohort of publicly traded hospital companies in the United States. In my career, I worked at three different hospitals. I know from the inside how hard it is to make money in those businesses and in the regulatory environment around them, the reimbursement environment. So, we've kind of always steered clear of those, but that was before me too.

What we've always kind of looked for in all companies, but certainly in healthcare are businesses that are very unique, that have something special to them that allows them to grow for very long periods of time, knowing that the backdrop for a lot of the healthcare industry is a lot of regulation and regulatory issues. So, we try to find companies that should be able to thrive regardless of that.

George Viney: Dan, I'm fascinated by the early phases of your career, because as you highlighted, you're hooked in like many in the late nineties by the dot com mania and the excitement, the novelty that came with that. And yet your first job in the industry was at Value Line. And then on the asset manager side at a deep value asset manager. You have progressively, I imagine, but maybe in leaps and bounds, and you can talk to us about that, made this transition towards being a US focus quality growth manager. So, explain to us how that happens. And what were the major influences and inspirations along the way?

Dan Davidowitz: Yeah, it sounds like I was somewhat contrarian in my thinking, but again, it wasn't like a well thought out plan on my part. At the time when I graduated from my master’s program, again, it was at night while I was working at the hospital, and I wanted to make that pivot to equity research, and this is 1999. Nobody really wanted to hire me. I didn't have any credentials that would impress anybody. You know, I was going to get a master’s degree at night from a city university in New York. And I think, by the way, Baruch is a fantastic school, but it's not NYU and it's not Columbia. It doesn't have that same cachet. And I was coming from the healthcare industry. I didn't really have any relevant research experience. And so, nobody would hire me essentially. I was having a tough time getting a job. And Value Line was the only place that would really show any interest in me. And for those of your listeners that don't know Value Line, it's one page tear sheets on 1,700 different stocks. It's very simple, straightforward. It's kind of the old school way of researching companies. And they don't pay very much. I took a huge pay cut from a not-for-profit hospital to go work there. But I needed the experience, and it was a great learning place for me.

I was quickly out of there after a little over a year, year and a half. But I was hired from a former value liner who was a director of research at a deep value shop. And by this time now, it's well into 2000, the Tech bubble had started to burst. And so, all of a sudden, the attractiveness of a deep value strategy sounded right. At that time, I was really starting to understand Ben Graham and Warren Buffett and realizing what was going on at the moment, it felt like a good place for me to go and it was great also, I learned a lot there. I worked at that shop in New Jersey for five years. And again, I got a lot of hands-on experience in research.

And I also started to learn what made an interesting investment to me. And what I found out is kind of deep value, contrarian type investing is not really what I was very good at, or all that interested in either. I was really interested in at that time what we call today compounders, back then it was just growth companies and I looked for other managers who ran concentrated, high quality compounder type portfolios, and Polen Capital was one of them. One of my friends was interviewing at Polen Capital at that time for a research analyst position, decided he didn't want to move to Florida, and then he recommended it to me, and he said this place is exactly what you like as far as investing goes and recommended it to me and it was awesome. It was a really great experience for me to finally find a place that aligned with the way I had finally developed my own kind of thoughts around investing.

George Viney: So, when you arrived at Polen, you already had a good sense of wanting to invest in the way that Polen did. It's not like you arrived at Polen, you were then indoctrinated into their methods. It was more of a meeting of minds.

Dan Davidowitz: Yeah, that's exactly what I thought. Finally, I'm going to find a firm that aligns with the way I think. Only to realize that I really hadn't fully evolved yet. When I had gotten to Polen Capital, I was pretty steeped in the value way of doing things and very, very valuation sensitive. And so, when I was learning from David Polen and Damon Ficklin, who had already been here for a couple of years, I still had a strong bias on it had to be cheap in order for us to buy it. And if it was no longer cheap, we had to sell it. And I had to have that kind of beaten out of me a little bit. To be a little less sensitive on companies that are constantly increasing their intrinsic value, to not be overly precise on valuation.

Tom Yeowart: What were the other key lessons you learnt from David Polen?

Dan Davidowitz: The biggest one was to not make it complicated. When I was at that other firm, we were kind of always researching companies that had problems, right? Because they had to be cheap, and if they're cheap, there's either a temporary or permanent problem, and you're trying to figure out which one it is and is the market overly punishing the company. So, you end up in complexity all the time. I remember doing a ton of work on Dow Chemical Company and their asbestos liabilities, their agent orange liabilities, like all of these things, how could you possibly know what the liability and risks are of those things. And I was trying. I was doing my best to figure out whether or not the stock was overly punished based on some existential belief about their long tail liabilities.

And then I come here to Polen Capital and the first thing that David Polen had me look at was Microsoft's 10K in 2005. And the one thing that struck me right away was how short it was. And I remember saying to him, wow, this is really simple and straightforward. And he kind of shrugged at it like why would you do anything else? And it made it seem so clear to me that you didn't need to discover something undiscovered, that these long-term compounders, they end up being winners usually for the reasons why you think. You don't have to have a variant perception. These are very large, well-known companies and what's appreciated, I think, by the long term investor is how long they can continue to compound for, not just that they have these short term opportunities, but these are decades long compounders that are appreciated by people who have the ability to think that long term.

I don't really like to quote Warren Buffett a lot because everybody quotes Warren Buffett but Warren Buffett's point about investing is not like Olympic diving. You don't need to go for the most difficult dive to get the most points. You can go right in off the edge of the pool and get paid the same way as doing the triple lindy off the high dive.

Tom Yeowart: Polen's been around, I think, 45 years. The US Focus Growth strategy you now manage has been around 35 years and delivered exceptional returns over 35 years. It's an amazing feat and I'd love to talk about the persistency of those returns and how Polen has been able to sustain its success. You've obviously just touched on a couple of aspects of that. But how much is related to that time arbitrage? And what are the other factors that pull into that?

Dan Davidowitz: I think the time arbitrage is a very big part of it. It's a combination of time arbitrage with businesses that are kind of the best of the best in the world. And what I mean by that is companies that have these giant cash rich balance sheets, self-funding, big competitive advantages, wide open growth prospects and sticking just to those companies. So, the discipline to stay with just those companies, not maybe what's always the sexiest thing or something that might be a little left or right of our discipline.

It's staying right down the middle. So, we have no big losers and continuous compounding of earnings growth in the portfolio that leads to compounded returns over time. And then exactly what you just said, that time arbitrage, because over time, the power of compounding works in your favour. And the returns that we've been able to generate would be roughly about a doubling in your investment every five years. And when you think about the compounding of that over 35 years, it gets to be very, very large. And what's important for us is to not get too far out over our skis, trying to push it even higher. Because if you try to go for 20 percent earnings growth, every percentage point higher increases the risk, I think, that you end up doing something a little dumb. Or at worst, something that impairs returns.

And so, what we are trying to do is keep the earnings growth of the portfolio in that mid-teens or better range, because we can do that. We can do that without a lot of heavy lifting, keep it in that mid-teens or slightly better range. We've found this group of companies. It's not a very large group of companies that have this continuous compounding over long periods of time. And it's just important for us to, while the companies are executing and they look great, and the valuations are acceptable, let them go. It's only when you think that something's not right, the competitive advantage is deteriorating, the growth prospects are no longer as attractive, or the valuation makes it very difficult to get a good return, then we can move things aside and find a replacement.

But it's more about that continuous earnings growth in a very kind of narrow window that allows us to do this.

Tom Yeowart: And how do you create a high-performance culture? What are the practical ways to design a set up for an investment team that delivers that high performance over time?

Dan Davidowitz: I think there's a number of things that you have to have for investment teams to be high performing. I think trust and very open communication are kind of at the foundational layers of that. And then no ego or very little ego. You want to have a team that thinks like a team. That thinks about the client first, about how do we help make our colleagues successful, not just ourselves successful. How do we give feedback to each other in a constructive way, without any bias, but just wanting to help each other become the best versions of ourselves. I think that's really the most important thing, open, honest communication, because at the end of the day, as an investor, we're predicting things that we don't know for sure are actually going to happen, right? This is a dynamic world. There are competitive companies, there's regulatory environments, there's bad decision making.

There's a lot of things that happen and we have to be very open and honest with each other that if things aren't going the way that we thought that we don't just kind of anchor into our previous beliefs. That we can see when things are changing and make decisions maybe that we have to change our way of thinking. That's very hard to do if you only think you're right and you don't listen to some of the advice you get from your colleagues. I think we've been really good at that. We train on that. We train constantly on how to identify and harness our own strengths, how to improve upon the things that we're less good at, how to really train on those things, how to communicate with each other so that we can help each other and really care about each other.

How do we make sure that our clients understand exactly what we're trying to do? We want to be overly communicative with our clients. A lot of investors think that it's kind of a drag to have to talk to their clients. We think the opposite. We want to have a very good and open dialogue with our clients, because if we can explain what we see, then they can understand better and hopefully we can kind of have the same long-term view over time.

So that foundation of trust and communication, I think, is the most important thing. And then also, we need to focus on what we do as investors, doing it well, and always trying to be a little bit better than you were yesterday.

Tom Yeowart: What do you think are the important attributes that both the most successful fund managers and analysts have to have to invest well within this sphere of the broader investment landscape.

Dan Davidowitz: I think to be an investor in growth companies, you have to have some optimism to you, right? A lot of investors, analysts are very sceptical, always looking for what's wrong with a business. And that's important by the way, you do have to analyse a business and be clear if there's a problem that you identify the problem and steer clear. But in order to really be a successful investor in these compounder businesses you also have to have some optimism that these great companies will likely remain great companies.

A company like Visa or MasterCard that's had this incredible 50-year growth period could actually keep growing like that for another, you know 30, 40, 50 years. You can't just say like, it's going to be great because it's been great. That's not smart. But if you find competitively advantaged businesses that have wide open growth, don't discount that. That's where some of the best opportunities are.

So, you have to have some optimism, but you also have to have enough self-awareness to be able to change your mind too. So, if you have that optimistic view, but it doesn't look like that's actually happening, there's something going on and its counter to your investment thesis, don't just dig in on the investment thesis. Don't just be contrarian. If something doesn't look right, it may not be right. You may be wrong, and you need to change your mind. When you're an investor, you want to have courage of your convictions, but you have to also know if your convictions might be wrong. This is where that communication across the team comes into play. I sometimes may have a bias, and then I may need one of my teammates to say to me, Hey Dan, this doesn't look like it's actually playing out the way we thought it was going to play out. What would be the reason why, let's talk about it.

So, you want to have optimism, but you need to be able to change your mind if it makes sense to.

George Viney: Dan, how do you think about the competitive environment that you and your strategy exists in? You mentioned that compounders weren't a common term when you got into the investment business. It seems very prevalent today. Your strategy is obviously large. Other growth strategies are also large and many of your core holdings are a big part of the indices. Are the things you've just articulated, the disciplined focus on your approach, sticking to that, the strength of Polen's investment culture sufficient to allow you to continue to add value for your clients.

Dan Davidowitz: We have to be better every day. The competition gets better. I think every five or 10 years that goes by, it's a tougher environment to add value in as a professional investor. And we do go through lots of cycles in investment where things work really well, and then they don't work really well for a while, and it kind of ebbs and flows.

So, I think it's really incumbent upon us to always just be getting better at our skill set, trying to improve what we do, trying to re-evaluate things that we've done in the past to make sure that they're still relevant today. Things change. We've gone back and done studies on our decision making on buys, sells, adds and trims of our portfolio, looking at behavioural patterns. Is there something that we are systematically biased that we do incorrectly? We want to fix those things. So, we have to keep getting better and better every day. And so, I think we're very good at that. I think we're very self-reflective.

One of the things I also think that we're really good at Polen Capital and specifically on our team, is being able to take in new information, even from our youngest, least experienced people, because oftentimes they have a clearer view of things, an unbiased view, and they'll ask questions like, why do we do this? Or why do we do that? Have we ever thought about changing those things? Those are really good questions to ask because things do change and sometimes maybe we have to reevaluate.

Tom Yeowart: And Dan, when you think about your career at Polen, I'd just be interested to delve a bit deeper into how the investment process and thinking has improved and evolved to reflect that continuous learning mindset.

Dan Davidowitz: It's definitely changed a lot since I've been here. When I got here in 2005, basically David Polen was here, our founder, he was still the lead portfolio and the only portfolio manager. And by the way, Polen Capital today has four different teams and over a dozen portfolios. But back then we had one product, one team, one product. And David was not the most sophisticated, book smart person. He was a very street smart and fairly savvy person, and he set up this portfolio to minimize mistakes, basically. If I invest in only the most competitively advantaged and financially superior companies in the world and nothing less than that, it would be hard for me to go very wrong investing that way.

By the way, Tom, you mentioned that Polen Capital is 45 years old, but our flagship portfolio is 35 years old. So, what happened in that 10-year period in between there? David Polen really didn't talk about it that much, but I kind of know what happened. David was running the portfolio in the 1980s. And he made a really bad mistake. When the 1987 crash came he didn't know what to do and what he ended up doing was selling everything at the bottom and then missed the rebound too, compounding that mistake. It was a really catastrophic mistake. So, he had to basically restart over at the end of 1988. And started the track record, which became Focus Growth at that period of time and the investment discipline that we have today prevented him from ever having to do that again.

I have these great companies that continue to compound their earnings growth. They have these big competitive advantages. So, when the inevitable say 87 crash or something like it happens again, I don't have to sell, I know they're fine. And so that was what became what we are today. When I got here David was pretty simple and straightforward, but he had great discipline and the portfolio that we have and the way we run it today, very similarly, is to maintain that discipline.

What we do better today is well, one, we have more people that our team is now 11 people. It is a far deeper thinking group, I would say, than it was when I first got here. Really unbelievable people that we have at Polen Capital with a lot of different experiences, a lot of different backgrounds and really amazing depth to the research. But at the end of the day, we're still researching the same companies, we still have a portfolio that looks and feels very much like a Polen Capital portfolio from 10 years ago, 15 years ago, 20 years ago. And so, we maintain the discipline. I just think we know more about the companies. We understand them a bit better than maybe David Polen did.

The investment returns are not wildly different which is maybe good and bad. You would hope that you have all these smart people and maybe we could actually get a little bit better than that. But I think it is harder to maintain the kind of returns over time. And I think it's a requirement now to have a team of really smart, bright people to keep compounding at this rate.

Tom Yeowart: And taking a step back, Dan, it would be useful to just explain to everybody, all our listeners, what the defining characteristics of Polen's strategy are.

Dan Davidowitz: We want to have companies that meet five very particular hurdles. We call them our guardrails. And those five guardrails are you have to have number one, a cash rich balance sheet with very little debt. We really don't like debt. Number two, you have to have excess free cash flow every single year, not just when times are good. You have to have sustainable returns on capital above 20%. And that's without any leverage. So, that's a bit hard to do. Some companies can do that with leverage, but not many can do it without. You want companies that have at least stable profit margins, hopefully improving over time. And we want companies that have real organic revenue growth that's better than the average company. So, you would think mostly mid-to-high single digit revenue growth or better.

And all those guardrails are pretty high hurdles. And individually we tie them all together and say, you have to meet all five of them, sustainably. And so, there's not that many large cap companies in the United States or in the world that meet all of those criteria sustainably. And so, our universe of companies that we cover is really quite small. For our three large company strategies, which can invest really anywhere, there's only about 160, 170 large cap companies that we spend the vast majority of our time studying. It's a very, very small group of companies.

George Viney: Dan, the guardrails are by definition backward looking, or at least kind of present day. But clearly you have to look out over the long term. The business's current value is its prospective cash flows decades from here. So how with a strategy like yours that puts great weight on historic performance, how far in the future are you looking to ensure that those returns are durable?

Dan Davidowitz: We're looking out about five years into the future, but you also have to have an idea of what's going to happen at the exit of that five years, right? You can't just say this company is going to grow earnings at a mid-teens rate for the next five years. You also have to be thinking about when it gets to that point, how mature is it going to be? Is it still going to be able to grow respectively in the next five-year window so you can have an idea of what kind of multiple will be reasonable five years from now? We don't really know for sure, but we're trying to probabilistically assess what this business is going to look like five years from now.

The type of businesses that we own tend to be fairly predictable, they're not perfectly predictable, but fairly predictable so that we have a pretty good idea within a range of what the growth is going to look like. There is an element of unknown, right? Even for some of the most consistent companies, you're not really sure exactly what the growth is going to be, but then we give ourselves a little bit of conservatism too. Like whenever we have a reasonable expectation for growth, we don't just assume that that's dialled in. We do have some assumptions that it could be lower than that, or that the P/E multiple five years from now may be significantly lower than it is right now. So, we try to build in some conservatism. In the real world, we understand nothing's perfect, and things can change.

We just are constantly vigilant in watching what's developing in these companies, in their industries to make sure there isn't anything that's changing the dynamic for growth. Is there something coming down competitively or technologically that's changing this business in a serious way? Is there a big regulatory concern that could change the economics of the business in a serious way? So, we're constantly reevaluating all of those things. To us, if there's a problem with one company, we just want to get it out of the way, right? We're all about continuous compounding of earnings growth across the portfolio. So, if there's a company that's hitting an air pocket that could last for a while, we don't need it. We can always come back later when it's fixed. We will find a replacement for it. It's not a huge universe, but there are other companies that we can own that keep that earnings growth going. It's about that engine of earnings growth that's most important.

George Viney: And the metrics you're focused on, all of them could be interpreted as underinvestment. You could have a cash rich balance sheet because you should be spending more. You could have a lot of cashflow because you're not investing in Capex, sweating margins, sweating returns on invested capital. So what work are you doing to ensure these businesses are appropriately reinvesting to sustain top line growth?

Dan Davidowitz: Yeah, that's a great point. That absolutely does happen. Not a lot, right, because if you think about it, most of these businesses that have all of these characteristics, they didn't just become high profit generators and cash rich overnight. It was because of something that they did that created this wonderful business. And then it is something that we have to analyse - is the management team here investing properly or are they depriving the business of something. And over the years we've had some companies that have gone into somewhat of a harvest mode, like you're saying, where they have not invested in product development or research and development. They have not invested in their brands or whatever. And so, the economics look good, but the future is starting to deteriorate.

And that's where we have to analyse the business and understand what is the company investing in? Are they properly investing for whatever is next in their business. We sold PayPal out of our portfolio because we felt that they had gone far too long without investing in product development to create a true one touch checkout experience, and it was taking too long for them to reignite that investment and then eventually deploy the product into the marketplace. And we just felt that that was risking the competitive advantage. Now they may get it figured out. They may get it deployed. They may go back to growing and taking market share back. But at the moment it looks risky and there are competitors now who are doing better than them in the digital payment space that we think might continue to take market share from them. So, if we evaluate that the company is under investing, we'll clearly get out of the way.

George Viney: The other risk with a strategy like yours is the businesses are too cash generative and maybe a bit too paranoid about competitive threats and over invest by wasting capital on M&A. You've got businesses that generate quite a low ROE, a Salesforce or a Thermo Fisher, tremendously successful businesses, will continue to grow their earnings for a very long time to come but their returns on capital, returns on incremental capital have been quite weak because of that capitalized investment in essentially other businesses. How do you assess that dynamic and the risks of overpaying for acquired growth.

Dan Davidowitz: I would tell you that acquisition driven companies are typically not a big part of our portfolio. When we think about capital allocation, we want to own businesses that are going to be great without having to acquire other businesses. Now, some get better, and some get worse when they do acquisitions. And then we have to evaluate each of these situations and understand what is the allocation of capital? Has it been successful in the past, acquisitions especially. What is management's mindset around acquisitions and the returns that you'll get through acquisitions? What kind of hurdles are they requiring?

You mentioned a couple that were interesting. Thermo Fisher, I think has done a wonderful job acquiring businesses. And one of the things that Thermo really wants to do is own a lot of different health care technologies, life sciences technologies that they can kind of cross sell and bundle to the same companies, whether it's pharmaceutical companies, biotech companies, reference labs, they want to be able to have a lot of leverage across their selling process. So, they're getting the number one, number two, or number three technology in a lot of different life sciences areas. Now they've also been very disciplined on the prices paid. We can see what the returns on their acquisitions have been. It's been very nice and very disciplined.

In the case of Salesforce, most of their acquisitions have been very good. They've had one and that was Slack, which was not a great use of capital, but they've done a number of other acquisitions that have been very value added as well. So, we do have to evaluate them one at a time, but our preference is more for organic growth. A company like Thermo Fisher, by the way, grows nicely organically and gets a little extra from these kind of bolt on acquisitions that they do. You're not going to see us in companies where all of the growth comes from acquisition. We want consistent growers that can use strategic acquisitions, not ones that are doing these big transformational deals that could be high risk, high reward.

Tom Yeowart: Another defining feature of your portfolio, Dan, seems to be your desire to own and hold companies with, I guess, varying growth rates. You want companies that are achieving good levels of growth, steady compounders, and then you want some companies that are achieving higher rates of growth. I'd just like to better understand how you balance that mix within the portfolio and what attributes you're looking for across that spectrum.

Dan Davidowitz: All of our companies we consider growth companies, but some of them can grow their earnings at 20 percent per annum for the next 5 or 10 years and some more like 10. If you look across a broad market index like the S&P500, the earnings growth, it's quite cyclical, but it averages out to about 6-7% earnings growth for the S&P500. And so, for our portfolio, even our slowest growing companies are probably doing 10, 11, 12 percent earnings growth.

But you want to be able to have that stability of earnings growth, too. It's not just about the overall level. I mentioned we're going for mid-teens or better. That's kind of our expectation, because we've been able to do that for 35 years. But you need to have some variability in there and the outcomes for a company like an Abbott Labs or a Zoetis are a bit more definable, they're less variable. Our faster growing companies, it's not that you don't have certainty about their growth, but the variability is a little bit wider sometimes. So, you know, some of our fast-growing companies, we think can grow 20%, but could it be 15 or 25? Yeah, and that's not terribly wide, but it could have a pretty big implication on valuation.

And the other thing about having those slower growers, a lot of them tend to be safer, safety like, that's the term we use, safety companies, meaning their stability of their business means their stock prices tend to be a bit more stable or just less volatile than others. So, when you have these drawdowns in capital markets that happen for one reason or another, oftentimes safety like companies that are a little bit slower growing, they preserve capital in down markets too. They make the overall portfolio a little less volatile as well. And we like that. We like having that stability of earnings growth, stability of returns. We try to give to the best of our ability, a lot of it's out of our control, but we try to give the clients the easiest possible ride.

George Viney: And Dan, what about quality and how you think about quality and maybe how that's shifted over the last 5-10 years? On the one hand, you have some software businesses that have 80-90% market shares are not unheard of. But there are other businesses in the portfolio that operate in much more competitive environments. I mean, you mentioned one Zoetis, but a Nike, some of the other retailers, it's just much tougher business, less lucrative as well as it relates to cash flows and returns on capital. So, there could be an argument just to stick with the former and drop the latter, but you seem to like having this concentrated portfolio with a mix of different businesses. Maybe the answer is also related to this stability point, but you could argue that the more competitive businesses, operating in more competitive environments have an element of instability attached to them as well.

Dan Davidowitz: You think about some of the software businesses that generate, 40 percent profit margins and a nearly a hundred percent recurring revenue, those are pretty awesome. The world doesn't make that many of those at the end of the day, but some of them are pretty fantastic. When I first got to Polen Capital, David Polen used to compare everything to Coca Cola. And he would say, well, it's not as good as Coca Cola. I'm like, well, what's as good as making sugar water. Today, we would say it's not as good as Visa or MasterCard, right, because those companies are compounding at 20 percent rates with 60 percent profit margins and a global duopoly. It's hard to compare to that. And if there were 20 Visa's and MasterCard's, we would own all 20 of them.

The reality is you have to have different types of businesses and there are different growth rates. There are different market shares, as you mentioned. There are different valuations. But what is common amongst all of them is that they do have very large competitive advantages. Some have one big competitive advantage. Some have multiple competitive advantages, but there's something that keeps that compounding occurring year after year, after year, that earnings growth compounding.

So, while I would agree, Nike doesn't have any recurring revenue. It is a consumer product, it's a brand and if they do something very, very dumb that kills the brand, it kills the entire business. Where with Microsoft, it's unlikely that that's going to happen because they have this giant network effect. Everybody is kind of wedded into their products. They don't have that same kind of risk. So, you have to acknowledge that not all businesses are built the same. And some competitive advantages are very hard to undo. Some are a little bit less hard to undo, but if you can find those unique businesses that can keep on compounding for long periods of time, and I would put Nike in that category too, it's been compounding beautifully for 40+ years. It's still an awesome business, even though it may not have the Microsoft level of competitive advantage. It's still in its own right a great business and qualifies in our portfolio, a top 25 in the world, or at least in the US, idea.

Also, even the best businesses in the world, they go through periods of time when they're not the best investments too. So, you need to have a little bit of diversification, so that you do have some of these other businesses that have different characteristics and growth profiles that allow you to compound continuously over time too.

Tom Yeowart: Dan, you mentioned one of the things that happened when you got to Polen was you had to have your deep value sensitivity shaken out of you.

But I'd love to understand how Polen think about valuation and also how you get comfortable with some of the higher growth businesses that optically look quite expensive. So, I'm thinking of companies like ServiceNow, which looking at a basic multiple trades on a high price to earnings.

Dan Davidowitz: Valuation is important to us, but it's one of the last pieces of the puzzle. For us, we need to understand the business first. We need to evaluate the businesses and say, is this business so great that we do want to own it if the price is right? So, we do all of the work on the quality of the business, its growth potential, and figure out, is this a business we would like to own if given the right circumstances? So that's the most important. We don't want to have danger in the portfolio. We want to have pristine, wonderful businesses and then we'll buy them when it makes sense to buy them.

When we get to the point where we say, yeah, this is definitely a business we would like to own. Then we say, okay, is it available at a price that will give us an acceptable return? And acceptable for us is a double-digit annualized return over the next five years. So, we think about the earnings today, the multiple today, what are the earnings conservatively estimated going to look like five years from now, and then what kind of multiple would have to sustain five years from now for us to get at least a double-digit annualized return. So, it's an expected return construct. And if it looks like the multiple required five years from now is a bit high, I'm not so sure about that, then we'll just wait. We can be patient, wait for a better opportunity. If we think that multiple does look undemanding, great. We'll own it.

So, it's an expected return construct. We do it for each company bottom up, one at a time. And then it rolls up to what the entire portfolio's expected return is as well on a weighted average basis.

Now, you mentioned a company like ServiceNow, which is a wonderful business that has giant growth opportunities. One of the fastest growers in our portfolio. And it's somewhat appreciated with the multiple where it is trading at a little over 40x free cash flow. By the way, sometimes the accounting does not reflect the true economics of the business either. So, the P/E multiple on a company like ServiceNow is probably not the best reflection of the economics of ServiceNow. So, on a free cash flow basis, the multiples a little lower but it's still among the higher ones in the portfolio. And so, when we set our expected return, we're looking over the next five years and with ServiceNow that path to that double digit return is getting tougher. It still can get there, but that's getting a little bit narrower than we'd like. So, we've been reducing that position and we've been taking the proceeds to invest in other companies that we think have been a little left behind in the rally that we've had.

We've had a rally around a lot of AI-related themes. ServiceNow benefited from that, Adobe had previously benefited from that. We reduced those positions. And we allocated to the Thermo Fisher's to the Abbott Labs, to Visa, to Nike, where we felt that there was no AI story there, at least not yet, and the valuations were far less demanding.

George Viney: We've been through a wild period as it relates to starting multiples, but also growth assumptions for some of the businesses we've been talking about, especially the digital first companies. I'd like to get a sense of what lessons you've learned through a period which none of us had seen before, really, in terms of the pandemic, inflation and an interest rate hike cycle as fast and as disruptive as it's been.

Dan Davidowitz: For some of the digital businesses, there was a pull forward in COVID and then a tough grow over. But if you normalize through that whole period, they've actually been pretty spot on what we would have expected. It just was a little bit choppier.

We've made a trade-off, you know, for 35 years, we've owned much better than average businesses, right? Better moats, better growth, better profitability, better everything. And those companies typically trade at a premium to the market. And that trade-off has worked so well for us. In 2022 though, when we're seeing that rapid rise in interest rates that also happened right as the tough COVID grow over was happening for the digital businesses, we saw a really nasty duration impact on the valuations of our businesses.

Dan Davidowitz: And the lesson learned from that was, of course, if we ever see this again, where rates are going to rise very rapidly, we will have an impact on the portfolio. It's hard for us to shield all of that because if we're going to maintain a fully invested portfolio, which is what we're trying to do and maintain these great businesses, it's hard to completely shield the portfolio from that, but we could have done a little bit better. I think we could have stayed a little bit longer with some of those safety type companies even though the valuations were not super attractive in those businesses. I think we could have stayed a little longer before tilting into some of the growth that we did. That timing aspect.

But again, it was the interest rate impact and the COVID grow over at the same time. It was almost like hitting two speed bumps at the same time. And it rattles the car a little bit, but then you continue driving and everything's fine.

Tom Yeowart: You mentioned generative AI, which is very much the topic du jour. But just thinking about company fundamentals, I'd be interested to hear your views on how you think generative AI could impact either positively or negatively your portfolio holdings over the longer term.

Dan Davidowitz: This is one area where you have to be very, very open minded because we certainly see a lot of the excitement around generative AI. We certainly understand some of the business applications for generative AI and risks. Because there are risks to established businesses as well. We're trying to be very open minded and watch these things develop a little bit because the hype is there, but the business model changes are still early. So, we want to be careful about making bold predictions one way or the other.

We can see some of our companies like ServiceNow and Adobe, which we're trimming, they have pretty cool generative AI add on functionality to some of their products. That's relatively small, but interesting and likely to be incremental growth drivers, but probably not going to dynamically change the businesses anytime soon, at least not in a way that will really change the investment case tremendously. There are potential risks. The ability to create images or video with open-source text to image type technology could be a risk for a company like Adobe. So, we're evaluating all of that.

The cloud service providers are the ones I think that are some of the most obvious beneficiaries in our portfolio. If you think about Amazon Web Services, Azure from Microsoft, Google Cloud. They're essentially buying compute infrastructure that they're going to resell as a service and get recurring revenue off of. Should be nice ROIs, again incremental to those businesses, is probably not transformational anytime soon.

But Gen AI has the potential to be very powerful over time, just like the development of the Internet, just like the transition from on premise to the cloud. These are big technological trends that could be very beneficial, but we're still very early days. I think the size of the revenue impact to NVIDIA got everybody very, very excited. But NVIDIA is selling the foundation layer of technology, then the infrastructure happens, then the applications happen. And so, you kind of have to see how all of this develops to have a strong idea on each part of the value chain. We're watching it very closely. And we're just going to be very open minded and make sure that we have the right thought process, meaning we have the companies that will benefit, won't have the risk involved.

George Viney: It's fascinating in the US version of the strategy, not the UCITS strategy, which we have our concentration limits in the UK, you've got a huge holding in Amazon, and it dwarfs everything else you've got. So, I'm fascinated what that says about your approach to position sizing and then the role that that particular holding plays versus several holdings that you have that are 1-2% and how you think about the contrast between having this really chunky holding at the top and then tail. It's not a long tail in a concentrated portfolio like yours, but it's still a tail.

Dan Davidowitz: A normal size position for us is somewhere between 3-6%. That's kind of a normal size position. We have a couple that are smaller than that. And they're usually for particular reasons, either because we're just going into a position or coming out of a position, or it may be paired together, like we own Eli Lilly and Novo Nordisk, they're both relatively small, but paired together as one company, it's kind of a normal size position.

When we have very large positions and it's not unusual for us to have positions that are 10% or higher of the portfolio. Today, you're right, Amazon is a very large one at about 15% of the portfolio. That happens when we see a very unique confluence of events. It's almost like the stars aligning, so to speak, when it happens. And the reasons we'd be willing to have a position size that large are when four things happen at the same time. One is it's a company that has an absolute enormous competitive advantage. So not just one of the best in the US or the best in the world, but the best even in our portfolio, which is only highly competitively advantaged businesses. So, we've done it in the past with MasterCard, Visa, Microsoft, Google and now with Amazon.

It has to be a fast-growing company and Amazon is about our fastest growing company in the portfolio right now, growing earnings and free cash flow greater than 20% per annum over the next five years. You have to have valuation that is exciting too. Oftentimes that might be the missing piece. A lot of times the valuations are good on our companies, but they're not very exciting. And when we brought Amazon up to the size that it is now, it was trading at under 20x free cash flow for again, one of the most competitively advantaged, fast growing companies. Rare to see that happen.

And then the fourth is a timeliness aspect. Is there something happening now or about to happen where we see an inflection in growth, where things are starting to pick up and again, when we sized Amazon last year, it was when we were about to hit this massive profit margin inflection that was going to lead to very fast earnings growth.

So, the confluence of moat, growth, valuation and timeliness all kind of lining up, that's when we added to that size position. Now the market is going to get wise to this. At some point the market's going to realize that Amazon was way too cheap and its already kind of starting to develop. The returns are starting to come through and at some point, it'll be more fully appreciated. And when it is more fully appreciated, we won't have that large a position because it wouldn't be so mispriced, like we think it is now.

We're not in the business of making big bets. We only do these kinds of things when we see all of these thing’s kind of lining up in a really nice way for us that skews the risk reward so positive.

George Viney: It seems like the AWS business is very well placed but the retail business, arguably when the business starts thinking about margins and sweating margins, sweating fees, increasing ad load, which is arguably like a slotting fee for third party merchants in particular, that may be a risk signal. And is that something that you're concerned about that this is day two or maybe day three or four for a business that in the past has just reinvested its spare profitability back into extending its moat?

Dan Davidowitz: Yeah, it's a good question. I think the bigger risk for us is if management decides to do something that gets in the way of the margin expansion. And that's what I think a lot of investors are sceptical on. Amazon doesn't have profit margins like Google or Microsoft. It's a much lower profit margin business. The company has never really had pre-tax profit margins above 7-8%. They always go into kind of a big investment cycle once those margins kind of get up to this range. And so, I think that's what a lot of people worry about, is Amazon going to just plough a lot of money into some big project and it's going to end up diluting the margins over time.

The reason why we don't think that's going to happen though, is because they're literally telling us it's not going to happen. They're telling everybody this. Andy Jassy, who by the way does not get enough credit for being an amazing CEO. I think he inherited the CEO role at Amazon at a time that made it look like it wasn't great, but we know him, he's the person who built AWS. He's been an Amazon employee for most of its life, and we think he's a fantastic CEO. and he's been saying very clearly that they are only going to invest in projects that have high ROI, that are contiguous with the core that are the right type of investments that a long-term shareholder would want.

If they do what they say they're going to do, it would be very hard for the margins not to expand a lot from here. And that's not a bad thing, George. It doesn't mean that they're leaving great opportunities on the table. I think they're just being more selective about the opportunities they go after now.

Tom Yeowart: Turning to our closing question, what piece of advice would you give a young Dan Davidowitz at the beginning of his career?

Dan Davidowitz: It's funny because when I look back to those times when I was in the healthcare industry and switching to the investment industry, to me at that moment, it felt like such a tough decision and the idea of taking a step back financially in order to change my experience and improve my experience, it felt like very, very risky for me at that time. But when I look back, what was so risky about that? Like there wasn't like I had a giant amount of debt, I had so much of my career ahead of me at that time.

And so, when I talk to students today, I just say to them, you have a lot of time ahead of you. And building any experience is good experience. It really does not matter. You don't have to be perfectly on an investment path in high school and undergrad. You can get there in your own time and, especially as an investor, really any life or work experience is relevant experience.

So, I think I would have told myself to chill out. That my healthcare experience was helpful. You have time on your side. Your knowledge is always compounding and just be open to what you think might be interesting to you. What might be enjoyable and fun to you and provide you with an income that is good enough for you to really enjoy. I don't know if I would have taken all that advice back then, but knowing what I know now, that's what I would say.

Tom Yeowart: Great answer, Dan, thank you very much for coming on.

Dan Davidowitz: It's great to speak with you guys today. Thank you so much for having me.