Matthew McLennan (First Eagle) – Investing for Resilience

Tom Yeowart: Matt, welcome to the podcast. Thank you very much for coming on.

Matt McLennan: Thank you for having me on. I'm looking forward to it.

Tom Yeowart: Matt, you had a really interesting childhood. First growing up in Papua New Guinea and then living off the grid in Australia. Can you talk a bit about that and also how that led you to want to become an investor?

Matt McLennan: So, it was definitely a happy and adventurous upbringing. And I would say as well, because we were off the grid for some years, and we didn't have all of the electronic paraphernalia, lived in a house surrounded by books, and so, the passion for learning was instilled pretty early on. What was also fire in the belly, if you will, is that I saw my parents endure various financial challenges.

And so, I think just growing up in an environment like that makes you eager to both learn and earn so that you can have a modicum of freedom. And I think those influences came together from my childhood, but I think most importantly just the curiosity stimulated by having an unusual childhood that's happy in these kinds of crazy places.

Tom Yeowart: There's a very interesting contrast between how adventurous your mum and dad were and your granddad, who I believe lived in Antarctica for a time, with the conservatism of your investment approach. Is it to the point you've just made about, because you had the childhood you did, that led you to want to earn as well as learn, but then also you recognised the value of conservatism and resilience in building that over the long term.

Matt McLennan: You know, if you're living in an environment where you don't necessarily have all of the amenities, whether it was my grandfather, for example, spending 18 months in Antarctica in the 50s, or just us growing up surrounded by the woods and not having electricity, etc., you do need to have somewhat of a margin of safety, if you will, in terms of the way you conduct your day to day existence.

One of the threads that connects my grandfather, who you mentioned, and my mother was that they were both avid gardeners. And it was their gardening in some ways that informed my approach later in life, because I could never understand for the life of me the amount of effort that they were putting into gardening. And it just seemed like they had to deal with all manner of problems. They are out there getting grubby. But I remember coming back to visit these places, and 20 years later, when I had my own children, I could see that that selective method and the passage of time had created these kind of resplendent settings that were quite different from what would have been the case if you had just actively mown the lawn every year or you just let the jungle take over.

Sebastian Lyon: Matt, you spent 14 years at Goldman Sachs before being chosen by the legendary investor Jean-Marie Eveillard to be his successor at First Eagle. Can you talk a little bit about Jean-Marie, who is such a great investor, and what gave him confidence in you as a person to succeed him? And how did he inform your investment philosophy, would you say?

Matt McLennan: Jean-Marie is a legendary investor and we've all been fortunate at First Eagle to stand on his shoulders, if you will, and I think there's no one in our team that feels that they've taken over the mantle per se. I think he really was unique. He had a nose for the eclectic and many of the businesses that he invested in were like these kind of mundane royalties. And he had obviously an eye to risk mitigation at all points. He was very sensitive to valuation, but he had a sense of the role of uncertainty in investing and he always ran the portfolio on a very diversified basis. He was very focused on accounting detail and getting to the economic reality of businesses. And this really mattered as there were so many different accounting regimes back in the late 70s. And so, I think it was this combination of skills, but if you get to know Jean-Marie, he's a gentleman as much as anything, and he's an incredible listener and has an ability to distil complexity.

In terms of what got Jean-Marie comfortable with me, it's probably best to ask him, but I would say that there was a group of people who were involved. The Arnhold family, Bruce Greenwald was part of the selection group and he was running the value program at Columbia at the time and Jean -Marie. And I guess they were looking for someone who had already organically developed into a similar mindset of investing and someone who didn't feel they had a monopoly on the truth who was going to be looking to build a collaborative team as opposed to coming in feeling that they had a monopoly on the right answers.

And so, I'd like to think it was a combination of just an alignment, in terms of philosophy, and temperament, that was key.

Sebastian Lyon: And has the process evolved much? Obviously, the scale of the portfolio is a lot larger than when you took it on in 2008. I was just wondering how that process has had to evolve, because I remember looking at the portfolios of old, and there were a number of small, very niche, as you say, royalty businesses, and now it's inevitably larger caps. So, I'd just like to hear how that process has evolved for you.

Matt McLennan: If you look at what Jean-Marie sought out and what we seek out, I think it's best described as scarcity value. And I think the core principles have remained in place. One of the evolutions is that the nature of the capital stock of the world has evolved over the last 40 plus years. Intangible assets play a far more definitive role in the economic value of a business than perhaps they did back then. And what that has led us to do is to really deepen the specialisation of our analyst team. It really takes dedicated industry knowledge to value intangibles. And we've also tried to embody certain mental models. And I give Bruce Greenwald and Tano Santos, our senior advisors, some credit for this in terms of how to think about valuing intangible assets. And so, I guess it has been more of a refinement than an evolution. I think the best way to think about it is a kind of continuous refinement of a kernel rather than any big shift. What's the old expression? If it isn’t broke, don't fix it.

Sebastian Lyon: The kernel argument is a very good way of expressing it. In terms of succession planning, you've been running this mandate now for 16 years, I think. The succession plan, undeniably, has been a success. What do you think has made it a success? Because that is rare in the investment management world, actually. That's really quite special. So why has it worked, that succession planning, do you think?

Matt McLennan: Well, succession planning is something that we talk about a lot at First Eagle. And in fact, it's something that's driven down from the board level, as well as endogenously from within the team. And I think part of it is that we have this culture of apprenticeship at First Eagle and mentorship.

And I think that's an important part because succession really comes out of developing people and processes that can perpetuate a given philosophy. Back to the idea of the core kernel of the business. We're in the investing business, if you will, of trying to identify underlying companies that have persistence. And we often think about what is it that would make our business persistent and succession is key to that. You really want to make sure that no one is of the belief that they have the monopoly on the truth, as we said before. But you're surrounding yourself with a lot of talented people who bring different perspectives.

You're developing them over time. Many of our employees have been with us for over a decade. A big part of mentoring is listening. What are people actually interested in? Do they feel ready to migrate from just focusing on an industry to dealing with the complexity of portfolio management? And so, these are the things that we're mulling all the time. But what we've done is we've made sure that at the portfolio level, you know, we've mentored in a range of different portfolio managers to bring different perspectives, different industry expertise. And we have a very collaborative process such that if someone comes up with an idea, then the other decision makers on that portfolio have to feel comfortable with that idea.

So, it's a high hurdle for a stock to come in and you have to check your ego at the door, if you will. On the other hand, if there's a name that we've owned for some years and one of us gets distinctly uncomfortable we'll tend to veer to that more conservative perspective. And so, part of succession planning is getting people to work together in a collaborative way where the ego is separated from the quality of the decision.

And so, it's really that combination of hiring people who are smart and nice, really investing in mentoring. Seeing where people naturally gravitate towards in terms of where they want to spend their time and creating forums to make decisions in a less ego packed way.

Tom Yeowart: Global Value's been going since 1979, so on the one hand it's hard to get succession right, but equally, it's very hard to sustain success and performance over periods of time. Most fund managers blaze out after relatively short periods of time. This franchise has sustained it for 40 years or so. So, could you expand on what the core kernels of that success have been and how you've managed to survive and thrive across such a broad range of different market environments?

Matt McLennan: Peter Thiel makes an interesting observation. He said, you know, every moment in business happens once. Resident within our team is a great amount of institutional memory about the kinds of businesses we'd like to be owners of that exist around the world.

That's helpful because at the end of the day, we're waiting to buy good businesses that have had a lost decade for one reason or another. Having a knowledge of what those businesses are so you're not having to discover the universe upfront, I think is a bit of a starting advantage. And I think the second thing is that consistency of purpose, the core kernel of what we do has remained intact.

If I could give you an analogy in fashion. You know, Hermès has a much more timeless design and appeal relative to some of the more fashion forward brands like the Prada's of the world and fund management businesses are no different. There are fads that come and go, whether it's in investing styles or whether it's in the vehicles in which people invest from hedge funds to ETFs, whatever it might be. And I guess what we've tried to do is design an investment approach that is more perennial in nature that can happily coexist with the fads of the day. We're unlikely to ever be the hot dot in any given year, but we can comfortably coexist because what we do is different enough and resilient enough that people are happy to have it as a core holding for the long term.

And so, it's that consistency of purpose that I think has really helped our duration. And the fact is that despite the inevitable cyclical vicissitudes of our business, we've continually invested in deepening the human capital. That keeps the platform regenerative to a certain extent in terms of the quality of insights you're getting.

And we've really invested in deepening our client relationships over the long term. One of the things that brings me great joy is if I'm traveling around meeting with clients and I don't get to do a lot of it, you might be surprised. It's probably less than 15 percent of my time. We like to keep the investing team focused on investing, but you meet people who have been invested in our strategy for 30 plus years, 20 plus years. And that kind of customer loyalty and those long-term relationships are critical to building an enduring investment management franchise.

Tom Yeowart: Turning to that human capital, I'd be intrigued to learn a bit more about what are the character traits and temperaments that you're specifically looking for?

I've heard you talk about the importance of humility before and flexibility and all those things. How do you keep that rooted in the investment team and how does it reflect itself in what you do?

Matt McLennan: Those are some of the core temperament character traits that we think are critical for long term success in investing. And the way we try to keep those traits in place at a team level is that we expect that our most senior members of the team are not just talented investors, but the embodiment of those kind of temperament attributes. If they're not embodying those temperament attributes, we tend to give them feedback so that they're self-aware in that regard. Humility is critical for our business because we have a fundamental belief that the tails of reality are far fatter than what a normal distribution would imply.

We also have a healthy respect for complexity. There are a lot of people out there who have got very specific predictions about what's going to happen to the S&P 500 or 10 year yields a year from today. But there's an acknowledgement that in a complex system, some things are just unpredictable. I don't know how many economists had specific views of the world in 2019 that were totally turned upside down by COVID or the invasion of the Ukraine by Russia a little time later. But I think if your team members embody a degree of humility, it makes it more natural to diversify. It makes it more natural to require a margin of safety in price, and it makes it more natural to focus on businesses that you think have staying power.

And so, humility is a foundational value for investing the way we do. I guess symmetrically with that, and this is back to the discussion we had earlier about gardening, the notion of patience. It is critical. We have a belief that most healthy growth processes are measured in nature. If you think about the sources of excess return in our approach, whether it's valuation normalisation across time, or whether it's margin normalisation in a business, or it's the impact of the accretive redeployment of free cashflow of a business that has superior margins and superior capital allocation. All of those things take a lot of time to play out. And so, we really think that patience is very important. And I think the vast majority of the market is extremely focused on trying to predict the next quarter. And we all know that stocks correlate neatly with earnings surprise. And we know if you could predict interest rate surprise, you'd be great in currency markets. But the problem is most people in the market are focused on that. And by definition, that's the most competitive arena and the one in which you're least likely to succeed.

Very few people have an ability to invest patiently. We're all wired in annual cycle time. You go up through grade school and you get your first job. You get your annual feedback session. To think in decades cycle time takes some learning. In fact, if you look at the turnover our portfolios, they're only about 10%. So, we really act with patience and that's an important thing.

The other variable you mentioned was flexibility. And I think that flexibility is key for us because we believe that you want to have both selectivity in terms of the kind of business and the kind of price point you want in a portfolio, but you also want diversification. And so, flexibility means that your kind of willing to go wherever the opportunity is.

And sometimes our clients, at least in the United States, need reminding of that because the U.S. has been such a strong market for so long. They're like, why would we look elsewhere for investment opportunities? The U.S. has many great businesses, but it doesn't have a monopoly on great businesses. And there may be times where the best businesses on offer in terms of a valuation standpoint are outside the United States.

It'd be crazy for Exxon, for example, to only drill in the United States. If you've got the best geologists, you'll go where the oil is. Having a flexible mindset's important and not just geographically, but across the capital structure. There are times when you can get equity like returns in bonds. We haven't seen that for a while, but those moments do exist. And you could have a more senior claim on a business with a satisfactory real return. And so, you have to be open minded to that. And likewise, there are times when risk is just not very well rewarded and maybe it's better to keep some deferred purchasing power in cash or ballast in gold, for example. And so, flexibility is necessary to invest with an absolute mindset.

Sebastian Lyon: You talk about time preferences essentially being one of your biggest advantages, which I would agree with. And we have that here too. One of the really big changes that has occurred during your tenure as manager since 2008 has been the remarkable growth of passive. I look at some companies in the S&P 500 that have 35 or 40 percent of their shareholdings with passive holders of Vanguard, State Street, et cetera. How do you think that affects us as investors, both in terms of the need for greater patience, but also in terms of the fact that you'll probably have extended periods of momentum, which you can be out of key with the market for longer periods. And also, effectively is price discovery and the signals that are coming from the market actually less reliable than they have been hitherto?

Matt McLennan: The growth in passive investing has been nothing short of remarkable and I think it's representative of the fact that if markets are reasonably efficient, it's a very low-cost form of earning a sound return. You know, Hayek teaches us in economics there is no free lunch, and passive investing is by its nature a parasitic strategy because it requires a vibrant and vital active host in order for markets to be relatively efficient. As a fiduciary to abnegate any sense of judgment on the valuation of the securities you're investing in, the management strategy, the capital structure, where you might be in the business cycle, is a challenging thing to reflect on.

And of course, often the biggest bubbles are in fact very large parts of the investment universe. And by definition, if you're passively investing in markets, you're going to be most exposed to adverse selection risk. And I think if I give an analogy here, it's often easier to understand in the context of fixed income, but often the biggest issuers in a passive fixed income index are those that at some point present the greatest risk because they've overdone it. And so, I don't think that passive is necessarily a panacea. And I think what it does do though, is it means that a bigger portion of the market today than I've ever seen is totally price insensitive.

And I think what that can mean is in outlier environments, that it can present more extreme opportunities. So, there's a symmetry to the risk, which you alluded to, which is that momentum trends can persist for longer because they're in a sense, self-reinforcing when passive monies are allocating more money to what has done well. But on the other hand, when crises occur, that process can go into reverse and great bargains can come about.

We have the belief that there will never be any shortage of demand for quality investment perspective and ultimately passive and active can coexist. And in fact, they need to coexist. Passive without active would be a total crapshoot. It requires a critical mass of thoughtful, active investors to kind of free ride, if you will.

And so, I see them coexisting, but I see opportunity as well as threat.

Tom Yeowart: Matt, you alluded to the fact earlier that you have a senior advisor board. Can you just expand on the mental models you've developed with the advice of the likes of Bruce Greenwald, Tano Santos, and William Green?

Matt McLennan: They each bring different things to the table. I think Bruce really innovated in the world of value investing because he kind of committed to an analytical framework, what Warren and Charlie had intuited and Bruce's great skill is his ability to reduce complex thinking to two or three factors that really make the critical difference.

And so, from Bruce, we really learned the importance of high and persistent levels of local market share as a key driver of fixed cost leverage and competitive advantage and franchise value. Bruce was also very focused on different metrics to capture customer captivity. Bruce is also a brilliant economist, and he's had a lot of deep insights on globalisation and some of the persistent current account imbalances and what drives that and how that can impact financial equilibrium.

Tano is the current head of the value program at Columbia University. He took over from Bruce. And Tano brings a different set of skills thinking about how to value growth. How to think about customer acquisition costs, how to think about cycles and risk premia over time. So, he's basically refining the kernel, if you will. And so, I think what's interesting to me is to have the analysts exposed to people like Bruce and Tano, so that they're always thinking about their analytical mental models and never becoming complacent. Just because a stock has a low P/E doesn't mean it's going to be a great investment.

William Green brings a totally different dimension. William has spent decades studying great investors and writing about great investors. And he's a student of the psychology and temperament of great investing. He sits at the middle of a very interesting network of thinkers. He was friends with Charlie Munger. He speaks beautifully about Charlie. But also folks like Ray Dalio or Howard Marks or Tom Gayner at Markel, Bill Miller. So, William has this reach, then we'll bring some of those investors to speak to our team when we have our annual offsites. I have found him to be an incredible resource to just think about how to think about investing and how to live as an investor. He's quite into Zen philosophy as well. I've had many a good discussion with him about managing the emotional process of investing. And he recommends books that really sort of make me think differently, like Peter Matthiessen's 'The Snow Leopard', for example.

Stepping back from it, if we have someone as a senior advisor, we really want them to help us refine analytical tools and mental models, or to help us reflect on temperament, philosophy and how it is that we live our role as investors.

Sebastian Lyon: Matt, how does value investing differ from simple contrarianism? You clearly have a qualitative bias. How do you avoid value traps? Does your focus on resilience effectively lead you away from certain industries? Are there some areas where you'll just say that goes into the too difficult bucket. Let's leave that for others. Let's focus on what we're good at.

Matt McLennan: Value investing has been somewhat of a confused term because there are multiple approaches. I mean if we look at the origins of value investing with Ben Graham, it was really about buying cheap cigar butts, right, liquidation situations. And then there was a vast pool of quantitative literature that evolved where it was basically, if you force rank the universe on price to cashflow or P/E ratios that the cheapest stocks tend to do better over time.

And so, it almost became a kind of a perceived empirical truth of sorts. The way that we think about it is somewhat different in that in order to make a judgment that you've got value, the precondition for that is that the business has value. And so, the way we think about value investing at First Eagle is that you have to start with the business. You have to feel that the business has the capacity to generate cash flow across time. And the root cause of that is usually some stable and sticky market share position that's meaningful. Or the ownership of physical assets that are well located and long duration in nature. But there has to be something that provides you with a long duration cash flow stream in order for you to be able to make a value judgment.

And so, we're very focused on trying to avoid business fade risk. That's a starting point. And then secondly, we're quite focused on capital structure integrity because you can own great assets, but if you have the wrong capital structure at the wrong part of the cycle, the debt holders can end up owning those assets. And then obviously management's a core intangible asset or intangible liability, a contra asset. And the reality is that most management teams are actually pursuing strategies that are modestly dilutive to shareholder value. And very few management teams really embody the founder or family run mindset that's required for generating alpha over time with the assets that they've got.

And so, we tend to ask a few splitting questions, if you will. It's like, if you're searching for a word in the dictionary, you can go through sequentially every page. It's going to take you forever. But you know, if you're looking for ‘serendipity’, you can flip to the back half of the dictionary and then two or three flips you're on the page by intelligently splitting the universe. For us, value investing is first splitting the universe in terms of business and then making a judgment about whether we have a sensible price. And I think where we differ from many investors is that we recognise that there are both what I would refer to as positional assets, that are embedded in the economy and therefore have a natural drift to their intrinsic value that's going to follow the trajectory of nominal GDP. A great example of a pure positional asset might be a vacant block of land in Mayfair. It may not have cash flow today, but you know it's going to have value and it's going to have more value in the fullness of time.

On the other hand, there are cashflow assets that give you a cashflow return today but may not have the ability to grow in real terms over time. So, a great example would be a long-term gilt, for example, or treasury, you know you're going to get a cash flow stream, but you've got a fixed nominal principle. And so, you're exposed to the risk of not keeping pace with nominal GDP growth.

And so, depending on the quality of the business, there's a combination of positional value and cashflow value. For a business that doesn't have a strong positional market share or long duration real assets, you're going to require most of your return from free cashflow yield. On the other hand, if you have an asset that's truly embedded, you may not require as much free cashflow yield. And so, we make a judgment based upon the nature of the company, what would constitute a valuation margin of safety, balancing drift and cashflow yield. And I think it's quite different from just filtering the universe on price. And it's designed to try and avoid the value traps.

Because at the end of the day, what is a value trap? A value trap is when the earnings power of a business really doesn't pace with the nominal activity level in the economy. There's fade risk. And that's usually a function of one of three things: eroding market share, you know, competitive substitution, or dilutive management behaviour, a management that's diversifying away from its areas of strength or making dilutive acquisitions, or a capital structure that gets you in trouble.

And so, we're really trying to avoid fade, agency and business cycle, capital structure risk before we make a judgment on price.

Tom Yeowart: It goes back to, I guess, one of the core kernels of your success over time and the longevity of the strategy. It's about eliminating risk. Winning by not losing. Investing in companies with a capacity to suffer. It's informed in everything you do.

Matt McLennan: A company that has the capacity to suffer is one that by virtue of the strength of its market position or the quality of its assets, can still generate some cash flow in the bottom part of the cycle. And better still, great companies have a regenerative nature to them. They have a customer platform that gives them regenerative feedback and enables them to grow in concentric circles around the core. Or if it's a real asset company, the great real asset companies are those that have brownfield reinvestment optionality around their core assets that give them better incremental returns than going out and buying these assets de novo.

And so, it's really that combination of positional integrity that gives you cashflow at the bottom of the cycle and something that's regenerative about the business. And this is a critical point, just going back to Sebastian's question about value traps. If I could distil it, there's many stocks out there that are statistically cheap, but they don't have endogenous integrity. They're melting ice cubes. They have market share erosion. They have bad balance sheets. They have management idiocy in some form or another. We try to buy businesses that we believe have endogenous integrity. Strong market position, sound management, sound capital structures at times of exogenous challenge.

So, you know, the greatest investments for us have typically been wonderful businesses that have gone through a lost decade because of the external environment that they're in.

Sebastian Lyon: There's much concern today about the effects on businesses of technology, and especially gen AI, new drugs like GLP1s, which have affected things like staples valuations. I know you have some staples in your portfolio. There's always plenty of noise in the investment zeitgeist. Now, some of those themes come and go. We saw that very clearly in the profitless tech bubble of 2021 and the meme stocks, which certainly came and went, fizzled out, but sometimes those factors actually have longevity, have value creative abilities, and similarly value destructive abilities. And how do you try to discern between what has that longevity and what effectively is hot air?

Matt McLennan: Therein is the judgment element of our business because it's incredibly difficult. We used to have an investment in Barnes & Noble, the bookseller, and obviously Amazon came along and changed the dynamic of the book retailing industry dramatically. At the end of the day, the core engine of Amazon was so strong that those pressures were just going to build. And so, we moved on from that investment. There have been other times when the noise has been a source of opportunity. And so, in the wake of the global financial crisis, Microsoft became our biggest investment.

And I remember speaking to people back then, who were like, don't you know, Apple has killed Microsoft. Everyone's moving from the PC to the smartphone. Why would you own Microsoft? And you know, that enables the opportunity to buy Microsoft with a double digit free cashflow yield. We made a very simple judgment back then that Microsoft didn't have to be everything to everybody. It was enough to be embedded in the commercial ecosystem, and they're truly an annuity on the enterprise. And we love their business and service base, and that became Azure and cloud.

So, the essence of investing is knowing when the noise is secular or when the noise is off base. Analytically, when people come together to trade in markets, they have different mental models. Part of their mental model is truth content, and part is noise. Now, the argument for efficient markets is that by definition, the truth in people's mental models should be correlated, and it should be magnified in the price when a lot of people come together, whereas the noise should be uncorrelated, and should come out in the wash. So, the price can be smarter than the smartest person, by virtue of the truth content being magnified and the noise diminishing. But sometimes noise is correlated. And that has for us often been the source of greatest investment opportunity.

You raise interesting questions around GLP1s and the growth of AI. We're just going to have to wait and see there. But my first instinct is that some of these influences are more complex than the first order reaction of markets. If more people take GLP1s, let's say that we go a decade, another decade, and there's no kind of tort litigation against these drugs and the efficacy is what we think it is, and more people are taking these drugs, then, you know, life expectancy is probably longer. And so, you might end up still needing the same amount of medical equipment in the end. Maybe you don't consume as many calories in any given year, but you might consume more calories across time because you live longer. The answer to this stuff is more nuanced than just the first order approximation.

And so, my sense is that the enthusiasm around GLP1 drugs has actually created some opportunity in the healthcare arena and in the staples arena, but we'll have to wait and see. And I would say on AI, it may be surprising that you end up coming back to where you started, that AI is not going to solve all problems. There's a book that influenced me greatly, and that was Stephen Wolfram's book called 'A New Kind of Science'. And he studied systems and almost like a spreadsheet that cascades down where cells do things, they change colours based upon the cells around them and an underlying deterministic formula. And he looked at simulations of thousands and thousands of these systems and what was really interesting is that only a small minority of systems are very linear and thus predictable. You could use a small formula to predict in perpetuity the behaviour of a system. And in fact, it wouldn't take you much observation.

And then there was another cluster of systems that had a kind of nested cyclicality that wasn't pure and linear, but you could imagine an AI inference engine would pick up those cycles and give you some predictability, perhaps more quickly than a human. But for the vast majority of systems, even though these were all deterministically driven it would take you more observations of all the data to backwards induce the formula than to just let reality play out. And so, I think there's a big part of reality that AI will never be able to master just because of the nature of complex systems.

But I do think AI will be hugely useful for everything from drug discovery to whatever it may be. But I think that what's likely to happen is that AI well deployed will be a cost enhancement tool. And I think that the companies that will benefit most from AI are those that have the strongest market share positions because they have the fixed cost leverage to invest in deploying AI software into their systems and they have the pricing power to hold on to those gains. But if you're thinking about more competitive industries, AI is just going to produce lower prices for the consumer and disintermediate lower end white collar jobs. And so, look, we think these are both hugely interesting developments. And in our portfolio, we have a range of companies that are essentially royalties on the workflow associated with AI. But that, you know, we're not having to pay 30 times revenues for the conceptual valuation.

Tom Yeowart: Matt, could you talk about what role other asset classes play in building a resilient portfolio and as a bottom-up investor, how you use macroeconomic or geopolitical signals to inform your approach there? Then secondly, the psychological role having other asset classes plays at times of stress in the equity markets and how perhaps it benefits your broader equity investing.

Matt McLennan: If the goal of investing, and you know, this is true North for us, is resilient wealth creation, what you're trying to do is produce a return stream that's not too volatile, but that has the capacity to compound out by more than nominal GDP growth. You're looking to grow purchasing power at a measured pace. And that's why three quarters of our portfolio is typically invested in equities, because if we've identified companies that have good positional value, they have the capacity for their earnings power to drift in line with nominal GDP. And if we own them with an attractive free cashflow yield, that's the ability to generate wealth relative to nominal GDP growth.

Every business has fade risk, but if the free cashflow yield is sufficient to compensate us for fade risk, and we've done our work on getting the right incumbency advantages of these businesses, we have a shot at GDP plus returns over time.

Having said that, we've also been mindful of the fact that the financial architecture of the world has real problems. We are standing at a fiscal precipice that is particularly bad. And so that systemic risk means that we want a potential hedge in our portfolio. We exist in a time where there's quite a bit of geopolitical risk. And so, we want something to do well if we have a lost decade for equities more broadly.

Now the usual response to that in a balanced portfolio is to have some long dated sovereign bonds. But the problem with long dated sovereign bonds is that they're priced for nominal GDP minus returns. And so, you have to pay quite a bit for that insurance. And the reason for that is that if you look at the fiscal situation of the major countries in the world, the fiscal deficits that are being run today are a combination of primary deficits, that is deficits before interest expense, and the interest expense.

And so, by definition, the stock of government debt now is growing more quickly than the interest expense itself. And so, it's kind of like a dog chasing its own tail. It's going to be very difficult as long as we're running these large primary deficits, for long dated sovereign securities to become GDP plus investments structurally. In fact, they almost need to be repressed relative to nominal GDP growth. And so, we've chosen to have gold as our preferred potential hedge. And gold has the advantage that it's relatively fixed in supply. And we've talked about scarcity value here, but it's the embodiment of scarcity value. The per capita supply of gold has been pretty much constant the last 50 years or so. And even though gold offers no yield, because of its unique position it has kept pace with nominal activity. In fact, since the dollar broke its link and the Bretton Woods agreement broke down in the early 70s, U.S. money supply has grown around 6%. T-bills have compounded at roughly money supply minus one. Gold has had about an 8 percent compound return.

And so, as the quality of man-made money has gone down, gold has not only given you nominal drift, but it's given you some alpha. And so, we've had a hedge asset that's had an equity like return. And if you look at gold's performance over the last century, it's had its best decades when equities have had their worst decades. That's about 15 percent of our portfolio between bullion and miners.

And then, there are times when risk perception is low, and we're net selling securities, and we don't know where we want to put the money straight away. And so, our cash levels build in the portfolio. Now, cash to the prior conversation is a GDP minus return over time. But right now, you're getting a cash yield that's pretty much in line with nominal growth. So, you're getting paid to wait for the first time in a while. And risk perception is very low in the United States. And so, our more U.S. centric strategies, we carry a little more cash today. On the other hand, if you look at our international strategies, they tend to be more fully deployed because we see much more reasonable valuations. And so, the core asset classes we have is really our equities, our potential hedge in gold and the episodic ebb and flow of cash as shorter term deferred purchasing power.

And then, as I mentioned before, the final one is sometimes we'll find equity like returns in corporate fixed income, but those tend to come in moments of distress and then we have other alternatives such as cheap stocks.

Sebastian Lyon: Would you say you thought of cash more as dry powder than as cash drag? What sort of percentages do you feel uncomfortable with in either direction?

Matt McLennan: It is dry powder. One way I think about it in aggregate is that the margin of safety we typically look for in an investment is plus or minus 30 percent. We like to think we're buying a business for 70 cents on the dollar. If we held cash in excess of 30 percent over time, on average, the cash drag would probably likely offset the alpha from our stock selection. And so, I think your aggregate cash holding needs to be less than the margin of safety over time that you seek in your equity investments. Obviously, we think of cash as having a low return for a few years, but there's option value in it being deployed at high returns in windows of cyclical distress. But if over the very long term, your cash levels average above your margin of safety, you'll have less statistical volatility, but it'll be hard to produce superior returns.

And the people I know who've carried most cash most successfully have been those who've invested with the deepest margin of safety. The Seth Klarman's at Baupost, for example, you know, where they really look for a lot of out of the money option value in what they invest. To the extent that we like sound quality businesses where the margin of safety and price on day one may not be a Baupost type discount then you might want to carry a little less cash.

So typically, our cash levels have been in the last several years in the sort of mid to high single digit range. And it also has to be consistent with how much you realistically deploy in a window of cyclical distress. And so, if I look back to Q1 2009 or Q1 2020, in those distressed environments we deployed 6 percent of the portfolio. And so, to me, once we start getting north of 10 percent cash, we're starting to make a bet about a more sustained downturn than an episodic market correction. And you know, for that, I'd prefer to own gold because even though gold has more volatility than cash, if I'm holding it for a longer period of time, it has a better return character and interestingly enough, the correlation between gold and equities is pretty much zero, but in tail states of the world, as equity drawdowns get bigger and bigger, gold's correlation tends to become more negative. So, it has a kind of convexity feature to it almost.

Sebastian Lyon: Do you not think at the moment, if you look at the US equity market, the equity risk premium is, I think, the lowest it has been in over two decades. One of the things I sort of agree with Goldman Sachs, not many things, but one of the things I agree with is that prospective returns in the US equity market are probably going to be low single digits for the next decade. Would you agree with that? Is that an argument not to have a little bit more cash than not?

Matt McLennan: Well, Warren Buffett's been a seller of equities in the US this year. I pay attention to that. Having said that, strange things can happen in markets. And I want to come back to the fiscal distortion. One market that has perplexed me for many years has been the Indian stock market, where you have a combination of high P/E ratios and high interest rates. So, I started to think about that. Why is that? And maybe it's because of the fiscal situation. India is also a regime where you have these persistent primary deficits and therefore you have more nominal drift in the economy because the stock of government debt is growing more quickly.

You can get higher interest rates in India, but they're not as high as the rate of nominal growth. And in a way, the only way to participate in nominal growth with low risk is to buy low beta Indian equities, if you live in India, or gold. And so, consumer staples in India trade at very high valuations, because you at least capture the nominal drift of the economy, plus some free cash flow yield. And so maybe what's happened a bit in the US is that there's a little sort of nominal illusion, for want of a better expression, that people are feeling that with large structural primary deficits, the only way to capture the nominal drift is to own these companies that are essentially royalties on nominal activity.

If you think of the math of equity investing, your free cash flow yield typically equals the risk-free rate plus the risk premium minus the growth rate. In a balanced macro situation, the risk-free rate should be similar to the growth rate. And so, your free cash flow yield should be consistent with the risk premium. But in a scenario where the risk free rate is repressed relative to the growth rate because of primary deficits, then you could conceptually have a lower free cash flow yield for any given risk premium because you're getting more of your return from the gap between growth and the risk free rate.

Maybe there's something weird going on like that that could mean that the US has okay returns. But the symmetry of that is, you know, in India, you've had a very weak currency. So, for that scenario to be true, I think you'd have a weaker dollar over time. You can't have everything. You can't have normal returns at high valuations and a strong currency over the long term.

Sebastian Lyon: In common with Troy's multi asset strategy, that I run, you have, as you said, been committed to having a holding in gold for many, many years. I think going back to Jean-Marie Eveillard's time. I've noticed that your holdings in miners have actually declined more recently, and that you've increased the holding in straight bullion. We've sort of come to the same conclusion, which is that miners haven't really delivered partly due to the cyclicality, partly due to capital allocation. And we've drifted towards having a greater commitment to bullion itself over miners. I'd just be really interested to hear your thoughts as to how your view has developed on the differences between the two.

Matt McLennan: Most of our potential hedge in gold we have in the bullion, and we have a minority in miners and royalty and streaming companies.

We're open minded to the gold miners. At the end of the day, if the gold in the ground, net of extraction costs, on a runoff basis is cheaper than buying the gold at spot, if we have a sufficient margin of safety, we're willing to own some of the miners.

And so, this is an area that we've been focused on for a long period of time. But when you think about the miners versus gold, it's a great example of how things can go wrong in businesses more broadly, right? You've got the physical commodity, and you've got an apparent margin of safety. What could go wrong? Well, there's jurisdictional risk. And management execution risk and there's management dilution risk through M&A. But I will say that what has happened over the last decade is that the best gold mines have gone into better management hands. Many of the large miners' trade at pretty large discounts. And so, we've been willing to hold on to some.

The other thing is you've seen the evolution of business models. 30 years ago, you really didn't have the royalty and streaming companies, and these are phenomenal business models. They are kind of exemplars of duration because if you own a gold mine, you'll drill it out. But as you get to the bottom of your underground mine, you might see that there's resource extension optionality, but you've got to put more capex in to achieve that. But if you own a royalty on that gold mine, you get that optionality for free.

There's a bit of a hedge element to the miners. Remember in the 1930s, the U.S. compulsorily acquired gold at $20 an ounce and then marked it to $34-$35. The gold miners were huge investments in the 1930s because the only way to own gold was via the miners.

And so, we're going to major in owning the bullion because we don't have to worry about all these other risks, but we will continue to minor in owning some of the miners and the royalty companies where we think the price makes sense.

Tom Yeowart: Matt, moving to our closing question, what piece of advice would you give a young Matt McLennan at the beginning of his career?

Matt McLennan: When I started out, I came at it almost from a more quantitative perspective. One of the things that I would have benefited hugely from is in understanding the process of growth at a younger age. About some of those principles on this call, but the notion of kind of regenerative customer platforms or real assets with brownfield extension optionality. And at the macro level, the role of endogenous confidence cycles. Those are things I wish I'd better understood.

The second thing is that I perhaps invested more prudently than I should have for the simple reason that I underestimated the nominal drift that would come from fiscal laxity over time. So just understanding, and there's now a theory around this, you know, John Cochrane's 'Fiscal Theory of the Price', but understanding the nexus between sovereign debt growth and the nominal price deck would have opened my mind to other compounding possibilities or made me more willing to hold more equities at different points in time.

And the final thing, is the importance of positional assets capturing the drift. Market share stability is a key lesson that I wish I had learned at a younger age. But I guess, as part of any process, you have to make all the right mistakes up front. And I've made my fair share of mistakes over the years.

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

Matt McLennan: Thank you. It's great to see you both. I have huge respect for Troy. And it's just a pleasure to spend some time together.