INDepth with Caroline Cai from Pzena Investment Management

James Dunn: Hi, I'm James Dunn. Welcome to the Inside Network. Joining me today on In-Depth is Caroline Cai, Chief Executive Officer and Co-Portfolio Manager at New York-based Pzena Investment Management. Welcome, Caroline. Great meeting you.

Caroline Cai: Thank you for the opportunity to be here today.

James Dunn: A real pleasure to have you here, Caroline. I'd like to start off talking about value in the sense that there are so many different forms of value investment around the marketplace or things that purport to be value investing. Take us through Pena's idea of what value investing is as a style and a philosophy.

Caroline Cai: Ah, yeah, so to us, value simply means you want to buy a good business at a low price. And now most people define good businesses along three dimensions: one, high profitability— we look for that. Two, good balance sheet— we look for that as well. The third one being earnings stability or visibility. If you have all three, it's a fantastic business, but rarely do you get to buy it at a low valuation. So what if you have the first two characteristics but for some reason earnings have declined in the company? That may present the opportunity for us to buy a good business at a low valuation. The key to that is to understand what happened that caused the earnings decline, and do we have a view on how the management may react to what's going wrong and eventually improve the underlying earnings power of this company? If we're paying a low price for what that eventual recovery looks like, we think that's a great value opportunity.

James Dunn: Let's take one of the mega themes of the moment that prevails in the market: artificial intelligence. Does AI and the fervor for it represent a risk or an opportunity to a value investor?

Caroline Cai: Well, any change is a risk and opportunity at the same time. Now the reality is, things have always been changing. Technology is an area that we started with the frame PC, we had the advent of the internet, mobility, cloud. AI may be bigger than anything that's come before it. But the reality is good businesses adapt to what's happening in the world. They adjust their business models, they leverage what they're good at, and potentially come out the other side even stronger. So what we see is if you have the right brand equity, you have the scale, you have the know-how to improve your value proposition or competitive position in the industry, technology often times is an accelerator of improvements as opposed to an impediment. So I don't think the issue is things are changing, the issue is always how does the change impact the specific company and what's being mispriced in the market in terms of the opportunity and risk this company is exposed to.

James Dunn: What about something that's both a theme and a market: China. It's been rarely out of the news in the past decade, under the spotlight all the time. What's the view at Pzena on China? Do you think China represents good value?

Caroline Cai: Definitely today. Now, that's not always been the case over the last 10 years. And you can see how sentiment has shifted on China, from very positive to people calling it un-investable. Whenever somebody says something is un-investable, all that really means is there's no price at which they would be willing to invest. That's an interesting starting point from a value investor's perspective, right? Now, if you look at China, it's underperformed by over 55% in the last three years versus the rest of emerging markets. That's a very provocative starting point in terms of the price you have to pay. And by the way, China has real diversity in terms of the businesses that you can expose yourself to. Not all businesses in China are exclusively exposed to what happens in China. But they're getting penalized the same way as a business that may be 100% domestically focused. So one of the things, one of the names we're very excited about in the portfolio is Haier Smart Home. And this is a company that makes major appliances, so washing machines, refrigerators, cooking air conditioners, and so forth. In fact, they actually own the brand Fisher and Pico, I always get the second part wrong- Fisher and Paykel here in New Zealand, even though it's a Chinese company. They own the General Electric branded appliance business in North America and the rest of the world. So over 50% of the company is outside China. They've done a really good job with innovation, moving things through the channel. They've been gaining market share in North America, they're losing money in Europe today, which they're working hard on fixing, and because of the China penalty, you're able to buy a global industry leader who's highly profitable, is on the path of market share gain, at a relatively low valuation. So we're very excited about that.

James Dunn: What about another mega theme: energy transition, which is so broad? How does a value investor think about a concept as broad, but as important as energy transition when researching potential value stocks?

Caroline Cai: Yeah, sure. So, I mean, one of the things I should mention earlier is being a value investor means you have a very long time horizon because long businesses take time to turn around themselves. So we generally have a three- to five-year time horizon. And if you think about these mega themes, they're really going to play out over a very long period of time. Energy transition—the world is on the path of decarbonizing, and over time, fossil fuel, traditional fossil fuel, will become a less and less important part of the energy infrastructure. And that creates opportunities and risks for all businesses in the market. The most important thing is actually understanding how this company is going to evolve in terms of its business model. So if you look at what we own in our portfolio, we have companies that are really taking advantage of the energy transition in terms of bringing new products and services to the market. We have companies that are evolving their existing business model to better adapt to lower fossil fuel consumption, to more renewable production. And then we have companies that we think are completely misunderstood in terms of their exposure to the energy transition. Michelin is a good example of that. It's a tire maker. As we move to more electric vehicles, will need first of all- tires wear out faster than they used to, so you'll need more tires. And second of all, the requirement for tire goes up significantly on an EV versus a traditional gas engine car. That's just pure physics. So that really favors someone who has a very rich product mix, who extracts a higher premium, higher profitability from that higher-spec tire. And we see the electrification trend really benefiting Michelin over the long run in terms of the profitability of the business. But when you say auto, everybody thinks, you know what you get, "Well, you're exposed to the potential electrification trend." It's really misunderstood in that sense.

James Dunn: What about specific stocks? Could you give us an example of a stock that you hold in Pzena's Emerging Markets Value Fund that really exemplifies the characteristics you look for in a value stock?

Caroline Cai: Sure. So one of the names we added in the recent period is Credicorp in Peru. So this is a developing market that's gone through a fairly difficult period during COVID, but also experienced some political instability in the more recent period. Credicorp is the dominant retail and commercial banking franchise there. It's an under-banked market with good demographics, so over time, banking service demand should be growing. Credicorp has a dominant position in terms of the quality of the franchise, the efficiency of their operations. So over time, we really see them continue to gain market share and grow the business in a profitable way. On top of that, they've been the leader in investing into the fintech channel, creating a digital banking model. It's money-losing at the moment but should be on its path to profit-making as it gains more scale. When you wrap all this together, it's a really exciting company that's exposed to all the structural things people like about emerging markets. On the other hand, we're just in a tough spot in Peru and there's some pain they're bearing based on the investment into the fintech channel. So that's creating a unique opportunity to buy a high-quality franchise at relatively attractive valuations.

James Dunn: Caroline Cai from Zena Investment Management, it's been a pleasure going in-depth with you.

Caroline Cai: Oh, it's a pleasure to be here. Thank you very much.

James Dunn: Thank you.

[Music]
[Music]