

Django Davidson (Hosking Partners) - Agents Inside the Capital Cycle

Tom Yeowart: Django, welcome to the podcast. Thank you very much for coming on. So, I think you studied geography at university. Can you tell us how you ended up with a career in finance and then investing?

Django Davidson: I was one of these annoyingly precocious students. I actually set up the Oxford University Investment Club, which had four members, two stocks. I was interested in investing and wanted to share that passion with some mates. But that was my first sort of foray into investing, and I did internships when I was at university. Cazenove was the one that I remember most. That was a great experience walking through the old Tokenhouse Yard with the liveried footmen, and it was a kind of window into the old city.

And then I went to work for Deutsche Bank in corporate finance. In retrospect, that was probably a bit thoughtless. I just had been told by sort of people who knew much more about the City than I did. I didn't come from a City background at all. My parents are academics and musicians, and it was a very creative and free-thinking upbringing, but wasn't at all interested in finance. And all of the people I knew who were in finance who were a bit older said, "Oh, you must go and do corporate finance. It's good training." And I look back on it now, and I don't know whether it was a good training. It was certainly hard work. You sold your 20s. You didn't get a particularly good price for it. You were leaving the office at midnight for days on end. I don't think it was particularly intellectually enriching.

And then from corporate finance, I moved into the bank's equity research team at Deutsche. That was just an amazing stroke of luck that happened about two years before the financial crisis. And so, when the financial crisis hit, I knew a little bit about banks and in the land of the blind, the one-eyed man is king. And so, this little bit of knowledge about banks meant that I got to talk to all of these investors who were trying to understand what was going on, and that really crystallized this idea that I wanted to move to the buy side. It's just a much more intellectually rewarding pursuit to be putting these ideas into action rather than just talking about them.

I went to work with a fund called Algebris, which was one of three firms seeded by TCI, and that was a great experience. That was more and more specializing into financials. And it was from there that I decided to broaden. Algebris went through a bit of a hiccup, and I was lucky enough to meet Jeremy

as he was starting out again after the Marathon journey and set up Hosking Partners in 2013 with Jeremy.

George Viney: Django, I'm a big believer in formative experiences, and working for a German bank during the GFC must have been quite interesting, a career defining experience. What did you take away that has stayed with you all these years later?

Django Davidson: A couple of things. Number one, as regards Deutsche Bank as an institution, it was basically taken over by investment bankers. This storied 150-year-old German institution that had financed so much of the German industrial economy that is in still some areas world-beating, was basically hijacked by avaricious investment bankers who took it into all of the areas that produced very high returns to avaricious investment bankers.

And that's extraordinary. Institutions can be captured, and when industries start to make supernormal profits, management teams are very good at getting their hands on those profits, and those high profits in and of themselves, determine the behaviour of agents.

The second thing I learned was that as regards banks in general, even the people inside them don't understand what's going on. And that's pretty terrifying. The regulators have cottoned onto that. And as a result, now, these very large balance sheet banks, these sprawling, Royal Bank of Scotland, which at one point had a balance sheet of 2 trillion sterling, those bank balance sheets have been trimmed and that's a good thing for the system. It's a good thing for society. It's a good thing for capitalism.

George Viney: Around this time, if I'm not mistaken, you were introduced to Buffett, the investment letters. Many people have read those or studied Buffett's career and come out with the lessons learned from Charlie Munger and the influence that Munger had on Buffett in that the end of that journey looks very different from the early Buffett partnership years. Whereas your career seems to have leant harder on the earlier years of traditional value investing. Why was it that side of things appealed more than the buy, the hold, the high-quality franchise approach to compounding capital?

Django Davidson: So, there are lots of messages to take from the early Buffett Partnership letters and then the early Berkshire letters. One of the main things I took away was how important it is to have your own independent view of valuation and not really be, pun intended, buffeted by other people. The level of concentration that Buffett applied in those early years, up to 50% of the

partnership into one stock. The types of workout situation he was in. He had his sort of three buckets. That really was the product of his own work, and he put a lot of effort into creating a structure that meant other people couldn't come in and second-guess him. Writing the letters once a year, living in Omaha not really responding to other people's requests for information.

And that building an environment in which you can act independently and do that kind of investing, which is very anti-consensus, call it what you will. I thought that was very interesting for someone who's got a sort of contrarian brain chemistry and likes to work things out for myself.

The meeting of Munger and the broadening of the mind to more sort of high-quality compounder ideas is an obvious sort of historical point. I wouldn't push back on it. I would just say I think that to some degree, it is also a reflection of the size that Buffett gets to. When you're deploying very large amounts of capital, it's difficult to go and buy, 30% of a Midwestern stamp producer. I don't in any way reject that way of investing. It is self-evidently true that over the long term if you can compound at high rates of capital, you will do better than the average if the average is below your high rate of capital.

But what I have learnt in my career is how difficult it is to forecast the sustainability of high returns, and I think far too many people outsource a view on a company's sustainability by reference to another higher authority. Buffett owns it; therefore, it must be good. And actually, the work a day job of being a business analyst and really understanding and being able to predict that long term, that is incredibly difficult.

Tom Yeowart: Django, you moved to Hosking Partners in 2013 to join Jeremy. Obviously, Hosking Partners and Marathon very well known for capital cycle investing. Many of our listeners are probably well aware of the capital cycle, but for those that are less familiar, could you just lay out what the framework involves?

Django Davidson: So, it's a super simple framework, and what it says is that over the long run, it's a company's return on capital, not quarterly earnings or announcements in new fields that determine its share price. And so, what the capital cycle does is focus you on the underlying returns of the business. And that, of course, is a function of the competitive intensity of the industry in which it works.

And what the capital cycle allows you to do by focusing on returns, focusing on the competitive characteristics of the industry, is find businesses that in what we

call the bottom half of the capital cycle might have low returns, but where returns will inflect upwards for whatever reason it might. For example, a ball bearing industry where there are 10 factories and suddenly five close, the returns, all else equal, will be higher on the remaining five.

At the higher end or the top end of the capital cycle, it gives you a lens with which to look at businesses that have high and sustainably high returns, companies that, in our terminology, beat the fade, that somehow manage to sustain these high returns.

It's a way of being able to look at the entire spectrum of global equities, we're global generalists, and be able to compare and contrast companies that have got high returns, but maybe very high valuations, with companies that have got low returns, low valuations, but where we think those valuations might improve because the underlying returns are going to improve.

Tom Yeowart: Obviously, there have been a couple of very good books written on this style of investing. But I'm interested in what you've learned from observing the likes of Jeremy. When you joined Hosking Partners, you obviously had an idea about capital cycle investing. What have been the nuances you've learned along the way?

Django Davidson: So, this goes back to something we were talking about earlier. Valuations in and of themselves, profitability in and of themselves, determine the actions of agents within the industry, the company that those high profits and high valuations come from. So, if you are in a highly profitable industry with high valuations that can raise capital easily, put a flippant example out there, you are more likely to go on a sort of team off-site heli-skiing in Alaska than you are if you work in an industry with low valuations, low profitability, threat of closure. And that very human desire to extrapolate happens to CEOs as much as it does to anyone else in the industry. And you see these underlying return on capital cycles amplified by the stock market because of the human behaviours of the agents who are the recipients of these high profits and high valuations.

So, what the capital cycle does is give you this very simple framework of industry returns reverting to mean in most industries. But on top of that, and much more important and what the great puzzle and great sort of unsolved Rubik's cube of capital cycle investing is how much do these human agents who are either the investors bidding up the shares or the management teams going and buying other companies or raising capital, how do they interact with these underlying returns?

And it's of course the way that these returns are amplified on the way up and amplified on the way down by the stock market that is really interesting. The cure for low returns is low returns. The cure for low valuations is low valuations, and vice versa.

George Viney: And what you're saying is ultimately the changes in those cycles are determined by human behaviour. So, you can look at capital deployment, Capex ratios, order books, asset prices, all that sort of stuff, but ultimately, it's human decision-making which is driving things to excess on the way up and the way down and a defining element of your thinking and how it's evolved is the study of human behaviour through that process?

Django Davidson: Yeah, absolutely. To put a bit of meat on that bone, if I am a management team that can raise \$1 of capital in new equity or new debt and have it valued at three or five in the stock market, what am I going to do? If I can raise three billion in debt, build a couple of data centres in Texas, and have 10 billion of additional market cap, what am I going to do?

And that very human desire to exploit the greed of others and to get on board a bandwagon is hard to resist, particularly when the sums involved, which for many of these management teams, is in the tens of millions. That very human desire to amplify these cycles is the cause of why they get so extended on the way up and on the way down.

So, one thing is learning this, the cure for high valuations is high valuations. The second is just how long it takes for high valuations to work through.

Tom Yeowart: Looking back over your career as well, there have been some fairly distinct interest rate environments which have probably distorted the capital cycle over those periods, in that there have been times when maybe creative destruction hasn't happened as quickly due to capital lingering because of very low rates.

But can you talk about how that rate environment has impacted just your sort of broad framework.

Django Davidson: Yeah, so interest rates are probably the most important thing. They're the discount rate for all investments, but they're also very important for capital formation. All else equal, if capital is free and underpriced, you're going to see a lot of money raised.

So, if I'm bashing steel today and making a dollar, or if I'm promising a new and super abundant world of AI in year 30, there's going to be the same discount rate applied to both of those dollars. So, when interest rates were low and suppressed the returns, particularly to asset heavy capital-intensive industries, the valuations were very low compared to businesses that were promising the future and delivering profits in the future.

That probably peaked around COVID and the unwind since then has been very positive for our style of investing. What I think is maybe not fully understood about the way the capital cycle works is that the capital cycle is not just a sort of template for finding value shares. It's a framework for looking at the way that the entire world has allocated its capital. I know it's quite a highfalutin, pompous thing to say, but put it into real world, roughly speaking about fifty cents of all the dollars invested in the S&P are in technology, AI, semiconductors, et cetera. It's actually closer to sixty than fifty. As a result of that, it has to be the case that if you are on the other side of that ledger building steel factories, trying to get copper mines permissioned, looking for rare earths, you're going to find it quite difficult to get capital because half of all of the dollars are in the technology sector.

So, in and of itself, the capital cycle is working to create opportunities away from the technology sector. What is so powerful about the capital cycle is it gives you this framework with which to address the investing world, which is to say I want to avoid these areas of overcapitalization because high valuations in and of themselves are going to attract a lot of capital and misallocation, and low valuations in and of themselves are going to attract a lot of opportunity.

So, what the capital cycle does is, it's not a treasure map, but it gives you a kind of vague route on which, okay the good ideas are more likely to be over here than they are over there.

George Viney: Does the capital cycle approach work for every sector, or is it just more relevant in sectors where capital, money, assets flow more easily? Where is it more fruitful to spend time because you can have confidence that the cycle will actually turn in a more predictable way rather than get locked by regulation, barriers to entry, management, whatever it might be?

Django Davidson: That's a good point. As a very big-picture framework for looking at where an investor should spend their time, it works everywhere. When you drill down into the weeds of particular sectors, for example, biotech, it's going to be very difficult on a company level for the capital cycle to tell you

whether or not this company is going to be able to come up with a cure for cancer or what have you.

But what it will do, and it did do for us, was skew us away from the biotech sector, five or six years ago, when I think I'm right in saying there were, in the NASDAQ biotech indices, over 80% of the companies didn't have any revenue, and of the remaining 20, the average EV/sales was something like 40.

That is clearly just not going to be a very attractive place. Fast-forward to today, there's been a big de-rating of the whole sector. We've made some investments in some effectively broad-based biotech investments which own companies that are doing interesting things, that are producing revenue, but where the valuations versus the NAV of these companies is an extreme discount.

We don't have any particular insight into the underlying science of the drugs, but we think that the massive valuation collapse, both in terms of the share price, but also in terms of the NAV is interesting.

George Viney: High-tech industries, maybe also highly regulated industries like utilities, for instance, or those that have high government involvement where the capital cycle is not really driven by capitalism.

Django Davidson: You're right, yes, that's right. I think that they are harder, but they're not immune to it. I mean, a good example would be the UK at the minute, which has a highly regulated utility sector. It's been under-invested in. The customer is privileged over the shareholder in most of these industries. But it has, nonetheless, a massive requirement for additional capital. And what's interesting about these regulated industries is that the regulator has to somehow incentivise that capital in. So, I wouldn't put that on the sort of blacklist. There is a need for capital, and the interesting thing about a regulated industry, if there's a need for capital, the regulator's got to attract that capital in with attractive returns.

George Viney: And this idea of agency is interesting too because for many years, Japanese companies were highly overcapitalised, and there wasn't a lot of incentive or motivation to unlock that capital, and you could've been invested in those businesses for a long time. Wouldn't have got very far. But it was really, it was a government mandate and then an institutional imperative to make a change that's resulted in Japan becoming a much more fruitful place. And it's like, the behaviour of people, but also government involvement, whether it be Chinese state-owned businesses, that can have a determining influence on whether actually these things unfold in a shareholder-friendly way.

Django Davidson: One hundred percent. We're very constructive on Japan for a very simple reason. If you want to improve your return on assets, you've got two levers. You can go out into the world and sell more stuff and make more profits and raise your margins.

That's the lever that 99% of management teams focus on. Or you can shrink your asset base, and that is incredibly difficult, especially to your point, George, in a society that is above all centered on job security and employment maximization. And for years and years, these Japanese companies would try and pull the top lever, not particularly successfully, and the bottom lever was just never ever being pulled.

The fact that we're seeing so many Japanese companies now respond to this incentive put out by the Tokyo Stock Exchange to explain why they're trading below book value means that we're seeing head offices sold. We're seeing the second head office sold. We're seeing crossholdings unwound. That from a pure capital cycle perspective is really simple and really powerful because it's just easier to shrink your balance sheet than it is to go into a new market. So, the long run returns on capital in corporate Japan have improved now I think for five consecutive years. They've gone from very low to okay. I think that trend is going to be long running. And what's so additionally powerful, and this is a lot of the time we spend when we engage with these Japanese management teams, is encouraging them to get ahead of the asset shrinking by shrinking their share count first.

Because the per share impact of this, if you can shrink your share count first and then shrink your asset base, is a per share value accretion, which is dramatic.

Tom Yeowart: Can you talk a bit about when you've identified a capital cycle opportunity, then how your approach focuses in on the management teams, the sort of human element of the people actually running those businesses.

So maybe in Japan, I'm probably going to butcher the name, I think you all own Hikari Tsushin? How did you come across that company? What attracts you to management teams and that sort of operational execution that hopefully also amplifies your returns?

Django Davidson: Standing back, here is a really important point that I think we all know, but maybe we don't pay enough attention to. If a company is generating a 15% return on equity and paying out 50% in dividends and retaining 7, in 10 years, the management team, a long-term CEO, 10 years, is going to have allocated 100% of the retained capital in the business. So, it's very

important to understand what these people, these agents, are doing with the capital. What are their incentives. We spend a lot of time on incentives. It's pretty simple stuff, but it's incredibly powerful.

So, if you are really serious about capital cycle investing, what's happening to the capital in the company or the returns on capital of the company, you will really understand what this company is doing with their own retained earnings.

In Hikari Tsushin, you've got a very unusual setup, which is that it's like a microcosm of everything that's happening in Japan in one company. So, they have an investment book of Japanese small and micro caps in which they are being constructivist. They're doing it in a Japanese way to improve the returns of lots of these businesses. They take significant stakes, many of which they have competitive understandings from their own core business. So, for people who didn't want to go and meet 150 Japanese small and mid-caps, one way to shortcut that would be to invest in Hikari Tsushin who are doing a lot of that hard work for you.

It's one of our bigger Japanese positions. But we have 65 Japanese investments, and this goes to this idea of diversification. When an idea like Japan comes, which is effectively a country-level capital cycle, this idea of shrinking the asset base to increase the returns, that is going to be expressed over a large number of shares.

And the way to prosecute that idea is through diversification, because you don't take the single stock risk of saying, I'm a Japan analyst, and the single best stock which I want to get in the global portfolio of 20 names is this one share. And it might be a very good share, but it might not. By having humility and reducing the overconfidence that comes with this specialization of industry knowledge and having a tolerance of a large number of shares, you can be approximately right about the idea and remove that risk of being precisely wrong in the individual stock.

That is absolutely crucial to doing this kind of capital cycle investing. I hear people who say, oh, we're capital cycle investors, and we've got 20 shares. That doesn't ring true for me because if you're going to invest in something like Japanese small caps or the offshore drilling industry you've got to be able to spread your risk across a number of companies.

And that gives us this extraordinary advantage, Tom, which is that most people in our industry, because of the specialization, work in a very confined portfolio setup. They have to have between 20 and 80 stocks. And if you do that, there

are going to be so many areas of the global equity universe you can't invest in. If you're going to have 80 stocks, are you really going to be looking at offshore drilling companies, South African platinum mines, beaten up emerging market stocks? You're probably not. There is a capital cycle in the fund management industry, the swing to passive has meant that in order to survive in active, you've had to be more and more specialist, and that has really left this gaping hole for the global generalist.

George Viney: I've got two more general questions about the capital cycle approach. One is the risk of terminal decline. A company or an industry may look like it's at the bottom of its cycle, but that industry is fundamentally changed, and there are lots of examples of industries that have struggled but continue to struggle. And so, with a focus on supply, to some extent at the expense of trying to forecast demand, at some point you have to have a view on what demand may look like to have confidence about how these companies may make money over time and improve their returns on capital.

And then the other one is around timing and how you give yourself enough time to get ready for the change in the capital cycle without waiting too long and exposing your investors to the costs of being too early.

Django Davidson: Taking your second idea of timing. You can never get the timing right. Occasionally you do, but most often you'll get the timing wrong. So, we have two process architecture-driven- methods to try and improve the timing of these cycles. The first is that we are five multi-counsellors. So, I... and this often happens because I'm very good at being early, I might go off to Sri Lanka. Sri Lanka in 2023 had a sovereign debt crisis, currency collapsed, the stock market fell 80% in US dollar terms. You go and buy some shares in very obvious replacement cost-type situations. And it might be that then there's an energy price spike, and the market falls another 30%. But then Fund Manager Two can come in and say, "I really like that idea that Django wrote up and talked to us about in our investment meetings. But I thought, perhaps it could go cheaper."

And now suddenly that idea is 30% cheaper. So, the way we've structured our firm architecture is to try and put some scaffolding around these expressions of contrarian investing. And so, what we've tried to do with this multi-counsellor approach, it's very important that we communicate with each other, we work very hard on this, we write meeting notes, we sit in a tiny little office all together, is that these ideas move between the fund managers so that the good ideas become larger in weight in a sort of dollar cost averaging way.

So, a good example of this would be the memory semiconductors, which we've held for 14 years now. We've added and sold all the way through the cycle. Recently, they've gone into a mega blow-off not for reasons of supply, but for reasons of demand. But the underlying picture has been this industry getting smaller, the supply being constrained, the barriers to entry rising with each technological iteration.

And over the years, some fund managers have sold at the top of these cycles, and then we've bought back. And that signalling of having a number of multi-counsellors helps you with the timing, both on the way in and on the way out.

Your first point was on- About

George Viney: technological-

Django Davidson: On technological-

obsolescence ... obsolescence. Yes. And having... Yeah, this is very important. So yeah, we say that supply is measurable, demand is storytelling. Focus on supply. You can count it. It gives you something to hold onto. I think that's very important. But you're absolutely right. The saddle making industry in 1912, I assume, had relatively good supply dynamics, but then you weren't doing very well 10 years later.

Of course, we are all, sensitive to demand. We just think it is more important to analyse supply. The analogy I would use here is that of asbestos, which since the 1990s when it's basically been banned and outlawed everywhere in the Western world. It now basically has two or three applications in F-35s and in certain military uses where you need the insulating properties of asbestos.

The global volume of asbestos has fallen 95%, but the dollar value of the asbestos market has increased by 2x. So not every decline in demand comes with a collapse in the underlying industry economics if the supply can keep pace. In fact, it's quite good if you have pricing power.

So, the supply of car factories in Europe is shrinking, but it doesn't look like a particularly attractive place yet. Would I want to own a platinum mine? The demand for platinum, it's actually flat. But yeah, I would because the supply of platinum is shrinking faster than the demand.

Tom Yeowart: You've clearly got a very broad portfolio in terms of number of underlying holdings, but can you talk about maybe the number of underlying

ideas. Because I guess at the moment, if you think about AI and AI capex you could own lots of different companies in different industries whether it's sort of semiconductor companies or power, energy, and there's a linkage to one massive capital cycle. So how do you think in terms of breadth of actually the underlying animating ideas within your portfolio?

Django Davidson: So yeah, we've got a large portfolio of just over four hundred shares, which is a mind-boggling number. But if you actually distil them into the ideas, there's probably about twenty big ideas in that portfolio. So, the PGM cycle, the memory semiconductor cycle. We've got these emerging market value companies and so on.

So, it's about twenty ideas. The idea there is it goes back to George's point about timing. We don't know exactly when these cycles are going to bottom, and we don't know exactly when these cycles have peaked. But by slowly entering and exiting them and having a tolerance of a large number of shares, we feel we can be approximately right.

It's like a bond portfolio with sort of maturities in different years. With the bond portfolio, you know when the bond's going to mature. With the memory semi cycle, we don't know when it is going to mature, but we think it's probably less attractive today than it was two years ago.

Tom Yeowart: Maybe that's a good segue onto some of the current case studies and AI in particular, and this AI cycle through the lens of those memory companies, which you've clearly done exceptionally well in owning for 14 years. But where I guess the last two years in particular has seen an exceptional surge in demand, which when married with the supply constraints has created powerful returns. But just how do you navigate such an extraordinary period like the one we're living through?

Django Davidson: It goes back to this point about architecture. How would you design a firm? How would you design your investment process to give you the maximum chance of being able to hold on to things like a, a memory cycle? And it comes back to this idea of diversification being a massive advantage.

That's a bit of a narrative buster. Everyone would say concentration is the advantage. Pick the 20 best stocks and you'll do better. But actually, when you pick the 20 best stocks or even fewer, you end up doing things like selling your memory semiconductor stocks after they have gone up 150%, which a number of sort of storied investors did in the last couple of years.

But because these positions were, small but meaningful there was no pressure for us to sell them. Our entry cost was thirteen years ago. We'd done a reasonable job of buying and selling them in the cycles prior to this. And it's an important point on the memory semis is that this long run capital cycle, that there were fewer players, that the barriers to entry were increasing, that there was a sort of steady state demand, but with a much better supply picture. What that meant was that during these cycles, which can be short because these are tech cycles rather than necessarily economic cycles. The returns at the bottom of each cycle over the last thirteen years have got higher and higher, which is the great evidence point for the capital cycle at work. Returns were improving at the stress points in each sort of three to four-year period.

And so, we got confidence that the industry analysis was broadly correct, which allowed us to hold these positions for a long time. If we had a twenty-stock portfolio, there would have been this very difficult discussion about should we exit these to make way for something else? Our average holding period is ten years, we've got over four hundred stocks, we're comfortable with these baskets of ideas. That gives you the ability not to be pressured into making a decision because of this competition for capital.

The valuations of these companies on any kind of price to replacement cost is high. So, what that means from a capital cycle perspective is all else equal, that will see a flood of capital come into the sector, which, we've seen with these Chinese IPOs in the last couple of months. So, we have been selling these things in small amounts for the past 18 months. Their valuations are relatively extreme. There is probably an earnings bubble in memory semi at the minute. It requires these high prices of memories to sustain. How much hoarding of memory is there in this very bubbly system? I don't know, but the answer is somewhere between a little bit and a lot. So, when and if this memory cycle turns, we will have sold probably about three-quarters of our shares in these memory semis. Will we still have some? Perhaps maybe we'll continue selling.

I think the key point is that by having a diversified portfolio, you can have an open mind about this, and it isn't going to be the key determinant of our performance for the next couple of years.

George Viney: The hyperscalers are funding the extraordinary spending that we're seeing, capital cycle that arguably none of us have ever seen before. They have been increasingly compared to the railroads and the railroad build-out, but there are clear differences in the technology, but also how it's being financed, at least up until now. Is your view here somewhat agnostic in that you just think it's kind of hard, and these businesses are spending, and history would suggest

that the returns on capital will be disappointing"? Or are you saying that their returns on capital will be lower than what they generated in the past, but if what they generated in the past is 30, 40%-type returns on invested capital, it's more a call on their valuations? What's your view of those businesses that are essentially at the epicentre of this build-out and how investors should think about their prospects?

Django Davidson: I think in these sorts of extreme scenarios, standing back and taking some very simple long-term observations is the best way to channel your thinking. We have this phrase internally that there's often a deep reality to a company or to an industry or to a political situation. What's this all about? And standing back, this just goes back to this idea of high profitability impacting human agents, this is a paranoid race to remain relevant.

The paranoia is all around AGI or some new application for AI that knocks down all of these gated front doors to the internet that we have at the minute. And the evidence point I would have for that is, Zuckerberg I think has said, "Oh if we lose a couple of hundred billion dollars on this, what does it matter?". I think Sergey Brin said, "I'm willing to go bankrupt on this race." It's well documented that the people who allocate your capital are in a race, and that's just not good.

That's not great as an investor. What are the implications of that? It means they are going to become more capital heavy. If they're going to become more capital heavy and all else equal the remaining profit take from society stays roughly flat, they're going to have lower returns on capital.

So, this is about agents determining behaviour. This is about the capital intensity of the business increasing. And the third thing that really is not bullish is that it's about believing in a future sold by people who are selling their shares. So, whether that's the SpaceX IPO, whether that's the upcoming IPOs of these frontier model companies, these people are selling you shares. And the history of all of these bubbles, whether it's George Hudson in the railway boom here or any of these great IPO capital cycles is that when you're selling shares you come up with great stories.

But that doesn't help you with timing. What helps you with timing? There's an interesting development which is that as of July, the hyperscalers finance more of the build from third-party financing than they did from their own internal cash flow. Now they are dependent on third parties to finance this boom, and the boom has gotten out of hand and is so large that they're literally crowding out the US government debt market. I think we are getting quite close to this

being resolved by the cost of capital. One of the things I've learnt is that by being very disciplined about simple analysis, you can make reasonably good judgments over the long term.

George Viney: There is clearly a lot of demand required to justify the amount of supply coming online in the next couple of years. What's your view about the demand we've seen so far and the fact that these businesses, the frontier AI companies, but also other businesses, AI native businesses, are scaling their revenues at an extraordinary pace based on this technology?

That's unlike the railroads in a way because the thing had to be built, then the fares had to be sold or the freight had to be shipped, whereas these businesses are growing at an extraordinary rate because of the importance and relevance of the technology.

Django Davidson: I'm nervous about making any predictions. I'm a great believer in this quip from Niels Bohr, who's a great Danish physicist, part of the sort of Manhattan Project. He says, "Prediction is difficult, especially about the future." That's another way of saying focus on supply. You can count it. Demand, who knows? So, I don't have any great insights other than, this is a slightly cynical thing, if you are developing a technology like AI, and you have some of the cleverest people on the planet, right? They are probably going to develop this technology for the areas where demand is highest first off, because there's a natural need for that.

Where the demand was highest, first off, was in coding. And it uses an incredible amount of compute to do that. So coding, yes, it's been incredibly disruptive. But what it needs to justify the trillion-plus valuations is it needs to start disrupting white-collar stuff that is not really about building more and more lines of code. It's about making good judgments. It's not doing the high value-added work yet.

What if they just solved the most compute intensive areas like software, and what if the other areas are actually going to be much more difficult to disrupt, take a very long time, need it to develop trust? It might take 10 years to develop that trust, and even then, we don't know what the outcomes will be. So, I feel quite comfortable in thinking that a lot of the fast growth has come.

And then here's a historical analogy for it. I'm a big fan of a book about George Hudson, who is the great kind of Elon Musk of the UK railway boom. He specifically focused on building out track on the most profitable routes first. Connecting London to York was, like, a really good idea. And then he started

connecting random areas of like the Pennines. But guess what? There wasn't much demand for I think it's the Settle to Carlisle Rail, I'm now moving into territory that if Jeremy listens to this, he's the world's foremost collector of steam engines, so he will know all about this. But I don't think there was much demand on the Settle to Carlisle Railway, but a lot of money got raised for it. And that's why, these numbers are approximately right, from 1830 through to 1930, a century, UK rail passenger numbers, compounded at 9%.

But if you bought the railway index in 1830, you were down 80% 100 years later. So, what that says to me is that if the constant here is humans, and the constant here is very clever capital-raising technologist humans, I'm not saying they're malintentioned, I'm just saying you go for the easiest stuff first.

Tom Yeowart: We've talked obviously about AI; we've talked a bit about Japan. What are the other ideas within the portfolio that from a capital cycle point of view you have confidence in today?

Django Davidson: So, standing back, there has been massive disinvestment or lack of required ongoing investment in capital-heavy areas of the economy. That's particularly acute in mining and energy. So, mining and energy make up over a third of our portfolio. And that, I think, is going to take at least a decade to right some of these misinvestment wrongs.

There's a simple return rationale for that, which is the most powerful. In order to put a dollar in the ground, to dig up some hydrocarbons or dig up some copper, the required return rate has to be so high that it becomes a no-brainer to invest. Even in the developing world governments are finding it very difficult to permission these new mineral extractive industries. I would point people to Panama where about 25 years ago work was started on a mine called Cobre Panama. It's one of the biggest new copper mines in the world. It's absolutely integral to electrifying the grid. The mine came into production about two years ago. It was working for about six months. It's about six percent of Panamanian GDP, a bigger number of exports and so on. Absolutely crucial to this tiny little low-income country. And even that mine was shut down for environmental reasons. They're very water intensive, these copper mines. It's not pretty.

If even Panama is shutting down producing mines that are supplying, a huge proportion of the tax base, capital will require even higher returns to back these projects. The cure for high prices is high prices. We need high prices for a long time to attract the capital in to really change these supply pictures. The story here really is so compelling, it's so difficult to bring on new supply that we just don't know how high these prices have to go. It's the kind of two decades really

of misinvestment that means prices have to go so high that it really does feel like a sort of two-foot bar, a lot of these things.

So that's about a third of the portfolio. Japan's about 15%. We also have a bucket of companies that are in these top half of the capital cycle companies. Companies that we've held for many years, often that we buy coming out of these big sort of market dislocations. We first bought Amazon in 2002, and we still own shares in it. We've been selling it, but it's still a reasonable position. Likewise, Booking.com. One of the things I've taken from Jeremy is that you normally get a chance in your career at least once, maybe twice, to buy some of these amazing companies at extraordinary valuations.

And if this idea about the hyperscalers plays through, there is probably going to be a time in the next few years when some of these companies will be valued very lowly. And that's a point where the capital cycle moves again. You've probably got highly valued oil companies, highly valued commodity companies, and that would be a time to take profits from those and recycle them into some of the higher quality companies that are genuinely able to prevent competitive attacks.

Tom Yeowart: Django, I was at the London Value Investor Conference 10 years ago when you stood up and talked about the death of brands. Clearly a lot of consumer branded goods companies have not had a good decade since for a variety of reasons, including a period during COVID where the supply and demand dynamics got muddled up. I'm just interested as we sit here today, as these sorts of stocks have significantly underperformed, how you're thinking about them and whether, in your capital cycle framework, they're becoming more interesting again.

Django Davidson: Those companies are a great example of this idea that ultimately high profits, high valuations will determine agent behaviour. So, the valuations of some of those branded consumer good companies that comprise this death of the brand idea that I talked about 10 years ago were doing insane things at insane valuations. The Kraft Heinz merger, it was just extreme to think that you could earn 40% margins selling revolting cheese that's highly priced. Like all financial extremes, they start off with a good idea. These guys at 3G were just ruthless operators, zero based budgeting. There's definitely fat you can take out of these big, branded goods companies, and they did that. But they pushed it to such an extreme that they were earning higher margins in 2017 than Google. It's nuts. And they were capitalized on seven times historic sales, whereas Google I think was about four times at that point.

So that was just a clear example of margin fanaticism, financialization going to an extreme, and then leading to very poor capital allocation decisions as the executives in these businesses who are basically in their own world of private jets literally flying around talking about cost savings and forgetting that if you're selling ever more financialized cheese, people might not want to buy it. And what that did was give this amazing pricing umbrella to own brand, to private label, who could come in and give the customer something better or just as good for way lower.

Depends where you are in the world, but cornflakes are roughly twice the price than own brand cornflakes today. Kellogg's has arguably been on a period of finding itself. It's been off to the find yourself yoga retreat and come back all thin and feeling better about itself. But it's still very expensive. I think these cycles are long. When Coke peaked at 40x P/E in 1998, it underperformed the S&P for nearly twenty years. And that's the best business in the world if you believe Buffett.

So first off, these high valuations, A, they take a long time to work through, but the management behaviours take a long time. There are some green shoots. The Kraft Heinz merger is being reversed. They've given up on it. It was full of accounting scandals and fifteen billion-plus write downs. That really is a stain on that whole approach of pushing margins really high in consumer goods companies. The management teams have got that, and they're starting a sort of slow unbundling, which I think is good. It's good for the industry, and it's a classic capital cycle data point. My take for what it's worth is that there are probably going to be some really interesting spinoffs among that process. I met Magnum Ice Cream recently, it span off at 1x EV/sales. Remember, Kraft Heinz peaked at seven.

So, I think there are probably some interesting things happening, and that sector is starting to heal. But I would just use that Coke example of how long it takes. And I've got a sort of working hypothesis that the higher the quality of company the longer the cycle. The lower the quality of the company or the industry, the shorter the cycle.

Drinks, I think it's different to package branded goods where they overpriced and let private label in. In drinks, own brand drinks, not really a thing. And the regulations are very interesting in drinks, particularly in the US where, it's not just federal level, it's state level. It's incredibly difficult to get your brand distributed in the US. But again, they abused the customer. They overpriced. They saw this demand in COVID. You just talk to anyone who is in their 20s, and they will tell you it's too expensive to go out and drink. That's an absurd

position for an industry to get to, to take the lifeblood of your future company and to outprice them. But I think they have understood that. They've got there.

I think we will continue to drink less but drink better. I think that's just a human trend. But within that, you can have these huge cycles. There was a great analysis of the whisky industry, which in the 1980s had a massive glut, and it took a very long time for the whisky industry to work through that. Now, whisky pricing has gone up. It's been a great industry and all that sort of thing. But you can have long periods where these supply and pricing dynamics work through. So, I think they're great companies. Will they be around for my grandchildren? Of course, they will.

Tom Yeowart: Turning to our closing question, Django. What piece of advice would you give a young Django Davidson at the beginning of his career?

Django Davidson: Really focus on business and industry analysis. What will happen is the world that you work in, the company you work for will try and make you an expert in a little niche somewhere. But try and use the learnings from all of your work on industries, companies, to create some ideas that allow you to see patterns when you look outside of just that one silo.

I mean I understand why it's easier to market siloed investing, but I think it can lead to bad outcomes. So, it would be really focus on your business and industry analysis and try your hardest not to specialize too early. Try and keep broad because over the long run, this ability to spot these cycles will really help you survive, which is what the game is all about.

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

Django Davidson: Thank you