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Q&A-Stocks with pricing power to outperform as reflation takes hold; Crypto's a threat to payment solutions firms: Sean Stannard-Stockton, Ensemble Capital

The best stocks to hold through the COVID-19 recovery in the U.S. will be those having the power to hike prices faster than the likely quickening inflation and the related further climb in yields, **Sean Stannard-Stockton, president & chief investment officer at Ensemble Capital**, told the Reuters Global Markets Forum on Thursday, May 27.

Stannard-Stockton, whose holdings include Mastercard, Netflix and Ferrari, said sectors such as industrials and areas like housing provide opportunities to capitalize on this economic recovery.

He also said the two big threats for payments solutions providers Mastercard and Visa are cryptocurrencies' rise and tighter regulation.

"The whole purpose of crypto and blockchain more generally is to remove the need for third party trusted intermediaries, which is exactly what Mastercard is," Stannard-Stockton said.

Following are edited excerpts from the conversation:

Q: Starting with a top-down view, what's your take on the U.S. stock market and sectors amidst rumblings of reflation?

A: We think the U.S. economy will stay strong not just all year, but into 2022 and beyond. There is huge latent economic production available, but the ramp up post-COVID-19 will be messy with supply chains in disarray. We think investors should look through the inflation concerns and focus on economically sensitive stocks who will benefit from strong growth, but importantly, we focus on companies with pricing power that can pass increased costs on to their customers. Sectors such as Industrials and areas like housing offer the sort of opportunity I'm pointing to.

Q: Do you think the U.S. housing market is driven by region-specific narratives, given trends of working from home, etc.?

A: We don't think cities are going to become less important, but high housing costs in cities and more work from home opportunities means a reshuffling of American households is occurring. We are long NVR Inc, a home builder focused on suburban and ex-urban areas in the south east of the U.S., where land is still inexpensive. Note that metro housing markets have seen multiple bids on houses for many years, so even a reduction in demand won't overly hurt prices.

Q: How do you feel rising input costs i.e. lumber etc., fit into this view?

A: Lumber is a great example of a supply chain restart inflation issue, but we don't think over the next couple years that lumber shortages will hold back housing.

Q: What are your thoughts on inflation?

A: Inflation has been abnormally low for a decade and the U.S. Federal Reserve has the tools to make sure it moves back up to where they want. We think the next year or two will see messy inflation numbers that will scare some investors, but that the U.S. economy has the output capacity to absorb the coming demand and we won't run into a persistently high inflation issue.

Q: Could the Fed's new inflation framework be considered dangerous due to allowing inflation to run hot?

A: 3% inflation for three to five years is not a disaster by any means, but yes, it is dangerous. Just not as dangerous as running a repeat of the last decade were weak demand led to weak wage growth and an increasingly unhappy U.S. population. The Fed is telling us higher inflation isn't the risk to worry about, it is the goal they are trying to achieve.

Q: What is your view on Ferrari's future once internal combustion engine (ICE) technology usage declines?

A: We believe ICE is indeed on its way out. Ferrari is embracing hybrid and even electric vehicles in future years, but note the average Ferrari is only driven about 2,000 miles a year. They aren't major emission contributors. They are mechanical works of art that buyers collect. Ferrari's SF90 **Stradale** plug-in hybrid is incredible. No compromise on style and performance. Ferrari is a luxury company that pretends to be a car company. While its products are indeed cars, they tend to go up in value, not down, after they are purchased.

In other words, Ferraris are not consumable goods, they are collectible assets. This gives the company huge pricing power that leads to profit margins far above what a "car company" would earn. The company sharply limits the level of cars they produce, but they will be launching a SUV-type vehicle that we expect to materially increase production levels and profits. Luxury SUVs are a proven market and we expect demand for a Ferrari SUV to be very, very strong.

Q: So much of the emotion around Ferrari cars are tied up in the glorious engine wail. Do you think their sales will hold up once that disappears?

A: Yes, the sound of an ICE engine roaring is a big deal, but we think the attributes that buyers desire will evolve over time. After all, a long time ago the sound of a train whistle sounded like cutting edge technological progress. Today, it sounds old-fashioned. Navigating the transition away from ICE is a key issue for Ferrari, just one we think they can navigate.

Q: What about Ferrari's geographic breakdown of revenue? What areas do you think will be sweet spots to drive sales?

A: One of the reasons to launch their SUV -- which the company insists won't be a standard sports utility vehicle, but will offer more functional transportation utility than their sports cars -- is to better address the Chinese market where luxury car buyers often have a chauffeur. No one wants to sit in the back sit of a Ferrari sports car! But we expect the SUV to offer comfortable back seats.

For those of you who have never bought a Ferrari [me neither!], it is amazing to note that there is a wait list and the company only offers the "privilege" of buying their high-end cars to existing owners who have proven their loyalty to the brand. (We took) a trip to Italy and (saw) how the company manages to get some of the richest people in the world to bend over backwards to be allowed to buy their most expensive super cars.

Q: Does Netflix look less alluring in the short-term as countries reopen? What's your long-term thesis on the stock?

A: The company saw huge increased growth during the pandemic, and we think they will keep the vast majority of them. There are no signs yet of increased churn as the world reopens, but yes, new additions will slow for a bit. But the big picture is their subscriber base going from over 200 million today to 400 million or so over time. For many years, investors thought that legacy media companies could pull their content from Netflix and destroy their business. But legacy media didn't do this until after Netflix had built their own content library, which today represents the very best content with Netflix regularly winning the most Oscars and Emmys and Netflix shows being watched more than any other.

Importantly, Netflix is the first global media business that has not only successful attracted non-western subscribers to watch shows produced in the west -- as Disney and others have as well -- but also produced non-English language shows that have not only been local hits, but have been some of the top shows in the U.S. as well. The key to understanding Netflix as a stock is to understand they are intentionally under-pricing their product. We know this because they have been raising prices at 7% a year without losing customers. Ask yourself, how much higher would a Netflix subscription have to cost before you cancel. For most people it is over $20. The fact is many people still subscribe to cable TV at $100 or more a month.

Q: Do you think this year's climb in yields has more room to run, and could that dent the tech sector's valuations?

A: It is truly incredible to think the U.S. 10-year Treasury currently offers a negative real yield, even in the face of an explosively strong economic recovery. With the Fed intent on keeping rates low, both short rates, but also using QE (quantitative easing) to tamp down long rates, they may well stay low in the short- to medium-term. But it is very difficult to see how the 10-year yield could avoid moving higher by a lot over the next few years. A 3% (yield on the) 10-year seems like a given. People forget real 10-year yields have historically been more like 3% with nominal yields of around 5%. So, tech stocks that are overvalued could well be in trouble, but look at a stock like Alphabet, trading at a low 20xPE (price to earnings) multiple. No reason the valuation has to compress just because yields go up.

Q: What are you excited about when it comes to Alphabet's future offerings?

A: Don't take your eye off the core search business for Google. I realize it isn't a fun topic to focus on, but it is just spewing out cash and continuing to grow rapidly. Add in YouTube really coming into its own and TV ad dollars being shifted to digital and you actually have accelerated growth prospects, which is amazing for a mega cap that has been growing at 20% for many years. But the new and interesting stuff is with Google Cloud. The company seems to have finally found product-market fit and is winning lots of new business. Over time, it will flip from being a drag on profits, to being a quite profitable business, like Amazon Web Services.

And then there is Waymo. They've finished testing in Arizona and are not doing self-driving taxi service testing in San Francisco. I was in the City last night and saw 5-6 Waymo vehicles. This is obviously a long-term thing for them, but switching commute time to internet surfing and ad clicking time would be a boon for Google!

Q: What makes you like Mastercard?

A: Mastercard isn't really a "financial" in that they don't let money to anyone, that is the issuing bank. Mastercard, along with Visa, manage the payment networks the globe depends on. While there has been huge innovation in the payments industry, for the most part, these innovations have been built on top of the Mastercard/Visa network, rather than attempting to disrupt it. So today, you can pay via Apple Pay, or Paypal, or by swiping a card, or waving your Watch or smartphone. But in each of those cases it is very likely you are just using your Visa or Mastercard to pay.

While merchants complain about the fees of accepting credit cards, merchants around the globe are also phasing out the acceptance of cash. Why is this? Because cash has costs too. Importantly paying with cards speeds up checkout lines, which is a key goal of all retailers. This is a business that has been growing at 10%+ rates for many years and again the pandemic has accelerated the opportunity. as cross boarder fees recover as international travel resumes, these very high margin fees are going to juice EPS (earnings per share) growth dramatically.

Q: What threats do you think Visa and Mastercard face, and how credible are those threats?

A: Two big threats: regulation and crypto. While Mastercard is embracing crypto and in fact executed the first central bank digital currency transaction via the Bahama's digital "sand dollar", we also recognize that the whole purpose of crypto and blockchain more generally is to remove the need for third party trusted intermediaries, which is exactly what Mastercard is.

Q: What is the payments situation like in China and how is Mastercard positioned there?

A: China had blocked Visa and Mastercard out until recently. That market is mostly lost to the home-grown payment companies, but it will offer some degree of incremental growth now that Mastercard is allowed to participate more.

Q: Any parting thoughts/things to look out for that you'd like to mention for us?

A: I think investors need to prioritize investing in companies that have pricing power. Those that can pass on inflationary costs to customers without customers complaining. Pricing powering sometimes comes from trapping your customers, but the key is to find those that have pricing power that comes from delighting customers. Pricing power is always important, but when inflation is high it because critical to success.

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