Quarterly report

VALUE EQUITY

Short-term uncertainty, but light at the end of the tunnel

The first quarter of 2020 will go down in history. It started with vague reports of a virulent new virus in China and ended with several weeks that defy description. Much of the world is now in lockdown, and we all follow the saddening statistics of case numbers and mortalities. From an economic perspective, the concern has shifted from one of localized impact in China, to concerns over global recession, or even depression.

Like everyone, we have been adjusting to a new reality. We feel deeply for those suffering in these tough circumstances, both closer to home and around the world.

Of course, day to day, we are focused on the portfolios we manage on behalf of our clients. Like many, we are getting used to working from our homes. We are fortunate to benefit from a strong IT setup, so the transition has been smooth. Of course, we miss seeing each other at the office, but the reality is that our work carries on the same. Instead of walking to each other's desks to stare at a spreadsheet, we share our screens remotely. Coffee machine chats take place over the phone. Instead of team meetings around a table, we meet by video – but the intense discussion of investments, and the sharing of bad jokes, remain the same.

We have of course been staring at charts plotting various data related to the virus, working to understand the various scenarios. However, we will not fill this letter with virus infection curves, or try to prove our credentials as competent amateur epidemiologists. As we discuss later in this letter, there is currently a high degree of uncertainty and a wide range of possible trajectories, but as time passes and more data becomes available, that uncertainty should decline – and that in itself is a positive.

In this letter, we aim to give a brief summary of some key developments in equity markets, and how they look from a historical context. We will outline where our focus has been on understanding the impact on our investments, and potential new investments. We also consider the impact on corporate earnings, although it remains very early to forecast this accurately. Finally, we will discuss where the market is now positioned, including the relative performance of difference investment styles, such as growth, value and small cap companies - and what this might imply for the months and years to come. In general, we find our conclusions reassuring.

Key developments in the markets

In January, Chinese equities suffered on news of COVID-19, and this impacted other Asian markets such as South Korea and Japan. Early February brought some market gains, on rising optimism that China could successfully contain the virus. However, by late February, other countries started to see case numbers tick upwards: firstly South Korea and Japan, and then Italy and Iran. As it became increasingly clear this was not a regional but a global issue, with potentially severe impacts on both supply and demand, equity markets started to sell off broadly – including the U.S., which had been relatively robust until that point.

It was in mid-March that the capitulation came.

As the virus' spread accelerated in Europe, governments began to respond with social distancing measures, encouraging – or requiring – people to stay at home and closing schools. Then, on 6 March, OPEC+ talks broke down, with Saudi Arabia and Russia failing to reach agreement on cutting production in response to weaker demand due to the virus. It rapidly became clear that Saudi Arabia would open up the taps on its oil production, to drive prices down. Monday 9 March saw oil prices dive around 25% to the low USD 30s. Equity markets plummeted, with the S&P plummeting over 7%. The next few days felt like capitulation. Asset prices collapsed across the board, whether equities or bonds, gold or bitcoin. Credit spreads exploded. Although the overall direction was sharply down, equities seesawed with extreme volatility: fears would rise sharply on the latest news on the virus and government measures to stop it, but would then be reassured temporarily by news of additional government measures to support the economy.

Markets have since calmed down somewhat. We have progressed from shock and capitulation, to markets that are slightly more discriminating – although still not functioning as the weighing machines Ben Graham liked to describe. There seems to be recognition that the financial sector, and the global financial system, is far better prepared for such times than it was before the Global Financial Crisis. Compared to mid-March, markets seems to recognize that the major central banks are now acting as strong facilitators, and there is less stress in the interbank market. It seems that the U.S. Fed, for example, has limited the widening of spreads on U.S. commercial paper, so companies can refinance. In equity markets, 23 March marked the short-term bottom. In just one month, MSCI World had fallen 33%, and MSCI Emerging Markets 29%. They regained some ground by end-March, so that over the entire first quarter, MSCI World fell 19.2%, MSCI Europe 22.6%, and MSCI Emerging Markets 21.8%. That market recovery has continued in the early days of April.

Typical bear market dynamics…

Many of the recent market dynamics are typical of bear markets. Here, we focus on the period from 20 February to end-March. Looking at sectors, within developed markets, those that fell least were some of the classic defensives: Health Care, Consumer Staples, and Utilities. Note, though, that even these sectors had significant declines in absolute terms, with Health Care down 15%. In emerging markets, it was broadly similar, although Communication Services also held up relatively well thanks to benchmark heavyweight Tencent, which fell only 8%. The worst hit sectors were Energy, for obvious reasons, and other more classically cyclical sectors such as Industrials and Materials (including non-energy commodities). In Consumer Discretionary, losses would have been bigger were it not for relatively limited falls for online retail giants: Amazon (developed markets) and Alibaba (emerging markets) fell only 11 and 12% respectively.

So, in a sense, these were fairly typical risk-off dynamics. That is also true when we look at the performance of different investment styles. Generally, the pattern has shown markets pricing in a recession, with cyclicals, value and small cap harder hit, and defensives, quality, momentum and lower volatility stocks performing better. In the first quarter, while the broad MSCI World index fell 19.6%, MSCI World Value fell 25.8%, and MSCI World Small Cap fell 28.7%. That dynamic was the same in European markets, and in global emerging markets. Looking at our funds, whether in developed markets or emerging markets, they have some underperformance to broad indexes like MSCI World, MSCI Europe and MSCI EM, but that has primarily been driven by their inherent investment style as value funds with some small and mid cap exposure. We will return to this topic later in the letter.

Looking at individual countries, the virus has significantly influenced the direction of markets. Some countries were hit by COVID-19 relatively early, but seemed to have success in slowing its spread, which also allowed them to move ahead in resumption of some economic activity. So countries like China, Japan, South Korea and Taiwan ended the quarter with more limited losses than many others. However, as lockdown measured are eased, a key question is whether they may face a second wave in which infections rise sharply again.

Meanwhile, weaker performing countries include those hit later by the virus, with lockdown measures still tightly in place, and those where the government response was arguably too slow or too weak. The UK, France and Germany were among the harder hit, as was Brazil, where President Bolsonaro spoke vehemently against social distancing.

However, the virus was not the only factor. Within emerging markets, oil prices arguably explain more of the disparity in country performance. For example, China is not only the world's largest importer of energy, but also has a relatively low weight of its equity market capitalization in the energy sector – so the plummeting oil price has been a relative positive both for the Chinese economy, and its equity markets. This stands in clear contrast to oil exporting nations like Brazil, Russia, Mexico and Colombia, where both currencies and equities were badly hit. Colombian equities (to which we have zero exposure) fell 49% from 20 February to end March.

… but not a typical bear market

Tolstoy wrote that, "Happy families are all alike; every unhappy family is unhappy in its own way". Arguably, every bear market is also unhappy its own way. So how does this one compare with others? It is already deep, with the dubious honour of 6th place in the ranking of the S&P 500's biggest drawdowns of the past 100 years. It has been particularly swift, falling 34% in just 23 days from 20 February. Bear markets typically take more like 18 months, or more, to play out.

The trigger was an external shock to the economy, caused by both the direct impacts of the COVID-19 virus and by global attempts to contain it. In a tragic catch-22, the cure for one crisis is the trigger for another. It is also a rapid trigger: the shutdown measures have an immediate impact. Normally, bear markets digest recessions before they actually start, selling the rumour and buying the fact. This time, the process was dramatically compressed, because the bear market and the recession started simultaneously. This highlights why markets in March were particularly brutal, even compared to other bear markets: they were rushing to digest a recession that is already upon us. That may suggest that much of the worst market pain is past - although of course volatility will remain. Besides, it does not necessarily tell us anything about when the recovery will come.

Short-term lack of visibility

Clearly, much has now been priced in. Have the markets priced in enough? We feel reasonably confident that after a pullback of this scale, and at current valuations, equities look compelling for the long term. That is significant.

However, it is more difficult to judge the short-term direction. We are simultaneously experiencing a health crisis, an economic crisis, and an oil price war, with the kicker that it is the response to the health crisis that causes the economic crisis. To say that this makes for poor short-term visibility would be an understatement. Evaluating the trajectory of these crises, and the effectiveness of responses to them, is complicated by their interconnectedness.

One might evaluate the response to a crisis by asking do we know the necessary tools, and can we apply them in sufficient scale at the appropriate time? For COVID-19, the right tools appear to be social distancing, testing, treatment and vaccines. However, there is difficulty in delivering many of these. Vaccines remain distant. While ventilator capacity is rising, drug treatments remain mostly unproven. Testing capacity is limited in many countries. This leaves social distancing. It is highly scalable, and in many countries was introduced at an appropriately early stage – but does come with high economic and social costs that may make it unsustainable in its current form.

Therefore, there is uncertainty, which is one of the most toxic elements in a crisis – both for individuals, and for broader society. As seen in recent years with lingering uncertainty over Brexit, sometimes-increased certainty – even of a negative event – can help individuals digest it, help participants in the real economy plan and respond, help markets model the impact, and look forward. It is perhaps reassuring to reflect that every passing day brings more information on the virus, which can reduce confusion and increase visibility. For example, as testing is expanded both for the virus and for antibodies, that data may allow social distancing to be relaxed, without triggering a second wave of infection. Some countries – mostly in Asia – have already eased some of the tougher measures, and the outcomes there will be significant. We hope for the best.

For the moment, though, the uncertainty remains. Until we know the impact of those measures on the trajectory of the virus, it is difficult to judge the scale of the economic problem – and therefore difficult to judge the required scale of policy responses to the economic problem. At such times, bold statements of intent from policymakers can be helpful, and we have seen leaders echoing Mario Draghi's seminal commitment to do "whatever it takes" in July 2012. More concretely, policymakers around the world have already announced dramatic monetary easing and massive fiscal responses. These include support for wages, tax waivers and deferrals, loan programmes, increased spending on health care and infrastructure, and even cash handouts. Measures have been rolled out much faster than seen in the Global Financial Crisis, and the massive scale of stimulus has reinforced the unprecedented pace.

Earnings

Like most investors, we are considering various scenarios, and what they may mean for the shape of the recovery in the economy and in financial - which of course will not necessarily move in lockstep with each other. As already discussed above, short-term visibility is low, and as in most crises, it is impossible to know the precise duration. We are certainly not going to predict exactly when COVID-19 peaks, whether in clinical terms, or in terms of macro-economic impact - but it does appear to be a finite external shock, which will come to an end. Certain sectors are being very hard hit, so the scale and specificity of fiscal measures will be key to ensuring that they can survive to participate in the recovery. Meanwhile, even for companies fortunate enough to suffer a relatively clean and short-lived V-shaped downturn, a temporary downturn in earnings always has an ongoing impact due to lower retained earnings and the time value of money. So, one should be wary of dismissing this downturn. There will be considerable longer lasting economic impacts, but arguably underlying corporate earnings power should not be damaged to the extent it was by the Global Financial Crisis, which rumbled on for so long.

Looking at corporate earnings, what started as expectations of a short-term downturn in first half earnings, have now expanded to encompass the full year. It seems quite possible that 2020 earnings will decline by 30% or more versus 2019. While financial analysts have already started slashing earnings forecasts, many corporates will not be doing so until they release first quarter earnings in the coming weeks. That process, as companies either cut guidance for 2020, or choose not to give guidance, could well trigger some volatility in equities. However, there is also significant potential for earnings recovery in 2021, and whether that is V-shaped or U-shaped, equity markets could be fast to start pricing it in. Reversions can be even more brutally fast than bear markets.

What have we been focused on?

As long-only long-term value managers, we tend to avoid automatic responses to short-term event driven market volatility, and that is also true recently. We have been focused first and foremost on our holdings, and working to understand how they are impacted by the pandemic and countermeasures to it, as well as the oil price. Generally, as one might expect, our health care and consumer staples holdings have held up fairly well, and indeed some have benefitted from recent conditions. More broadly, we consider the impact on earnings and cash flows over both the short and longer term, and whether this significantly alters our long-term assumptions on the company. Our investment process leans conservatively towards companies with relatively strong balance sheets, but at stressed times, we test our assumptions on debt and liquidity, to ensure that our holdings are not being exposed to new vulnerabilities. This process can help us identify opportunities to increase our position in companies that have been excessively punished. It is important to remember that, however volatile market prices can be short-term, the long-term intrinsic values of companies tend to be a little stickier. One useful reminder of this recently has been Chinese real estate company Soho China, a holding in our emerging market funds. In early March, the share price leapt 38% on news of a potential takeover bid at an even higher price, by private equity giant Blackstone. This highlighted the significant value of their real estate portfolio. While nothing is confirmed, and the share price has been volatile since, the underlying point holds good: we invest in companies due to the long-term value of their earnings-generating assets, and those values are not accurately reflected by the market moves of recent weeks.

We also consider stock market liquidity, and that has generally been reasonable. While bond markets have seen some challenges, equity market liquidity has generally increased, albeit with some increase in spreads. We have not experienced any difficulty in our ability to trade in both existing holdings and new investments.

Beyond this triage of existing holdings, we of course consider potential new investments. We have not made any dramatic changes to the portfolios in the short term, such as significant shifts in our country or sector allocations. We also take comfort from the significant potential we see in our existing holdings. However, the market turmoil is creating significant mispricings, and we are finding compelling stock picking opportunities. At times like these, it feels odd to speak of "opportunity", but our duty is to ensure strong long-term returns, and as long-only equity investors, it is a responsible response to consider which companies are being excessively punished by stock markets, and merit investment. New investments have ranged from Chinese automobile dealers, to European pharmaceuticals.

The energy sector

One sector that has naturally demanded a lot of our attention recently has been energy. We think the oil price war is inherently time limited. Saudi Arabia may have the lowest cost of extraction on the planet – stick a pipe in the ground and the oil will flow – but it cannot tolerate this low a price for long. Russia may be hit harder, but Saudi Arabia's fiscal balance is also heavily reliant on an oil price significantly higher than the current level, and there is little leeway for reducing the budget without significant domestic implications. The market has been in contango (a situation where the futures price of a commodity is higher than the spot price) since day one, with long-term prices remaining significantly higher. Our assumption in recent weeks has been that the price war would not be long lasting, and a deal would be reached to adjust production to more appropriate levels. Indeed, since quarter end, a deal has been announced with 10% production cuts. It remains to be seen whether this is enough to stabilize the market.

Irrespective of any supply side deal, COVID-19 countermeasures have significantly impacted the demand for oil. The questions here are largely the same as for the economy overall – how long until normalization. Without some form of normalized demand, neither volumes nor prices are likely to recover enough to relieve the pressure on producers further up the cost curve, like U.S. shale players. It is also worth considering that, the longer COVID-10 countermeasures remain in place, the greater the chance they lead to longer lasting behavioural shifts in society, such as less business travel and more remote working, with structural impacts on energy demand. What could that mean for the transition to cleaner energy, which gained a lot of momentum in recent years? On one hand, some argue that lower oil prices could sustain oil demand and delay the energy transition. On the other, if peak oil demand was already fast approaching due to commitments to lower emissions, the current crisis could mean that peak oil demand is already upon us. Lower demand and lower prices could increase the numbers of stranded assets, and squeeze out some of the highest cost and most carbon intense oil producers, accelerating the shift to cleaner energy, with the virus countermeasures showing society that rapid change is, in fact, possible. It remains early to judge this, and of course, short term, the focus remains on the Saudi-Russia conflict. In our funds, we work to understand the implications of the energy transition because it can clearly have significant impacts on long-term returns.

So, as in other sectors, we have been looking at how our holdings are impacted both shorter and longer term. In the shorter term, a key question is strength of balance sheet and cash flows, and the flexibility of capex plans, and we have generally been reassured. We also consider potential investments, although we do not anticipate dramatic shifts here. Meanwhile, in certain funds - Ethical Global Value and Ethical Emerging Markets Value – we specifically exclude energy companies that are not committed to the energy transition.

Style

As we noted earlier, the sector and style moves of recent weeks have been fairly typical of risk-off markets pricing in a recession. We can understand why the market behaves defensively short term amid such uncertainty. Policy response also plays a role. We have already seen a clear monetary policy response, which has given some confidence to the markets, but has not pushed up long-term inflation expectations or the long end of the curve. We have discussed the influence of interest rates on style performance many times. In the short term, the low and flat curve probably supports the high valuations of the 'safer' parts of the equity market.

However, it is worth remembering that the market in some ways had already been positioning for a recession since late 2017. While overall market returns were reasonable, investors were shifting further into the perceived safer areas of the market. We often look at 'style charts', which plot how different investment styles are performing relative to each other. When stock markets go through such a dramatic event as a 30% fall in a few weeks, you would expect to see style charts - please forgive the technical language – go crazy, showing a clear break from the market dynamics of the preceding months. However, looking at style charts for March 2020, at first glance you would barely see that anything changed. Styles simply continued the trends they had already been displaying, but at a faster pace. Value and small cap factors underperformed, while quality, momentum and minimum volatility factors outperformed. If investors were already walking towards safety, now they were running.

We find this rather comforting for value investors. Although the bear market and recession started simultaneously in March 2020, a market rotation to reflect a pending recession had already been taking place for a couple of years. It had already taken the relative valuations of value versus growth, or value versus quality, to extremely stretched levels. However, one push back we have sometimes heard is that, until a recession actually materializes, it is difficult to envisage a trigger for value. In a sense, it goes back to the basic point that markets often sell the rumour of recession, and buy the fact. A recession is now upon us.

So, while value has been further punished in the short term, its inherent potential is significant. In recent years, primarily the valuation gap stretching has driven the underperformance of value. This is an asset class, which has become significantly cheaper, and which could see significant support as a steeper yield curve ultimately develops. One should also bear in mind that while short-term monetary policy lends support to the high valuations of growth and quality stocks, strong fiscal measures might have potential to support more diverse parts of the economy, including more cyclical areas, which are more typically associated with value. As we noted above, reversions can be even more brutally quick than bear markets – and faced with that risk, value exposure plays a vital role in diversifying market exposure.

If you have read our letters before, you will know that we never attempt to predict the timing of markets, and that remains the case in these uncertain times. We will remain focused on our holdings, and on opportunities to add compelling new investment cases to the portfolio, building the potential for strong long-term returns. The intrinsic value of our holdings is strong, and we look forward to that being reflected by equity markets.

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