The U.S. election and the impact on equities

A look back at our past two letters highlights how swiftly the pandemic and its implications have developed. The first quarter letter focused on the first wave of the pandemic: the rising toll of human suffering and the erratic and inconsistent response of governments around the world, with a stock market capitulation in March.

The second quarter letter offered hope of recovery, with lockdowns easing despite the pandemic continuing to impact significantly on countries slow to act. Economic stimulus, however, had begun to perform its work, both easing the dire circumstances of individuals but also bolstering equity prices, with indices recovering much of their first quarter declines.

As we sit after the end of the third quarter, the pandemic very much remains a staple element of daily life. Within Europe, fears of a second wave appear validated by rising numbers of infections and a return to elements of the lockdown that had previously been eased.

However, as governments attempt to add nuance to lockdowns, by applying different rules to different regions or segments of society, we face the reality that some forms of lockdown are likely with us for many months to come. The medical community has made significant advances in fighting COVID-19, as has the pharmaceutical industry in developing drugs. However, even assuming that a successful vaccine is identified that can act as the panacea we all hope for, it seems likely that wide distribution of a vaccine will not be possible for some time – certainly not until early 2021. The long-term societal implications of the pandemic and associated governmental actions, whether in terms of physical, emotional and mental health or in terms of economic wellbeing, are yet to be fully understood or appreciated. However, it is clear that both as individuals and as collective societies, some adjustments to our long-term expectations are needed.

So, COVID-19 remains a key consideration for both individuals, society, and markets. However, there has been a change. In the first half of the year, markets were driven almost entirely by the loud drumbeat of pandemic related news flow. In the third quarter, other issues beyond COVID have recently come to the fore. In this letter, along with an overview of the market performance in the quarter, we will address one of the most significant of these other issues, the U.S. presidential election, with a particular view on the potential long-term impact on our portfolio holdings. We will conclude with a review of some of the most significant developments amongst our holdings in the third quarter.

Third quarter market developments

In terms of market performance, the third quarter offered modest but steady returns. The MSCI World returned 3.37% in Euro terms. While that headline figure for the index paints a picture of calm, the markets remained buffeted by news flow, pandemic related and other, and when we delve into the quarter in more detail a different picture emerges.

Looking first at different geographies, within developed markets the U.S. was once again the standout performer, with European markets struggling with the arrival of the second wave. However, emerging markets outperformed developed markets in the quarter, with the MSCI Emerging Markets index returning an impressive 4.93% for the quarter. Emerging market performance was driven by strong returns in key markets such as China, South Korea and India.

A month-by-month review of performance also shows significant differences. Markets in July were flat as news of a reopening in some geographies, notably Europe, offset a deteriorating situation elsewhere, including North America. However, in August markets returned to good performance as recovery gained the upper hand, despite rising fears related to the end of government stimulus. In September, markets sold off modestly as a second wave of the pandemic reared its

head in Europe, with a dawning reality that we are still many months away from a real return to any sort of normal.

We discussed at length in our last letter the disproportionate effect that a handful of stocks has on index performance. On a quarterly basis, the relentless march of this handful of U.S. technology-focused names appears undiminished. Although for the quarter, Microsoft declined 1% (in Euro terms), Amazon was up 5% and Apple 22%. However just as the quarterly figures for the market miss some intra-quarter details, so too for these tech names. July and August certainly followed the trend of the first half of the year, with Amazon rising 20% and Apple up an astonishing 42% in those two months alone. However, September showed a significant reversal, with Amazon down 10% and Apple down 13%. In emerging markets, internet retail giant Alibaba kept charging on, rising 31% in Euro terms over the quarter, but Tencent was lackluster, and after a selloff in September actually ended the quarter with slightly negative returns.

Of course, one swallow does not a summer make, and only time will tell if the September selloff of these tech giants names was the beginning of a longer-term reversal. However, we remain aware that when we talk about index performance, we must be cognizant of the distortions coming from large moves in these few names.

The September sell-off of these tech names was reflected in index movements. In developed markets, the broad value universe modestly outperformed the overall market. The outperformance was indeed modest; with MSCI World Value returning just 0.2 percentage points more than MSCI World, but it was significant because September was the first month in 2020 where the value index had outperformed the overall index. In emerging markets, MSCI EM Value again underperformed MSCI EM over the quarter, but at a notably reduced pace in September.

The coming election

The U.S. presidential election grows ever closer. On November 3, the voters of the United States will make their choice. Elections are obviously important to the citizens of the specific country, but perhaps as no other, the U.S. elections are of global importance. In this, most unpredictable of years it is a fool's errand to make firm predictions as to the result. This unpredictability is compounded, as we look further down the election tickets to the senate races. The outcome of the presidential election will either be magnified or muted by the outcome in the senate.

However, despite the inherent unpredictability, as long-term investors we need to evaluate the possible outcomes and draw conclusions as to how our portfolio holdings may be impacted. In this letter, we focus on three areas in terms of the possible impact from the election.

Firstly, climate change is an issue of crucial importance, and the U.S. election could possibly alter the trajectory of the world's largest economy with respect to carbon and other greenhouse gases. Climate change is a massive risk both for global society, and for companies – but there are also opportunities for companies that can adapt more effectively. A change in the U.S. commitment to carbon reduction could create a dynamic environment, opening significant opportunities both for society and for companies.

Secondly, we briefly referenced in our last letter an issue that some have titled a 'tech cold war'. This issue has become even more salient over the past three months and the election may well further accelerate events. We will review both the events that have led us here and as well of some of the key investment implications from a further escalation.

Finally, we discuss some longer-term economic changes and the potential for both the value investment style as well as our portfolio holdings.

Sustainability

We have long integrated ESG analysis into our investment process, to evaluate both how companies mitigate risks and negative impacts, but also how they adapt to exploit opportunities, with the potential to generate both corporate value and societal good. One of the most important sustainability challenges we face is that of carbon reduction. Investors have a role to play in facilitating the shift to a low carbon future – and we think as value investors we are particularly well placed to effect change.

We take the view that sustainable investment must be about more than buying feel-good companies. It should be about driving real change. As value investors, instead of investing in seemingly perfect companies that trade at expensive valuations, we look for a broad range of discounted investment opportunities - including some companies that have potential to generate strong returns by delivering fundamental improvements over the medium to long-term. We see engagement with our holdings as a critical part of encouraging that improvement. This is particularly relevant when it comes to carbon. There are some industries that are relatively carbon intense but essential for society. If a company within such an industry can successfully transition into significantly lower carbon intensity, the benefits can be massive, both for society, and for corporate value.

We recently hosted a seminar with steelmaker and portfolio holding, ArcelorMittal. (For more details, please see "clean conscience or real change?") Steel is a crucial material, but is responsible for a sizeable portion of global carbon emissions. We have an ongoing dialogue with ArcelorMittal, with a particular focus on carbon. In the seminar, the company highlighted not only the challenges in shifting to low carbon steel, but also the technological solutions in which they are invest-

ing. Arcelor had previously announced a plan to achieve carbon neutrality within European operations by 2050, and subsequent to our seminar, released its second Global Climate Action report. This report announced that their 2050 target of carbon neutrality was no longer just for Europe, but for global operations. This perhaps offers hope that the lead taken by certain regions, or certain companies, can then expand to generate global benefits. One challenge with the move to a low carbon future is, of course, that the world is not moving at an even pace and that some countries are leaders and others laggards.

The U.S. for the past few years has been considered a laggard, with its withdrawal from the 2015 Paris Agreement on climate change mitigation the most often cited example. However, the Federal Government is not the only form of governmental authority in the U.S., and many individual states have enacted tighter environmental and carbon related requirements over the past few years. For example California, the largest individual state economy in the U.S., has a carbon cap and trade scheme in place and a 2045 target for statewide carbon neutrality.

However, it is without doubt that the Federal Government has a useful role to play in developing and enforcing regulations and facilitating better inter-state cooperation, and this is an area that we are monitoring as we head to the election. The candidate for the Democrats, Joe Biden, has announced significant green investment, notably in carbon reductions of the electricity grid, and if he were to win this would be as positive for low carbon energy providers as it would be negative for fossil fuel based energy companies.

Trade and the tech ‘cold war’

The policy area where President Donald Trump has possibly had the most significant impact during the past four years has been trade. He spoke harshly of China, in particular, even as he was campaigning in 2016. True to his word, trade policy and relations with China have been very different under his administration.

For decades, the West had a trade policy with China that encouraged investment and hoped for a fair share of the spoils. Under President Trump, U.S. trade policy became much more transactional in nature, with an “I win so you lose” mentality. The trade war was primarily motivated by the large trade deficit that the U.S. had with China and involved the imposition of tariffs and other trade barriers. The aim of the trade policy was to increase U.S. exports to China with a particular focus on farm goods.

However, a second complaint concerning Chinese policy was that of forced technology transfer. For many years, to be allowed to sell to Chinese companies and end consumers, Western companies investing in China were forced to take local partners and share their technological secrets. The concern was that this technology was somehow being expropriated by the local partners and being used without reference to the original Western source of the technology.

This policy was compounded by the important role that China had in supply chains globally, with goods manufactured in China ending up in the hands of Western consumers. For example, China annually purchases $300B of semiconductors, over 50% of global demand, and these semiconductors are then incorporated into devices that are then sold to Western businesses and consumers. However, 45% of those semiconductors originate from U.S. companies. The supply chain is truly integrated and extremely difficult to untangle.

China has itself ambitions on parts of this supply chain that it does not control, such as semiconductors, as part of its ‘Made in China 2025’ plan, and these ambitions feed further U.S. concerns over the technology transfer and the rise of a competitor.

One of the first salvos of the tech focused confrontation came in May 2019 with the placement of Chinese tech companies Huawei and ZTE on a list of companies not allowed purchasing products based on U.S. technology. This list now numbers over 300 separate Chinese companies. Such is the concentration of U.S. expertise in markets such as semiconductors, that being placed on the list very effectively blocks a company from accessing global technology. The list of companies is still being expanded, with Chinese company SMIC being added as recently as September this year.

These supply chains have taken many years to develop, and offer significant advantages to the Western companies that utilize them, in terms of both costs and flexibility. Replacing such a complex supply chain would be extremely expensive and take a long time. However the ultimate outcome of this facet of the trade war is the possible need for a duplicate supply chain – one for Chinese companies and one for non-Chinese. As well as the higher costs and the greater inefficiency this duplication brings, this also makes individual companies “pick sides”.

The most recent development has been the move from a focus on the hardware side of tech – such as semiconductors – to the internet. Western internet companies such as Facebook are banned from China, but until recently Chinese internet companies had free reign in the U.S. Recently, the Trump administration identified Chinese short video company TikTok as a data security risk, with its 100 million users in the U.S. Further actions against Chinese internet firms are to be expected.

As investors, we need to be cognizant of not only the higher risk factors that come from investing in these supply chains, but also the potential for lower earnings due to the duplication of effort. Trade policy has had little focus placed on it during the recent campaigning. One possible reason for this

lack of attention is that there are much more urgent issues to campaign on, for example COVID and the domestic recovery. However, a secondary reason is that despite the difference in tone, the substantive differences between the candidates may not be that great. Whatever other achievements he may claim, President Trump has undoubtedly successfully shifted the debate on China, and his view on Chinese trade policy is now the starting point for future administrations, irrespective of their political persuasion. This new, aggressive, trade policy is likely here to stay.

The need for Infrastructure Investment

The headwinds for value investors over the past few years have been well documented in prior letters. Our commitment to value is undiminished. Despite the underperformance of the asset class in recent years, we believe that long term, both the extremely discounted valuations of value stocks overall, and the stretched valuations of many growth stocks, are unsustainable. Many growth stocks will struggle to justify the lofty expectations built into their valuations. However, it is reasonable to ask what events could refocus attention on the currently unloved corners of the market where value investors loiter.

As of the time of writing this letter, negotiations are ongoing around the size and structure of a second stimulus measure to counter the economic effects of COVID-19. Whilst the exact structure of this stimulus is yet to be determined, the focus appears to be on short-term economic recovery, cash transfers and support for struggling businesses. However, there is no doubt that there is a longer-term economic need for investment as well. Two areas have received attention during the campaign. One is the general infrastructure in the U.S. and the second is the need to prepare for a low carbon future.

The U.S. infrastructure is aging and the country has failed to perform the maintenance investment required to sustain the existing stock, let alone invest appropriately to support future growth. Although not alone amongst developed countries in underinvesting, the size of the country exacerbates the scale of the challenge.

Roads, rails, bridges, airports, waterways and schools are all areas that need investment. Due to the distributed system of government, responsibility for the infrastructure is split between the Federal Government, states, and individual counties and municipalities. A consequence of this distributed responsibility is that it is wishful thinking to believe a single, federal based solution can solve all ills. Coordination is required between all levels of government. There is no question, however, that a significant push from the Federal Government can assist. Anyone who has driven the U.S. Interstate Highways system can see the power of the Federal Government when motivated. More recently, the American Recovery and Reinvestment Act of 2009 was an $800 billion Obama era stimulus bill, including $100 billion of infrastructure investment, to aid U.S. recovery from the financial crisis.

The $100 billion allocated to infrastructure by the ARRA also demonstrates the scale of the challenge. A massive amount of investment spending by any metric, it also represents a small amount of the need. The American Society of Civil Engineers estimates there will be an infrastructure investment shortfall of over $2 trillion by 2025. As President Trump has discovered, stimulus spending is a product of negotiation between the executive and congress. As such, any post-election stimulus will depend on not only who is president, but also on the exact composition of the House of Representatives and the Senate. However the need for longer-term investment is recognized by almost all, and there is real opportunity for this to contribute to the economic recovery.

Infrastructure investment has the potential to reach into long neglected parts of the economy. Traditional, cyclical, industrial businesses stand to benefit disproportionately. Machinery, basic materials and equipment are all areas that are essential in this type of business. Due to their long neglect, they also happen to be a fertile hunting ground for value investors.

A possible, secondary effect from the stimulus bill is driven by the size and speed with which any stimulus is dispatched. The utilization rate of the economy is currently low, due to the declines related to COVID-19. Unemployment is high, manufacturing has plenty of spare capacity, and interest rates are low. However, the stimulus will get people working and manufacturers producing. Considering the experience of the past decade, a brave forecaster predicts high inflation rates in the coming years. However, it is possibly sufficient to note that the strong consensus view is for low inflation rates and low bond yields for many years to come. Inflation does not need to dramatically spike, merely rise above expectations, for there to be an interest rate response, an outcome that would strongly favour value stocks.

The second area for potentially large spending is on preparing for a low carbon future. As discussed above, it is only reasonable to point out that this area is one of significant disagreement between the candidates, and therefore more than the general infrastructure investment, this type of spending will depend on the results of the election.

However, notwithstanding the impact of the election, once again the distributed system of government means that even if the winner of the presidential election does not directly support these aims, individual states can proceed on their own path to carbon neutrality and so some of this spending is very likely to happen.

Of course, carbon neutrality conjures visions of electric cars, wind farms and arrays of solar panels. True, these are some of the most visible and tangible elements of the move to carbon neutrality. However as value investors we sometimes

find ourselves looking for beneficiaries that are less obvious, overlooked by the market, and therefore available to us to invest in valuations that are more reasonable.

An example is companies that support the electricity transmission grid in the U.S. Not as immediately exciting as electric cars, it is just as essential. Renewable power generation places new and different stresses on the grid and without suitable investments, it will not be able to cope with these changing demands. Those electric cars are going nowhere if the grid cannot deliver electricity to charge their batteries. Portfolio holding Quanta Services helps utilities upgrade the grid to deal with these new demands. Although Quanta is not a household name, its role and its opportunity are no less significant than other companies that are better known.

Of course, the election is inherently unpredictable. Early October has been eventful, but there is still time for at least one more 'October Surprise'. However, our role as investors is to identify the long-term risks and opportunities and incorporate that thinking into the portfolio. The three policy areas identified above: sustainability, trade and infrastructure are only three of the many possible implications from the election, but we believe they are three of the more relevant.

Our holdings

As one may anticipate, in developed markets our performance reflected to some degree the performance of value, with struggles in the first two months of the quarter followed by strong outperformance in September. In emerging markets, our funds marginally outperformed the market over the quarter, despite value headwinds, thanks primarily to strong selection returns.

The quarter saw a number of notable performers among our holdings, both in developed and emerging markets.

One of the strongest performers was Danish wind turbine manufacturer Vestas, which rose 47% over the quarter. We had initially invested in Vestas after it had disappointed the market with a period of weak orders. We evaluated the potential for the business, and determined that not only was the period of weakness a normal variation of timing, but the long term opportunity was strong, something that the market has begun to recognize in the stock's recent performance.

Another long term holding that had strong performance is Whirlpool, rising 40% in the quarter. We have been familiar with Whirlpool - a home appliance manufacturer – for many years, having initially invested in late 2011, and divested relatively quickly in 2012 after a surge of share price performance. In more recent years, we invested again, as we recognized that it had significant cost improvements available to it that would structurally improve its earning capacity. The recent stock performance reflects the strong execution of the business towards those cost reductions and the market beginning to recognize the potential earnings improvement.
Mexican precious metal mining company Industrias Penoles also performed well in the quarter, rising by over 50%. We bought Industrias Penoles because, simply put, we felt that the underlying value of the mines was greater than the market gave credit for. Some of the performance of the stock in the quarter was due to the rise in the price of gold and silver, the main metals the company mines. However, the share price has risen more than is explained by the rising metal prices alone, implying that the market has started to reflect more of the underlying mine values.

A standout performer was BYD Electronic. BYD's main business is producing mobile handset components, especially mobile phone casings in metal, plastic or glass. This core business has performed well recently, with glass casings growing and an expansion in tablets. Apple is expected to account for an increasing share of revenues of this core business. However, the company has also pivoted rapidly into making face masks, which astonishingly look set to deliver 50% of gross profit in 2020. The share price has rallied over 150% this year, and although some analysts start to factor in recurring earnings from masks, we prefer to be conservative: our strong sell discipline means we have now exited the position.

It is always gratifying when an underlying investment thesis plays out as intended, with value being discovered and the stock price rising. However, as long-term investors, we also recognize that it can take time for a thesis to reveal itself to other market participants, and, while we are waiting, many things can go wrong. That is why, even though we pride ourselves on our long investment horizon, a critical part of our process is the ongoing maintenance of our portfolio holdings. We are constantly evaluating the investment cases on our holdings to ensure they are intact and the potential we see in a stock remains in place.

As we noted above, we do see significant potential for the overall asset class of value equities. The stretched valuation gap between value and growth stocks has reached such levels that it potentially requires only relatively minor surprises in the form of inflation, in the form of upticks at the long end of the yield curve, to trigger a change. As we have noted in past letters, it is not a question of expecting the valuation gap to contract sharply. The headwind has been the continued expansion of the gap, and if it simply ceases to expand, the potential for value equities is solid. This is reassuring. However, as bottom-up active managers, we remain focused on our individual selections, identifying new cases and maintaining existing investments, all the time working to generate strong returns.

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