Investment Insight

INVESTMENT THEMES AND OPPORTUNITIES IN 2021

As we start the year, we would like to share some of our expectations for markets, industries and the companies we invest in.

Our World Stars Global Equity strategy finished the year +21.4% in US dollars, strong absolute performance and well ahead of the MSCI World. We were optimistic this time last year but did not expect the Covid-19 pandemic to have the impact it has had. Our approach to invest in quality and value for the long-term has allowed us to weather the crisis and to generate significant value.

While we are deeply concerned about the pandemic and the impact it has on all of us, we believe that we will overcome it and are optimistic again this year. We believe that vaccinations will work and could allow reopening faster than markets expect. The vaccine development effort is the single most positive outcome of a horrible year.

Even as the current second/third wave of the Covid-19 pandemic is forcing governments to move into strict lockdowns and the vaccines are rolled out we must remember that the shutdowns are not intended to protect the average population. Their purpose is to make sure healthcare systems are not overwhelmed. The critical issue is the capacity of healthcare systems to provide the necessary care to those who need it. Severe outcomes, hospitalization and deaths disproportionally affect vulnerable populations, the elderly and those with pre-existing conditions. Exposure, quarantine and illness for healthcare workers mean that staff shortages have a far greater impact on capacity than lack of equipment or beds, which can be addressed with investment after all.

Among all the atrocious newsflow we must keep two basic facts in mind: The vaccines work and there are enough doses to cover vulnerable populations and healthcare workers so healthcare systems are not overwhelmed. It is entirely possible that the US and Europe will achieve this by the end of the March. Within weeks and months we should see healthcare capacity improving and complications, hospitalizations and deaths (but not infections) declining. Governments will be in a position to reopen schools, businesses and economies. There will be complications and delays (in particular the uncertainty about the effectiveness of the vaccines on all variants of the virus), but reopening does not require vaccination of the entire population and could happen faster than markets expect.

That is why we believe the opportunity is now. We have every chance of overcoming the pandemic, the business fundamentals of the companies we invest in are strong, the digital platforms and other businesses that have done well will continue to do so and the consumer, healthcare and industrial companies that have been held back will rebound strongly. Governments and their fiscal and monetary policy will be supportive, rates will stay low and inflation will mean that companies with growth and pricing power, and assets with scarcity, will do well. There is significant cash on the sidelines and while markets have been strong the rally took many by surprise. The opportunity is now for investors to buy some of the greatest companies in the world at a point when their businesses will improve, their comps will be easy and their valuations are attractive.

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We also believe investors should beware of the value trap. The potential rotation from 'growth' into 'value' stocks is an ongoing question for investors. We believe in quality, companies with strong competitive positions in good and growing markets, managements that generate value and balance sheets so strong as to weather any adversity. We do not believe in market rotation and in the long-term we do not care.

The performance of stocks this year may be more balanced as more companies do well, but it does not prevent bad companies from getting disrupted. Value stocks may do well but only because they have done so poorly recently. We do not see how they will do well sustainably because getting disrupted is still getting disrupted. Just because companies have businesses that are slightly less terrible, and just because some of them will have survived and others won't, does not make them any less terrible.

These are the key reasons why we think that there is cause for optimism this year and that any pullback, whether it is due to concerns about the virus and vaccines, political and economic uncertainty, fiscal and monetary policy, or investor concerns and positioning, will be an opportunity to invest for the long-term.

Equities

Technology and Digital: Increasing Need for Selectivity

The Covid-19 pandemic has led to a significant acceleration in many technology trends. Companies and consumers were forced to adapt quickly to the enforced stay-at-home measures to contain the virus and the many changes it has caused to our daily lives.

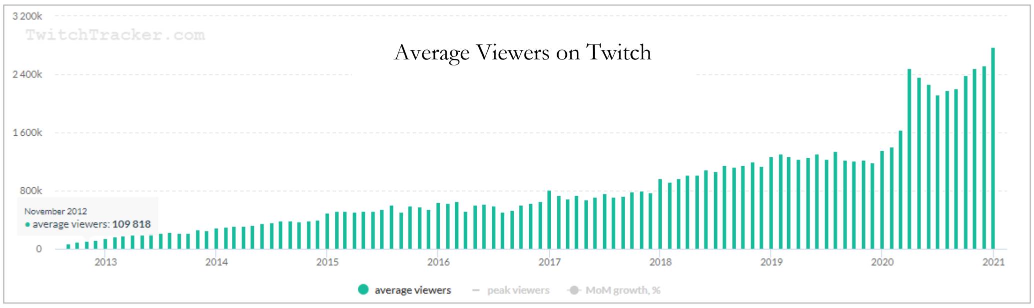
We can broadly categorise into three categories the impact of the pandemic on the technology sector. First, some businesses and industries were heavily impacted, for example the ride sharing and online travel companies which experienced substantial declines in revenues as the pandemic forced them to effectively shutter operations.

Secondly, there were those that were impacted but came out of the pandemic stronger, such as the online advertising giants Facebook and Alphabet, where there was an initial fear of a precipitous decline in advertising demand, but the shift from offline to online in social interaction and consumer spending showed the strength of their business models.

Source: Mark König on Unsplash

Lastly, there were those companies that benefitted directly, such as e-commerce and home entertainment, as the stay-at-home measures meant that they experienced outsized demand.

Companies that have done well will have to have to show that they are able to sustain the momentum and transform themselves. Take the video game industry, which has seen a large increase in users as people turned to video games as appealing entertainment during the lockdown. Twitch, one of the most popular gaming streaming sites Twitch (owned by Amazon), has seen an explosion of viewers since the pandemic.



The video game publishers have an enormous opportunity to retain and monetize this greater audience through ever more compelling content and experiences. However, some publishers have struggled with this heightened expectation and will lose share to their competitors.

Those companies whose businesses were heavily impacted could offer opportunities if their business has not been permanently impaired or disrupted and they are able to recover to pre-pandemic levels.

One of the issues with many of the smaller, more specialised companies is that the publicly listed ones get all the attention. Their share prices rocket because they appear like the only play when in reality there are many private companies that compete with them. These companies include some of the best-known IPOs of the past year and we are concerned that investors do not appreciate the dynamic nature of many of the markets they operate in.

The technology sector is full of overexuberance as well as value traps. That is why the objective of our investment approach is to identify and invest in those companies that have the necessary quality to execute on their business plans and to buy them at valuations that allow us to generate significant returns.

As we look towards 2021, we think that it is more important than ever to be selective towards investments in the technology sector. We think that there will be great investment opportunities as companies show that they can sustain the benefits of last year or that they are able to emerge from the pandemic stronger. However, investments need to be selected with great care, with high thresholds for quality and at attractive valuations.

Healthcare: Primary Focus on Life Sciences and Medical Technology

2020 has been a tale of two stories for healthcare. On the one hand, companies that provided Covid-19 testing, treatment and vaccine development and manufacturing have benefited from overwhelming demand for their products and have done well. On the other hand, companies that relied on elective surgeries were more impacted by Covid-19 because of the delay of surgical procedures as hospitals prioritised the treatment for Covid-19 and because patients were reluctant to seek non-essential treatment as they feared catching the disease.

As we enter 2021, three Covid-19 vaccines have been approved by various regulatory authorities and governments across the globe have started the race to put vaccines into people's arms. We expect we will be in a much better place beginning at some point in the second quarter when most vulnerable people and healthcare/care home workers have been vaccinated. The continued vaccination into spring, summer and fall for the rest of population should help societies return to some level of normality before next winter although the next few months will be challenging as the healthcare systems fights the second/third wave of rising infections.

Source: Daniel Schludi on Unsplash

That is why we are constructive for the healthcare sector for 2021. In medical technology, we favour companies that have suffered most in 2020 and are more geared for the recovery of elective surgeries. Demand for medical devices remains strong. The speedy recovery of the procedure volume we saw after the first lockdown last summer/fall was a testimony of this.

We also prefer the medical technology sector over pharmaceuticals. The latter has been reasonably resilient during 2020, although recruitment of new patients into recently approved therapy has been slow as patients stayed with existing treatments during the pandemic. We expect 2021 will be a better year for new therapy adoption. On the political front, the immediate tasks for the Biden administration will be fighting the pandemic and ACA stabilisation. We do not expect major healthcare reform or significant drug pricing legislation in 2021. However, the latter has been a long-fought battle for the Democrats and the issue will not go away. We expect the topic of drug pricing to come back in 2022 and beyond which could continue to impact investor sentiment and prevent the pharmaceutical sector from re-rating.

Industrials: Driving Organisational and National Resilience through Automation and Green Infrastructure

As the virus is finally brought under control, attention is shifting towards what a post Covid-19 world will look like in the years and decades ahead. For governments and businesses around the world, building organisational and national resilience will be a key area of focus.

One of the lessons from the current pandemic has been the importance of automation in ensuring the uninterrupted delivery of goods and services at a time of unprecedented disruption globally, which has affected everything from supply chains to manufacturing facilities and service access points. Industry 4.0 and Industrial Internet of Things solutions that enable remote asset monitoring, dynamic manufacturing and connected logistics chains have driven strong growth in selected industrials and have emphasised the financial benefits of automation.

This has been already reflected in the earnings reports for some of our holdings. Honeywell, a leading industrial software technology company, saw extraordinary growth in its warehouse automation business, Intelligrated, with its backlog growing by over 100% during the year, reflecting the accelerated investment in online retailing logistics platforms. Beyond this year, the company's key enterprise performance management SaaS platform, Forge, presents an over USD 100 billion market opportunity as Industry 4.0 becomes a global reality. Healthy building solutions, unmanned aviation and smart cities are other multi-billion opportunities that have been reinforced by last year's crisis.

On a similar note, leading sensor and connector company Amphenol saw a spike in demand in its Communications and Industrial end markets as working from home and the need for remote capabilities translated into higher bandwidth requirements across the globe. These trends are not new, but the pandemic has fuelled a step change in demand, bringing forward years of planned investments as resilience becomes a key pillar of enterprise planning going forward.

Source: Ed van duijn on Unsplash

At the same time, climate change is returning to the headlines, as a return of normality also means dealing with some of the most urgent problems of our planet. Governments are pushing forward with their plans on that front, and indeed the UN Climate Change Conference, COP 26, will be a pivotal item on the international agenda in November 2021.

The EU Green Deal has committed over EUR 750 billion in supporting the de-carbonisation of the economy by 2050 and fostering renewable technologies. The US, under the incoming Biden administration will also push forward with its green agenda, bolstered by having secured a majority representation in both Congress and the Senate. And China has vowed to reach carbon neutrality by 2060, catapulting demand for green technologies.

Our holdings within the industrials space are well placed to leverage on these opportunities. Both Eaton and Amphenol are key participants in the electrification of the economy, supporting the shift to smarter, more complex, distributed grids and the electrification of the transport sector. The need for more energy efficient buildings is underpinning demand for our holdings in Sika and Otis. Honeywell is playing a major role in helping fossil fuel heavy industries transition to a low carbon economy, not only through energy saving automation solutions but also through new offerings in grid scale energy storage, advanced plastics recycling and alternative fuels.

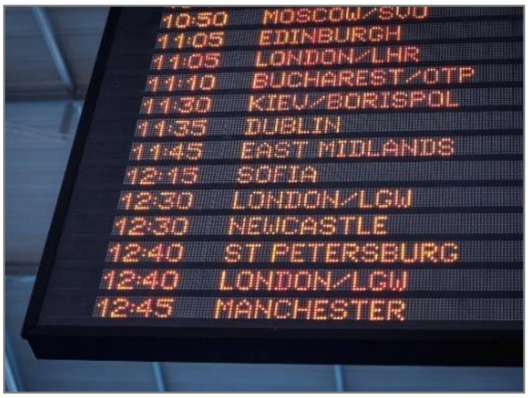
It has been an exceptional year, with unprecedented challenges and untold human suffering, but as the baton is passed to 2021, the promise remains for humanity's ingenuity and unrelenting technological advancement to continue driving prosperity for generations to come.

Fixed Income

Emerging Markets: Bonds

EM corporate credit had a strong finish in 2020 as the recovery continued on the back of positive vaccine news and impressive growth momentum in EM economies. We expect this performance to continue in 2021 as the backdrop remains supportive for emerging markets as vaccine rollouts boost activity, the low-rate environment persists, and the new administration in the US opens the way for a more global approach.

With Asia leading the economic recovery and China's large post-Covid stimulus package driving infrastructure investment and increasing demand for metals, we expect commodity prices to be buoyant in 2021. Within oil and gas, the rollout of a vaccine should also prove constructive for demand and bring back some semblance of normality, along with increased travel which should provide a boost to oil prices. For both the metals & mining and oil & gas sectors, the current US dollar weakness is expected to persist which will also provide support. Finally, we remain positive on telecommunications, which performed well in 2020 but continues to be attractive given the appealing demographics, increased data usage and ongoing digital transformation in these economies.



Source: JESHOOTS.COM on Unsplash

Overall, we expect an improvement in credit metrics over the next 12 months with leverage ratios returning to 2019 levels, driven by a combination of a rebound in EBITDA growth as well as a reduction in debt. This improvement in fundamentals, combined with limited upcoming debt maturities should also limit defaults this year, with the forecast for the EM corporate high yield default rate below that of 2020, and also below the long-term average.

This constructive view on both the fundamentals and the macro backdrop should allow for continued inflows into the asset class. Meanwhile, net new issuance is expected to be moderate, with proceeds focussed on refinancing rather than aggressive capital expenditure, and should be absorbed by the increase in demand for yield. Whilst the rally in EM bonds last year has meant valuations are tighter, they still offer an attractive yield of 5.8% which compares favourably to DM high yield which offers 4.2%. Such an environment should provide a backdrop for additional spread-compression which will drive moderate capital appreciation, whilst continuing to generate an attractive income.

Last year we gradually shifted the composition of the portfolio to take advantage of sectors where we see better opportunities whilst at the same time improving its overall quality. We are positive about the prospects going into 2021 with a portfolio current yield of 6.6% and yield to maturity of 5.8%. Key risks to our outlook are mainly macro driven (including higher US rates, dollar strength, weaker banking systems on withdrawal of Covid-19 support programs, geopolitics in Middle East and Turkey), although we believe the quality of the underlying companies in which we have invested should allow them to navigate such risks. Any meaningful pullback in prices should be seen as a buying opportunity.

Multi-Asset Income

2020 was an extraordinary year by any standards and despite the very strong year end performance (+9.9% in USD) within a very volatile current environment, the year ahead just looks as challenging. We are in general very constructive regarding prospects for 2021 as we look through the current surge in Covid-19 new cases and rising death tolls. This is particularly relevant for our portfolio, which benefits from a balanced positioning between resilient companies that have done well last year and more economically or cyclically sensitive holdings that have strong prospects for rebound this year both on the equity and the credit side.

Our positive outlook is supported by recent political developments in the US, which should allow for a shift from monetary support from the Federal Reserve to economic stimulus via fiscal policy backing to a further extend than would have been possible if the Democrats had not gained control of the Senate. This in turn is very positive for corporate earnings growth following the difficult year in 2020. However, it also means that US interest rates, which declined under the central bank's vast monetary expansion from 1.9% in December 2019 to a low of 0.51% in August 2020 (both 10-year treasury yield), will reverse this trend as things normalise. This upwards adjustment has already partially taken place (currently at 1.16%) without damage to other asset class' performance. Rising interest rates normally impact asset classes valuations as well as price performance and the challenge going forward for markets will be the balance between those factors.

We generally believe that interest rates will remain low for a reasonably long time and do not foresee sharply rising inflation beyond recent normal levels. However, the above-mentioned change could take place faster than expected and lead to volatility in the short term.

Increasing GDP growth, earnings and interest rates relatively favour economically sensitive equities and short-dated bonds. Our asset allocation has firmly remained focused on a barbell approach all through 2020 and we have used the opportunities provided to us by lower prices to improve the quality of our holdings. As it stands the portfolio offers a well-balanced mix of earnings growth potential for equities and attractive yields for our credit portion, with a 7.5% current yield and 8.5% yield to maturity.

Furthermore, we expect a return to normal transaction flows for our trade finance funds through the course of the year. Last year's global lockdowns were exceptional as they prevented the movements of most goods for long periods of time.

We are confident in the ability of our strategy to deliver visible income and potential further gains from our long-term quality holdings.

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