Investment Insight

ACCELERATING CHANGE AND DISRUPTION

Lessons and Reflections from Investing during the Covid-19 Pandemic

Our approach of investing in quality and value for the long-term has allowed us to navigate this year from a position of strength. The pandemic affected all of the companies we invest in. Some have benefitted and others have been impacted. We have sought to make the most of opportunities where we could and have learned important lessons throughout the year.

Our investment team has highlighted some of those lessons, how they have impacted our thinking and our portfolios and what opportunities they hold for the future.

ESG – Sustainability, Corporate Resilience and Investment Returns

One of the most powerful developments of the last few years has been the increasing focus on the integration of environmental, social and governance (ESG) factors in traditional financial analysis. Rightly, much of the focus in developing and implementing standards at the political and economic level has focused on the unfolding climate crisis. Corporates have faced increased calls to properly account for and mitigate the polluting environmental externalities they generate, and the impact on industries and individual companies has provided evidence of the value of incorporating the 'E' into long-term financial analysis.

But more than any other previous crisis, the Covid-19 pandemic has demonstrated that sustainability and corporate resilience are interrelated and that best-in-class ESG practices can allow companies to create value beyond just the E. As we discussed in our January insight "Our Roadmap to Sustainable Investing," for us ESG integration involves incorporating a broad range of factors into our analysis of our investee companies. This starts of course with environmental factors, but extends to social capital (including a company's relationship with its customers, local communities and the government); human capital (including the management of a company's human resources as a key asset); the inherent business model (including business model resilience, supply chain management and materials sourcing); as well as leadership and governance (including systemic risk management and critical incident risk management). As we look back at how Covid-19 has swept through the globe, what has distinguished companies in their ability to respond to this crisis was how embedded and mature their competencies and practices in exactly these areas were.

We have identified the factors in our holdings across sectors. Food producer *Nestlé* and flavour & fragrances ingredient provider *Givaudan* were both called upon to keep critical food and beverage supply chains open. As consumers rushed to supermarkets in panic to stock up their pantries at home, Nestlé had to ensure that its ability to source inputs from over 550,000 farmers globally and keep food production lines open remained unaffected. Similarly, Givaudan had to keep supplying over 110,000 flavour and fragrance ingredients to over 10,000 global food, beverages and personal care product producers.

This wartime-like effort meant not only that elevated consumer demand could be met despite unprecedented challenges, but also resulted in other tangible business benefits. It is no coincidence that after years of share losses to smaller brands this was the year when large,

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traditional, trusted brands regained their standing with both retailers and consumers. Retailers gravitated towards those suppliers which could guarantee that shelves would remain stocked and consumers sought the comfort of familiar brands associated with quality and known attributes.

At the same time, as suppliers and customers struggled to cope with sharp fluctuations in demand, Nestlé stepped in offering CHF 500 million in free products, extended payment terms and other support to its out-of-home customers and dairy farmers, two of the worst affected segments in the value chain. The firm also joined forces with the International Red Cross and Red Crescent societies, donating food, medical nutrition and bottled water to bring relief to those most affected by the pandemic. These initiatives were not only the right thing to do short-term but were also a powerful way of building social capital long-term, and will reap benefits long after the virus has abated.

Similarly, within the life sciences space, global leader *ThermoFisher* leveraged the company's unmatched capabilities in research and operational capabilities to meet the healthcare response to the virus. The company was one of the first to develop a Covid-19 testing kit, with the product now available in over 50 countries and a capacity of over 20 million tests per week. At the same time, it continued to supply uninterrupted 24-7 research facilities across the world with equipment and consumables used in virus and epidemiology research as well as vaccine development, and provided PPE to over 7,000 customers, keeping health care and research personnel safe in this time of crisis. Highlighting the breadth of its relationships, the company participated in over 250 projects related to virus research and vaccine development, including all major vaccine programs as well as working with governments across the world to enable a rapid production ramp up as the race to inoculate the global population gathers pace. This has translated into over USD 5.0 billion in incremental revenues realised this year alone, but more importantly deepened relationships with customers and governments and broadened the company's installed base, providing opportunities for share gains and further growth for years after the pandemic is behind us.

Finally, connector and sensor manufacturer *Amphenol* provided a case study in the value of operational excellence and flexibility. The company stepped up to meet unprecedented demand in its IT & Datacom businesses as working from home led to a spike in data-related bandwidth requirements, as well as higher demand for its medical sensor solutions, with governments rushing to increase ventilator and patient monitoring equipment capacities. Equally important as security of supply, the ability to quickly adjust production levels to meet demand as and where it is needed emerged as a key differentiating factor. In this way Amphenol rapidly gained market share across verticals, broadening its competitive moat versus smaller players.

Common also among these companies were best-in-class employee welfare practices, putting in place enhanced safety measures in offices and factories, offering extended sick leave arrangements, providing alternative transport arrangements to reduce the risk of factory employees getting sick and extending financial support packages. These practices are all aimed at fostering employee health & safety, keeping operations going whilst building valuable long-term goodwill.

These examples drawn from different areas of economic activity highlight the value of organisational resilience during times of crisis. Investments in social and human capital, robust supply chains and the inherent governance structures that enable businesses to respond to unforeseen challenges are the factors that distinguished those businesses which were able to keep serving their customers and communities during the last year. These are also the companies that have further deepened their competitive moat, emerging even stronger out of this unprecedented crisis, with deeper business relationships, stronger brands, and greater market share positions. Never has the value of the S and G in ESG been more evident.

Technology and Digital Transformation – Accelerating Change and Disruption

"You're on mute" — One of the main features of 2020 and the Covid-19 pandemic has been the acceleration of longstanding technology trends. Indeed, the Microsoft CEO, Satya Nadella announced at the end of April that he saw "two years' worth of digital transformation in two months". This has continued throughout 2020 as everyone has adjusted to life with Covid-19.

At the start of the year, not many members of the public would have heard of the company Zoom. Now it has been elevated to verb status as 'to zoom' has come to mean to video conference. This technology has been around for years. We remember Cisco acquiring Tandberg in 2010, in order to be at the forefront of video teleconferencing and collaboration technology, closely followed by Microsoft acquiring Skype in 2011. However, it has taken almost a decade and a pandemic for video conferencing to become truly mainstream and for family gatherings and business meetings to take place via video calls. It is Amara's law that we tend to overestimate the effect of technology in the short term and underestimate it in the long term.

This pandemic has been the catalyst for video conferencing, and we wonder if business travel will return to the same extent. Many have found the time saved from travelling has allowed them to be more productive and efficient, but we all have had suffered from a new affliction, 'zoom fatigue,' from too many online webcasts and meetings. We are believers in human interaction and do not want to see all communication and relationships with others go virtual. However, it has been striking to see just how readily we have all adapted. In the past, working from home had been viewed a perk afforded by companies for those whose circumstances allowed or necessitated it. Now it has become a critical measure in the the fight against Covid-19, with governments actively encouraging working from home in 2020 and into next year.

We also saw an acceleration of entertainment consumption at home as people binge-watched Netflix and played more video games. Broadband traffic records were broken in the UK earlier in the month as the new Xbox and Call of Duty video game was released. We expect that this decade will require significant investment and upgrades into the internet infrastructure in order to cope with this step change in demand with more time spent at home.

Technology

Xbox and Call of Duty cause record broadband data use in UK

By Leo Kelion
Technology desk editor

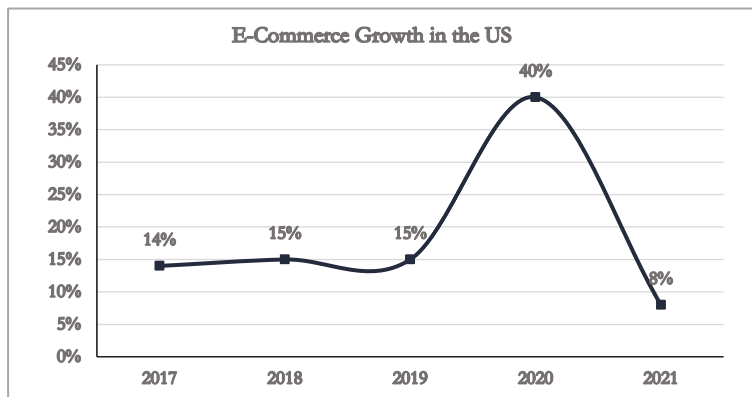
12 November

GETTY IMAGES

The Xbox Series X and Series S consoles were released to the public on Tuesday

As people stayed at home, E-commerce has significantly increased its penetration rate of retail sales and has been one of the main investment stories of 2020. Morgan Stanley estimates US E-commerce will grow by 40% in 2020. The enforced stay-at-home measures have meant that many more people tried E-commerce out of necessity and then appreciated the convenience of the service and items delivered to their door.

Some categories such as groceries and takeaway food have experienced significant growth during the pandemic. We are long-term bulls on the E-commerce trend, with *Amazon's* shares rising over 70% this year, adding over USD 600 billion to its market value. It has increased fulfilment centre capacity by over 50% this year and hired over 400,000 more staff to cope with the strong demand. Whilst this year has been exceptional for E-commerce and growth rates will slow next year, we think that a by-product of the pandemic has been to create new shopping habits and there will be much more consumption online. The traditional Black Friday sales have been set to break even more records with forecasted growth of over 30% for E-commerce.



The pandemic has created new demand for technology and whilst we have every hope that the roll-out of vaccines will allow a gradual return to normalcy, whatever 'new normal' we will end up with will include much more technology.

Luxury Goods – Strong Demand and Spending Power

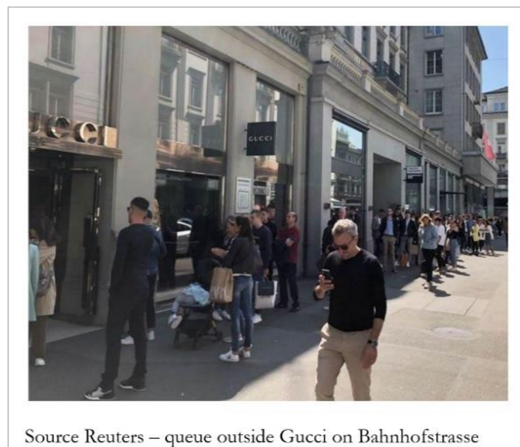
The December 21 winter solstice, the shortest day of the year, is fast approaching in the northern hemisphere. After that, days will be longer and there will be more light. Soon, spring will come.

2020 felt like we have been in the darkest day all year long, but what has surprised us is how resilient consumers are and their unquenched desire to buy luxury goods, defying the historical trend where demand tends to be linked to GDP growth.

China came out from the lockdown first. Chinese consumers are important for the luxury goods market, accounting for approximately 30% of global consumption and much of the growth. We spoke to a luxury mall operator (which owns 42 malls in China) a month after lockdown was lifted in late March. Activity in these malls had already returned to 80-90% of the pre-Covid level. A 'V-shaped' recovery was evident. The trend continued through the year.

By early November when we spoke to another luxury mall owner, sales had not only caught up with the decline but had already surpassed the pre-Covid level growing at 40-50% year-on-year. What is more startling to us is that the major driving force for this luxury spending is from those aged under 40. They are the affluent middle class whose own income is supplemented by both parents and grandparents thanks to the previous one-child policy. They have enormous spending power with the top-tier spenders only interested in limited editions and exclusive offers through, for example, VIP clubs. The travel restrictions means that money that would have otherwise been spent on airfares, restaurants and lodging is being redirected to purchasing luxury goods within China.

'Revenge Spending' was not just happening in China, it was a global phenomenon. The Saturday after the restrictions for non-essential shops were lifted, queues formed outside luxury shops such as Gucci, Louis Vuitton, and Tiffany in Zurich's affluent shopping street Bahnhofstrasse. The picture repeated itself in some other European capitals. Domestic demand for luxury goods is noticeably strong from Germany, UK, France and Italy.

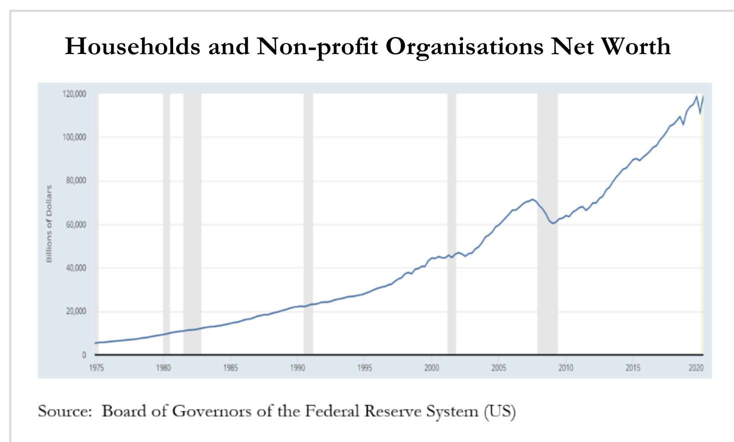


Source Reuters – queue outside Gucci on Bahnhofstrasse

In the US, luxury goods demand has also been surprisingly resilient this year. The unemployment rate for higher earners is still relatively low. Going into the pandemic, the household saving rate was already very high. 'Helicopter money' from the federal government and buoyant stock markets may have also contributed to a continued build-up of savings in households during the pandemic. This, coupled with a deeper penetration of online sales in the sector, resulted in very resilient consumption of luxury goods.

Brand equity and pricing power are cornerstones of luxury goods. Strong demand has enabled the top luxury brands to increase prices even in the mist of the pandemic. For example, Louis Vuitton has increased its prices twice this year and other well-known brands like Chanel and Dior have also implemented price increases.

The resilience of the luxury sector this year is a testimony to brand power. As we pass through the darkest days of winter, with the help of vaccine and vaccination, life will gradually return to normality sometime next year. Consumers will once more be able to indulge themselves not just with luxury goods but also with the luxury experiences that the sector has to offer.



Households and Non-profit Organisations Net Worth

Source: Board of Governors of the Federal Reserve System (US)

Emerging Markets Bonds – Strong Fundamentals Create Opportunity

Last month's insight explored the conundrum of negative interest rates and how we got to such a point. Naturally, the focus was on measures implemented by key central banks (the Fed, ECB and the BoJ) – some old, some new but all mostly expected. The policy reaction to Covid-19 for developed markets has been mostly in line with the measures taken during past crises, albeit at a much larger scale. When looking further afield in developing economies however, what has been striking to note is how different the policy reaction has been this time around.

Historically, many emerging market countries were not able to use these tools because they weaken currencies, thereby exacerbating foreign currency debt burdens in local currency terms, giving rise to inflation. The playbook has been very different in this instance as policymakers in a wide range of developing countries have been able to follow their developed market counterparts, allowing fiscal deficits to widen, easing policy rates and injecting liquidity into their financial systems to help cushion the severity of the crisis and keep markets functioning. Most interestingly, they have broadly been able to 'get away with it' as currencies and other related assets have not been particularly punished by markets.

Part of this can be explained by the increasing credibility and independence of developing economies' central banks which supported their response. Moreover, the size and speed of policy measures taken by developed markets helped to curb US dollar appreciation and calmed the financial markets, allowing rates to be cut aggressively in developing economies without seeing major capital outflows.

Such dynamics have led to greater local market depth and allowed the local banking sector to essentially be part of the solution by providing credit and liquidity, rather than part of the problem as per the global financial crisis. We have seen some of our portfolio companies be proactive and take advantage of such conditions. Take *Cemex* for instance, a leading Mexican building materials company, which is in the process of shifting roughly 10% of its debt out of US dollars into local currencies including the Mexican peso to reflect revenue composition more accurately. Meanwhile *YPF*, a leading Argentine O&G company, has also turned to local markets to secure financing (and seen strong appetite), whilst international capital markets have been all but closed given the sovereign restructuring and FX controls imposed by the government.

Similar to what we have seen in developed markets, excluding certain industries that were caught in the eye of the storm (e.g. airlines, retail and hotel companies), corporate fundamentals remained largely intact and access to sources of capital may have actually increased given the support from local markets.

It is worth noting that in general EM corporates began 2020 with strong financial metrics – i.e. lowly levered with high cash balances, and this helped underpin the resilience of the asset class with the HY segment returning 4.1% YTD. Looking at asset prices now, without the benefit of hindsight, one could easily think there had been no crisis this year, such has been the speed of the recovery and we argue this is partly due to a financial sector which is in better shape this time around.

Multi-Asset Income – Trade Finance Challenges and Opportunities: "Sailing is an activity that is not suitable for impostors"

"In many professions, one can delude and bluff with impunity. On a boat, you either know or you don't. Woe betide the cheaters. The ocean is merciless." (Eric Tabarly, French yachtsman and winner, of many solo races across the globe who disappeared at sea in 1998)

Many times this past year, the financial markets felt like merciless seas. As we close in on what will hopefully be strong performance this year, we believe we did not bluff nor cheat, but stuck to what we know best and have always been doing: focus on fundamentals and cash generation, buy quality assets and hold them for the long term.

However, the extraordinary investment environment we have had to navigate over that period has challenged some of the 'known knowns'.

Our trade finance investments which traditionally benefit from strong collateral and asset backing found themselves under pressure from the rolling global lockdowns as Covid-19 majorly disrupted the global supply chain, preventing the movement of goods or access to merchandise. It also made the implementation of some of the securities in place for each loan a lot more difficult than in normal circumstances. Whilst a large portion of the underlying loans were still performing even if sometimes with help (interest holidays or loans extensions), some loans suffered from those restrictions which have made it difficult or impossible for certain shipments to take place, meaning that contracts could not be fulfilled and access to the goods was temporarily unavailable both for purposes of shipment and for seizure of

collateral by the funds. Nevertheless, defaulting loans have remained within their usual expectations for loan losses.

As global trade activity recovers going into next year, it is likely that some portion of the provisions made by the managers could be recovered.

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December 2020

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