Investment Commentary

"Does volatility in market prices equal risk?"

"Volatility in market prices can be an indicator of risk, but it is not necessarily equal to risk. Volatility refers to the fluctuation of prices in the market, whereas risk is the potential for loss or the uncertainty of an investment's return. While high volatility may indicate a higher level of risk, it is not the only factor that determines risk. Other factors such as company fundamentals, macroeconomic conditions, and investor sentiment can also affect risk. Therefore, volatility should be considered in conjunction with other risk factors when evaluating an investment."

Chat GPT

We have quoted everyone from Warren Buffett to Kim Kardashian in our monthly comments, but this month we thought we should ask ChatGPT for its thoughts on an important topic.

ChatGPT's answer to our question is impressive. It is clear and coherent, and its balanced conclusion is right and uncontroversial. However, could we turn over what we do? It is helpful to know that we could take into account ChatGPT's perspective, but it lacks judgement and of course accountability. We asked it more specfic questions about companies and financials and received answers that looked equally compelling but had errors and omissions that were apparent only because we know the facts. What is more, when we asked the same question more than once each answer seemed similar at first but had different issues. Our experience holds important lessons for investing and other things: An algorithm may be able to analyze data and to provide outputs based on patterns and correlations, whether it is ChatGPT or a systematic trading system; but there is no substitute for knowledge, judgement and consistency.

Our core conviction is that investing in companies that have quality and value for the long-term is a time-tested and proven way of preserving and increasing the value of assets. We think this is all the more important in the current environment. A global economy with strong and sustained growth, nominal interest rates of 4-5%, inflation of 2-4% and real interest rates of 0-2% is something to look forward to, not to fear. Market valuations have reset and are fully compatible with these levels of growth, interest rates and inflation. Nothing has changed about the fact that equities are the primary asset class that can generate real returns for investors. However, there will be more winners and losers, and quality will matter more. Companies that have the quality we look for have strong competitive positions, the ability to innovate and to grow, pricing power, the scale to offset cost increases and strong balance sheets, which enable them to invest in growth or to buy other companies. Those companies will prevail and others will fail.

We invest in companies, not markets, and the results reported by the companies so far this year have been resilient. The longer the duration of corporate and consumer spending, the stronger it has remained. Our industrial companies have reported significant increases in sales and orders, in some cases with doubling backlogs and robust margins as they have been able to pass on cost increases. ChatGPT and other AI applications that will have an increasing impact on our lives will drive demand for semiconductors and cloud computing. Likewise, luxury goods companies have reported strong demand and pricing power. As our colleague Zhixin Shu discussed last month, we believe that Chinese consumers have accumulated savings that could be as high as 5-10% of GDP by some estimates and will add to this

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demand. We see a slowdown in more discretionary spending in areas like corporate software spending or lower end consumer spending, but it is to be expected and is likely to be temporary.

We think a Goldilocks economy is the most likely outcome this year. Bulls and bears will continue to clash as economic data will come too hot or too cold. That is why this year is likely to be as volatile as any year, but fundamentals and valuations will prevail as they always do. We agree with ChatGPT that market volatility does not equal risk. On the contrary, mispricings like we had last year offer opportunities for long-term investors and we will look to use our knowledge, judgement and consistency to buy great companies at great prices whenever we can.

World Stars Global Equity

The year started strongly for our World Stars Global Equity strategy, up 8.3% in January in US dollar terms. You can find the USD factsheet for our World Stars UCITS fund here.

Performance was led by a sharp recovery in some of our holdings that had a challenging 2022. The top performer was *Nvidia*, the advanced semiconductor company, up 34% as news flow around the capabilities of artificial intelligence, including ChatGPT, dominated the headlines. The company is uniquely placed to benefit from increased spend in areas including AI and edge computing, and has recently launched a new product suite of graphics cards.

More broadly our digital holdings benefited from a series of cost-cutting announcements as they reassessed their footprint strategy after three years of aggressive expansion. *Amazon*, up 23% on the month, became the latest company to announce job cuts and revealed plans to reduce investments in marginal return projects like warehouse robots. Amazon's announcement added to similar plans announced by *Meta* and several of the other digital platforms we hold.

At the same time, *Walt Disney* (+25%) found itself in a proxy battle against Nelson Peltz, the activist investor, who called for a greater focus on operational efficiency as well as tighter discipline on capital allocation. The company swiftly responded with an extensive restructuring plan, realigning the reporting lines of its divisions and announcing cuts to headcount and content expenditure within its streaming business.

Beyond the broader digital sector, our companies with exposure to China's reopening powered ahead as the market anticipated an uptick in local consumer spend, as pent-up demand caused by its lengthy Covid restrictions began to unwind. Similarly, within the speciality materials sector, some of our high quality franchises recovered as the market reacted to a better-than-feared macroeconomic environment in both the US and Europe and to peaking input cost inflation.

On the weaker side during the month was global water technology leader *Xylem*, which announced the acquisition of peer Evoqua in an all-stock deal. Xylem's stock (-6%) reacted negatively to the news. We took it positively given that the acquisition achieves Xylem's repeatedly stated intention to deepen its offering within the highly attractive industrial end market. It creates the undisputed global leader in the water infrastructure space, with strong capabilities across verticals, geographies and product offerings, including digital and smart solutions. We believe the deal has placed Xylem in an exceptional position ahead of what is a super-cycle in water infrastructure investment. We used the weakness to add to our holding and the stock subsequently recovered from the initial sell-off.

We introduced a new holding in the portfolio, *ASML* the leading manufacturer of high-end semiconductor equipment. The company is set to benefit from elevated demand for such equipment as the West races to re-shore critical foundry capacity to reduce its reliance on semiconductor supply from Taiwan. At the same time, demand for semiconductors continues to increase exponentially with increased penetration across applications, especially on the high end as we are seeing with *Nvidia.*

We funded these purchases by reducing our positions in ThermoFisher and Alphabet. ThermoFisher has been an exceptional holding for us as a material beneficiary of Covid-19 related spending on testing, therapies and vaccines. As these normalise, we decided to lock in some gains. In addition, we trimmed our holding in Alphabet following the stock's recovery earlier in the month, as macroeconomic headwinds remain on the digital advertising market and as news flow on ChatGPT and its implications for the search market weigh on the stock. Microsoft may be winning the PR war today but longer term we continue to believe that the company's competitive position remains unassailable given the significant investments it has made in the AI space.

Multi-Asset Income

Risk assets started to recover at the end of last year and January proved a continuation of this trend. Our multi-asset income strategy was up 5.3% in US dollar terms, led by equities up 8.9%. Our credit portfolio was also up strongly with a 4.6% return for the month. With a 0.6% positive return, the alternative funds were more subdued but their trajectory for recovery also seems to be underway. You can find the latest factsheet here.

The constructive global macro backdrop provided an impetus for increased risk-taking, with the probability of a soft landing of the US economy increasingly discounted by capital markets. The sudden and unexpected Chinese reopening brought further comfort that the goldilocks scenario (an economy neither too hot nor too cold) could become a very real probability. Furthermore, market observers priced in interest rates cut by the end of this year based on their dovish reading of the US Federal Reserve's comments.

This drove a sharp price bounce back in most of our technology equity holdings. Other strong performers were our luxury and personal care names (*Estee Lauder* +11%) which benefited from the expected increase in spending from Chinese consumers.

The Chinese reopening and the expected resulting higher oil prices supported our energy names in our fixed-income portfolio. Overall, tighter credit spreads and lower US treasury yields proved a boon for the asset class.

Looking ahead and following further strong performance from our equity portfolio, we have decided to slightly reduce our equity exposure and increase our bond holdings in the multi-asset strategy. With an 8% current yield and above 12% yield to maturity for a duration of fewer than four years, we feel that our fixed-income portfolio provides an attractive risk-reward opportunity in the current investment environment. We expect that economic data may well drive the next direction for markets in the coming months and after such a strong start to the year would prefer to protect against possible short-term volatility whilst collecting an 8% current yield from cash income.

Emerging Market Bonds

Our Emerging Market Bond strategy was up 3.1% in US dollar terms, with all sectors and geographies contributing positively. The improving economic backdrop combined with attractive valuations led to sizeable inflows into the emerging market asset class. Credit spreads tightened marginally and now trade around 50 basis points inside the last 20-year average. You can find the latest factsheet here.

Primary euro bond markets looked to be gradually opening as bond yields declined, which is particularly relevant in Sub-Saharan Africa given the greater reliance on external financing. The momentum flowed through to corporates in the region which were some of the top performers during the month. Added to this, *Tullow Oil's* (Ghana; energy) fiscal year 2022 operational update ended in line with guidance on production levels, free cash flow and leverage. Fiscal year 2023 production levels are expected to be flat year-on-year but importantly the company signalled intent to reduce debt via bond buybacks, which was also positive for asset prices.

In Argentina, the government appears to be regaining some credibility after passing the latest review of the IMF and announcing a US dollar bond buyback program on the sovereign debt. The economic minister said that such an initiative was aimed at helping corporates access financing and taking the first steps to improve their debt profile. This helped continue the broad rally in Argentine corporate bonds including *YPF* (energy).

On the downside, the main detractor was *Millicom* (Guatemala; communications) on news of a potential private equity-led buyout. Previously the company has shown disciplined capital allocation prioritising leverage reduction over shareholders. Whilst talks are still in the early stages, bond yields have priced in the likelihood of a shift in financial policies.

Credit fundamentals are starting from a strong base, albeit a moderation in growth could see credit metrics slide. Importantly companies were generally proactive in terming out debt maturities at low fixed rates which mitigates them from refinancing risk in a higher rate environment. Whilst credit spreads have tightened recently, overall yields are still attractive and should bring further inflows to the asset class. Such a setting is an opportunity for investors to lock in attractive carry and total yields by selectively buying and holding bonds to maturity.

Today, our Emerging Market Bond strategy offers an 11.0% p.a. yield to maturity (in US dollar terms, gross) with a relatively short duration of 3.8 years. This comprises a 7.4% p.a. income yield and 3.6% p.a. capital appreciation potential given the average bond price is 90 cents on the dollar.

As we reflect on a good start to the year, with a resilient global economy, moderating inflation, stabilizing interest rates and resurgent markets, we are deeply affected by the suffering in many parts of the world. The earthquakes in Turkey and Syria has caused catastrophic human loss and our thoughts are with our friends, colleagues and all those who have been affected in Turkey and elsewhere. Russia's invasion of Ukraine has had a terrible human cost that continues to increase and we hope that this year will bring peace among the devastation.

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J. Stern & Co.

The Value of Long-Term Investing