Investment Commentary

PATIENCE REWARDED

The big money is not in the buying and the selling but in the waiting.

Charlie Munger

The latest *Financial Times* headlines say it all: 'Kristalina Georgieva, head of the IMF, said the economic landscape was less bad than we feared a couple of months ago'. 'Sharp about-turn in sentiment as IMF indicates it will upgrade its global economic forecasts'. 'Eurozone set to avoid recession as economic gloom lifts'.

Last year tried the patience of long-term investors. What should have been a sustained recovery from the shock of the pandemic turned into a headline-driven sell-off. Economic growth and inflation should have picked up from where they were in 2020 and interest rates gradually increased to normalised levels over a 12 to 24-month period. Instead the lack of investment in public and private capital, capacity constraints and pandemic-related issues with labour supply and supply chains significantly increased inflationary pressures compounded by Russian president Vladimir Putin's decision to invade Ukraine and to cut off European gas.

But as Charlie Munger of Berkshire Hathaway says, 'the big money is in the waiting'. We know that if you tried to trade the S&P 500 over the past 25 years and missed the 20 best days you would have turned a 9% return per year into 2% a year, giving up almost all your profits. That is because the best days in markets come right after the worst ones, and it is impossible to get them right.

Our World Stars Global Equity strategy invests in globally leading companies that have quality and value for the long term. Growth is a necessary attribute of quality, as is sustainability. Last year, short-term forces wreaked their havoc as quality companies with higher valuations of the type we hold sold off, particularly the biggest digital platforms, the main beneficiaries of the shift from offline to online during the pandemic.

Several of the companies we hold had to reset revenue expectations for their more cyclical businesses like digital advertising or enterprise software. They had overestimated growth and over-hired during the pandemic and took decisive action to reduce costs and refocus on their core businesses. However, their scale and resources allow them to invest and innovate, and the underlying demand for their businesses remains strong. That is why we think that reports of the death of online search, e-commerce, social networking, digital advertising, enterprise software and semiconductors are greatly exaggerated. It has happened before, whether Alphabet 'missed mobile' or users would abandon Meta's family of apps because of political issues and we believe that it will be well worth the wait.

We also think that the event risk is more favourable than it was last year. Our senior analyst Zhixin Shu has been visiting family – her first visit since the pandemic was declared – and recently sent us a note from Beijing that we would like to share with you as this month's investment insight. With President Xi Jinping's third term in office approved by the party congress in October and awaiting confirmation by the people's congress in March, it appears that he has decided, to reopen the economy in the most sudden and decisive way possible.

As Zhixin, writes, in a matter of weeks China has gone from a closed country reminiscent of previous periods in its history with quarantine enforced by the most advanced digital surveillance in the world, to full reopening and herd immunity. The impact on the Chinese economy will be significant, increasing demand and unblocking global bottlenecks.

Indications are that President Xi's focus could shift to economic growth and prosperity, and he could seek to improve ties with the US and Europe, including scaling back threats against Taiwan. Many of our companies are positioned to benefit from China's reopening.

There are other events as well. We must hope for a peaceful resolution to the Russia/Ukraine conflict. Could President Putin's approach to Ukraine change in the face of Ukrainian resistance, US and European support and the domestic impact of the human losses and the costs? Energy prices could fluctuate to higher levels again, in particular as China reopens, but natural gas prices in the US are back to pre-pandemic levels, European gas storage is sufficient, and Germany's new LNG terminals are opening at a rapid pace.

We base our decision on company fundamentals, and while it is likely that the rapid rise in interest rates will have an impact on corporate and consumer spending, it is also likely that inflation indicators will annualize last year's significant increases and will slow sharply, perhaps even turning negative, over the next 12 months. Many of our companies have been reporting good business conditions, robust demand and the ability to increase prices to offset cost increases. We expect a slowdown but have consistently between more positive than others have been. Given what we know we are not surprised to see the IMF and others improving their forecasts and we think there could be more to come.

Most important of all for our outlook for 2023 is the conviction that a world in which there is sustained growth, inflation of 2-4% and interest rates of 4-5% is a world to look forward to, not to fear.

Things are not as bad as feared, there is a sharp about-turn in sentiment, the gloom is lifting, and the best days follow the worst. That is why we are not surprised that after the sell-off last year, our portfolio is up 7% year to date in USD. While there will be volatility, we think valuations are compelling, fundamentals are supportive and macro-data is set to improve steadily. We believe that our patience will be rewarded and that there is big money to be made from investing in quality and value for the long term.

World Stars Global Equity

The World Stars Global Equity strategy closed down -4.1% for December and -25.0% for the year, both in US dollar terms. Performance was impacted by the macro-related factor exposures that have driven markets throughout the year, in particular a sharp divergence in returns across sectors. Notably, our strategy was up [+ %] from its lows in November and has continued its strong performance this year.

It was a challenging year for investors in companies that offer quality and value for the long term. Weighing most on performance during the year were our holdings in the digital space, including *Meta Platforms*, *Amazon* and *Salesforce*. The long duration of these franchises meant their valuations came under pressure as interest rates rose. At the same time, pandemic-related elevated demand over the past two years moderated to more normalised levels in the shorter term, especially in areas like online advertising and enterprise software. Fundamental and market factors combined to cause significant sell-offs in the shares of these companies.

Short-term earnings expectations had to be revised and companies took action to reduce their costs by laying off some of the significant staff hired in anticipation of higher demand. Meta also faced questions about its capital spending discipline, especially on the futuristic Metaverse project, where the path to monetisation is not yet fully visible. Markets have difficulty looking through difficult comparisons at the best of times but the fact that these revisions took place against the high growth rates of the previous two years meant that short-term investors whose primary focus is on near-term sales and earnings growth were doubly disappointed.

Many of our industrial and consumer holdings had more resilient performance. *Raytheon Technologies*, the world's largest aerospace systems and engine supplier was the best performer of the year. It benefited from the step up in defence spending following the outbreak of the Ukraine war, with the company being a major supplier of missile defence systems to the battered country. More broadly, our holdings within the industrials sector benefited from accelerating structural trends including the demand for automation solutions amidst labour scarcity; the ongoing recovery in commercial aerospace; investments powering the transition to a net-zero economy; the modernisation of civil infrastructure fuelled by fiscal stimuli programmes; and the call to reshore critical manufacturing capacity.

Our holdings in consumer companies held up similarly well, driven by solid spending trends in categories like luxury goods and spirits.

As we look into 2023, we believe many of the extreme patterns we saw in the last year will reverse. Energy prices are already normalising and inflation is showing signs of peaking. Interest rates are closer to the normalized levels that we think are right for the period of sustained global growth we expect over the next five years and that we have been using in our discounted cash flow-based valuations of companies. As we have highlighted during the past year, the need to invest in the world's capital stock remains unabated. The Chinese economy is opening up after three years of strict Covid-19-related restrictions. Global consumers are continuing to spend on 'feel good' categories like personal care products despite the elevated cost of living. The return of travel is buoying spirits and luxury goods sales.

Digital companies rightly moved quickly to address the short-term slowdown in demand by cutting excessive costs aggressively, while continuing to allocate capital to strategic transformational investments that will ensure their long-term success. The companies we own represent compelling value at these levels and are poised for outperformance as demand recovers and sentiment improves.

The macro factor-driven market sell-off last year allowed us to buy several great companies at great prices. Our new positions in *Nvidia*, *Disney* and *Xylem* are three more of the best companies in the world, with sustainable competitive advantages in some of the most attractive structural areas and with great prospects for value creation. That is why we are confident that 2023 will prove highly rewarding and profitable for the companies we hold.

Multi-Asset

The past year was characterised by a rare and almost complete correlation of most asset classes including those which usually rank as among the safest, such as US Treasuries and global investment grade corporate bonds. In this difficult environment, our strategy was

down -0.9% in December and down -15.7% for the year, following a strong recovery (+7%) over the last quarter, both in US dollar terms.

However, these figures mask the disparity of underlying performances between asset classes. Equities were the most volatile, finishing the year down -24.5%. The fixed income portfolio was down only -6.6% and the alternative income funds were down -12%. Our holdings in equities suffered most from higher interest rates and the correction in yields that pushed longer-duration asset valuations down following three years of remarkable performance.

Contrasting with the overall performance of the asset class, *Schlumberger*, our only investment in the energy sector had a remarkable year (up +80%). Our fixed-income portfolio generated its targeted amount of cash yield (around 8%) which allowed the overall strategy to generate around 4% income. However, this portfolio still had a negative return of -6.6% for the year. Of note was the positive contribution from *YPF* (+14.6%), our only Argentinian holding, as well as the clear outperformance of our Turkish holdings (*Akbank, Koc and Sisecam*) despite a volatile local economic environment. Our alternative income funds were affected by investors using those assets as pockets of liquidity as their underlying performance was less affected by the broader economic issues.

Looking at 2023, we expect another volatile year to navigate but with a more positive outcome. With last year's increases in interest rates, central banks have ended the search for yield. With US Treasury yields in the region of 4%, investors have plenty of investment opportunities to choose from. However, we feel that the Fed is unlikely to pivot as early as markets currently expect and with quantitative tightening reducing liquidity away, we believe there could be renewed bouts of volatility that should provide opportunities to enhance future returns.

We believe that our diversified portfolio is well positioned to deliver on its targets, supported by the attractive estimated yield (around 4%) provided by the fixed income portfolio and the alternative funds. As the global economy slows we expect default rates to rise but our issuers are in good shape and should sustain those pressures.

Emerging Market Bonds

It was a challenging year globally for risk assets driven by macro headwinds centred on aggressive Fed interest rate hikes and a steep rise in US Treasury yields in the face of higher inflation. Emerging market bond yields came under pressure but credit spreads only widened marginally supported by strong underlying corporate fundamentals.

Our Emerging Market Bonds strategy was down -8.2% for the year in US dollar terms, outperforming the reference JPM benchmark by 410 basis points. Total returns were impacted by the rise in rates but the strategy still delivered an attractive realized income of 7.1%.

Our Turkish companies were some of the best contributors to performance. Earnings reports demonstrated their ability to operate robustly in a volatile environment. We believe this is due both to the quality of their management and to their geographic diversification, competitive position, ability to access multiple sources of capital and balance sheet strength. Meanwhile, our oil and gas and mining companies in Africa and Latin America were key

beneficiaries of elevated commodity prices, supported by recovering global demand and supply constraints as the West looked to curb Russian exports.

Aside from the broader market dynamics, the largest detractors of performance were our Ukrainian holdings given the elevated risks since Russia's invasion. Whilst any outcome is still difficult to predict, investee company *MHP* (agro-industrial) has shown a high degree of resilience with poultry production volumes and most exports continuing despite war-related logistical challenges. Meanwhile, an UN-brokered deal has provided some respite for *Kernel* (agro-commodities) allowing for the resumption of grain exports from Black Sea ports.

Going forward, performance will continue to be impacted by macro conditions. There are signs that the focus is shifting from inflation and monetary tightening to concerns about an economic slowdown, which likely indicates rates are peaking. A moderation in growth means that credit metrics may slide (albeit from a very strong base) and lead to some widening in credit spreads that are currently at 20-year historical averages. Such a setting is an opportunity for long-term 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 11.5% per annum yield to maturity (in US dollar terms) with a relatively short duration of 3.8 years. This comprises a 7.5% p.a. income yield and 4.0% p.a. capital appreciation potential, given the average bond price is 85 cents on the dollar.

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