J. STERN & CO.

The Value of Long-Term investing

Commentary

MIRACLE IN CARLTON GARDENS

BERKSHIRE HATHAWAY
HomeServices
Kay & Co

“In these dark days, we tend to look for little shafts of light that spill from heaven” is the beginning of one of the great comic letters of all time. We do not want to be mean and selfish about what little brightness is shed upon us from time to time. So we propose to share with you a tiny flash that has illuminated our sombre lives. On a recent dark December night in Carlton Gardens, we hailed a London taxi that turned out to be one of only two Berkshire Hathaway branded taxis among the 20,000 licensed here in London. It turned out that Berkshire Hathaway Home Services had bought its first real estate brokerage in the United Kingdom and fitted out two taxis in celebration. As you can see, the taxi driver was as cheered as we were by the occasion and we have his number in case you are looking for a taxi in London.

We need a bit of cheer as we reflect on the year just passed. This time last year we said that we thought it would be a year in which politics would be in turmoil but the global economy, the US and Europe foremost, would do well. Growth, employment and incomes would all increase. Inflation would be sustained but moderate (after years of feared deflation). Central banks would raise rates at a reasonable pace, striking a balance between growth and inflation. Ten years after the financial crisis we could finally feel that we had put the worst behind us even if we still suffered from its impact in politics and other ways.

We also said that economic turning points like the one we are currently experiencing would come with volatility as markets and investors had to adapt to the reality of growth, inflation and rising interest rates. We thought that companies in general would also do well, and none more so than the global leaders we invest in for our portfolios that have the quality and value we look for in everything we do, alongside the opportunity, innovation and pricing power to grow and to offset inflation.

The good news is that we were right, for the very most part, about both the economies and our companies. We were also right about the volatility. The other good news is that most of the companies in our portfolios have become cheaper over the past three months than they were at the end of September, some of them at prices higher than they were at the beginning of the year but others lower.

Last month we asked "what is a long-term investor to do?" and concluded "mostly nothing." So it will not come as a surprise that our message for the New Year is one that will be familiar: Keep calm and carry on. Politics of course will only get more tumultuous in the US, UK and Europe as this year's issues all come to a head. Volatility, ultimately, will not abate.

But volatility can create opportunities as well. We have to remember that we have reached the turning point because economies and companies are doing well. We do not see the signs we would if we were close to a cyclical peak. Corporate investment is low, the stock of public and private capital stock is older than ever and there is no overcapacity, no excessive growth in wages and no rampant rise in inflation.

The message from companies (so far) is also clear: Good businesses are doing well. They are increasing their employment and investment and their outlook for next year is strong despite the challenges, political or otherwise. Most, if not all, of our companies benefit from opportunities that are not cyclical in nature, like increasing consumption and prosperity, digital transformation, increasing demand and innovation in healthcare, and automation and the internet of things in capital goods.

Part of what we do is to meet the companies we invest in. Many of them have been in our portfolios for considerable periods of time, and in some cases for many decades. As we write in our insight on *Long-term Shareholding and Activism*, we look to have constructive dialogues with the managements, to learn about their businesses and their approaches, and to contribute what we can in terms of our perspective as long-term investors and shareholders.

As you can read in the investment insight, we were asked this month what we thought about activism by a well-known hedge fund against Pernod Ricard. That in itself followed another similar piece of activism by a hedge fund against Nestle last year. We called it "tiresome" and said that we hoped that their managements would give the hedge funds an objective hearing but then get on with their jobs of managing their businesses.

We will base our views on the same discussions with managements of public and private companies, and the same analysis of companies, their customers, their suppliers and their competitors, as we always do. We will be vigilant of course, but we are resolute and look forward to the coming year as a time of opportunity among the turmoil. After all, such events can create clear entry points into companies as others overreact, and it is then that we, as fundamental, long-term investors, will strike and deploy capital where greater value presents itself.

Equity portfolios

Our World Stars portfolio was marginally lower in November at -0.4% in US dollar terms, with global equity markets taking stock of the economic and geopolitical news flow after October's turbulence.

Performance was led by the more defensive holdings within health care. *Abbott Laboratories, Roche* and *ThermoFisher* were up strongly, with the outcome of US congressional elections providing additional support in the form of a benign regulatory environment for the sector. At their core, these businesses are well diversified, highly innovative franchises, with solid earnings trajectories and balance sheet flexibility to execute on available growth opportunities or return excess cash to shareholders. Similarly, consumer staples players, *Pernod Ricard*, *Diageo* and *Henkel* also delivered solid returns.

On the negative side, *Activision* came under pressure after reporting mixed results. Although both revenue and earnings exceeded management's guidance for Q3, the company's guidance for the fourth quarter did not meet market expectations. Notably, the crowded slate of video game launches in the holiday season has affected sentiment on future sales for its Call of Duty game. Additionally, the video game sector has faced some questions over the short-term uptake of in-game purchases, exacerbating the negative reaction in the shares. We continue to believe, however, that the video game industry has plenty of runway in terms of growth and that *Activision* has additional opportunities including e-sports and advertising.

Income-driven portfolios

Following October's risk assets sell-off, November still witnessed high volatility but with less dramatic effect at month-end. The income portfolio was down 0.7% for the month in US dollar terms but up 0.4% since the start of the year.

Although world equities stabilised, our equity portfolio gave back 0.6% over the course of the month (but up 0.9% year to date), losing some of the outperformance relative to the broad indices. Whereas credit benefited from some respite the previous month, investors decided to carry on exiting the asset class during November. Our credit portfolio was not immune but despite the higher concentration, it performed in line with a 1.4% decline for the month (and also for the year). The funds did what they are best at which is not to be correlated. This part of the portfolio was up 0.2% last month and is now up 5.5% since the start of the year.

Like a mirror image of October, markets were worried about increased trade tensions between the US and China, and the sharp drop in oil prices. Furthermore, renewed hostilities between Russia and the Ukraine, as well as negative comments from the new president elect of Mexico regarding its airport triggered further volatility. Most affected names in November were *Pemex*, *Tullow*, and *Stillwater,* as well as *MHP*.

Investors are brushing aside the fact that all US economic data confirms that growth is still solid and although some expect a slowdown next year, there is no sign so far of a collapse in activity. Ten-year US treasuries have corrected to the downside indicating investors' flight to safe havens. Our expectations of increased volatility have not been disappointed, and we had already adjusted our asset allocation ahead of the event.

Our fundamental style and long-term investment horizon are well suited for this type of environment. Our credit portfolio is currently yielding close to 7.5% with a duration close to four years, and so far this year has generated 7.1% cash on cash. We remain very comfortable that over the near-term the portfolio will generate attractive returns for our investors.

Emerging market bond portfolios

Emerging markets were volatile ahead of the G20 summit held in Buenos Aires at the end of November, with trade talks between the US and China being the focus. Meanwhile, supportive comments from the US Federal Reserve hinting that its monetary policy will follow a moderate course helped risk assets. However, the most significant intra-month drop in oil prices in the last ten years, on the back of macro-political considerations and concerns of global oversupply, derailed the performance of oil-producing credits and countries.

Overall, the emerging markets bond portfolio experienced a 0.8% loss in November, bringing the year-to-date performance to -5.6% (-4.2% if we exclude the *Rusal* position), but it has generated 5.3% of income. The best performing bond was our *Rusal* position, up 6.8% on the month, probably as a result of the payment of the semi-annual coupon during the month which reassured investors about the ability of the company to service its debt. Since the month end there has been encouraging news that the US Government intends to lift sanctions on *Rusal.*

As noted, the tensions in the Azov Sea between Russia and Ukraine derailed the performance of our Ukraine allocation, with *MHP* and *Kernel* down respectively 6% and 3.7%, although the conflict does not present any risk for their operations or exports. The combination of lower oil prices and policy uncertainties in Mexico dragged down our *Pemex* position, which we acquired mid-November at what we thought was an attractive level, and closed -4.6% on the month.

We continue to watch for new opportunities in 2019 to deploy the 20% cash remaining in the portfolio towards higher quality names

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