Commentary

THE J. STERN & CO. WAY: GENERATING VALUE FROM DISRUPTION, ADAPTATION AND CHANGE

The US Securities and Exchange Commission Rule 156 requires mutual funds to tell investors not to base their expectations of future results on past performance before they invest. It is advice well heeded. The current pace of technological innovation and disruption may appear faster than ever. But it is in fact nothing new. Change has been a fact of society, business and investment from the beginning.

Great businesses and great fortunes have always been built by finding new markets, products and services and profiting from them. Our changing ways of live and our preferences as consumers have always been a source of opportunity for some companies and a threat to others. Take Nestlé. It had its origin in 1867 when Henri Nestlé developed a breakthrough infant formula combining milk, wheat flour and sugar to provide nutrition for infants, in response to the societal changes brought on by the industrial revolution, in particular factory labour and urbanization, and to improve infant mortality. 150 years later Nestlé is the global leader in nutrition and health sciences, investing billions in the effort.

Nestlé has been a holding in Stern family portfolios going back decades. It has generated double digit returns and hit a new all-time high when it reported results just last week. But Nestlé is just one of countless examples. As we look to invest in quality and value for the long-term, as the Stern family has for three generations, it is critical that we find the winners of tomorrow and not of yesterday.

We cannot be complacent but have to observe how society, technology business and consumers are changing and think about what these changes mean for the companies we invest in, what opportunities they create and what threats they imply.

That is why Nestle and other leading consumer and healthcare companies in our portfolios have been joined by the digital leaders like Amazon, Google and Facebook that are transforming the way people all over the world live, work and consume and that have great prospects of value generation.

Quality to us is a company with a strong competitive position in a good and growing industry, with a management that has a track record value generation and a balance sheet that is strong enough to weather any adversity. Value is buying that company at a price that allows it to generate returns of 8-10% or more per year over the long-term.

One of our key criteria in quality and value is companies that strike the right balance between growth and profitability, reinvestment and capital return. We had the opportunity to discuss this recently with Mark Schneider, the CEO of Nestlé, at a meeting in London last week. The clearest example of the approach we look for is the “Nestlé Way”, articulated by Peter Brabeck, the former long-term CEO of Nestlé and architect of its success of the past decades.

At is core it is about creating a virtuous circle: Nestlé’s scale as the biggest food company in the world allows it to buy its raw materials and services more cheaply resulting in higher profitability and margins. This profitability allows Nestlé to reinvest more in its brands through advertising and promotion and to reinvest more in its growth through research and innovation. This reinvestment in turn means that it can achieve higher growth to keep the circle going. Nestlé has achieved sustainable sales growth and margins expansion for decades while maintaining a strong and flexible balance sheet and increasing dividends and buying back shares. Not everything Nestlé has done has been a success and it has faced calls to do more of what does at a faster pace, but shareholders have benefitted from the Nestlé Way for decades.

The contrast to the Nestlé Way may be called the “3G Capital Way”, which focuses on value creation through consolidation, scale, efficiency and leverage. Jorge Paulo Lehman and the group realized the significant opportunity for greater efficiency from a relentless focus on efficiency and zero-based budgeting. The latest issues at Kraft Heinz have highlighted, however, that this approach can only go so far and what happens when a company gets out of a balance. We got his wrong ourselves on Anheuser-Busch and had to change our thinking We decided last Fall to sell our long-term holding in the company because we realized that we had made a mistake and that despite protestations to the contrary, 3G’s cost focus meant that the company had not found a way to adapt to changing consumer preferences and was hampered by its leverage.

The Nestlé Way itself has been impacted by some of these challenges as well. As we discussed with Mark Schneider, it is contingent on growth and as growth slowed markedly over the past couple of years, Nestlé too has had to increase its focus on efficiency to generate more capital for its reinvestment and to increase the pace of product introductions and innovation. The new Nestle Way is grounded in the old but it has observed the lessons of the past and has had to adapt under his leadership.

The “J. Stern & Co. Way” applies to all investments we do. In our insight this month Zhixin Shu discusses how companies like some of the global cosmetics and spirits companies we invest in have adapted their approaches to the opportunities and challenges. They are succeeding by innovating their products and approaches to the concerns and preferences to cater to their global millennial customers. The insight also includes two articles in which we discussed these issues in *Morningstar* and the *Financial Times* as part of our commitment to having a voice in the public debate about investment and value generation. Please follow the link here or click on the attachment.

This month also marks the close of the spectacular exhibition "Lost Treasures of Strawberry Hill: Masterpieces from Horace Walpole's Collection" at Strawberry Hill, the gothic country house in Twickenham near London. The Stern family owned Strawberry Hill in the late 19th and early 20th centuries and had its own share of festivities and entertainments. The exhibition has been a brilliant success and has drawn record numbers of people to Strawberry Hill and had wide critical acclaim. We were pleased to continue the family's association and to sponsor the exhibition, and hope that many of you have had a chance to see it.

We believe it is of great importance to help preserve the legacy of the past for present and future generations and as the exhibition closes, Strawberry Hill, its garden and its future exhibitions have much to offer for our contemplation and enjoyment. Robin Lane Fox has written a wonderful article in this weekend's *Financial Times* and we thought we should share it with you.

World Stars equity portfolio

The World Stars equity strategy started 2019 strongly, up 5.8% in US dollar terms. Performance was broad based but led by our holdings within technology as well as industrial and energy sectors.

Social network giant *Facebook* recovered strongly following positive earnings that underlined the fact that, despite recent scandals around privacy, the company's business remains unaffected. An increase in active users, increasing user engagement with its Stories format, and advertisers continuing to increase their allocation of marketing spend to the platform were all key positives. Though the company continues to invest to ringfence its business model and address prior issues, we believe this will translate to further strengthen the company's competitive position.

Similarly, *Amazon* posted 20% revenue growth, driven by ongoing momentum in its advertising business as well as the cloud computing AWS franchise. Though the company pointed to higher investment levels for 2019, we believe this, like in the past, reflects the company's long-term focus, with several disruptive opportunities - like healthcare and grocery - still ahead of it.

Finally of note were our broader energy and industrial holdings, including *Eaton* and *United Technologies*. These responded strongly to robust earnings and order books updates that underscored that activity in key end markets, like commercial construction within the US and aerospace globally, remains solid despite the geopolitical headlines.

On the weaker side, adhesives and household product provider *Henkel* came under pressure as the company announced higher spending levels. The company has been facing increased competitive pressures within its consumer businesses, especially within the US, whilst also having battled logistics issues within that market in recent quarters. Though disappointing, we believe that the company is right to spend to support its business despite the short-term margin headwind that imposes. Additionally, we would point that other parts of the business, like adhesives which accounts for half the portfolio, as well as professional hair within the consumer sector, continue to do well. At current price levels, we believe there is solid valuation support for the stock, though the market will wait for evidence that the higher spend is translating into a reacceleration of the top line.

We have made a several changes to the portfolio, selling and reducing some positions while making place for new ones. An example is *Rockwell Automation*, which has been a very successful holding for us but we decided to switch into *Honeywell*, another global industrial player with similar exposures to Industry 4.0 and the digitalisation of the industrial space. As a rather more diversified play in terms of end market exposures, and with more scope to further enhance its margins, we believe that Honeywell offers a better risk reward profile at this point. We also took the opportunity of a bounce in the broader markets to sell our position in Weir. Though we believe that the recovery in its energy and mining end markets is ongoing, we believe that other stocks offer greater upside potential.

As another example, we decided to sell our holding in *Swatch*, switching to *LVMH* within the luxury space given the better growth profile of soft luxury categories like fashion and leather goods, and the company's increased exposure to experiential luxury through the recent Belmond hotel group acquisition.

We continue to be optimistic about the long-term value generation prospects of our companies despite the uncertainties and will continue to look to take advantage of opportunities as they arise.

Income-driven portfolios

Similar to last year and following a very difficult December, 2019 started on a strong note, with our income driven portfolio up 3.2% in US dollar terms in January. Equities were the main driver, bouncing back from the trough of 2018 with an outstanding performance, up 7.4% on the month. The fixed income holdings continued to perform well, up 3.1% in January, showing their resilience to equity markets' increased volatility.

As a result of January's performance, and despite the volatility of the last few months, we are close to being back on track with our annualized net return of 6.5% since inception (now 6.3% as at the end of January).

Risks assets found support following the change of tone by the US Federal Reserve chairman, Jerome Powell, who highlighted a possible pause in interest rate hikes. We very much still believe that global economic growth is slowing down, the outlook remains generally constructive.

Our asset allocation and securities picks have by and large remained unchanged, and the recent price movements have provided more valuation support to the whole portfolio.

Earnings data released for equities we hold has confirmed our central investment thesis, which focuses on quality and value. On the bond front, our fixed income portfolio has a current yield of 7.4% and a yield to maturity of 8.4%, with a very short duration of 3.4 years, and again our central thesis remains clearly reflected in the holdings we have.

The generation of a solid cash yield with low volatility continues to be our key investment objective. Although we believe this year could be more volatile than 2018, with a first possible hurdle being the Brexit deadline on 29th March, we expect that over a whole year our fundamental and disciplined investment process will again prevail.

Emerging Markets bonds

After a tumultuous 2018 and a deluge of gloomy forecasts for this year, January actually bucked this negativity, with a rally across Emerging Markets asset classes. The Federal Reserve shifting to a dovish tone and signalling that they will not respond to stronger growth unless they see inflation risk, coupled with the US economy showing resilience, are crucial factors supporting risk assets in general, and emerging markets more specifically.

Both robust inflows into the market and a significant increase in emerging market corporate bond issuance also clearly indicate a resumption in optimism.

Amid these shifts in sentiment, our Emerging Market Bond portfolio was up 3.9% in January, the strongest monthly performance since we initiated the strategy in October 2015. All our holdings ended the month in positive territory, except *Grupo Kaltex*, down -3.3% on position squaring ahead of the quarterly earnings release. *Rusal* bonds jumped 32% as part of this positive swing after the formal announcement that OFAC was lifting sanctions on the company. We are holding on to the bonds, which, although now trading at a “normalized” level, offer a spread over 400bps which still looks too generous to us.

We continue to hold 18% cash as we are not completely convinced by the recent rally, but we are aiming to invest on market pull-backs. The potential triggers we have identified could be disappointing growth in developed markets and China, a failure of trade negotiations between China and the US, and volatility around elections in the countries we have on our radar (Nigeria, Ukraine, Turkey, India, Argentina).

As political turmoil continues, and we approach important milestones in the US with the expected release of the Muller report and in the UK with the March 29 deadline for leaving the EU, we are sure to see more volatility in markets. We see little point in speculating on political outcomes although we are happy to discuss them with you in person.

All we can do as long-term investors is to carry on with the J. Stern & Co. Way, to base our investments on our conviction in the long-term fundamentals of the companies we invest in and look to take advantage of opportunities that arise from any volatility.

As always we look forward to your questions and comments.

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