*Commentary*

## "YOU HAVE TO KILL THE CHICKEN TO SCARE THE MONKEY"

The global turmoil we have experienced for the first half of this year reminds us of this famous Chinese proverb. Like many proverbs it is hard to translate but it means something like a measure of fear is necessary at times in order to bring bigger things in line. To us it more aptly describes the confusion which has grown immeasurably across the political landscape.

The events of the first half of the year have served to remind us once again that, as long-term investors, the best we can do is to focus on the fundamentals.

Our basic view is still what we thought at the beginning of the year. We see a robust global economy that is delivering growth, employment and rising incomes in most major economies, whether it is the US, Europe, China or other emerging markets. This growth is moderate but sustained and does not look like it is excessive or giving rise to higher inflation.

The risks we see are twofold: political risk, with politicians in different countries pursuing policies that are more confrontational and adversarial than we have seen for a long time, and economic risk as a consequence of political risk (like trade wars) and policy errors by central banks (like unnecessary rate rises in the face of an inverting US yield curve as you highlighted in your note to me last month).

On the first, political risks are real but all we can really do is focus on quality and value as we do and believe that it is in politicians' interest to deliver growth and prosperity and that much of what we are seeing has to do with posturing and populism.The trade wars are the key global issue today but there are others. On the second, we will have to see if the political issues spill over into the real economy in terms of lower growth, higher inflation or lower investment.We think it is less likely that we will see policy errors in the US and in Europe because we do not think it can be in the Fed's or the ECB's interest to imperil economic growth at a time of such political uncertainty, with mid-term elections coming up in the US and Brexit and immigration causing tensions in the EU.

But as always, "micro" is what we do and "macro" is what we put up with as Charlie Munger has said.

Given such a backdrop, the progress of economies and companies this year has been nothing short of remarkable.

What we focus on looking through all this noise and volatility, in order to make the right decisions for the long-term and to take advantage of any mispricings.

Warren Buffett and Charlie Munger at Berkshire Hathaway are the champions of this investment approach. They do not just talk about looking to profit from short-term swings but actually do it, as evidenced by Berkshire Hathaway's decision just this week about share buybacks.

Breaking with its own tradition, Berkshire has taken the decision to remove a restriction it had around buying back its own stock. The board has given Buffett and Munger the authority

to together approve buybacks when they believe the share price is below the company's intrinsic value.

This is absolutely the right thing to do in the current environment. Other companies can and should take a similar pragmatic and sensible view. One case in point for that is Nestlé, on which we were recently quoted in the *Financial Times*. We think that Nestlé's priority should be to allocate the significant amount capital it has (including its proceeds from a sale of its stake in L'Oréal) to grow the business through innovation and acquisitions if possible but should buy back shares if they cannot find opportunities to put it to work at good returns and within a reasonable time frame. You can read more about it here. https://www.ft.com/content/f4677208-69a8-11e8-8cf3-0c230fa67aec

Nestlé is one of the companies facing a challenge from activist investors. We look to engage with the companies we invest in and look to build strong relationships with their managements over time. We will also stand up for what we think is right and necessary as we have in the case of Sika, the Swiss material technology company whose independence we successfully defended against a hostile takeover. However, we often disagree with short-term activism looking for quick share price gains. In the case of Nestlé and Third Point, we believe that the long-term initiatives put in place by Nestlé's new CEO Mark Schneider are right and will help the company to generate innovation, growth and value for shareholders as it has in the past. Making our views public is part of our engagement and we spoke to *Reuters* about this at the start of July. https://uk.reuters.com/article/us-nestle-ceo-analysis/cultural-mix-a-hidden-weapon-in-nestle-ceos-activist-defense-idUKKBN1JW0VH

Whether it be short-term activists, politicians or other challenges, there will always be rumblings going on to distract investors. We think that our portfolios and their positions are well placed to continue to do well both this year and long-term. The broad exposures are to companies that have good prospects for growth through digital transformation and consumer spending that are either not directly impacted by the political and economic issues we are seeing or should be more resilient than most if those issues do spill over into the real economy.

But what remains clear to us is that opportunities and value will continue to abound for long-term investors who truly understand the companies they own. Our insight this month, written by Jean-Yves Chereau discusses how strong brands and brand equity as seen in the recent FIFA World Cup are key drivers for potential future investment growth.

*Equity portfolios*

Our World Stars equity strategy was up 0.5% in US dollar terms during June bringing year to date performance to 7.2%, continuing to strongly outperform global markets.

Performance was led by global brewer *Anheuser-Busch,* up 7.8% in June. The company has been recovering previous losses, with key brand Budweiser the title sponsor for the World Cup and thus providing a nice near-term boost in demand. Longer-term, we believe the company has plenty of growth opportunities as it leverages the expanded global distribution platform that the SABMiller acquisition has provided.

At the same time *Activision Blizzard*, the gaming software developer, continued its upward trajectory. The industry's annual flagship conference, E3, took place in June in Los Angeles,

generating great excitement as the video game companies previewed new games. It also highlighted the close relationship that these firms have with their player communities and with developing trends, with much talk about new industry drivers such as streaming games.

Activision also recently reported a new television deal with Disney to show Overwatch league, the company's eSports game, on ESPN, further demonstrating its potential to expand from just selling games into other media content.

Finally, pharmaceutical giant *Roche* benefited from improved market sentiment for the sector as investors reflected on the deep value of the name and its attractive drug pipeline.

On the negative side, oil and mining services provider *Weir* was weaker, reflecting the short term volatility in the oil price, but we believe it remains an attractive asset benefiting from the progressive inflection in capital spending trends in both the energy and mining industries.

*Income-driven portfolios*

The month of June saw further weakness in the fixed income asset class and as a result our Income Portfolio wasn't totally immune.

Down 0.4% in US dollar terms over the month, the portfolio was still up 1% year to date. The positive performances of both equities and the non-correlated funds, up 0.3% and 0.2% respectively, were not sufficient to offset the counter performance of credit which was down a further 1.3% for the month (now down 3.3% since the start of the year).

Despite those negative headline numbers, the credit portfolio has shown further outperformance relative to its benchmark (the Bloomberg Barclays EM HY index is now down 5.9% year to date) underlining the strong fundamentals and the shorter durations of our securities.

Over the past few months, prospects of rising US interest rates and a strong US dollar have prompted investors in the asset class to cash out. Fear of a repeat of the 1990's emerging markets' crises is at the forefront of investors' minds, and volatility has increased as credit spreads have widened significantly since early April.

However, emerging markets' fundamentals are still healthy, with sovereigns' balance sheets and economic growth prospects much improved from those critical times. This also rings true for corporates which are generally relying less on US dollar funding, with strong earnings and cashflows.

We mentioned on numerous occasions that earlier this year we felt the risk-reward of investing in emerging market debt wasn't attractive enough to initiate new investments. As we see value developing, we have started to arbitrage some of the holdings to take advantage of the wider spreads, whilst keeping duration at the shorter end (below five years) on average.

Our focus still remains on cash generation. So far this year the portfolio has produced around 1.7% and with our increased positioning on credit we expect further strong generation till year end. Although volatility could stay relatively high over the summer as liquidity is likely to subside, the underlying cash buffer should reduce the possible downside.

*Emerging market bond portfolios*

The sell-off in emerging markets continued its course in June, with no signs of outflows abating, as the high-profile backdrop of a trade war between China and the US continued to prompt further waves of risk aversion amongst investors.

Our emerging market bond portfolio was down -1.2% for the month, dragging the year to date performance to -6% (-4.3% if we exclude the Rusal position).

It was a heavy month in terms of the political agenda, with Turkey and Mexico holding presidential elections (although Mexico's vote was on July 1st). Whilst both victories were largely discounted, the follow-ups diverged. Andres Manuel Lopez Obrador (AMLO) gave conciliatory speeches in which he committed to fighting corruption, boosting much-needed infrastructure investment, respecting important existing commitments and keeping public finances healthy. Conversely, Erdogan felt under no pressure to reassure capital markets, as demonstrated by the nomination of an economic team on July 9th promoting his son-in-low to the position of Finance Minister. Our Mexico and Turkey positions all ended June in the red. Since then, Mexican assets have rallied, while Turkish assets are back at their lows.

Looking at individual positions, the worst performing holding in the portfolio was the South African gold and palladium mining company *Stillwater Mining,* down -6.5% following several casualties at its South African mining operations. Whilst deeply regrettable our discussions with management point to several of these incidents being due to individual circumstances and seismic activity rather than underlying operational issues. We continue to feel the company's acquisition of the Stillwater mine in the US will provide strong earnings growth to reduce leverage and additionally provide a pivot away from South Africa, facts which are not in the current spread in the bonds.

*CLISA,* the Argentinean conglomerate involved in waste management, construction, transportation and water supply declined another 4.8% on the month. We believe the price action on the bonds reflect the state of liquidity in the market and continue to see fundamental value in the company.

On the positive side, our Russian positions were up, probably on low volumes as well. Overall, Russian assets look fairly disconnected to the rest of Emerging Markets and expensive in relative value terms.

We strongly believe that following the current sell-off which has pushed emerging market bond spreads to levels not seen since June 2016, buying opportunities are arising. Volatility is likely to persist over the summer as trading volumes remain low, but we can finally say emerging market bonds are now looking attractive.

Our fundamental outlook for the second half of the year continues to be constructive despite the political and economic risks and we look forward to taking advantage of opportunities as they arise.

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