

Commentary

ONE WAY OR ANOTHER ...

We were speaking at Latticework, an investment conference in London earlier this month, where one of the other speakers, one of Europe's most prominent value investors, said that he does not believe in projecting what companies do more than two years out because nobody can know what will happen.

Good for him but we do. Short-term investors make money from buying at a discount to what they see today, whether they are mutual funds looking to outperform, hedge funds going long or short to generate monthly returns, or value investors looking to pick up businesses on the cheap because they are in difficulties, because of their markets or problems of their own,

Real companies do not make money in months, quarters, one year or two years. Real companies have strong competitive positions in good and growing markets, they have good managements who are have a track record (and an incentive) to generate long-term growth, strong balance sheets, the ability to invest in technology and innovation to strengthen their businesses and find new ways to grow, and the scale to buy competitors if they want to add to their businesses or avoid disruption.

That is what we call quality and that is why we make our money not from what happens today or even over the next two years, but from the compounding of a business over the long-term, when short term investors, investment banking analysts and others have long stepped away to find the next thing.

The risk for us is disruption of the business, by new technology and innovation, changing markets or preferences, by new competitors or by neglect of their own businesses. Take the *Coca-Cola Company*, which we wrote about earlier this year. Then we wrote that this was the year where Coca Cola, its flagship product for more than a century, one of the world's most valuable brands, was transitioning from full sugar to sugar free. We noticed several years ago that Diet Coke, a category of its own, was being supplemented by Coke Zero, which imitated the real Coke flavour. This year we saw the Coke Zero can go from black to red with only a small black band at the top and the name from Coke Zero to Coke no Sugar. And here in the UK at least, this month saw the actual transition: Coke no sugar or sugar, it is the same thing, have it your way. Soon Coke will be the one without sugar and Coke Classic will be back with sugar.



Diet Coke was introduced in 1982. 36 years later we have come to the end of a managed transition, disrupted by changing customer preferences and a concerted public health

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campaign against the risks and impact of sugar on diet and public health, obesity, diabetes, heart disease, sugar taxes, portion limits and municipal bans. In the UK currently, Coke Classic with sugar is sold in 330ml bottles while Coke No Sugar is sold in 500 ml bottles for the same price. We said it was too little too late, with customer preference having moved on and Coca-Cola and fizzy drinks as a category being left behind. Could Coca Cola have been more proactive? Perhaps, but with all the resources in the world it saw the issues, embarked on a plan that it implemented over two generations, and here we are. That is what real companies do, even if in this case it was not successful.

We have many other more successful examples, whether it is Nestle with Alcon contact lenses, and then Nespresso and now Health Sciences, or Amazon with AWS and cloud computing. We try to identify the challenges and opportunities by observing what emerging companies are developing and incumbent ones are investing in, by trying to understand the cutting edge of technology and innovation, to worry about what they (actually) worry about, to learn what they learn and to think about how it may impact them.

Equally important to learning is to benefit from the experience that others have had in overcoming adversity and realising their passions and ambitions. Nothing is easy and perseverance and luck are equally necessary. Our friend Gillian Zoe Segal has spent five years interviewing 50 of the most successful people in all fields about their experiences and their lessons. Don't believe us, believe Warren Buffet who told people at this year's Berkshire Hathaway annual meeting that her book "Getting There" is a must read.

We have attached an article that Gillian has kindly allowed us to [circulate](#). We hope you find it interesting and if you do, please do us and our portfolios a favour and buy it on [Amazon](#), talk about it to your friends on Facebook or Whatsapp, and look at Gillians videos on Youtube.

Equity portfolios

Our World Stars portfolio finished up 0.4% in US dollar terms in August, bringing year-to-date performance to 10.9%. Returns were led by *Amazon*, fuelled by the ongoing momentum within e-commerce and as the company tested the \$1 trillion market capitalisation mark. Creative software producer *Adobe* also continued to perform strongly as investors recognised the strength of its underlying business. Indeed, in the quarterly results released on 13th September, the firm reiterated the significant revenue growth in both its creative software products and its digital marketing offerings. At the same time, amidst the market volatility, our defensive holdings such as *Abbott Laboratories*, *Henkel* and *ThermoFisher* held up nicely.

On the negative side, *British American Tobacco* came under pressure from a combination of emerging market exposure and acute local currency depreciations. Simultaneously, the market is assessing the pace of transition to next generation products, following Japanese industry data that suggested consumer engagement is levelling off.

Nonetheless, the short-term volatility does not detract from our view that the firm's emerging market exposure remains a driver of value. In a similar vein, we believe that ultimately there will be strong adoption of next generation products as both individuals and governments seek to respond to the health effects of combustible alternatives.

Income-driven portfolios

The month of August was characterised by increased volatility in emerging market debt, triggered by renewed concerns about the deteriorating economic situation in Turkey and Argentina. Currencies in both countries came under severe pressure and resulted in further weakness in the fixed income asset class, down 2.3% over the month. However, equities and non-correlated funds were up 1.1% and 0.5% respectively (taking them to 11.6% and 4.3% year-to-date), providing the expected downside protection they are there to deliver, and meaning the overall portfolio was only slightly down (-0.3%) for the month. Year-to-date it is still up 2.6% in US dollar terms.

Globally the picture continues to be mixed when looking around the various markets. The US remains on a strong footing and Europe is in good health but concerns over the outlook for emerging markets are clouding that region. In truth, with regards to the latter, negative economic news was almost entirely focused on Argentina and Turkey last month (more on this below) where both regions suffered from self-inflicted damage. However, investors need to be cognisant of the risks from the ongoing US-China trade war which could further pressurise emerging market assets.

As ever, we take a long-term view and the fundamentals of our emerging markets investments are still very healthy, with strong earnings and cash flow underpinning our holdings, leaving them less reliant on US dollar funding. The past two months of volatility have also presented us with the opportunity to optimise the emerging markets corporate bond portfolio by increasing exposure to the credit asset class, upping the expected yield and further reducing the duration (now around four years).

Cash flow generation so far this year has been 2.3% and we expect to finish the year on a strong note on that front. The extra yield buffer will also further dampen the volatility of the portfolio.

Emerging Market bond portfolios

August was a painful month for emerging markets which were hit by general risk aversion across all countries and credits. Our Emerging Market Debt portfolio shed 3.4% on the month, bringing the year-to-date performance to -7.5%. Year-to-date, the portfolio has generated 3.9% of Income. All our bonds ended in the red except *Petra Diamonds*.

Early on in the month, Turkey's twin deficits were in focus amid persistently high inflation and a Central Bank resisting calls to tighten monetary policy. On top of the economic stress, political tensions escalated between Turkey and the US, leading to a 30% drop in the value of the Turkish lira vs the US dollar. Investors therefore reduced their exposure to Turkey, whilst market liquidity was thin, as it usually is in August. However, we maintained our Turkey exposure through the turmoil and are currently looking to increase our Turkey allocation, taking advantage of the indiscriminate sell-off which has affected strong corporates with robust cash flow generation.

Investors quickly drew parallels between Turkey and Argentina, with both countries running twin deficits, whilst Argentinian President Macri requested an acceleration of the release of the IMF loan. The Argentine peso also fell 30% in reaction, taking in its slide all Argentina Eurobonds without differentiation. In response, we have opportunistically increased our position in USD-generating companies whose capital structure would not be affected by the recent turmoil.

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Elsewhere, we sold our entire position in *TV Azteca* after *American Tower*, the cell tower owner and one of the holdings within our World Stars portfolio, released a statement announcing TV Azteca had “missed two payments on a loan to MATC”, a division of its business. We decided to take action swiftly to avoid running the risk of a rapid market correction.

Overall, we are actively talking to our prospects and clients as we believe that current market conditions offer attractive entry opportunities. The yield-to-maturity on our BB-rated model portfolio is now 9%, with the running yield at 7.4% with a duration of 3.7 years.

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