J. Stern & Co.

The Value of Long-Term investing

Commentary

When the going gets tough, the tough go shopping…

Markets have declined over the past three months. As we know, volatility creates opportunities for long-term investors. Economic turning points like the one we are currently experiencing come with volatility as markets and investors have to adapt to the reality of growth, inflation and rising interest rates. Now is the time to take advantage and buy great companies at marked down prices.

Politics may be in turmoil but the global economy is doing well. It may not be growing quite as fast as last year, but growth, employment and incomes are all still increasing in the US, Europe and China. Inflation is sustained but moderate. Central banks are raising rates at a reasonable pace, striking a balance between growth and inflation.

We have to remember that we have reached this turning point because economies and companies are doing well. Ten years after the financial crisis we can finally feel that we have put the worst behind us even if we are still suffering from its impact in politics and other ways.

Along with the global economy, companies in general are doing well, and none more so than the global leaders we invest in for our portfolios. These companies 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 message from most if not all of our companies 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. Our companies benefit from opportunities that are not cyclical in nature, like increasing consumption and prosperity in consumer goods, digital transformation in technology, increasing demand and innovation in healthcare, and automation and the internet of things in capital goods.

The pullback of many of the large technology and internet stocks has been among the most striking features of the correction. We continue to have strong conviction that digital transformation is a critical driver for the global economy and a tremendous opportunity for its leading companies and their prospects for value creation.

With the reshuffle of the MSCI GICS sectors, many of our digital and internet companies have moved from Tech to Communications and other sectors. To us it makes no difference. Each of the companies we invest in is selected based on our fundamental analysis of the company and its business. They are distinguished from the wider tech sector by a number of factors:

- We look for companies that are not exposed to product cycles or design wins. In technology, there is an ever-present risk of missing a product cycle, not having the best chip or simply being unable to produce a hit product, most recently experienced by Apple. Instead, the competitive moat around our investments lies in network effects and strong relationships with the customer.

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- Many of our investments are platforms with high incremental margins. Once they have reached a critical mass, the additional customer is at a very high incremental profit margin. These companies benefit from a very high free cash flow generation. This is in contrast to the traditional technology hardware and semiconductor companies where the bill of materials constrains the gross margin. This high cash flow enables our companies to invest into new exciting areas, for example, Alphabet currently with Waymo or historically when Amazon built AWS.

- Finally, none of our current investments in technology and internet stocks have meaningful exposure to China nor do they have a supply chain with Chinese exposure which would be subject to a trade war.

We see enormous long-term opportunity ahead. However, as Giles Tulloch writes in our insight this month, technology developments move in cycles and so there could be a temporary lull or pause in growth. It reminds us of the discussion of Amazon's investment cycles as they invested e-commerce fulfilment warehouses and built AWS. Both were criticised at the time and led to pullbacks in the shares, but both bore fruit a few years later. Those declines are blips on the long-term share price development today but were significant at the time and we must take them into account as we manage our portfolios.

Our thoughts on our investments have not changed in the last couple of months just because of the widespread market downturn. We are not concerned about short-term volatility during quarterly earnings or bouts of market volatility like the one we are currently experiencing. The current downturn creates clear entry points into companies as others overreact, and it is now that we, as fundamental, long-term investors, can deploy capital and find bargains where true value presents itself.

World Stars equity portfolios

Amidst a turbulent month for equity markets, the World Stars portfolio was down -6.5% in US dollar terms in December. It closed last year down -5.2%, but nonetheless outperformed global markets, with the MSCI World down -8.2% over the same period.

The portfolio was supported by the relative stability of some of our more defensive names, including *Diageo* and *Pernod Ricard*, the leading global spirits providers, as well as *EssilorLuxottica*, the global leader in lenses and frames, and mobile cell operator *American Tower*. Indeed, we would again highlight that the majority of the World Stars portfolio is invested in companies with high visibility of earnings, whether that is in the consumer, technology or healthcare space, where demand for products or services is unaffected by the economic cycle.

Among the names coming under pressure in December was oil services provider *Schlumberger* as macro concerns weighed on sentiment for the energy sector. Nonetheless, we believe that following four years of unprecedented cuts in capital expenditure, oil companies will inevitably have to increase their spending again as they look to replace reserves and as project economics have improved. More broadly, we would highlight that our holdings within more cyclical areas like industrials are concentrated in names with high recurring revenues, rich intellectual property and high structural growth drivers. Such companies include aerospace systems and elevator producer *United Technologies*, and the effect of this is to cushion the portfolio against any macroeconomic volatility.

As noted in our introductory comments, some of our holdings within technology, like *Adobe* and *Amazon*, also sold off amidst the turmoil. As we point out however, this short term profit-taking has nothing to do with the long-term fundamentals of the companies. Digital transformation remains a critical driver for the global economy and we continue to see value creation opportunities ahead.

Income-driven portfolios

The end of the year was almost a mirror image of its start with risk assets sharply correcting around the globe, led by the US equity markets. Our expectations of higher volatility for the year were not disappointed.

As risk assets broadly corrected, the income portfolio gave back -1.9% during the month of December for a year-to-date performance of -1.4% in US Dollar terms. Equities drove the performance down -7.4% on the month, with performance of -6.6% since the start of the year as a result. However, the fixed income portion of the portfolio wasn't affected and showed a positive contribution of 0.6% over the month, finishing the year just slightly down by -0.8%. Meanwhile, the non-correlated funds performed in line with expectations, up +0.2% in December with a total return of +5.7% for the whole of 2018.

All in all, the portfolio's volatility was much lower compared to the market and the cash generation was in line with expectations.

Our quality and value mindset drove our selection process, with our fixed income portfolio benefitting from the short duration of most of the selected bonds (average duration below four years). In addition, our increased allocation to emerging markets corporate bonds during the course of the year, made at the expense of US high yield bonds, also helped the performance. We expect this year to bring similar opportunities and favour our fundamental style.

Overall 2019 is likely to remain challenging as far as the investment environment goes, but we also feel that our strategy is well positioned to perform well. The uncorrelated funds and the high cash generation from the fixed income portfolio provide downside protection as witnessed in 2018, while our exposure to high quality global equities ensures a higher degree of visibility on future returns.

Emerging Market bond portfolios

Given the overall high volatility across asset classes in December, most particularly in equity markets, emerging market bonds were resilient, supported by a drop in 10-year US Treasury yields from 3% to 2.7%.

Our emerging market bond portfolio closed up +0.1% in December bringing the year-to-date total return performance to -5.5% (-4.1% if we exclude the *Rusal* position). The portfolio generated 5.9% of income for the year as a whole.

The top performers within our portfolio in December were the ones that lagged the market in November, and vice versa. Despite oil prices shedding another 20% in December, with Brent hitting $50 on 24th December, 40% lower than its October peak, three of our five top performers were oil producing companies. These businesses bounced back after the stark correction in November, but the gains also reflected investors' confidence in government-

owned national leaders like Pemex or Petrobras and low-cost exploration and production companies like *Tullow Oil*.

Elsewhere, we took advantage of a correction in Mexican assets to initiate a position in Posadas, Mexico's largest hotel operator and focused on the upper economy segment.

Whilst sentiment remains vulnerable to exogenous uncertainties related to the US economic cycle, the direction and the impact of the Fed's monetary policy and finally the China/US trade dispute, we feel that our Emerging Market Bond portfolio offers an attractive risk/reward, with a yield to maturity of 9% and a current yield of 7.5% (compared to 5.3% and 6.1% at the beginning of 2018) for an average term well below five years.

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