Commentary

YOUR MARGIN IS MY OPPORTUNITY

> "It is not the profit margins of the past but those of the future that are basically important to the investor. It is the nature of business that in even the best-run companies unexpected difficulties, profit squeezes, and unfavourable shifts in demand for their products will at times occur." *Philip Fisher*

We have been saying for some time now that we expected markets to become more turbulent and volatile as we are in the midst of a turning point for the US and European economies. On top of that, we also face significant upheaval from the US political environment remaining fluid, the ongoing Brexit negotiations in the UK, and the uncertain geopolitical situation more broadly.

Well here we are. Markets oscillate between warnings about rampant interest rate rises and the fears of impending global recession. Stocks, including many in our portfolios, have corrected as investors look to lock in profits by selling what has worked. Given the worries, any company that does not produce results is penalized harshly as if a slight beat or miss of quarterly growth or margins should indicate a flawed investment thesis and a permanent impairment of value.

What are we to do as long-term investors? For the most part, nothing. We must be vigilant to the risks to the economy and to our companies. At times like these, we redouble our efforts to make sure our fundamental work is right and that we are justified in our convictions. But we must not let market turbulence cloud our judgment or precipitate hasty decisions. For us as long term investors, the protection of capital comes from investing in companies with quality and value, that have strong competitive positions, good management teams and healthy balance sheets to weather the storm, use it to get stronger and to generate value over time

As Philip Fisher has said, it is not past but future profitability that matters to us. All of us know from our experience that real businesses face real issues of growth, efficiency, investment, timing and uncertainty, sometimes because of the markets they operate in and sometimes because of issues of their own. As with markets overall we must look through those periods to judge whether they are temporary or permanent and whether they change our views about the long-term prospects of the business. That is what we spend almost all of our time doing, talking to the companies, their customers, their suppliers and their competitors to build a fundamental picture of their businesses, to identify risks and seek out opportunities.

Amazon is a prime example of this (pardon the pun). Based on the same reasoning as Philip Fisher's, Jeff Bezos has said that "your margin is my opportunity." Amazon has a clear and rigorous approach to identifying, analyzing and investing in its business for the long-term, which has allowed it to disrupt major industries like retail or build their own, like cloud computing.

The healthcare opportunity for Amazon is an example of the kind of innovation, investment and value creation that is a major part of the quality we look for in the businesses we invest in and work to identify that they are grounded in our long-term, fundamental, research-

J. Stern & Co
4 Carlton Gardens
London SW1Y 5AA
United Kingdom

Tel: +44 20 3478 1800
Fax: +44 20 3478 1799
info@jsternco.com
www.jsternco.com

based approach to investing and our ability to leverage our investment team's expertise in technology, healthcare and other industries to recognize opportunities and appreciate their potential. By keeping our focus on what we know about the companies we invest in and on our convictions we are confident that we can take advantage of opportunities like the present and generate value for the long-term.

World Stars portfolio

The global sell off during October weighed on the World Stars strategy, which closed the month down -9.3% in US dollar terms, though it remained slightly ahead year-to-date at 1.8%.

The market, as we have highlighted, has been dominated by macroeconomic concerns, leading to an indiscriminate sell off across equity markets globally.

Amidst this volatility, it is important to remain focused on the fundamentals. For our holdings these remain solid as they continue to post good revenue and earnings growth numbers. This was of course evident in some of the more defensive names, like *Nestle* and *Pernod Ricard*, enjoying healthy global demand for coffee, infant nutrition, pet care and spirits. Similarly, life sciences leader *ThermoFisher Scientific* continued to benefit from the virtuous cycle of using its unmatched product portfolio breadth to sell bundled solutions to its customers, whilst utilizing its balance sheet strength to acquire more assets and further entrench its competitive position.

Strong numbers were also evident both for our more cyclical industrial holdings, as well as our technology positions. Within industrials, *United Technologies* continues to benefit from solid demand in verticals like aerospace and commercial construction. The same applies to our internet holdings. *Amazon* posted revenue growth of 29%, with its cloud computing business AWS growing 46% and its advertising business more than doubling, something we have been advocating as another driver for Amazon's growth, and especially its profitability. Nonetheless despite these positive dynamics, these names came under pressure along with the broader market, with the solid results being dismissed as "not good enough" in the current environment.

Our companies continue to deliver revenues and earnings growth amidst this volatility given the strength of their competitive positions, and this is why we look at the current dislocation as an opportunity to buy great global companies at cheaper multiples.

Income-driven portfolios

As world equities broadly corrected, the income portfolio declined 3.3% during the month of October but still shows a positive performance since the start of the year of 1.0% in US Dollar terms.

While equities were down 10.0% (but still up 1.5% since the start of the year), the credit portfolio carried on with its recovery from the weakness experienced over the summer across emerging markets, with a slight positive contribution of 0.2% for the month (now flat since the start of the year). The non-correlated funds were down 0.4% for the month, but remain 4.8% ahead for the year. The latter performance was driven by one of our funds, The Biopharma Credit Fund, which announced the launch of a capital raising exercise linked to the opportunity to invest in a very strong deal pipeline underlying the strength of its business model.

In fact, despite the abrupt correction and increase in volatility, our portfolio behaved as expected with two of the three components de-correlated from the other.

This was evidenced when confirmation of strong US economic growth triggered a correction in 10 year US Treasuries, with the yield rising from 3.06% to reach a peak of 3.23% during the month. Higher quality corporate bonds which are more sensitive to interest movements suffered the brunt of the adjustment. However, high yield and emerging market corporate bonds benefited from further credit spread compression. Also, normalisation in both Turkey, Argentina and Brazil currency exchange rates - and subsiding political tensions - further supported the performance, with QNB Finansbank, Sisecam, Tupras, Cosan and Rumo all showing positive returns.

We are very constructive for the end of the year as our balanced portfolio could benefit from an equity recovery whilst our fixed income portfolio, with an average duration of 4.5 years, and our alternative funds will buffer any more volatility.

Emerging market bond portfolios

Despite a generally tumultuous month for markets, we saw a consolidation in our Emerging Market Bond portfolio, up +0.4% in October. Year-to-date the portfolio is down -4.9% in total return (-3.5% if we exclude the *Rusal* position) but has generated 4.8% of income.

Normalisation of diplomatic relations between Turkey and the US following the release of the Pastor gave a strong boost to Turkish assets, whilst President Erdogan has been skilfully choosing his allies following journalist Jamal Khashoggi's assassination. As a result, the *Lira* appreciated 8% in the month, and *Halkbank* was our best performing bond, up 6 points.

Jair Bolsonaro's victory in the Brazilian Presidential election was positive for Brazilian credits. All our positions were up, including *Petrobras* (+2.9%). We will be closely watching the ability of the new administration to pass through Congress the badly needed pension reforms as a clear demonstration of their willingness and ability to make sweeping changes.

AMLO is taking office on December 1st in Mexico and has already caused ripples following the referendum on the new airport in Mexico City, and his stated intention to cancel the $13bn project. We are looking at opportunities to increase our Mexico allocation towards solid names.
Overall, we are not worried by the sudden correction in oil prices and remain sanguine on the prospects of our E&P companies, which have been significantly de-leveraging in recent years.

November 2018