Monthly Commentary

GLIMPSES OF THE FUTURE

"We tend to overestimate the effect of a technology in the short run and underestimate the effect in the long run." This 'law of technology' keeps getting validated not because we do not understand how technology works in the near term but because we simply cannot imagine the future.

Great innovations have impacts that are measured not in years but in decades, not in numbers but in how they the change the world. Whether it is our parents' generation, ourselves or the next generation, it helps to recall that just in the course of the last century, cars, airplanes, computers and the internet have changed our way of working and of living in ways that we could not have anticipated.

Every once in while we get a glimpse of what the future may hold. As long-term investors we want to be as open, attentive and humble as we can because it is through these glimpses that we have sight of great opportunities, even if we can only begin to fathom their impact and potential. Recognizing those opportunities and finding ways to invest in them is our greatest challenge and potential.

Blockchain, whether through digital currencies or other applications, is a new technology that has the prospect of achieving such an impact. We think that blockchain for supply chain could provide the companies we invest in with unprecedented opportunities for efficiency and profitability. Like with SAP we ask them constantly how they are integrating blockchain into their businesses and like with SAP we expect that we expect that we will not see the benefits for many years. It took Nestlé 15 years to implement Project Globe, the rollout of SAP and we have only begun to see the benefits in capital allocation, investment, growth and profitability. We have written about it and had a highly insightful symposium about it with our friend Bettina Warburg last year. We still do not yet know how or when blockchain for supply chain will have an impact, but we are asking the questions now.

Cryptocurrencies are another matter. Facebook's announcement of Libra in partnership with other technology and payments companies, is another such glimpse of the future. As a 'stablecoin' backed by assets it could offer a payment mechanism that could revolutionise the way money and value is transferred and used. Its effect is nothing short of disrupting central banks and their control of money and of currencies. There are far more questions than answers, not least because the consequences for the global financial system and regulation are so great.

Facebook is a core position for us because we think it offers irreplaceable and valuable services to its 2.7 billion monthly active users. The company is undergoing necessary change in terms of its practices, resources and management, but we have publicly said that as its services and its users shift to greater awareness about privacy, data and how it is used, they the platforms will offer a better experience and greater utility to its users. Payments is one of the great drivers of Alibaba and Tencent in China, the biggest digital economy in the world, where WeChat Pay and Alipay are taking over payments from other players.

We have expected Facebook to find ways of engaging its Facebook, WhatsApp and Instagram users, to offer greater services to them, and to monetize those services for the benefit of the

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company and its shareholders. It is too early to say what impact Libra may have, if it is viable and if it offers benefits that other solutions do not have. It will be years before it is launched.

We did not know that Facebook and its founder had identified it as an opportunity for technological innovation. However, that does not mean we are surprised that they did. Facebook's billions of users mean that it is bigger than China. Most of its users are not in the US and in Europe but dispersed widely across the globe. It is main social network in South East Asia for example. It is uniquely positioned to pioneer a global digital currency that clearly has enormous potential and could change the world. We will do our best not to underestimate it just because we cannot imagine how it will work today and we will keep asking questions to recognise its potential if we can.

The cities of the future are another area where disruption is taking place on a global scale. Thinking about broad changes driven by technology, demographics, climate change and other forces is critical to understanding the impact they may have on our societies and economies. It is also essential to identifying the risks and opportunities they hold for our investments. In addition to blockchain, we have already written about the disruptive potential of digital healthcare, electric cars and the internet of things. In her insight this month, Katerina Kosmopoulou looks at smart cities and concludes that they are already here—another change whose short term impact we may have overestimated but whose long-term impact we are only beginning to understand. You can read it by following the link here or by clicking on the attachment. All our insights are available on our website www.jsternco.com.

Back to today. Micro is what we do, macro is what we put up with. There are always industry and company specific issues but overall businesses are doing well and are getting on with it despite the headlines. But it feels like a normal mid-cycle period where growth is slowing after a period of high growth and where companies, central banks, and other players are adapting what they do accordingly. It is also in no-one's interest to unsettle the economy and in particular we just do not see how it can be a surprise that the Fed is data driven and that as they see growth and inflation slow they will slow the pace of rate rises as well. We prefer to stick with the micro, to what we see from our research and our conversations with companies. Many if not most of our companies are positive about their businesses so we look at any major volatility as an opportunity.

World Stars Global Equity Portfolio

Our World Stars global equity strategy gave back some of its recent gains in May amidst increased trade tensions, closing the month down -4.5% in US dollar terms. The portfolio remains up 10.9% year-to-date, and continues to outperform global markets.

Performance was led by mobile tower operator, *American Tower*, which stands to benefit from the rollout of next generation 5G technology. The defensive nature of the firm's recurring revenue base acts as a cushion against the current market volatility.

The portfolio's performance was also supported by medical devices player, *Medtronic*, which posted a solid set of results. Importantly, the firm provided an upbeat guidance for the fiscal year, ahead of upcoming product launches in its cardiovascular and diabetes franchises, as well as the introduction of its long anticipated robotic surgery platform.

During its capital markets day, leading food & beverage player *Nestlé* provided a solid update on progress in its strategic plan, with an ongoing focus on delivering operational efficiencies and driving growth across its franchise. The company recently announced that it has entered talks to sell its Nestlé Skin Health business for a potential CHF 10.2bn, further delivering on the strategic repositioning of its portfolio.

On the weaker side, some of our more cyclical names including *Schlumberger* and *United Technologies* came under pressure amidst concerns of the impact of deepening trade tensions between China and the US will have on global economic growth. Though we recognise these concerns, we believe they are amply reflected in current valuations. Although we will continue to monitor such developments, we are of the belief that a resolution is the most likely outcome, given the strong economic incentive for all parties. Ultimately, it is the ability of these companies as leaders in their industries to capture growth and strategic opportunities even amidst a volatile environment that underpins their through-the-cycle performance.

Multi-Asset Income Portfolio

The month of May was marked by a risk off trading pattern led by geopolitical noise. Most risk assets showed negative returns, confirming that higher volatility is probably here to stay for the rest of the year. In this context the Income Portfolio was down 1.5% in US dollar terms in May but remains up 5.6% year-to-date.

The more volatile equities portion of the portfolio suffered a drop of 5.2% in US dollar terms (but still showing a healthy year-to-date gain of 12.7%) as profit taking took place across the board, with more cyclical names being affected and only a few names managing to fight the tide.

In comparison, fixed income markets were generally supported by the rapidly subsiding yield on US treasuries, offsetting widening credit spreads for higher yielding corporate bonds. As a result, our fixed income portfolio generated a small positive return of 0.2% over the month, leading to yein ar-to-date performance of 5%.

In May we also made some changes to the bond portion of the portfolio. We took profits in some of last year's successful Turkish investments *QNB Bank* and *Tupras*, which are now yielding close to 5%, and long-term holding *Rumo*. Following a bout of recent strong performance, Rumo is now showing a yield to maturity of around 5.4% lower than our expected medium-term return. As a replacement, we purchased *TV Azteca*, *Grupo Posadas* and *Chesapeake Energy*, all yielding in excess of 8% and with potential for capital gains.

Our fixed income portfolio is now yielding 7.5% with a yield to maturity close to 8%, and a duration on the short side at 3 ½ years, which should reduce volatility.

Although we expect the investment environment to remain challenging, we feel that our current barbell positioning for both equities and bonds will provide investors with the right balance of downside protection through the income cushion, alongside growth from the idiosyncratic equity stories.

Emerging Market Bond Portfolio

May was dominated by the news flow around an aggravation of trade tensions between the US and China, escalating in an increase in trade tariffs. The potential downside drag of these tariffs on global growth sparked an immediate reaction of risk aversion and "flight to quality". Whilst spread of Emerging Market Bonds widened, the movement was more than offset by the rally in US Treasuries, fuelled by a more dovish Fed. The yield of the 5yr US Treasury bonds dropped by 53bps on the month, crossing the 2%-mark, a level not reached since September 2017.

Overall our Emerging Market Bond portfolio ended May up +0.3%, bringing the year-to-date performance to 6.5%, net of fees.

Kaltex was our top performer, up 7.5%, after the release of its Q1 financials showing a strong margin improvement driven by efficient cost control and declining cotton prices. Although its capital structure remains stretched and bonds are still trading significantly below purchase price, we are comforted by the positive outlook on cotton prices, as cotton accounts for 30% of its cost of goods. We are also optimistic around the momentum in the textile business in general, and the recovery in the retail segment in Q2. This is a position that we will continue to monitor closely.

Whilst Argentine oil company *YPF* declined as Cristina Kirchner presented herself as a credible candidate for the Presidential elections, they rallied two thirds in May, making up for lost ground. The bonds are now 7.7% up year-to-date. Volatility is likely to persist in Argentina until the first round of the Presidential elections on October 27, given the frail macroeconomic situation. August 11th is an important date to watch being as the primary elections, known as PASO, will provide a first indication of whom the voters want.

We made three trades in the portfolio in May. We bought *TV Azteca*, Mexico's second largest TV broadcaster, controlling around 40% of the TV advertising market, and yielding close to 9% for 2024 maturity. We also took a position in *Hidrovias do Brasil*, a leading logistics company focusing on water transportation, a fast growing and efficient segment given Brazil's dominant position as commodity exporter and decades of underinvestment. We sold our position in South African mining company *Sibanye Stillwater*, willing to capitalise on the recent strong gains (up +2% in April and +9% year-to-date), as we note the risk of potential strike action at the platinum mines, following repetitive strike movement at the gold mines last year.

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We continue to see a constructive outlook for the major economies, companies and markets. However, despite the ongoing strong performance of our portfolios and markets we do not think we have seen a 'melt up' yet. Stock market valuations are at the higher end of periodic ranges but in most cases still consistent with solid returns given prospects for growth of sales and cash flows. Fixed income is a different story with yields back to record lows. In this kind of environment real assets that can generate returns and offset inflation are at a premium. The 'hunt' for those assets will be the cause of any melt up in stock markets if do see one in the future. Political uncertainty continues unabated so we are braced for volatility, which will hopefully opportunities to buy some of our favourite assets at lower prices. It is another trope or meme, but interesting times indeed…

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