J. Stern & Co.

The Value of Long-Term investing

Commentary

What is progress? You might think that the question is so subjective and culturally relative as to be forever unanswerable. In fact, it's one of the easier questions to answer. Health, safety, literacy, sustenance and stimulation. All these things can be measured. If they have increased over time, that is progress. And here is a shocker: The world has made spectacular progress in every singly measure of human wellbeing. Here is a second shocker: Almost no one knows about it.

Steven Pinker, *Enlightenment Now*

Reading *Enlightenment Now* by Steven Pinker over the summer has been a salutary and timely reminder of why we have cause for long-term optimism even if short-term worries abound. The book is a passionate defence of modernity and progress based on psychological insights into the roots of human behaviour and countless charts documenting the facts that prove his point.

Some of it relates to ancient biases, that optimism and belief in progress is simplistic and unserious. As Pinker writes, "intellectuals know they can attain instant gravitas by pointing to an unsolved problem and theorize that it is a symptom of a sick society."

Others are related to media and the way we consume media in ever shorter cycles. Pinker writes that "whether or not the world is really getting worse, the news, far from being a 'first draft of history' is closer to play by play sports commentary. News is about things that happen, not things that don't happen. As long as bad things have not vanished from the earth, there will always be enough incidents to fill the news on, especially with billions of smartphone turn most of the world's population in to crime reporters and war correspondents." Those same smartphones bring the news to us in an immediate and personal way that magnifies its impact and its urgency.

Even one of our favourite publications, the *Financial Times*, ranks articles by those that are most popular, meaning that the front page of the online edition is at least in part a reflection not of what the FT's editors think is the most important news but of which headlines caused most people to click on them. News stories and editorials are measured in part on the numbers of page views and comments, creating a strong incentive for journalists to focus all too often on profit warnings, legal troubles, corporate activism, personal issues of managements and other controversies. Pinker and others call these the 'Availability Heuristic', the 'Optimism Gap' and the 'Negativity Bias'. They are obvious but insidious, they confront us every day, and they force us to work to acquire facts and knowledge—Enlightenment—in order to overcome them.

The analogies to investing are clear. Some people simply believe that it is never a good time to buy stocks because they are either far too expensive because they have just gone up or far too risky because they have just gone down. When was the last time there was a front page headline "The Global Economy is Doing Great" or "The Stock Market has not Crashed"? Our challenge is to do the work to acquire the facts and knowledge to find great companies that have the competitive position, resources, innovation and resilience to grow over the long-term and to have the conviction to hold them in times of adversity.

Those facts are why there is 'no news' about our outlook for our investments for this year. A degree of slowdown, whether it is the US, European and other economies or corporates, is to be expected after a period of high growth. However, we do not see indicators for an

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

overheating, neither in the economy nor in markets or valuations. Central banks are clearly poised to support the economy amid the political uncertainty we face in the US, the EU and the UK, much of which will come to a head in the next weeks and months. A recent investment update by one of the major investment banks had only four of its 18 'sell signals' in place, including the US government yield curve after the recent inversion and US non-financial corporate debt/EBITDA at 1.6x. Their 'euphoria/panic indicator' was just above panic despite the positive performance of the stock market this year. Fear itself may be a partial explanation for the yield curve inversion along with the supportive stance of central banks. As we write below, reported earnings have been solid overall and while corporates are always cautious (see the biases we list above) and have to deal with business issues, short term cycles, regulation and other challenges, our underlying outlook is still constructive.

The most wonderful discovery in Pinker's book is a quote from David Deutsch that we have alluded to before in describing our approach to investing in companies. It is worth quoting in full:

"The most important of all limitations on knowledge creation is that we cannot prophesy: we cannot predict the content of ideas yet to be created, or their effects. This limitation is not only consistent with the unlimited growth of knowledge, it is entailed by it."

Believing in progress and basing judgments on facts, whether it is about global progress in human wellbeing as described by Pinker or about preserving and increasing the value of assets by investing in companies that drive global growth and innovation, is the opposite of being simplistic or unserious. It is about justified optimism in human creativity and entrepreneurialism, and our ability to tackle problems through education, technology and persistence. Pinker's book is an affirmation of this belief, which we passionately share, and is well worth a read.

World Stars porfolio

Our World Stars global equities strategy finished July up +1.1% in US dollar terms, bringing year-to-date performance to 19.2%.

The sources of performance were broad-based with positive earnings updates supporting our holdings across sectors. Within Communication Services, *Alphabet* delivered a robust 20%+ revenue growth, displaying positive momentum across its main platforms including mobile search and *YouTube*. The company continues to stand out as a leader in artificial intelligence and machine learning, enabling it to offer new and innovative services to clients and advertisers. At the same time, it is utilising its $100 billion cash chest to continue to buy back shares and make strategic acquisitions.

Within Health Care, *EssilorLuxotica* delivered another quarter of solid growth across its lenses and glasses businesses, whilst synergies arising from the integration of the two legacy companies are being realised as planned. At the same time, the acquisition of *Grand Vision*, a leading retailer in Europe, further consolidates the company's position within the industry.

Also within Health Care, medical devices player, Medtronic continued its upward trajectory as the market began pricing in the company's robust product pipeline, with numerous exciting launches due over the next 12 months.

Within Consumer Staples, *Nestlé* benefited from sustained momentum across its businesses, led by pet care, nutrition and coffee. Of note, the company is seeing very strong consumer engagement for its recently introduced *Starbucks* branded products, a testament to the more focused, nimbler approach to its R&D and product introduction processes under the new CEO, Mark Schneider.

On the weaker side, life sciences player *ThermoFisher* came back from its all-time high levels. The company delivered robust organic growth, despite suffering an outage in one of its main data centre facilities towards the end of the quarter, as it continues to gain share in its markets and utilise its financial flexibility to add to its asset portfolio. Nonetheless, higher levels of investments affected short-term profitability, weighing on the stock. We see such investments as evidence of the management's commitment to capitalise on long-term opportunities and see the company as a core holding across our strategies.

In summary, we are encouraged to see the positive underling business momentum across our holdings, underpinned by the attractive structural characteristics of their end markets, the strength of their competitive moat and their managements' focus on steering the businesses for the long term, irrespective of any macroeconomic or geopolitical volatility that arises.

Income-driven portfolios

July was quite uneventful overall, except towards month-end when volatility started to increase post the decision by the US Federal Reserve to cut interest rates. As a result, the overall performance was flat for the month (up 9.4% year-to-date). However, while equities were up 1.7% in USD terms (taking them up 22.9% since the start of the year), fixed income and the non-correlated funds were respectively down 0.3% and 0.4% (up 7.6% and 2.6% year-to-date).

Our equity portfolio benefited by and large from positive earnings releases and outlooks. However, our fixed income portfolio was adversely affected by idiosyncratic stories, such as *Chesapeake Energy* suffering from weaker oil prices, investor concerns regarding the changing business model and transition from gas production to oil production, and slower than expected asset disposals.

Non-correlated funds were impacted by the negative performance of the Biopharma Credit Fund, following the announcement by *Sanofi* that it would terminate its collaboration with Lexicon Pharmaceuticals. The latter had been provided a USD124.5m loan from the fund, but Sanofi's actions do not impact *Xermelo*, the main drug approved by the FDA when the loan was written. Furthermore, the loan is secured by all of Lexicon's assets, providing substantial excess collateral value to support the loan.

Both equity and fixed income markets have benefited from major central banks reversing their monetary policies since the beginning of the year. However, markets may have gone ahead of themselves and expected much more support at a time when global growth seems to be faltering and trade tensions not abating. Of key concern for investors is the prospect of a further deterioration in the economic growth outlook, and the longer the trade tensions last the more impact they are likely to have on corporate confidence, with potential ramifications for growth and corporate profits.

In this context investors have flown to perceived safe haven assets, i.e. sovereign debt such as US Treasuries and German bunds, with global yields again at historic lows. The search for yield is back on!

As ever, we take a long-term view and the fundamentals of our underlying investments are still very healthy, with strong earnings and cash flow. We still expect volatility to increase in financial markets, which will present us with opportunities to further optimise our portfolio.

Cash flow generation so far this year has been 2.7%, on target for a strong income delivery for the end of the year.

Emerging Markets portfolio

The comfortable environment for Emerging Markets bonds continued during the month of July, with stable US Treasuries yields and solid risk appetite across countries and regions. As a result, our Emerging Market Bond portfolio ended July 1% up, bringing the year-to-date performance to 9.8%, net of fees.

As we mentioned in our commentary last month, we were concerned by the Turkish new Central Bank governorshiP with regards to President Erdogan's pressure to cut rates aggressively. As a result, we have reduced our Turkey exposure ahead of the Central Bank's meeting on July 24.

We sold our position in *Petra Diamonds* after the firm released fairly weak numbers in its Q4 trading update, given the context of subdued demand for rough diamonds and a decrease in diamond pricing. Although Petra Diamonds' equity reacted sharply on the news, bonds held rather well. Despite this, we chose to take risk off the table, as bonds have returned close to 9% year-to-date and we see no real catalyst which would push the bond price up.

As a result, we were running a 23% cash position at the end of July, as none of the credits on our approved or watch lists offered attractive returns at their current trading prices. We opted to sit on this hefty cash position, waiting for the next bout of volatility to offer attractive entry points to buy bonds of solid companies, which could suffer in the context of a country's specific developments.

August 2019