Commentary

EVERYTHING MAY BE OK

Earlier this year, a classic Matt cartoon from the *Daily Telegraph* had an English couple walk by a deranged-looking man holding up a sign saying "Everything may be OK". The man turns to his wife and says "Lunatic."

It is an apt depiction both of the current state of discourse and the negativity bias we have been discussing in our comments over the past couple of months. We see it in politics, economics and markets, where predictions of impending collapse and tail events are a constant din and the much more likely outcome, that everything may be OK, is discounted and dismissed.

That is not to say that we should be complacent. On the contrary, we should be greatly concerned about the issues we face but should not confront them urgently, by taking action ourselves or by insisting that our representatives in politics and government address them with the greater means at their disposal. However, we have to be careful not to let our concerns and our frustration at the lack of progress blind us to the very means by which we can overcome those issues and achieve the progress we hope for.

Because we invest in companies that offer quality and value over the long-term, we have always been highly concerned with the sustainability of their industries, their businesses and their practices. Environmental, social and governance issues (ESG) have been central to our investment decisions. Quality is a gating condition for us and it includes key criteria such as a strong and sustainable competitive position in a good and growing industry.

The clue is in the name as we are sometimes reminded by younger members of our families. No matter how good it is today, a business cannot sustain its competitive advantage in the long-term if its industry is in decline, if it exploits resources in an unsustainable way, if it treats its workforce poorly, if it violates government policy or regulation, or if it is rejected by its customers because of real or perceived issues with its business and its practices. Nestlé is a good example. It has been in Stern family portfolios since the 1950s and despite the many issues it has faced, most prominently in infant nutrition and water, it would not have generated the strong returns it has since then and it would not still be a core holding for us if it were not continuously addressing these issues, innovating and changing along the way.

It is of great importance to recognize that companies like Nestlé and many others that we are invested in may be part of the problem, because they are large businesses that operate globally and have great economic and social impact on our societies, but they are also an important part of the solution.

This is the link to our earlier discussion of progress: It is human spirit and entrepreneurialism that has been the driver of the progress we have seen. Corporations have an absolutely critical role to play because of the resources they can bring to bear in terms of capital, research and innovation. That is why the ESG debate is complicated and cannot be reduced to simplistic, exclusionary principles.

It is our role as investors and shareholders to identify companies that are sustainable, that have the quality and value to be good investments over the long-term and to engage with them actively to support them in taking a long-term view, investing in their businesses and creating the solutions to the issues they face.

We continue to believe that 'everything may be OK' and that we are seeing a mid-cycle slowdown that is to be expected after a longer period of growth. Markets have remained volatile given the unfolding trade war and continued evidence of weakening in global industrial activity.

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

In Europe, Germany is facing headwinds within its manufacturing sector given its export-driven nature and as the country's auto industry adapts to the transition to electric vehicles. At the same time, in the broader region, concerns around the implications of Brexit and the trade war have continued to weigh on sentiment. In China too, industrial activity and some areas of consumer demand have reflected uncertainties, although importantly spending in key end markets remains very robust, a fact once again evidenced by the recent strong growth reported by luxury goods leader LVMH. The US economy continues to lead in the global arena with healthy employment trends supporting domestic demand, though here too there has been some evidence that pockets of industrial activity have been affected by the trade war.

Although we recognise the macroeconomic uncertainty as well as the elevated geopolitical risks we continue to believe that central banks, including the Federal Reserve and the European Central Bank, are providing the necessary policy support and that ultimately it will be in the interests of all parties to find a resolution in the current trade dispute.

Our insight this month, Emerging Markets bonds: Nature or Nurture, discusses how we apply our approach to the complex interaction between the inherent fundamental qualities of the companies we invest in and the significant external factors affecting markets and prices. We believe that here too looking through volatility and focusing on long-term fundamentals is the right approach to generate returns over time. You can read the insight by following the link here or by clicking on the attachment.

World Stars Global Equity portfolio

During September, our World Stars strategy was slightly down -0.4% in US dollar terms, continuing to show resilience in volatile markets. It is up 18.8 % year to date.

During the month, performance was supported by our holding in pharmaceutical manufacturer *Roche*, which continued to perform strongly as investors started to realise that risks from biosimilar competition are likely to prove less acute than feared and gave increasing recognition to the company's robust pipeline of new drugs. We have argued for both based on our fundamental analysis and are pleased to see it reflected in Roche's share price performance, up 23% in 2019 in CHF.

United Technologies gained momentum as investors started to look towards the planned breakup of the company into three globally leading pure play businesses, an event that we believe will act as a trigger for the re-appraisal of the company's valuation compared to it its peer group.

Finally, software gaming developer *Activision Blizzard* benefited from investor anticipation ahead of its flagship Call of Duty: Mobile launch, which aims to capture a broader audience by bringing the game to smartphones and tablets whilst also deepening player engagement.

On the weaker side during the month, mobile tower operator *American Tower*, saw some profit taking after its strong recent performance and richer valuation. Longer term it remains a key beneficiary of structural growth in mobile data usage. We saw similar profit taking in some of our consumer staples holdings, like *Diageo* and *Pernod Ricard*, despite still healthy underlying fundamentals.

Multi-Asset Income portfolio

Following August's market fluctuations, the month of September saw volatility increasing and investors moving back into risk assets despite the uncertain economic outlook, helped by more positive noise on the trade negotiations between USA and China, and generally supportive statements from both the European and US central banks. In this context the income portfolio recovered 0.7% from the previous month in US Dollar terms (up 8.5% since the start of the year).

Global equities were the most volatile asset class last month. However, our own equity portfolio fell just 0.1% and is still up a strong 23.6% year to date. Following a torrid month, our fixed income portfolio recovered some of its losses with a positive contribution of 1.6%, helped by the recovery in emerging markets corporate bonds. Overall the credit portfolio is now up 4.6% for the year. The non-correlated funds had a slight positive contribution of 0.3% in September, taking the performance year to date to a positive 3.3%.

Market volatility was used to initiate a new position in the fixed income portfolio with the purchase of Fage 2026 bonds at below par. Although the duration is at the longer end of our maturity range, this issuer has a leading position in the global Greek yoghurt market, a turnaround story and the bond has a 7.5% yield to maturity.

With global economic figures weakening investors are finding comfort in the supportive comments from central bankers and the hope that the major trade issues will be resolved before they have greater impact on economic growth. Corporate earnings releases for the upcoming quarter will be important for short-term market direction and we expect volatility to remain a key feature.

Our fundamental style, long-term investment horizon and barbell positioning are well suited for this type of environment. Our credit portfolio is currently yielding 8.4% with a duration of 3.3 years. So far this year the total portfolio has generated 3.4% cash on cash, in line with our year-end target of approximately 5%.

Emerging Markets Bond portfolio

The Emerging Markets Bond portfolio bounced back +1.3% in September as investors returned to the asset class, encouraged by the resumption of China and US trade talks and not deterred by the attacks on Saudi Arabia's oil facilities by Yemenite rebels backed by Iran.

The narrowing of Emerging Markets bond spreads more than compensated for the rise in US Treasury yields to 1.5% for the 5-year. The average yield to maturity of our portfolio is 7.6% with a duration of 3.2 years, a level we consider attractive in the context of overall low yields.

The strongest move in the portfolio came from YPF up 21% on the month, which is in line with our August commentary after the bond dropped 31%. As we say in our Investment Insight this month, we consider YPF as a stand-alone credit that can withstand the volatility around politics and macro policies.

September was a busy month for us as we made three purchases, reducing our cash position to 8.7%. We participated in the new bond issue of IHS, the largest telecommunications tower infrastructure owner and operator in Nigeria. We like the defensive nature of the sector, the long-term visibility of revenues and cash flows and the strong shareholder base. We bought back Petra Diamonds, a position we exited last July (at a yield to maturity of 8.5%) when declining prices in the diamond market had a severe impact on the company's equity and bond levels. As bonds reached a yield to maturity of close to 18%, we were comfortable re-entering the position at this attractive level.

For us, the current backdrop provides support for our approach in focusing on businesses that benefit from robust structural growth in their end markets, enjoy strong competitive moats, and whose managements have a proven track record of steering the businesses for the long term, irrespective of any volatility that arises.

October 2019