J. STERN & CO.

The Value of Long-Term investing

Commentary

PUSHING BACK THE FRONTIERS OF THE POSSIBLE

In tackling a truly global challenge like climate change, we must maintain our belief in the power of engineering to make a better world. Because (…) our future will depend on engineers who are equipped to push back the frontiers of the possible.

Lord Browne of Madingley

We invest in quality and value over the long-term. Quality to us is a company that has a strong and sustainable competitive position, in a good and growing industry, a management with a track record of value creation and a balance so strong as to be able to withstand any adversity. Value means generating returns of 8-10% per year over five to ten years or longer.

Each of those words matter, but none more so than 'sustainability'. In order to succeed over the long-term and to generate value, companies have to be sustainable themselves, in the products and services they provide, in the sourcing of their materials, in the treatment of their workforce and in their interactions with their customers, suppliers, competitors, regulators, and society as a whole. Perception can matter as much as reality as consumers are increasingly connected and concerned. To us the question has always been about the disruption of a company's sustainable competitive advantage by innovation, competition or other factors. We have innumerable examples, like retail getting disrupted by e-commerce or the automotive industry by electric vehicles and ride sharing, whether through platforms like Uber (itself being threatened by Lyft, Kaptan and other platforms) or through car sharing and driverless cars, pods or drones that are as futuristic to us today as a smartphone or iPad were for some of us when we were at school or university.

Sustainability and progress are inseparable in our view. As we continue to integrate ESG thinking into our approach of investing in companies we look to the opportunities that companies have from contributing to sustainability as well as to the risks. We are informed by the information, data and ratings available from providers, but we base our decisions on our own fundamental assessment of what companies do, which requires us to make judgments that are grounded in facts and realities, and can differ in many ways from more simplistic perceptions and approaches.

We share our conviction in progress with Lord Browne, corporate leader and author, to whom we are grateful for contributing our insight this month. Lord Browne makes an important argument for engineering as a key to overcoming global challenges, in particular climate change. Science and engineering have improved the life expectancy and quality of life of millions, by preventing and curing diseases and by creating healthier and safer places for life and work.

As Lord Browne says, climate change is a truly global challenge. But as it is a (relatively) clear and crisp November day in London, we only have to think of the 'London fog', which was not fog at all but pollution from so many wood and coal fired stoves, to see that there has been progress and that there is cause for optimism if we make a concerted effort to invest in science and engineering and harness their power to overcome our challenges. Lord Browne has recently published a book entitled Make, Think, Imagine: Engineering the Future of Civilization, which is available on Amazon if you wish to contribute to one of our core holdings. You can read Lord Browne's insight by following the link here or by clicking on the attachment.

As part of our commitment to contribute to the discussion of important issues that impact society, we are pleased to be hosting Lord Browne for a discussion today on The Impact of Climate Change on Global Energy Policy and Investment, with a group of distinguished, academics, policy makers and investors.

Thinking about how businesses, research institutions and governments can work together to achieve positive change, and how we can contribute as investors and shareholders in global businesses, is a critical part of what we do. The answers are always more complicated and differentiated in their implementation than in the public debate. In our role as the manager of assets entrusted to us it is incumbent on us to identify those companies that contribute to sustainability and progress, and we are committed to asking the right questions and finding the answers.

World Stars Global Equity Portfolio

During October, our World Stars portfolio was up 2.3% in US dollar terms, bringing performance year-to-date to 21.9%.

Performance was led by *Facebook* which posted another strong set of results for the third quarter, with 29% revenue growth overall as the 'stories' format continued to drive user engagement. At the same time, monthly average users rose 8%, with growth in both North America and Europe, countering the perception that these markets have reached maturity. The company also provided operating expense guidance that was lower than expected whilst continuing to invest in the business and leveraging its scale.

Software gaming developer *Activision Blizzard* benefited from the record launch of its flagship Call of Duty Mobile game, which posted over 100m downloads within its first week. This was a pivotal success, with the company capturing a broader audience by bringing the game to smartphones and tablets.

Within Industrials, *United Technologies* continued on its solid trajectory on the back of strong results driven by its Aerospace business, as investors started to look towards the ultimate breakup of the company in early 2020. Also, within Industrials, *Eaton* continued to show resilience despite headwinds from the volatile macroeconomic environment, with its Electrical and Aerospace businesses posting solid order trends. The company also continued to realise value by optimising its asset portfolio, reflected in the recent sale of its Lighting business for $1.4bn.

On the weaker side during the month, *British American Tobacco* suffered on the back of ongoing concerns regarding the health effects of vaping and the ability of the industry to manage its transition to next generation products. Nonetheless, we still believe that ultimately the industry will successfully steer itself towards next generation alternative products. It also continues to offer investors strong cash flow generation and an attractive dividend yield.

Multi-Asset Income Portfolio

In October, the Multi-Asset income driven portfolio carried on with its steady positive progress by returning 0.7% in US Dollar term over the month, taking year-to-date returns to 9.6%

Helped by a strong global market, the equities portfolio was up 2.5%, and 26.7% since the start of the year, while the credit portfolio posted a positive 0.5% contribution for the month (leaving it up 5.3% since the start of the year). The non-correlated funds portion was slightly down 0.1% for the month but remains up 3.9% for the year.

October was a month of two halves, with rapid reversals in performance for many assets, driven by macro factors. The beginning of the month saw relatively weak economic data from the US and Europe, with both equities and high yield reacting negatively. It was then followed by positive noise emanating from the US-China trade negotiations and further supportive movements from global central banks. However, although equity markets rebounded as a result, the performance of credit markets lagged.

One area of note within the portfolio was the negative impact from Chesapeake Energy's (2026) bonds, which saw a 6.4% decline in value over the month. This issuer has been under pressure from investors, initially because of weak oil prices but more recently due to disappointing results. Markets have become increasingly concerned with the slow transition of the business model and its disposal of assets. As a result, investors are now increasingly looking at the upcoming refinancing, and at its covenants. We have recently purchased shorter duration bonds that have limited refinancing risks but still offer a very attractive yield (16% Yield to Maturity).

Elsewhere, we have entered the earnings release season and so far, most results have been solid.

We continue to focus on investment opportunities which are well positioned to generate strong cash flows and which are deleveraging, allowing us to hold them to maturity. Out of the targeted 5% annualised cash yield, 3.7% has been produced so far this year, leaving us well on track to achieve our goal.

Emerging Market Bond Portfolio

The Emerging Market Bonds portfolio was up 0.8% in October, bringing the year-to-date performance to 9.9%, both in US dollars terns.

Uncertainties around the US-China trade talks last month ended on a positive note, with an agreement between the two countries to suspend the planned increase in tariffs. Together with the Fed rate cut, these events were conducive to an increase in risk appetite, evidenced by healthy inflows toward Emerging Markets, and a dynamic primary market.

Within specific regions, the Argentine elections went as expected, with victory for Peronist candidate Alberto Fernandez in the first round of voting, albeit with a narrower margin than in the primaries. Our Argentine holdings, both corporate bonds, were stable, consolidating on the September rebound after the sharp August drop. We are waiting for the announcement of cabinet appointments as a harbinger of the type of bond restructuring the government will offer to holders of sovereign debt. High quality corporates like *YPF* could be volatile around headline news, although we are confident about the company's ability to service its debt.

Petra Diamonds, which we bought at the end of September, shed 10% in October amid poor market technicals. The company itself indicated modest improvements in the diamond market, especially around the typically busier year-end retail sales period. Liquidity is not an issue given the company's cash balance and undrawn bank facility. In our view, the bonds offer value at the current yield to maturity of 25%.

Elsewhere, Mexican apparel company *Kaltex* jumped 15% on the month without any specific news, probably boosted by investors in search of high yielding names and comforted by the decline in cotton prices which has typically had a positive impact on the company's margins.

We continued with our strategy to allocate the cash portion of the portfolio to short term or callable bonds. Our purchase of *Seplat*, a leading independent oil and gas company operating in Nigeria, will generate a yield-to-call of 6.7%, which we believe is attractive considering the company's low-cost asset base, strong reserve life and stable gas revenues.

Our outlook overall is unchanged. We have seen good results and favourable outlooks from many if not most of the companies in our portfolios, resilient economies that appear to be in the midst of a mid-cycle slowdown after a period of growth, and political uncertainty, in particular in terms of the US-China trade dispute, that has had an impact on the global economy but is in the strong incentive of politicians to resolve. There are a number of serious geopolitical issues and conflicts that could cause issues but as we hope that they are resolved we believe they are unlikely to impact the global economy.

It is interesting to note that our positive view, which we have expressed throughout the year, appears to have gone from contrarian to consensus, not least because the global economy has not collapsed, markets are back at record highs, interest rates are moderate, and inflation is contained.

We are just as happy to have been somewhat on our own with our views as we are to be part of a crowd. We will continue to base our decisions on the facts and fundamentals, and although we so no reason to change our views today, we can assure that we will change our minds with the facts.

As always we look forward to your questions and comments.

Best regards,

November 2019