

Commentary

WHAT A YEAR IT HAS BEEN!

One of our themes this year has been the progress achieved across so many measures of human life, health and prosperity, and that offers a justified cause for hope that we can overcome the challenges we face from poverty to conflict, disease and climate change through determination and innovation. The corollary to it is the negativity bias that pervades so much of our discourse. Lord Browne of Madingley spoke about both progress and negativity in his comments to us last month and highlighted the importance of having a positive approach to push back the frontiers of the possible: “When we achieve this more inclusive and optimistic mindset, we unshackle our imaginations, and threats such as antibiotic resistance and climate change cease to be existential. They are just another set of problems to be solved”.

We think of this not just because we believe strongly in progress and innovation but because the negativity bias has a direct impact on how we think about risks and opportunities. Being positive about something and seeing its potential is perceived as an opportunistic sales pitch whereas being negative and pointing out the problems and challenges is perceived as providing impartial advice. Being positive also bears the risk of constant repetition. We aspire to Warren Buffett’s ability to say the same thing in different and inspiring ways over five decades but have to admit that we have a long way to go.

At the beginning of this year we wrote:

As we enter 2019, we continue to be constructive on the global economy despite the fact that growth is expected to slow somewhat from the strong progress we have seen over the past several years. We also are alert to the current geopolitical turmoil, which is likely to intensify over the next couple of months, and to central bank policy decisions, which could impact upon this view.

However, we believe that our investments have strong prospects and that they can do well this year. Our focus is on the quality and value of the assets we own, and this should allow us to weather the increased volatility we have witnessed and look at it as an opportunity, not a risk. Our outlook is almost entirely consistent with what we thought at the beginning of 2018 and we expect it to prevail this year as well.

What should we say? We are at the close of a spectacular year for investment returns for our investments in great global companies with a 26% return in US dollars and yet our outlook is largely unchanged, as is our approach.

Geopolitical issues will continue to affect markets. We certainly expect interesting times to continue next year, as the US presidential election exerts its inexorable pull on global affairs, President Trump’s impeachment and Senate trial loom, trade wars rage, regional conflicts persist and Brexit happens without resolving Britain’s trading relationships with the European Union or the US.

We continue to believe that economically the new normal is more like the good old days, and that we are coming through an entirely normal and familiar expected midcycle period where a period of low, flat or even negative growth follows after a period of rapid growth, but that depending on the country and the industry we are either going through the slowdown or coming out of it.

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The Value of Long-Term Investing

But unlike last year, when these challenges were getting worse, this year the global economy is annualizing easier comparisons and some of the issues affecting it are likely to get resolved, in particular the US China trade dispute, in which it is in both President Trump's and President Xi's interest to declare victory and agree to terms.

Our team has put together our thoughts on many of the issues that have driven the performance of our investments this year and that we believe will be important for them as we look into next year. We discuss both overall investment themes and a number of individual investments and the opportunities we see. You can read it by following the link here or by clicking on the attachment.

As we think about different outcomes for next year we have to say that we continue to think that the risk is to the upside, as investors realise that things may be alright, that at least some of the issues will be resolved, that rates will remain low, that inflation will be contained, that there is only so much money that can be invested in illiquid and structured private equity and alternative investments, and that public equities are the one asset class that has the ability, the track record, the liquidity and the scale to generate the returns required.

In that case an enormous amount of cash that has been in fixed income investments yielding little, zero or negative returns, and that has been increasing year in year out with incomes, profits, returns and dividends, has to be invested in a limited number of public equities that are further diminished by the share buybacks conducted by leading companies and the problematic tendency of some companies to avoid public scrutiny by staying private for as long as they can attract the capital necessary to finance their losses. There is a case that Nestlé's price to earnings ratio could go to 50x, at which point even we would look at it as pricing in a good part of its potential. We do not think that is likely but think it is more probable than a collapse of the global economy or loss of confidence in the global financial system, all of which we read about on a daily basis.

Through all this, we will be vigilant but true to our convictions of looking for companies that offer quality and value, have a powerful competitive position in good and growing markets, a management team with a proven track record of value creation and a balance sheet that can weather any adversity. These are the stocks that have the ability to generate significant value over the long-term.

As we close the year, we are grateful for the trust placed in us to manage assets on behalf of long-term investors who share our conviction of compounding the value of assets by investing in quality and value over the long-term. We propose that we should raise a glass of Dom Perignon, LVMH's flagship champagne, preferably bought on Amazon with your Prime membership, and toast to a prosperous year of investing.

World Stars Global Equities

During November our World Stars Global Equities strategy continued its positive trajectory, closing the month up 2.6% in US dollar terms, and bringing performance year-to-date to 25.9%.

Performance was broad based, with positive contributions across investment themes and sectors.

Creative software provider Adobe provided a positive outlook for the year ahead at its annual investor presentation event in Los Angeles. Also in November, we had the opportunity to attend the Adobe Max Conference in Los Angeles, an extraordinary gathering of 15,000 Adobe partners, creative professionals and developers, and experienced first-hand the positive sentiment around the company's numerous product launches, reinforcing our conviction in the name and the long term runway of its growth profile.

Global luxury leader LVMH reached an agreement to buy iconic brand Tiffany's for USD 16.2 billion, strengthening its franchise in the jewellery space and entrenching its position as the leading player in luxury goods. British American Tobacco recovered from recent lows as the FDA softened its stance on the issue of nicotine levels in cigarettes, thus boosting sentiment around the tobacco sector. The company also reiterated its medium-term target of GBP 5 billion in sales for its next generation products, underlining the strength of its competitive offering in this area at a time of transition for the industry. Finally, we saw a continuation in the positive momentum for some of our cyclical holdings, including Eaton and Honeywell.

On the weaker side during the month online travel platform Booking Holdings came under pressure on the back of disappointing results by peers Expedia and Trivago. The company itself actually delivered solid results, with room night growth still at healthy levels. Booking's size and market positioning has enabled it to better adjust to industry challenges, including the increasing competitive threat from Airbnb. The firm remains the leader in a growing market and with the stock currently trading at the lower end of its range we believe concerns are fully reflected in the share price.

Multi-Asset Income Strategy

The month of November saw a positive return of 0.6% in US dollar terms taking the year-to-date performance to 10.1% following on the steady performance of the past few months.

Whereas the previous months enjoyed positive contributions from almost all asset classes, this past month was characterised by a strong performance of up 3.2% from equities (up 30.7% since the start of the year) and another positive 0.6% for the month for the non-correlated funds (up 4.6% for the year), whilst the credit portfolio lost some of the recovery witnessed in the previous month with a negative 1.7% contribution for the month (now only up 3.6% since the start of the year). Despite this disappointing price performance, the current yield of the credit portfolio is 7.7% and the yield to maturity of the credit portfolio is 9.9%, providing both recurring income and valuation support.

The disappointing performance of our fixed income portfolio was driven by some idiosyncratic stories and also some specific regional concerns. Affected in part by the election results in Argentina and the ensuing volatility, a number of Latin American countries found themselves engulfed by political unrest and although we do not have direct exposure to those countries, as a collateral damage some of our Mexican bonds came under pressure. The credit performance also suffered from significant price weakness in the bonds of Chesapeake Energy as rumours regarding the financial stability of the group were circulating through the markets. In a difficult gas and oil price environment, management has been unable to implement their change of business model and deleveraging of the balance sheet as quickly as expected.

Looking into next year we believe that the trade tensions between the US and China are likely to recede as both leaders have an incentive to do so, allowing global economic growth to recover. In an environment of moderate economic growth, subdued inflation and interest rates that are likely to remain low, and with yields on fixed income investments that are mostly zero or negative, the hunt for yield must focus on equities and higher yielding bonds, including emerging markets corporate bonds.

Our multi asset strategy provides a balanced approach based on strong individual corporate fundamentals generating higher earnings and cash flow growth. So far this year the cash yield generation has been 3.9%, on target for another strong year and we expect 2020 to benefit from the same favourable platform.

Emerging Markets Bonds

The Emerging Markets bond portfolio experienced a (- 0.3%) loss in November, bringing the year-to-date performance to 9.6%, of which 5.5% came from income (all in US dollar terms).

The completion of the US-China first phase deal led a modest risk-on sentiment, although we believe that trade negotiations will remain a significant cause for market volatility into the next year. As stated above, social unrest in several Latin American countries had an indirect impact on our portfolio as two of our Mexican positions, TV Azteca and Grupo Posadas, were together responsible for a (-0.6%) negative contribution to the portfolio. We see this as a market overreaction to Mexico's admittedly challenging economic and political environment. As expected, Argentine company YPF bounced back 7%, demonstrating investors' attraction towards high yielding solid companies whilst the country is going through sovereign restructuring.

We took a position in Cemex, part of our strategy to allocate the cash portion of the portfolio to short term or callable bonds. Cemex is the third largest cement company in the world in terms of installed capacity and the largest concrete company in the world. We are positive about the progress made towards deleveraging and the business profile of the company and think it is an attractive use of cash. The bonds have a 5.5% current yield and a 4.5% yield to call.

We started the year with a 20% cash position in the portfolio, which we have reduced to 5% in November. However, a quarter of our positions are due to mature or expect to be called in 2020, reflecting our overall cautious approach to the market. We expect to generate the bulk of our returns in 2020 from current yield with only modest capital appreciation. We continue to search for stories with low refinancing risk given their business model and capital structure, in order to capture income from their coupons.

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