

Monthly Commentary

QUALITY IN TIMES OF UNCERTAINTY

It is a time of great uncertainty and concern for investors in global markets because of the COVID-19 outbreak and the possibility that governments in Europe (at time of writing), the US and elsewhere will have to take similarly extreme measures as China has (apparently successfully, again at time of writing).

The outbreak is a serious issue and its impact is at this stage difficult to assess. COVID-19 will spread (China currently accounts for 94% of current reported cases whereas it ended up having only 66% SARS cases). Countries including the UK may have to close schools and self-quarantine people, which will have a dramatic impact on business and social activity, sentiment and markets.

However, it is important to recognize a number of things: COVID-19 is a flu with an elevated mortality rate among elderly populations, in particular those with pre-existing conditions. It is not the plague, ebola or a similar disease with high mortality. The rate of new infections in China has slowed significantly, indicating that the measures taken are having an effect and that containment works. The flu is a seasonal disease and typically starts in November, peaks in February and decreases in March, so it will become less prevalent with the summer season in the Northern hemisphere. Finally, universities, research institutions and pharmaceutical companies are working together in unprecedented ways and a vaccine is likely to be found in due course.

So the effects are likely to be temporary and there will be opportunities to take advantage of market overreaction. There is a risk of a global credit led economic collapse but it is only one of a number of possible outcomes and governments and central banks are highly aware. Even if such a collapse were to take place, it would be more challenging but our companies will get through it and it will be an opportunity.

That is why we think it is timely to recall the principles of quality and value that underly our investment approach and the strong performance and outlook provided by most if not all of the global companies we are invested in only a couple of weeks ago, when they reported full year 2019 results and initiated their outlooks for 2020.

Quality to us is companies that are part of a good and growing industry, with strong and sustainable competitive position, managements with a track record of value creation and balance sheets so strong that they can weather any kind of adversity. Value is the ability to buy those companies at prices that allow us to generate returns of 8-10% or more over the long-term.

The reason we insist on quality as a gating condition is because that is what Maurice Stern realised when he was faced with the need to invest assets in the face of the uncertainty that was the Second World War, the escape from the German occupation of Paris to New York, the loss of the family's bank and its assets in France, and the possibility of never being able to return. He made it his principle to "only ever invest in quality" because quality prevails over time.

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We have adapted our definition of quality and value to our time, one of our key views is that digital transformation is perhaps the greatest driver of global growth and value creation. Digital transformation also has downsides in that its social media platforms provide unlimited, unverified and unaccountable information so that individual events become global issues. That is why we must focus on our principles and what we know.

Last month we wrote to you about an important principle of our definition of quality, the sustainability of a company's competitive advantage and our work on integrating environmental, social and governance principles into our analysis. This month we have to consider a different principle, the strength of a company's balance sheet that enables it to keep operating when its revenues and earnings are impacted by externalities. Having a strong balance sheet means that a company does not rely on banks or bond markets to finance its operations and to take advantage of opportunities to strengthen its competitive position by investing in its markets or by buying complementary companies or assets that are in distress. It also means that the decision to sell is entirely ours if we choose and that we are not forced to sell and realize losses by a rights issue or worse. One of the strongest consistent negative correlations in our portfolio risk analyses is to US and European leverage.

China has taken unprecedented steps to halt the spread of the disease, which is having a significant impact on its economy and the global supply chain. It will all but wipe out global growth in the first half of the year. Markets currently anticipate a gradual easing of the impact through the second quarter of this year. The pace of this easing is the key question. If COVID-19 can be contained and if a vaccine can be found, the effect should be short-lived, with a sharp slowdown followed by a bounce-back through 2020. The impact will be significant on some companies and sectors. If it spreads to Europe and the US in more materials ways, the impact will be greater.

The reason why a strong balance sheet is so important is because our real worry is if it leads to a global credit crisis as weaker companies are unable to weather the business impact and go out of business. We think we are a ways away from such a crisis, but we will watch it closely. We expect our companies to be resilient, but it is a further reminder that quality matters most in times of adversity.

That is why our insight this month is not so much an analysis or argument, but a summary of our investment team's comments on the most recent results and outlooks of a representative sample of companies in our World Stars Global Equity strategy. To read them you can follow the link here or click on the attachment.

They were issued just a few weeks ago and serve as a reminder of just how strong their businesses are and how likely they are to prevail over time. The disruption we are experiencing may have an impact on short-term supply and demand but will not on the underlying growth of nutrition and wellness, greater life expectancy and expectations, increasing penetration of mobile data and services, or innovation in cloud computing and blockchain.

Whether it is *Nestlé's* Starbucks Nespresso capsules, *Thermo Fisher's* diagnostics equipment and consumables, *Amazon's* ecommerce and cloud computing, *Diageo's* whiskey or *LVMH's* Louis Vuitton bags, nothing has changed about their products or services, or about their customers' desire to acquire or use them.

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With the all but inevitable spread of the outbreak to Europe and the US, it is entirely possible that we will face greater disruption, volatility and uncertainty.

But in the same that it is easier to predict what a company will do over the long-term than over the next quarter or even year, what value it will generate and what price it share will trade at, it is easier to predict that over the long-term COVID-19 will be overcome, that a vaccine will be found, that the Chinese, the US and European governments and central banks will do what it takes to offset the impacts, provide the required credit and liquidity, as well as the necessary monetary fiscal stimulus to restart their economies, and that the global economy will rebound.

Bouts of volatility happen from time to time. We have quoted Nathan Meyer Rothschild about buying at the sound of guns and Warren Buffett about liking things when they are marked down whether they are stocks or socks.

This current bout makes us think of one of our favourite sculptures in all of London, a far greater than life size bronze bust of Tan Sri Khoo Tek Puat, the Singaporean banker and philanthropist, in the Royal Garden Hotel in Kensington.

The sculpture must be seen to be appreciated and is inscribed with words of great wisdom. In addition to pioneering consumer banking in Singapore and Malaysia, becoming the largest shareholder of Standard Chartered bank and building one of the greatest property portfolios in Singapore, Tan Sri Khoo expanded his empire across continents and with 'great foresight' acquired several prized assets in Australia and in London, including the Royal Garden Hotel. His hotel is the home of the Min Jiang Chinese restaurant overlooking Kensington Gardens. Min Jiang has the best Peking duck in London and we rub Tan Sri Khoo's glasses for good luck whenever we go (while the staff looks at us in bewilderment).

We were virtually on our own having dinner at Min Jiang the other day because people were shunning Chinese restaurants. With hindsight the falls in share prices that we have seen so far and that may go on for a while will be significant opportunities to buy quality companies at lower prices. It is incumbent on us to stay true to our principles and to have the great foresight to make the most of those opportunities.

World Stars Global Equities

Our World Stars global equities strategy started the year on a positive note, showing resilience as markets have attempted to digest the economic effects of the COVID-19 outbreak, closing the month up 0.2% in US dollar terms.

With 2019 full year earnings reporting starting to unfold in the midst of the uncertainty, outlooks for 2020 were necessarily cautious given the possibility of significant repercussions from the outbreak's impact on China and the global economy. While we are vigilant about those impacts, as long-term investors we are most concerned about the performance and prospects of underlying businesses. That is why we have been encouraged to see the strong results and positive views about their underlying business coming from a number of our holdings.

Amazon posted strong earnings with fourth quarter revenue growth of 21% and still solid demand in its e-commerce business, fuelled by over 150 million Prime members. At the same time the cloud business, AWS, continued to grow robustly at over 30%, with Amazon

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maintaining its share against competitors. It is also important to recognise that the company is seeing operating leverage despite high levels of ongoing investment, with EBIT margins at 4.4% coming in ahead of expectations.

Alphabet had another set of solid earnings with revenue growing 19% on the back of strong momentum in its core advertising business, whilst also posting better than expected margins due to ongoing efficiencies. At the same time the company has over \$133bn of cash on the balance sheet, enabling it to tap into strategic opportunities.

Payments provider *Mastercard* also had a good quarter with revenues growing 16%, benefiting from healthy levels of consumer spending and the structural shift to a cashless society.

Pharmaceutical and diagnostics provider, *Roche*, too reported solid numbers, with robust growth from new products, including Tecentriq for cancer and Ocrevus for multiple sclerosis, as well as giving a positive update on its pipeline of drugs under development.

On the weaker side a number of our holdings were affected by concerns surrounding the effect of the coronavirus outbreak. This particularly affected our holdings with high exposure to China, such as *L'Oréal* and *LVMH*. We are monitoring the situation closely but we believe that any effect is likely to be shorter term in nature. Indeed, this has proved to be so in similar such instances historically (such as the 2003 SARS outbreak) with demand returning to trend levels after a period of disruption for a few months. Therefore, we see any weakness as a buying opportunity.

Multi-Asset Income Strategy

Our portfolio closed January flat in US dollar terms net of fees. Both equities and fixed income contributed positively, up 0.8% and 0.3% respectively, for the month in USD. Non-correlated funds had a slightly weak start, down 0.2% in January. This is reflective of delayed performance reporting and price weakness in the Biopharma Credit fund.

This first quarter was initially marked by signs of positive global economic growth, with the US economy showing steady growth and Europe troughing out. The advent of COVID-19 in China and the threat of the illness spreading rapidly across the globe affected markets in the second part of the month, with investors retreating to safe havens such as government and investment grade bonds.

The performance of our fixed income portfolio was essentially driven by idiosyncratic stories, except for *YPF* which was affected by the beginning of the Argentine debt restructuring talks and oil price weakness (more on this in the emerging market debt section). Our high yield portfolio saw some profit taking in some of the names that performed best at the end of last year such as *Platin* and *Douglas*. In addition, we saw a good recovery from *AA Bonds*, whose operating performance confirmed our turnaround scenario.

It is worth noting that we have added a new fund to our selection of non-correlated funds: the Hipgnosis music royalties fund. This strategy provides the portfolio with a diversification compared to other trade finance investments, increases the liquidity profile of this segment of the portfolio and adds a differentiated new angle to generating both income (around 5% p.a.) and the possibility of additional capital appreciation derived from the revaluation of the music portfolios.

Although the global investment environment has become more uncertain as a result of the potential direct and indirect impacts of COVID-19 on economic growth, companies have so far been very transparent in explaining the current impact and as such our well-balanced portfolio appears to be holding up well. The key risk is a global credit issue. It is important to note that global monetary conditions are being significantly loosened, particularly in China but also in other economies, indicating that authorities are aware of the risk and are seeking to provide sufficient support to businesses.

Although not immune from bouts of volatility, our focus on high quality investment opportunities with strong fundamentals, the short duration of the fixed income portfolio and our diversified non-correlated funds should offer reasonable downside protection.

Emerging Markets Bonds

Our Emerging Markets Bonds strategy had a good start to the year, up 0.6% in January, with the majority of our holdings returning positive results. In this low interest rate environment, the hunt for yield continues. As a result, fund flows into Emerging Markets debt were exceptionally strong in January, with \$6.9bn flowing into the asset class.

Talks between the Argentine government and the IMF regarding public sector debt and the restructuring process have begun and it looks increasingly likely that private investors are going to have to take haircuts or a loss on the face value of their debt. We have previously flagged these concerns and the volatility this will cause to Argentinian corporate bonds and have deliberately kept our exposure to Argentina low. Having said that, we continue to hold YPF which was down -0.4% for the month, although we view this more as profit taking given the strong performance in December of 10.5%.

Tullow was the biggest detractor to performance for the second month in a row, down -3.1% due to a combination of weaker oil prices and some negative news from the Marina-1 offshore exploration well in Peru.

Going forward we expect volatility to pick up with the latest news about the spread of the coronavirus. We will be vigilant about the potential impacts as the outbreak slows in China, where economic activity is gradually resuming, but spreads elsewhere and may cause disruption. For now, as our companies release their earnings over February and March, we remain positive about the underlying fundamentals and expect to view any significant pullback in prices as a buying opportunity.

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