Monthly Commentary

RESPONSE TO THE SELL OFF

As long-term investors we are used to thinking about different outcomes, including extreme ones, and trying to ensure that our investments have the quality and value to weather the crises that inevitably happen from time to time. After all, the origins of our investment approach go back to the crisis that was World War II and the impact it had on the Stern family and so many others. However, no words can adequately describe the scale of the change over the past weeks, months and quarter. February began like a song, the roadmap to the US presidential election was slowly unfolding, markets were continuing their steady ascent, driven by moderate but sustained global growth and expected growing bottom lines. We were following reports of the outbreak of a flu-like virus in China for some weeks, but it seemed like a local problem, in a region that was used to dealing with new contagious diseases and was taking harsh but appropriate measures. The world was definitely not aware of the tremendous global consequences this local problem would have on public health, politics and economics.

Fast forward a few weeks. We live in a world riven by a global pandemic which has led to close to a million of registered infections and more than 40,000 deaths. Fear engulfs us as soon as we hear a cough, or we feel a fever creeping on us. We are confined to a new world: our homes. We have not seen or met anyone outside of our household for the past weeks. With schools closed, children attend classes through e-learning facilities or are taught by parents drafted in as teaching assistants. Most of us work from home. We all eagerly compete for our limited broadband capacity. Communication networks have slowed as usage has surged. Streaming sites have reduced quality.

We have learnt that nurses, delivery drivers and supermarket cashiers are true heroes. Our daily exercise routine is driven by kids' television programmes and Youtube videos. Our streets are empty and fewer planes fly in our skies, so the air is purer. Some people sing from balconies and most join in clapping our health workers in the streets. Artists sing, recite, draw or play freely for everyone to listen, see and experience through Instagram. We call, mail or message our loved ones, quarantined away, more often than before. Whilst distances have actually increased, we feel almost closer to some. We all know friends, relatives and acquaintances who have been infected by Covid-19, most with mild or moderate effects, but some with devastating and life-changing consequences. We have also learnt that in the face of the virus, we are all equal, whether you are in a village in Italy or in the deepest French countryside, or living in New York, London, Beijing or Sydney. It does not matter to the virus whether you are a royal, a politician, a captain of industry, a tradesman or a shopping assistant. Infection rates are statistical variables. If exposed, we all have the same chance of being infected.

The only thing that truly matters is to wash our hands, increase our social distances and reduce the R nought (R0). Whilst many of us had never heard of R0 before, this epidemiological variable defines the speed of the spread of the disease, which scientists call the basic reproduction rate. This variable is at the heart of the social distancing measures taken over the past weeks. If we reduce our social interactions, the R0 will decrease, and hence we will - through our common efforts - tame the outbreak. We are hopeful of the efficacy of those measures as recent data out of Italy is starting to demonstrate.

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

The social distancing measures, closures of national borders and new policing powers are the most important reduction of freedoms we have seen since World War II. Overwhelmed by the speed of the spread of Covid-19, national governments have – some faster than others – unwillingly resorted to those measures for the greater good, to reduce the number of lives this pandemic will destroy. The wrecking effect on the global economy will be horrendous. Early estimates predicted a decrease on most major economies' GDP of at least 20% during the period affected by social distancing, with the impact on 2020 growth dependent on the length of time these measures must stay in place and the government actions taken to offset them.

With China's economic activity now back to close to pre-Covid-19 levels, statistics begin to show the extent of the economic impact. Fixed asset investment was down 24.5% in the period of January and February 2020 vs. 2019. Retail sales were down 20.5%. Exports were down 15.9%, and so forth. China might have a negative GDP growth for the first quarter of 2020, the first time since 1976.

This predicament will also come to our shores. We have seen US weekly unemployment figures rising from 300,000 to 6.5 million over the past week. US manufacturing activity has dropped to its lowest level since 2012. Globally discretionary consumer spending has dropped to a trickle during confinement. US GDP is estimated to contract by 20-25% during Q2 2020, only after to rebound by 10-15% in the following quarters.

The global policy response has been impressive in its speed and scale. Lessons have clearly been learned from the global financial crisis in 2007-2009. National stimulus plans of unimaginable proportions have been signed into law. The US$ 2 trillion plan is truly unprecedented because of its magnitude but also because of how these government dollars will find their ways into the economy. Helicopter money, direct handouts to consumers, stabilisation loans, government guarantees: Everything is on the table this time. The key central banks around the world have equally loosened every string of the purse. Mario Draghi's "Whatever it takes" mantra has become mainstream. All institutions are working tirelessly and relentlessly to offset and overcome the approaching economic adversity.

The markets have taken this in their stride. As usual perceptions have a way of anticipating or lagging reality, and most certainly amplifying it either way. During a first period of denial whilst the virus was wreaking havoc in China, markets were up broadly 3-4% up to mid-February. Then, as Italy issued confinement orders for the Lombardy and Veneto regions, followed a realisation of the immense effects the virus would have on our society and on our economy. The MSCI World then fell 34% from peak to trough at an incredible speed and in an indiscriminate fashion across sectors and geographies. Shortly after markets realised the extent and the speed of the policy response, the MSCI World shot back up 17% to broadly current end March levels. In parallel, the VIX volatility gauge rose back to levels not seen since the 2008 global financial crisis and gold increased to above US$ 1,660 per ounce, but only a 10% increase since Jan 1.

During these unprecedented times, we can report that our business at J. Stern & Co. as continued to operate without interruption and that we have been able to adapt to the new circumstances. Our operations team has done an exceptional job of anticipating the issues and ensuring that our portfolio management and other systems and processes are fully functioning throughout. Most of us are working from home and investment, trading, reporting and other functions are fully operational.

Most importantly, our focus on quality and value has not wavered. Maurice Stern taught us that quality prevails over time and it is at a time of crisis like the current that it is borne out. Some of us have weathered other crises but for some of our younger team members, this crisis is their baptism by fire. It is in times like these that our convictions are tested and that we learn the most.

We pleased that our approach of investing in companies that have quality and value has been resilient. While they have been impacted it is no surprise that our strategies have significantly outperformed major global indices by 5-7% year-to-date. As we say in the more detailed summary below, despite the significant impacts on the economy and on markets, our World Stars Global Equity strategy is down 14.7% year to date in USD and 8.9% in GBP. Our Multi Asset Income strategy is down 13.6% year to date in USD and 7.7% in GBP. We continue to be highly confident of the inherent quality and stability of the companies we invest in. This conviction has helped drive returns in the past, in both favourable and adverse market environments and we see no reason why this will change.

Where do we go from here? In this month's insight we analyse this situation, define key variables surrounding the pandemic and draw potential scenarios of the social, political and economic evolution. You can read it by following the link here or by clicking on the attachment.

Governments have had to make the difficult decisions of weighing the ability of public healthcare systems to cope with the demand for critical care for those most ill against the impact of unprecedented shutdown on the economy with all the significant human and financial costs it entails. They have decided to prioritize the provision of care and we think that this is the key metric we will have to look at it in terms of expecting a derestriction of social distancing measures and resumption of economic activity. In the Imperial College study that has shaped so much of US and European policy response and that we quote in our insight it is the green line of people needing intensive care remaining below the red line of available capacity.

The American Enterprise Institute, the conservative US think tank, has published a 'Roadmap to Reopening the US Economy' that has three conditions: (i) a two week decline in new infections, (ii) the ability of public health systems to provide care for those who need it and (iii) widespread testing to provide certainty about the number of people infected and the ability to identify, track and contain any new clusters. We find these conditions plausible and would appear to have influenced the US government's decision to impose measures at least until April 30. You can read it by following the link here.

We have the confidence that governments and companies will work together to provide the resources necessary to fulfil those conditions, to provide the necessary care and testing and to reopen our economies. Indeed, many of the companies in our portfolios are at the forefront of the efforts, including *Abbott*, *ThermoFisher*, *Roche* with their leadership in testing and *Amazon* with its unparalleled ability to fulfil shipments and eventually provide therapeutics and testing to those who need it.

The companies we invest in are resilient by virtue of their business models and are at valuation levels that are compelling today even if it is possible that we have not yet seen the lows of markets as the impact on the US economy becomes clearer over the next weeks and months. For us as long-term investors it is an opportunity to reflect on our convictions and to invest in those companies with the view that quality and value will prevail as they always have and that times like these, with all their risks and uncertainties, are also times of opportunity for long-term investment.

World Stars Global Equities

During the first quarter of the year and against the backdrop of the fastest and sharpest market sell off in over a generation, our World Stars Global Equities strategy demonstrated the resilience of our investment approach, with the portfolio down -14.7% against the MSCI World down -20.9% in US dollar terms.

Our focus on quality and especially cash flow generation and balance sheet strength translated in our companies being more shielded from the Covid-19 crisis and the standstill this has resulted to across major economies. In fact, some of our holdings most notably in technology, closed the quarter on positive ground as these names emerged as beneficiaries from the current crisis, with *Amazon* enabling consumers to shop for critical supplies, and *Activision Blizzard* benefiting from higher user engagement as more people stay at home. Similarly, *American Tower*, the mobile tower operator, held up well, benefiting from higher demand for data as more people worked from home whilst *Adobe*'s subscription revenue based model provides cushion in the current uncertainty.

Within healthcare, *Roche* and *ThermoFisher* have emerged as leading players in the provision of testing solutions for patients, with their scale enabling them to quickly ramp up production to meet an ever expanding global demand. And as consumers fill up their kitchen pantries, companies like *Nestlé* benefit from higher demand for food and beverages whilst utilising their global supply chain capabilities to maintain availability.

This does not mean of course our holdings were unaffected by the sell-off. Within industrials, *United Technologies* suffered as air traffic came to a standstill. Looking at the long term however, with the separation of its commercial buildings franchises, Otis and Carrier, and its upcoming merger with defence peer Raytheon, the company will be transformed into the largest Tier-1 supplier in the aerospace industry with a leading presence in key next generation technologies, in addition to its strong balance sheet and over $1 billion in synergy opportunities, whilst the greater than 50% defence exposure of the combined group will cushion cash flow until the inevitable rebound in air travel.

Similarly, *Essilor Luxottica*, the leading lenses and frames producer, came under pressure on concerns of the impact of the current environment on its retail store operations and demand for glasses. Again, longer term we believe the structural demand for the lenses and frames remains intact, driven by demographics and higher end products, whilst in the meantime, the planned synergies from the recent merger of the two legacy companies, Essilor and Luxottica, provides near term earnings cushion.

The pullback has also provided us with opportunities to further optimise our portfolio. As part of that process we decided to exit our positions in *Henkel*, *British American Tobacco* and *Schlumberger* as our investment thesis in all three cases has evolved in recent months with each company facing challenges in its markets that will continue beyond the current market volatility. We deployed part of proceeds in building new positions in *Givaudan*, the leading flavour and fragrances provider, as well as *Alcon*, the leading optical surgical and consumer solutions provider, with both names having sold off unjustifiably in recent weeks. We are holding the rest of the proceeds in cash, looking to deploy this further as opportunities arise.

Income-driven portfolios

As risk assets violently corrected, the income portfolio gave back 13.6% during the first quarter of 2020 in US dollar terms. This is by far the most volatile environment the strategy had to endure since the worst months of 2008, with all asset classes correlating with each other with the exception of our non-correlated funds.

While equities were down 14%, the credit portfolio corrected 27% with the non-correlated funds only down 1.6% for the period. The latter performance was driven by our two royalties funds, The *Biopharma Credit Fund* and the *Hipgnosis* music royalties fund, which both saw investors selling out not because of issues with the underlying credits but to raise liquidity. The latter issue is the main theme behind our portfolio performance as the credit portfolio was impacted by record level of flows out of the asset class, similar to the levels witnessed during the global financial crisis. In previous corrections our portfolio showed lower volatility as usually two of the three components decorrelated from the other. This time around the run for liquidity was too much across our securities.

Where does this leave us? The quality of our equity holdings is solid and we have taken the decision to gradually increase our exposure to equities towards the higher end of our targeted range (35%) as we arbitrage the expected returns for the next 3-5 years between the asset classes. Our fixed income portfolio shows a current yield of close to 8% and a yield to maturity in excess of 10% for a duration of three and a half years. The current environment provides us with the opportunity to improve the quality of the overall credit risk of our portfolio whilst maintaining the yield potential. Thus, we have started to purchase some of the high quality credit names that are now trading below par: *CenturyLink, MTN, Kernel, Koc Holding, HTA*, all relatively sheltered from the economic cycle.

As a strategy, our focus remains on capital preservation and cash income generation. In an environment where corporate are preserving cash and as a result cut expected dividend payments, we are very comfortable with the majority of our investments and the fact that either dividends or coupons payments are safe, and we do expect our annual target of 4-5% cash income to be generated.

Although we expect volatility to remain elevated into next quarter as the news flow on the Corona virus and the collateral economic damages develops, we also feel that a good part of the forced selling could be behind us. Markets will, as in past crisis, move to the next phase and the focus will then again be back on company fundamentals and the upside potential. As long term investors we are very comfortable with the underlying strength of our balanced portfolio and its ability to generate superior cash income.

Emerging Markets Bonds

Emerging Markets bonds were not spared extreme volatility during the month, with spreads widening 383bps in the month. Our emerging market portfolio returned -18.4% which takes the year to date returns to -19.2%. Besides the negative impact of Covid-19 and the direct impact it is having on world economies, this has been further exacerbated for emerging market assets by increasing risk aversion among investors. The flight to safe haven assets and cash, specifically the US dollar has caused outflows from Emerging Markets bond funds of $11.8 billion last week alone.

In addition, the lack of an agreement within OPEC+, which has sent oil prices into a tailspin, provided another shock to Emerging Markets countries and their corporates, many of which are oil exporters. This is evident in the E&P names within the portfolio such as *Tullow*, *YPF* and *DNO* which have been some of the main contributors to the negative performance for the month. Nevertheless, these businesses are well hedged for 2020 and we remain comfortable with their liquidity positions.

The positive side to this is that we believe the current dislocation is a significant opportunity and we are using it to add high quality "wish list" names to the portfolio, which were previously trading too richly in terms of yield and we will discuss further next month.

March 2020