Commentary

Quality Stands the Test

The Covid-19 is the first pandemic of our globalized age. It is also the first serious crisis we have faced with our investment approach since we started our World Stars Global Equities portfolio in 2012.

As we said in a webinar that we held last week, we think it is fair to say that in these challenging times, quality stands the test.

Never has our insistence on quality been so important. Investing in quality companies is the answer to preserving and increasing the value of assets over the long-term, as the Stern family has done for 75 years. This month marked the 75th anniversary of the end of World War II in Europe. It was this global crisis that forced the Stern family to leave Paris for New York and faced with the loss of their assets and business in France to invest in stocks following the approach we follow to this day.

Nestlé and *Roche* have been positions since that time and continue to have great prospects for value generation that are as strong today as they were then. Our insight has been to look for quality in businesses looking forward, not backwards, and to recognize that the global leaders in digital transformation, *Amazon* and *Alphabet* have prospects that are just as strong and as long-term.

We were asked last week about different approaches and whether our approach of investing in quality and value would be superseded by others. What about income? What about value? What about growth?

Our answer is that these approaches are about style, not substance.

What are the long-term prospects of a company that has a high dividend yield but pays it out of its substance or funded by debt or whose yield is so high because its business is pressured by disruption or cyclicality?

What are the prospects of a company whose share price is low compared to its past, whose multiple of book value is low because of physical capital invested in the past, and whose price/earnings multiple can be adjusted for a hoped for rebound in its earnings; but whose business is as troubled by poor management, leverage, cyclicality or disruption as the previous one?

And what are the risks of investing in untested companies in emerging businesses, with Icarus-like growth prospects but proportionate risks, whose equity value prices in growth not over the next five to ten years from existing or proximate revenues and cash flows but prospective future ones, whose share prices could soar as easily as they could crash, and who often burn cash that has to be raised from investors such as ourselves in good times and then runs out in bad?

We care about the substance of the companies we invest in, not the investment style. Quality to us is companies with strong and sustainable positions, in good and growing industries, with managements with a track record of value creation and a balance sheet so strong they can weather any kind of adversity. Value is buying those companies at prices that allow us to generate annualised returns of 8-10% or more over the long-term.

Our companies are global leaders in their industries. They comprise some of the largest companies in the world but also global midcaps, companies with market capitalizations of $25-50 billion that have strong differentiated businesses and have great prospects of value generation. Many of them are in industries that are actively contributing to overcoming the pandemic. Our list of positive actions taken by the companies we have invested in is more than four pages long.

As we note in our more extensive comment below, our portfolio has been as resilient as the companies we have invested in. We have been able to use cash we accumulated through prudent sales to buy companies at lower valuations.

Covid-19 is accelerating the change and disruption that we have seen over the past decade, none more so than the inexorable shift from offline to online, but also investment in healthcare and in infrastructure, and the increasing importance of corporate responsibility and sustainability.

Our insight this month is entitled Risk, Resilience and Opportunity: Covid-19 and its Impact on Key industries and Companies. Our investment analysts discuss in detail the changes we see and the opportunities they offer for the companies we invest in. You can click on the attachment or follow the link here.

We also encourage you to listen to our webinar if you are interested in a more interactive discussion of our views. You can find it on our website www.jsternco.com or follow the link here.

World Stars Global Equities

Our World Stars strategy rebounded strongly during April, closing the month up 11.1% in US dollar terms. The strategy continued to significantly outperform global markets. Remarkably, amidst the Covid-19 pandemic and the volatility we have seen in recent months, the strategy is now down only -5.3% for the year.

The performance was driven by our holdings across sectors reflecting the underlying quality characteristics of the companies we invest in and their ability to withstand external shocks and macroeconomic volatility.

Leading the portfolio were our digital holdings. *Amazon* has emerged from the Covid-19 crisis as the undisputed leader in global retailing, able to keep its supply chain open to consumers, with revenues up 26% during the first quarter. The company continues to invest heavily to meet this increased demand, recruiting 175,000 additional people and making significant investments to maintain appropriate safety standards in its warehouses. Though this is placing a cap on short term profitability, it is another example of Jeff Bezos' determination to invest in order to capture growth opportunities as they present themselves.

Facebook too posted a strong performance, recovering from its March sell-off as the company posted revenue growth of 10%. Importantly the company was able to offset advertising weakness in the auto and travel sectors with strength from gaming, e-commerce and technology. And as people stayed at home, monthly active users grew 10% with the company now having over 3 billion users across its family of apps.

On a similar note *Alphabet* also posted solid strong results, with revenues up 15% as corporates shifted to digital advertising amidst the crisis given its inherent ROI and flexibility. At the same time, Google is working with Apple to develop a tracking app for the Covid-19 virus which can be rolled out on both Android and iPhones, playing a pivotal role in responding to the crisis.

Showing strength also were our holdings in health care, especially those companies that have emerged as critical solutions providers to Covid-19. *ThermoFishe*r benefited from the global demand for its testing solutions for the virus, now approved in over 50 countries, as well as its ability to maintain uninterrupted supplies to labs doing vital research in the virus. And looking forward to the ultimate development of a vaccine, the company is already working with governments and commercial partners to ramp up capacity for mass production in preparation. Similarly, *Abbott Laboratories* is benefiting equally from its own Covid-19 testing solution, whilst demonstrating the resilience of its diversified business mix, with its nutrition and diabetes businesses largely unaffected by the current lockdowns.

Finally, within industrials, we saw some of our holdings recover significantly from the March sell-off. The recent spin-offs from *United Technologies, Otis* and *Carrier*, performed strongly post their separation early in the month as the stand-alone entities closed some of the valuation gap with their peer group. At the same time, the newly formed *Raytheon Technologies*, created from the merger of the legacy United Technologies aerospace businesses and Raytheon, recovered from its lows, as investors started to reflect the resilience of the group's defence business, now 55% of its revenue base, and the strength of its combined balance sheet.

During the month, we sold our position in Carrier after a strong rise and used the proceeds and other cash to build initial positions in *Sika* and *Amphenol*.

Sika is a global leader in speciality chemicals and material technology for the construction and automotive sectors, and a consolidator in the industry, with a strong track record of reaping synergies from acquired franchises. Most recently it purchased, Parex, a leading global manufacturer of specialist mortar solutions with a strong presence in many distribution channels, especially in China. Sika has a high exposure to refurbishment activity, lending it resilience through the economic cycle whilst its well-articulated cost savings plan will cushion profitability. We have a long history of engagement with Sika. Over the past six years, we played an active and vocal role as shareholders working with the management and board as they successfully fought off a hostile takeover bid from Saint-Gobain.

At the same time, we also bought an initial position in Amphenol, the global leader in connectors and sensors. The company provides highly engineered solutions to a wide range of industries including industrial, IT, broadband, mobile network, military, medical and automotive. It benefits from the structural growth in the "electrification of everything" driving higher content for connectors and sensors across applications. The company is a consolidator within the industry and has a proven track record of managing its cost base through the economic cycle shielding profitability. We plan to build these positions further on any short-term market weakness.

Multi-Asset Income

Our multi-asset income strategy produced a strong performance up 7.5% in US dollar terms for the month. Equities were the main driver, bouncing from the trough with an outstanding performance of up 12.8% on the month. The fixed income holdings followed the trend, up 9.1% and the non-correlated funds up a relatively small 1.1%.

All in all, after the volatile past months, although the portfolio is still down 7.2% since the start of the year in US dollar terms, we are well on track towards our annualized net return of about 6.5% over the cycle and a cash income of about 5% per annum, with an annualised return of 5% since inception.

Following the global synchronised collapse in asset prices during the month of March, April witnessed a sharp bounce back. Risk assets were supported by the announcements of broad and substantial economic programmes by governments globally and by extended QE programmes by developed markets central banks. Asset class correlation increased the volatility of our portfolio. However, as fundamentals take over once again, we expect volatility to subside.

We adjusted our asset allocation slightly to take advantage of attractive equity prices, increasing existing holdings and also initiating a new position in *L'Oréal* the leading cosmetic group. Similarly, we used the opportunity presented to us by the market to purchase some bonds that were, in our view, too expensive prior to the correction and enhance the overall credit quality of the fixed income portfolio.

We recently took new holdings in *Pemex* 2022 and *Turkiye Sisecam* 2026, bonds offering respectively 11% and 8% yield to maturity.

We are in the middle of the earning release season for both equities and bonds issuers and we feel ever more strongly that our investment thesis focused on quality and value will prevail in the current environment. Our fixed income portfolio has a current yield of 8.5% and a yield to maturity in excess of 12% for a duration of less than 3.5 years.

We remain firmly focused on generating a solid cash yield with low volatility. We believe this year could remain volatile, but our recent repositioning based on our fundamental and disciplined investment process should support the portfolio towards its investment objectives.

Emerging Market Bonds

Following an extremely volatile month of March, our emerging market bond strategy returned +5.5% in US dollar terms in April, taking the year to date returns to -15.1%. The asset class suffered from substantial outflows and widening of credit spreads in March. In April the outflows continued, but at a much slower pace. This was offset by overall spread contraction which supported the bullish move up, although the tightening wasn't as marked as with developed market credit.

The agreement reached between the world's oil producers helped most of our energy names, with a strong performance from *Tullow*, *DNO* and *Pemex*. Besides the energy names, most of the performance came from our highest quality names, which saw a strong rebound. They had clearly suffered the most from technical factors, with investors rushing for the door and forgetting about the fundamentals. *MHP*, *IHS* and *Greenko* all bounced back sharply, returning more than 10% in the month.

Although the general sentiment has rapidly improved for developed markets, emerging economies are still relatively plagued by fiscal and growth challenges with central banks less likely to aggressively deplete their currency reserves. As a result, we expect currency weakness will be a key issue for the asset class over the next few months.

We have used the current opportunity to further strengthen the credit quality of our portfolio, adding some new names such as *Goldfields*, an investment grade name, which was yielding c.7%. We have also added to existing holdings or enhanced the overall yield by starting new positions in some longer duration high quality issuers, for example, *Turkiye Sisecam* 2026 yielding close to 8%.

Our fundamental approach and focus on quality will allow us to navigate the markets ahead, which we believe are likely to witness increased volatility.

We hope you continue to be safe and well, and as always look forward to your thoughts.

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