Commentary

THE JOURNEY IS THE DESTINATION

"There's a lot of baggage that comes with us. But it's like Louis Vuitton baggage. You always want it."

Kim Kardashian

It certainly looks like we have a lot of baggage. The US elections are imminent. Brexit is about to happen in earnest. US markets are at all-time highs despite the pandemic. The major vaccine trials will report in a matter of weeks. The Fed no longer has an inflation target. The top 5 digital and technology companies, including a number we have been invested in for years, now account for 25% of the S&P. The Kardashians are ending and Kim has announced she is taking a break from Facebook and Instagram. Where is this journey taking us?

Our World Stars Global Equity strategy has performed strongly this year, up 14.8% year to date despite the baggage as you can see in the performance summary below. While we agree with Kim Kardashian about Louis Vuitton, LVMH has not done as well this year because it is held back by consumers affected by the uncertainty of the pandemic and the impossibility of travel. Its Chinese business has been strong and every indication is that underlying demand is unchanged.

Our journey to generating value over the long-term is guided by the fundamentals. That is why we continue to be positive about our portfolios and the companies we have invested in. They have the quality to prosper over time. Some are doing well like the digital platforms that are helping to keep our economies, businesses and social interactions going during the pandemic, while others are held-up by consumer spending and travel like LVMH or Essilor or by hospital shutdowns and interruptions to elective procedures as Medtronic or Becton Dickinson. They all have the balance sheets to get through the difficulties and to turn the set back into an opportunity, as several have done by making acquisitions at lower prices. Their valuations, while in some cases at higher ends of historical ranges, represent great value in the long-term and we are confident in their prospects for growth and value generation over the long-term.

At the same time we recognize the risks. Politically the US elections will have an impact on markets and economies. If the incumbent loses and the majority in Congress changes as is currently indicated by the polls, the period between the election and the inauguration of the next president and Congress could lead to significant uncertainty and volatility. We think any such impact should be short-lived and would represent an opportunity.

Economically the biggest impact will come from the course of the Covid-19 pandemic and the outcome of the vaccine trials. As we outlined in our insight in July, we are positive about the prospects for vaccines, in particular the mRNA vaccines in development by Pfizer/BioNTech and Moderna. We expect results from the Phase 3 trials in the next few weeks and will provide an update on them in our insight next month. It is clear the impact will be with us for the next 12-18 months as the second and further waves of the disease take place and as we learn about the likelihood of vaccines. It does appear that the issue has been complicated by politics as doubt about the safety and approval processes of the vaccines can only delay their widespread use and the positive effect it should have.

Different countries are at different stages of coping with the disease. China and other major countries in Asia seem to have it under control with the more stringent measures they have taken. In the US and Europe it seems as if countries like Germany, which have the ability to provide testing and health care in such a way as to enable people to go about most of their daily activities, are showing the way in which we can head to stabilization and recovery.

Our insight this month addresses a critical issue raised by Kim Kardashian in her break from social media. We have been extremely positive about digital transformation as a driver of global growth and development. We have been invested in several of the leading platforms which have strong competitive positions, great prospects for growth and high levels of cash generation. They have done well and have been significant contributors to our performance and we are confident that they will continue to perform in years to come.

Yet they have come under increasing scrutiny because of their very size and scale, in terms of their market power, and in terms of their role in the polarised political discourse that we are experiencing and that will not end with the US elections. Giles Tulloch, our Senior Investment Analyst, writes about the US elections, the serious political and regulatory issues that will impact the companies, the investigations we expect them to be subject to and the reason we think that the outcomes will allow them to continue to grow and prosper.

We believe that private enterprise and corporations are critical to achieving the development outcomes established by the UN Sustainable Development Goals because of the scale, resources and innovation they can bring to bear. Digital transformation and its leading companies have an important part to play in achieving those outcomes but they are not the only ones.

We invest in many such companies. Some of them have baggage and not all of it is Louis Vuitton but we look to understand the issues, the way they are addressing them, and to engage with them to play our part along the way, because we think that the sustainability of businesses is inextricably linked with the sustainability of investment returns.

World Stars Global Equity

Our World Stars Global Equity strategy continued its strong momentum. The portfolio was +5.9% in August and up +14.8% year-to-date (in US dollar terms), significantly outperforming the MSCI World, which returned +5.7%, as well as all other global indices.

Performance continued to be broad based across companies and sectors.

During the month, our holdings within the broader technology space continued to show strength. Within the payment networks industry, both *Mastercard* and *Visa* performed well as spending remained resilient and e-commerce firms gained greater share from traditional bricks and mortar retailers. At the same time, the structural shift to a cashless society continues to gain momentum in the current environment as more businesses no longer accept cash payments in an effort to mitigate the transmission of the virus. Social media player *Facebook* also continued to show robust momentum. Following the strong results reported last month, the company continues to build its product offering, fuelling the stock price to new highs. The company introduced new features to its Shops offering, with more merchant tools and enhanced messaging functionality, as well as introducing Instagram Live Shopping. These initiatives are deepening Facebook's relationships with merchants and represent a push into "social commerce", blurring the boundaries between e-commerce and social media. If Facebook proves successful in enabling merchants to sell more via its platforms then this will increase demand for advertising, further powering the virtuous cycle of revenue opportunities. Finally, Adobe, the creative software and online digital solutions leader, benefitted from the better than expected results reported by its enterprise software peers, Salesforce and Workday. Importantly, the key message from Adobe's peers was that enterprise software spending trends remain robust despite the increase in remote working, with these companies still able to close large client deals and execute software implementation programs remotely.

Highlighting the diversification of our portfolio, during the month we saw solid performance from our holdings in the industrials space, including *Eaton* and *Honeywell*. Both companies, though affected by disruption in demand as a result of Covid-19 and related lockdowns, have responded quickly to the current environment, leveraging their operational flexibility and adjusting their cost base, but also pivoting to take advantage of new revenue opportunities. These include logistics automation solutions and healthier buildings for Honeywell and increased infrastructure spending for Eaton. Also of importance, both companies entered the current crisis with a very strong financial position allowing them to maintain their dividend payments to shareholders whilst also being able to tap into strategic M&A opportunities.

On the weaker side during the month, medical devices and life sciences company *Becton Dickinson* disappointed investors after providing a softer than expected earnings guidance for the upcoming quarter. We see this, however, as a result of one-off factors including a higher than expected tax rate and the fact that the company is in the process of ramping up its Covid-19 testing capacity, which is affecting near term profitability. Long term the company remains a well-placed player in its industry with multiple revenue opportunities ahead. Also weaker during the month was spirits producer, *Diageo*, which has been suffering from its exposure to the on-trade channel in Europe as well as its significant exposure to emerging markets, where some downtrading has been observed. Nonetheless, we see this as a clear buying opportunity, with the progressive return to normality fuelling the recovery in revenues as we look ahead into next year.

Multi-Asset Income

August saw a positive return of +3.2% taking the year-to-date performance to +5.5% (in US Dollar terms). This follows on from the steady performance of the past few months.

All asset classes contributed positively last month, with another very strong performance from equities, +5.9% in US dollar terms (now +18.7% since the start of the year). The credit portfolio continued its recovery with a +2.7% positive return for the month (but still showing a -9.2% negative return year-to-date) and the non-correlated funds witnessed a further positive +1.1% contribution for the month (now +2.6% since the start of the year).

Although the equity portfolio benefited from the strong contribution from the digital transformation names, the overall performance was broader, with equities such as Estee Lauder, Honeywell, Medtronic and Eaton contributing to the general strength of the asset class.

The credit portfolio's steady performance originated from a number of positive earnings releases and the constant buying flow from investors looking for yield. Despite substantial amounts of new bonds being issued globally by corporates using the current high demand to refinance their existing debt, the potential for further reduction in credit spreads and the stable default rate are contributing to investors' increasing comfort in the asset class.

Over the past couple of months, we highlighted our gradual re-allocation of exposure within our Multi-Asset Income strategy, reducing equities in favour of corporate bonds. This was done because of the remarkable performance of our equity portfolio and the relative attractiveness of the credit investments in our radar. But where does this leave us for the rest of the year?

We believe that the equity performance will still be supported by the vaccine development news flow and the prospect of a return to normality sometime early next year. Monetary backing by central banks and the expected fiscal stimulus by most governments should contribute to further economic recovery. As such any new equity rally should broaden to more cyclical sectors and, as already mentioned, we are well positioned for this.

The recent change of tune by the US Federal Reserve now targeting average inflation without yield caps means that short term interest rates are likely to remain low for a long time. Markets are speculating that long term rates (10-year US treasuries) could rise faster than expected. However, beyond the normal expected adjustment to reflect the steady economic recovery, we do not foresee a significant risk of much higher inflation, especially in an environment where wage growth is likely to be under pressure in developed economies and disinflationary forces are still much alive. This combination should be very supportive of our credit strategy.

Our Multi-Asset Income strategy is providing 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 2.3% and the second half of the year should see strong income growth.

Emerging Market Bonds

The Emerging Market Bonds strategy had another strong month, recovering +1.7% in August and taking year-to-date performance to -5.5% (in US dollar terms). Performance was broad based, with almost all bonds positively contributing. However it was particularly encouraging to see a strong rebound in some of the underperforming credits such as TV Azteca and Grupo Kaltex which were up +26.8% and +8.1% respectively, likely explained by a combination of weaker liquidity in the markets over summer, as well as an improving near-term outlook for these companies.

August was a busy month with most companies releasing their Q2 financial results. What was plainly evident is the bifurcation between those businesses that have the balance sheet and operating models to survive in this environment and those who have not. We were encouraged to see that the majority of our holdings reported robust results despite the negative implications caused by Covid-19, reinforcing the importance of allocating towards stable sectors and distinguishing between the 'winners' and the 'losers'.

In emerging markets, the top story came out of Argentina, which managed to clinch a near-unanimous backing from creditors to restructure their sovereign debt putting an end to the country's ninth sovereign debt default. Despite this small victory, Argentina will now need to focus on restructuring their $70 billion of debt with multilateral organisations and come up with a credible fiscal and monetary policy plan at a time when the country is reeling from the economic impacts of the lockdown caused by Covid-19. Our outlook remains negative and our exposure to Argentinian corporates is limited accordingly.

Over the next couple of months we view the main risks as being political in nature and will be closely monitoring the upcoming US elections, Brexit negotiations and trade tensions between the US and China. In line with our broader views we see any potential pull back in emerging markets as an opportunity to lock in attractive yields for the next 3-5 years.

August 2020