

## *Monthly Comment*

# It's the Fundamentals, STUPID !

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Please get in touch with us if you want your own example of our bumper sticker for 2017!

Our conviction is to invest in quality and value, do our own work and invest for the long-term. 2016 was a profitable year for us despite the political upheavals because we were right about following the fundamentals.

The US and European economies were resilient, employment improved, wages increased, moderate deflation turned into moderate inflation, and rates rose in the US. Most if not quite all of the companies in our portfolios did well, whether they are global leaders with stable businesses, tech companies with dominant franchises or cyclical companies with strong competitive positions.

We expect the same for 2017. The fundamentals continue to be good. The global economy is expected to grow 3.7% according to the latest IMF upgrade. The US and European economies continue to be strong (the US and Germany are approaching full employment), China is recovering, India is implementing unprecedented structural adjustment and other parts of the world are recovering. Companies are doing just as well or better. Companies that have strong competitive positions, good and growing businesses, good managements and solid balance sheets, and the pricing power to offset inflation will do best of all.

Of course political uncertainty is heightened. The list of issues is long and we are not complacent. Taking a step back, the reality of globalization is that the post-war settlement (as reflected for example in the composition of the UN Security Council), is obsolete and we do not quite know what will follow. What we do know is that globalization has brought us unprecedented prosperity. The US, China and the European Union represent the greatest economic powers. Many other countries are working hard to catch up. Their goal has been the long-term prosperity of their people and we have every reason to assume that it will stay that way.

More immediately, the inauguration of Donald Trump is only days away, elections in France and Germany are coming up and Britain will file Article 50 in a matter of months. Trump's proposals so far look good for business, for now the polls in France and Germany do not point to the kind of change we have seen in the US and the UK and what it would mean for the EU, and we are still at a preliminary stage of a Brexit process that will take years.

We were at a meeting with the CEO of Nestlé where he was asked not long ago if he would curtail investment in an emerging market because of concerns about the currency. He replied that Nestlé had been active there for over a hundred years and that these were times to invest. The kind of global businesses we invest in are continuing to innovate, invest and

increase their value throughout these uncertainties. For the long-term investors volatility and uncertainty are opportunities not risks.

It's the fundamentals, stupid! We look to follow the fundamentals of investing in quality and value that have been precepts for the Stern family for three generations and are confident that they will serve us as well in 2017 as they have over time.

We have attached two insights to this month's comments. The first is a resend of the insight we sent last month about our investment team's thoughts on investment opportunities for 2017. The second is our take on a potentially major opportunity that is taking place for all of us to see. Forget about self-driving cars or online retail: The tobacco industry is trying to disrupting itself with healthier alternatives to cigarettes. The CEO of Philip Morris International himself is talking about stopping the sale of cigarette. Giles Tulloch writes about the impact it will have on the industry, public health and its prospect for us as investors. The insights are attached or available by following the links below:

## PORTFOLIO UPDATES

### *Equity portfolios*

Despite the headlines, global equity markets maintained a positive trajectory against a broadly supportive economic backdrop. In the US, the economy maintains a robust outlook with solid jobs growth and levels of consumer spending. Looking into the year to come, key pledges of the incoming Trump administration in terms of lower tax rates, higher infrastructure spending and a more accommodative corporate regulatory environment, should provide another leg of support for the economy, especially capital spending which has been a more muted area in recent years. In Europe, economic data point to a progressive recovery of the region and in the UK the economy remains resilient in the face of Brexit uncertainty, though some headwinds are emerging in terms of inflationary pressures. Further afield, economic growth in China remains supportive, and other major emerging economies stand to benefit from the recovery in commodity prices from previous depressed levels.

Against that backdrop, our World Stars portfolio continued to deliver. Looking at performance in 2016, unsurprisingly, names that stand to benefit from increased capital spending or which are tied to an inflection in the energy or broader commodities end markets did best. Among our holdings, Weir closed the year up 89%, followed by Rockwell Automation at 31%, Eaton at 29%, Schlumberger at 20% and United Technologies at 14%. We had long argued that these names would emerge as winners from the period of adjustment over the past three years. Each of them has experienced management teams that have been swift to address their companies cost bases, solid balance sheets that allowed them not only to weather the storm but also take advantage of strategic opportunities and used that flexibility to strengthen their leadership positions in their respective industries. Looking forward the combination of recovering revenue lines with operational leverage translates into a powerful earnings potential.

At the same time, as we had highlighted after the extraordinary sector rotation in November, the sharp selloff in some sectors post the outcome of the US elections was followed by a more nuanced assessment by the market of opportunities ahead. In that light, some of the quality holdings that had been sold off during November, like British American Tobacco and Diageo, recovered previous losses, to close the year up 22.6% and 13.7%

respectively, both beneficiaries from a structurally weaker British pound following the Brexit vote and solid underlying operating momentum.

As we look into 2017 the environment remains supportive from an economic perspective. Geopolitical risks will stay of course in the foreground. But, as we have highlighted we believe the fundamentals of the companies in our portfolio will continue to be resilient and deliver on the foundation of the strength of their competitive positioning and secular drivers.

## *Income-driven portfolios*

The last month of 2016 closed on a strong note up 1.1% for our portfolios, bring year to date returns to 7.5% in USD. As noted, December was marked by a recovery of safe quality equities that had been sold off during the previous two months and a continuous rally by riskier assets in the fixed income universe. US treasuries further suffered from the sell-off whilst money flows focused on purchasing higher yielding securities in developed and emerging markets. Rising commodity prices and the improving outlook for global economic growth resulted in spread tightening.

The danger last year was always to be too risk adverse following a difficult first quarter and therefore to miss the underlying improvement in the global economy, which has continued despite the various geopolitical concerns. Our barbell strategy of investing in quality stocks and high yield bonds worked well in an environment in which investors were underinvested in risk assets as they underestimated the strength of the underlying economies, the inflationary effect of the cyclical revival, which was further compounded by the expected impact of Trump's new policy regime following his surprise election.

For the first time in a number of years, we are starting this year with an upside momentum for surprises for global economic growth and inflation. Interest rates have started to adjust consequently. This trend is likely to continue and spread from the USA to other regions.

As long as the adjustment is not too violent we expect equities to benefit from positive earnings surprises, stronger cash flows and dividend growth. The overly expensive safe end of the fixed income market is likely to suffer relatively. More interestingly though, we are positive on the high yield space, although volatility is likely to increase with rising interest rates. Global economic growth should profit from expected fiscal and monetary policies. In such a scenario and based on historical precedent, we would expect positive returns from higher yield corporate bonds as default rates improve. Benefits from the OPEC's decision to curb production will bring further support whilst we expect normal level of supply.

All in all, we are very constructive about the prospects for generating returns in the coming year and about our market positioning. At the same time we have a patient approach and advise investors to be patient and use the increased volatility and inevitable pullbacks to opportunistically invest at better prices.

## *Emerging market debt portfolios*

Despite the uncertainties on the monetary and political fronts in G7 countries, our core emerging market debt portfolio returned 0.6% for the month of December. Bonds finally appreciated in price, benefitting from a moderating sell-off in US Treasuries and confidently reversing the trend after two negative months. Russian credits outperformed, boosted by the spike in oil prices. Otherwise, there was no clear pattern in price movements, which

were seemingly driven by typical end of the year portfolio adjustments. Overall, the portfolio printed a 11.9% performance for 2016, split between income and capital appreciation.

We are sanguine on the outlook for emerging market bonds for 2017. Expectations have adjusted to the reality of a rise US rates and a steepening of the curve. Countries and corporates in general are in a much stronger position to absorb higher borrowing costs having substantially improved their balance sheets over the past several years. Furthermore, the benefits of stronger US growth on emerging market economies will largely offset the impact of higher benchmark rates.

The first half of the year is likely to see large redemptions by sovereign and corporate investors to the extent that 2017 could see “negative supply,” meaning that primary issuance will not meet total redemptions. This will provide a powerful buffer to any risk of fund outflows that could be the result of potential protectionist measures by the Trump administration, greater volatility in US Treasuries or a stronger US dollar.

We think that the main source of return for Emerging Market Bonds in 2017 will be the carry, the raison d’être of the asset class, and with close to 20% cash in our portfolio, we are ready to take any sell-off as a buying opportunity.

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