Monthly Commentary

THE RETURN OF CLASSIC COKE: ARE BIG BRANDS A DECADE LATE TO THE PARTY?

A trip to the local Waitrose supermarket last week revealed something many of you will have noticed as well. Classic Coke is back for the first time since the ill-fated and short-lived rebrand to New Coke in the early 1980s.

This time around, in the new age of health conscious consumers and with pressure growing to address obesity - one of the major public health issues of our time - Coca-Cola has decided to change its Coke Zero brand to look and feel like the full fat version, with Classic Coke the option for those with (very) sweet tooths.

Make no mistake, this is a pivotal moment for the business. Coming as it does 36 years after the introduction of Diet Coke, this rebrand is an acknowledgment that the business has reached a tipping point.

But is it far too late? Consumer products companies need to keep on innovating and adapting what they are doing to meet changing consumer requirements and preferences. That is an ongoing challenge.

Today it is apparent that the soft drinks industry is a declining business. Concerns over health and awareness of the medical consequences of obesity have been growing for decades. A number of governments have introduced sugar taxes and Mike Bloomberg tried to limit serving sizes when he was mayor of New York City. That is why we think Coca-Cola has made a mistake: it should have done this ten or fifteen years ago. It underestimated the speed, extent and scale of these health issues and allowed its core brand to be impacted negatively.

Other industries need to take note, and there are signs they are doing just that. For example, as we highlighted last year, the tobacco industry has its own take on addressing the very significant health issues facing its products through a combination of innovation and the switch to next generation products. Heat-not-burn-products may be to cigarettes what Coke Zero is to soft drinks. These products contain significantly less toxins and companies are attempting to migrate their customers towards them, effectively disrupting their own existing combustible cigarette businesses.

While consumer companies continue to adjust to the ever-changing environment, fundamentals continue to remain supportive in terms of the macro environment, with the global economy showing no obvious signs of strain.

Whether it be the US or Europe, the trend continues to be one of robust employment which is fuelling consumer demand, while even capital expenditure is also starting to pick up.

The big unknown is the US trade war, which continues to dominate front pages but, thankfully, has had little impact on global growth as yet.

We have to remain vigilant in case the situation escalates, but for now we still believe it is more about US domestic policy than anything else. Trump is trying to ensure the voters who put him in power see him taking action after his aggressive comments during the election, and the US's closest neighbours - as well as China - are bearing the brunt of the policies that are looking to follow up the rhetoric.

How does this conclude? No one can truly know, but we think, given what is at stake and the ability of countries like China to be much more focused with any retaliation, sense will prevail.

In this month's insight our portfolio manager Catherine Blanc-Adams, discusses how the recent sell off provides significant buying opportunities in emerging markets bonds, notably in Turkey and Argentina. You can follow the link here or click on the attachment.

Equity portfolios

Our World Stars portfolio continued its positive trajectory, closing May up 2.7% in US dollar terms and is now up 6.6% year to date. Our holdings within the technology sector, led by *Adobe*, *Facebook* and *Activision*, continued to do well. Of note during the month *Adobe* acquired Magento, an e-commerce software solutions provider for $1.7bn. The acquisition broadens *Adobe's* product suite and strengthens its presence among mid and small sized enterprise customers. At the same time, the company announced an $8bn share buyback program underscoring its financial flexibility. Within industrials, our holding in Rockwell Automation also continued to perform solidly on the back of expectations that global capex activity is picking up, with, importantly, larger project activity also starting to inflect.

On the negative side, *Anheuser Busch* declined somewhat along with other consumer stocks such as *Henkel* and *Nestlé* as institutional investors continued to rotate their portfolios out of companies with more defensive characteristics into more cyclical and financial stocks. With valuations at attractive levels and benefiting from high dividend yields we believe these names present a compelling opportunity given the prospects for future innovation currently on offer.

Income-driven portfolios

In the words of Led Zeppelin, "the song remains the same". This has been the case for the past three months following the market correction at the beginning of year. Volatility has increased, developed market sovereign bond yields are rising and whilst the path of least resistance remained higher for equities, especially in the US, driven by optimism for fundamentals, fixed income markets are correcting led by emerging markets and substantial flows out of the sector.

The Income Portfolio was roughly flat in US dollar terms but last month saw important variations between asset classes. Whereas equities were up 2.3% in USD for the month (and 6.6% year to date), fixed income was down 2% (and down 2% year to date) and the non-correlated funds were flat (up 2% for the year). Cash generation so far this year is around 1.5% and continues to deliver on expectations.

Although the fixed income portfolio has shown some weakness, it is worth noticing that it is outperforming its benchmarks by a reasonable margin (year to date our emerging market benchmark, the Bloomberg Barclays EM HY is down 3.6%). This correction was not unexpected as expressed in previous monthly comments. This explains why the portfolio had a lower portion of its assets invested in fixed income. This part of the portfolio had been very resilient until last month but further pressures, particularly in emerging market debt, pushed the performance into losses.

Default rates haven't increased yet and globally economies are still doing fine with a few clouds on the horizon (Argentina and Turkey being the most obvious at this stage). So although we feel that there could more some more weakness in the asset class we do not expect a general contagion. We see this as a healthy adjustment following a period of over valuation due to money flowing in looking for higher yields. The emerging and high yield markets are already starting to show some attractive returns and it feels like investors will have a chance to position themselves in higher quality issuers but still expect good returns.

We already mentioned that the portfolio has limited exposure to Argentina, Russia and Turkey. As proven in the past, our focus on fundamentals, cash generation and long-term investment (although the fixed income portfolio has a duration below five years), provides a unique foundation for future return generation.

Emerging Market bond portfolios

Emerging markets were badly hit in May, with all asset classes, foreign exchange, bonds and equities suffering massive outflows as investors turned risk averse.

Our emerging market bond portfolio was down -1.2% for the month, the second worst monthly sell-off since our start date on October 2015, pulling down the year-to-date performance to -4.9% (-2.7% if we exclude the impact of our *Rusal* position).

Higher funding rates are hitting the two largest US dollar sovereign issuers, where investors are now requiring higher yields to compensate for increased perceived risks. We comment on the overall Emerging Market picture and more specifically on Turkey and Argentina in our *Insight* this month. The worst performing credits in our portfolio are companies based in those two countries. *CLISA*, the Argentinean conglomerate we have been following since its debut bond issue in spring 2016, was down -15% in May, clearly on low volumes and poor liquidity. The company generates all its revenues in Peso, down 40% on the month. We spoke to the management and they are confident that they will withstand the domestic volatility given their ability to adjust prices to inflation. *YPF,* also beaten, is on a strong footing with all its revenues generated in hard currencies. The -5.6% drop in the bond prices does not seem justified in our view.

Our *Petrobras* position was down -4.3% on the back of a nationwide truck drivers' strike against hikes in fuel prices, a protest against domestic prices reflecting international prices rather than being subsidised by the State. Investors were suddenly reminded of Petrobras' pre-2016, where it was used as an economic policy tool by the government. On the other hand, we are convinced that the transformation and de-leveraging policy of the company are well-anchored.

Overall, we are withstanding the current volatility, a reminder of the nature of Emerging Markets, which some recent investors might have ignored. Clearly, a very tight and close monitoring of the credits we are investing in is the key to continue to deliver income to our clients.

As always, we look forward to your questions and comments.

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