Commentary May 2021

If only we knew…

We like market routs because we can buy more for less. This week our friend Rob Armstrong, former editor of Lex, launched a new investment column in the *Financial Times* and we could not avoid getting into an argument on day one.

We thought the view that valuations are high as expressed in Rob's very first column is simply wrong, at least as far as our stocks are concerned. Yes, average market price to earnings (P/E) ratios for indices like the S&P 500 appear to be at the higher end of historical ranges, but they are not that high if they are capitalized at current and likely future interest rates, and there is great dispersion between stocks. There are many companies that are at low multiples in absolute terms and relative to their earnings and cash flow growth. Alphabet is an example: even we were surprised by the strength of their results this month. We said at the beginning of the year that stocks were cheap. Knowing what we know now means that we were buying Alphabet at 16.5x 2022 P/E, or rather owning it since we first bought it in 2012… No wonder it is up 35% this year. You can see our exchange in the FT here and we look forward to more robust discussion.

We continue to believe that we will see a strong recovery from the pandemic even as it continues to have a significant social, economic and political impact. As vaccines are rolled out in the US, Europe and other wealthier countries throughout the summer, the discussion will move on to providing doses for less wealthy countries that are in desperate need. It is in all of our interests to vaccinate as many people as possible to avoid the proliferation of variants that could impact the fight against the disease. The pandemic is far from over but as with other issues, the further we look ahead the clearer the picture becomes.

Economically the discussion is also moving on, from the recovery to its consequences. As the global economy recovers from the pandemic, the shortest, sharpest of economic externalities, we are seeing shortages everywhere. Demand is strong, incomes have been resilient and supported by governments, services have been closed, manufacturing has been idled, and supply chains have been disrupted. It is entirely obvious and expected that that we should see shortages in labour, inputs and finished goods, and it is equally obvious and expected that this should lead to a spike in short-term inflation. Just as in 2003 and 2009, we have to recall that this is because of good news, not bad, and that these temporary issues will resolve as economic activity resumes and supply improves.

To us the next obvious and expected question is the slowdown that will follow the recovery. Not even the US economy can grow at 7% two years in a row, and so the next six to twelve months of strong growth will be followed by lower rates of growth, stability or even declines. It is a question of if, not when, just as in any other recovery, it will require companies, governments, and central banks to manage it, and it could lead to volatility as numbers over- or undershoot. However, the slowdown will be among the most anticipated of all time, and it will be supported by government and central bank action. We think in particular that the Biden administration's insistence on providing stimulus and infrastructure investment should be seen as a prudent provision of cushion for the slowdown rather than fuel for the recovery, in particular because many measures will only take hold over the next several years. It is a fact that the US mid-term elections in 2022 will come right after the period of the most

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challenging comparisons and the Biden administration will be highly sensitive to employment, growth, and other indicators.

But enough of the macro, as important as it is. What about the micro? As we discuss below, our companies have delivered exceptional results this quarter and are confident of ongoing strength and/or recovery for the year ahead. Quality will prevail as companies with strong competitive positions, good and growing markets, experienced managements, and strong balance sheets will have the growth, pricing power and economies of scale to offset inflation and the resilience to weather externalities and adversity.

Our fundamental analysis means that we know the results our companies are capable of delivering, even if we do not always get it right, as was the case with Alphabet, still one of our cheapest stocks despite its strong performance this year. That is why we are confident in their long-term prospects and the value they offer today and will use any routs to buy more of them.

Our investment insight this month provides our views on the ongoing regulatory issues facing the big digital platforms. It builds on our previous investment insight in September last year, in which we anticipated the multiple lawsuits that have been filed by the US FTC and others. We continue to believe that the issues will be resolved and that they are unlikely to impact the companies' businesses, competitive positions, and prospects for value generation. You can read the investment by following the link here or by clicking on the attachment.

World Stars Global Equities

Strong sales and earnings from the companies in our World Stars Global Equities strategy drove our portfolio up 7.0% in April bringing year-to-date performance to 9.3%, both in US dollar terms. The first quarter earnings season has underscored the exceptional competitive positioning of our companies and the strength of the structural trends fuelling their growth.

Our companies involved in digital transformation continued to reach new highs, with Google owner *Alphabet* leading performance during the month. Alphabet achieved 34% revenue growth during the quarter, with strength coming from both YouTube and its cloud services business. The company has emerged as a clear beneficiary in the post-pandemic world as online retail remains robust and verticals impacted by the pandemic like travel or hospitality recover. Importantly, this top-line momentum benefitted from significant operating leverage and fuelled earnings and cash generation. Alphabet bought back USD 11.4 billion in stock during the quarter and announced a new USD 50 billion incremental buy-back program.

Social media giant *Facebook* benefited from similar trends, with revenues up 48% in the first quarter of the year. The company saw strong growth in monthly active users. It reached 3.5 billion of monthly active users globally across its platforms, an increase of 15% across the company's suite platforms. The 'blue app' Facebook platform had an increase of 10% despite its strong position in the US and Europe. Not to be outdone, *Amazon* enjoyed 41% revenue growth for the quarter as the firm continues to set itself apart from competition within the retailing industry. Advertising also grew by 70%, underscoring the correlation between e-commerce and online advertising and highlighting the multiple incremental avenues the company can pursue to generate revenues. Finally, payment processors *Visa* and *Mastercard* were also beneficiaries of the ongoing shift towards a cashless society, with US domestic volume growth in the mid-teens. As international travel resumes, we expect the profitable cross-border transactions business to return to more normalised levels. This resumption in activity will contribute to both firms continuing to increase their earnings.

Luxury goods producer *LVMH* delivered another strong set of results, with a 30% rise in sales reflecting momentum across its brand portfolio. Spending for luxury goods, especially in key markets like China, has already exceeded pre-pandemic levels. LVMH's heritage of creativity and exclusivity continues to ignite consumer excitement, illustrated in the recent Lady Gaga/ Dom Perignon collaboration, whilst legendary jewellery maker Tiffany has seen a robust start to the year following the January merger closure and its official inclusion in the LVMH family.

Another highlight was healthcare devices producer *Medtronic,* which continued to recover, supported by the progressive recovery in surgical procedures as hospitals start to allocate resources back to normal healthcare services. The company continues to widen its competitive moat through its robust pipeline of new products, with 220 additional approvals globally since January 2020, including a new insulin pump for the treatment of diabetes and a modular robotic surgery solution. Medtronic's progress in this field underscores its market leadership position.

Within industrials *Otis*, the global leader in elevators and escalators, achieved 10% organic growth as a recovery in construction activity supported new equipment sales. At the same time, the company has been reaping the benefits of its recent investments in sales & marketing and product additions, including its connected elevator Otis-One solution, which saw the business take share from competitors. We believe Otis is emerging as a differentiated compounder within the industrials space following its spin-off from United Technologies, with an accelerating revenue profile and a strong focus on shareholder returns. Similarly, aerospace and defence supplier *Raytheon Technologies* continues to be supported by the anticipation of the recovery in international travel. In the meantime, the company's defence business continues to support its cash flow profile, with the company reiterating its commitment to return USD 18-20 billion to shareholders within the first four years of the merger's closure.

Multi-Asset Income

Our Multi-Asset Income strategy finished April up 3%, with gains of 4.5% year-to-date. Equities were the main driver, showing further strength on top of the previous month after an exceptional performance of 6.7% in April. The fixed income portfolio bounced back from its bout of weakness in March, gaining 1.6% in April to bring performance to 2.2% year-to-date. However, the non-correlated funds portfolio struggled somewhat, down 0.77% amid some profit-taking in the asset class. All data are in in US dollar terms.

There are many reasons to be positive about the economic recovery, including the acceleration of the vaccine roll-out in Europe. However, risk assets and bond yields have rallied on this good news and we believe the way forward will not necessarily be free of setbacks. These could include volatile economic data and the possibility of new Covid-19 variants, which may somewhat tarnish the mostly successful vaccination campaigns in the developed world.

As firms continue to report results, companies have shown very strong revenues and earnings momentum from the first quarter of last year. As we have outlined, in the case of our portfolio, we have seen some outstanding performances driven by both top line growth and exceptional execution by our holdings' management teams in a very difficult environment.

Following the purchase of *Banco do Brazil* in March (6.25% Perp), we decided to build a position in leading Turkish bank *Akbank* (6.8% 2026), taking advantage of the opportunity to buy them at lower prices following the resignation of the Turkish central bank's governor. Those two bonds are examples of opportunities which arise in our emerging corporate debt universe, triggered by country specific issues rather than issuers' performance. Our fixed income portfolio has a current yield of 7.5% and a yield to maturity in excess of 9% for a duration of less than 2.5 years, which is extremely attractive in a very low yield environment.

The portfolio is well positioned for possible higher bond yields as economies benefit from re-opening and further fiscal boosts. More than ever, we continue to favour quality and value stories across a broad range of industries. Their fundamentals will provide a natural hedge against any potential higher inflation whilst also offering a degree of protection against the possibility of short-term disappointment in the execution of the economic re-opening. Whilst highlighting this risk, we continue to believe in a multi-year bull market for risk assets.

As we remain focused on generating a solid cash yield with low volatility, we also believe that this year could prove volatile. However, our fundamental and disciplined investment process will support the portfolio in achieving its investment objectives.

Emerging Market Bonds

Our Emerging Markets Bond strategy finished April up 1.4%, bringing performance to 0.9%, year-to-date, both in US dollar terms. The portfolio's performance came on the back of the Fed delivering a dovish message that acknowledged a pick-up in economic activity but also noted a labour market that is not fully healed. The Fed also signalled that it views inflationary pressures as transitory in nature, justifying its continued accommodative stance. Yields on the benchmark 10-year treasury note retraced some of the recent widening to end the month at 1.6%. Meanwhile, emerging markets credit spreads tightened as improving commodity prices, lower and more stable rates, a weaker US dollar and continued vaccination programmes provided a supportive environment for EM growth.

Set alongside this, crude oil prices were volatile in April, with concerns that surging Covid-19 cases in India − the world's third largest oil importer − could weigh on demand. Initial weakness was quickly offset, however, by strong economic data out of China and the US. Combined with large inventory drawdowns in the US, this led to Brent prices rallying 6% in the month. As a result, our oil credits performed well, with *YPF*, *Pemex, Tullow* and *Seplat* all returning over 3% in the month.

Last month we spoke about the sell-off in Turkish assets following the replacement of the central bank governor. As mentioned above, we used this weakness to add two new Turkish corporates to the portfolio at attractive prices. *Akbank*, which is one of the largest private banks in Turkey and the best capitalized in the sector, and confectionary business *Ulker*, which is Turkey's largest public food manufacturing company by revenue, are now part of the portfolio. These additions proved to be timely as we saw the central bank hold its main interest rate at 19% and it eased market concerns that the new governor would follow an unorthodox policy to tackle inflation. This lack of policy change drove a strong rebound in Turkish assets, with our latest additions returning 3.9% and 3.6%, respectively.

Finally, the largest detractors to performance this month were our Ukrainian corporates, *Kernel* and *MHP,* which were negatively impacted by news that Russia was building up troops on the Ukrainian border, stoking fears that years of tension could finally erupt into outright war. The US reacted by imposing additional sanctions on Russia and concerns about an escalation have largely eased after Russia withdrew troops in late April. Although geopolitical risk remains, we are comfortable with the quality of the companies whose bonds we hold, have maintained our low overall exposure to Ukraine and expect to see some price recovery in the next months.

With the earnings season underway, we have seen companies deliver strong operational and financial results and believe our portfolio is well positioned to benefit further from both the global growth recovery and the significant rally in commodity prices. Key headwinds are macro, mainly around political instability, fiscal consolidation and rising US rates, albeit we argue that these should provide attractive entry levels.

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