Commentary

REMEMBER THE BIG PICTURE

At J.P. Morgan's recent third quarter results call, Jamie Dimon, Chairman and CEO, was asked about comments he had made about the supply chain problems easing and what he had been hearing from around the world about the potential for logjams to open up. This is what he said:

I'm not hearing much different than you're hearing. I know that the overfocus over time is so extraordinary sometimes from the press that people forget the big picture. The economy is growing 4% or 5%. There's not one company I know that's not working aggressively to fix their supply chain issues. Sales are still up – credit card, debit card spend still up – consumers in great shape. And capitalism works. I doubt we'll be talking about supply chain stuff in a year. I just think that we're focusing on it too much. It's simply dampening a fairly good economy, it's not reversing a fairly good economy.

We are with Jamie Dimon, who has steered J.P. Morgan successfully through the ups and downs of economic and financial crises over the past twenty years and has made it the world's biggest bank by market capitalization: We should not overfocus on short-term issues. J.P. Morgan reported strong results and offered a first-hand look at what is going through its consumer and corporate lending businesses. There is of course great uncertainty as we go through the transition from the covid pandemic and the supply chain problems will have an impact. However, the underlying forces are in place and so if the pandemic can be contained and the link between infection, hospitalization and severe outcomes weakened or broken, as appears to be the case so far, we should look forward to next year and the recovery with optimism.

There is short term focus too on markets and valuations. Many investors are worried that market valuations are too high or that there could be a shift from growth to value stocks that would mean that the companies that have done well over the past several years will do badly going forward.

We invest in companies, not markets, and believe that there are many quality companies that are still attractively valued and will continue to deliver strong returns going forward. What do we mean by quality, though? For us it is all about the fundamentals: What do companies actually do, why do they do it well, is there demand for their products or services, and do they have the resources and the balance sheets to keep investing in their businesses and grow their sales, earnings and cash flows? That is what we mean by quality.

The key is that quality companies grow their sales, earnings and cash flows, and that stock prices follow fundamentals. A company that can grow its earnings by 15% a year doubles them every five years. Those earnings are the 'E' in the P/E or price-to-earnings ratio, so if the share price does not move, the P/E ratio halves. This means that a company that many think is expensive at 30 times P/E is cheap at 15 times over five years. Quality companies deliver those kinds of results not just over five years, but over ten and 25 years. Finding them is not easy, but that is why we have to do the work to analyse the fundamentals and make sure we have the right ones.

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One of the reasons P/E ratios de-rate is inflation. Quality companies have the sustainable competitive positions to increase prices, the scale to absorb cost increases in their raw materials and labour, and the balance sheets to be able to get through the tough period in the middle, like right now, when costs go up but there is a lag before prices can be raised. This is when other companies go bust and quality companies get stronger by taking market share or buying their competitors. That is why quality companies can grow their sales and protect their margins. It is also why it does not matter if inflation means that interest rates go up and cause discount rates to go up too: if a company can grow its earnings at a significantly higher rate than inflation, its P/E multiple can de-rate like in the example above and investors can still generate attractive returns. This is also why it is almost impossible to find a five-year period in which shares have not gone up 8% a year, and why it is worth owning quality companies for the long term.

Also, quality companies are much more sustainable. We believe that sustainability and long-term investment returns are inextricably linked. Only sustainable companies have sustainable competitive advantages and can generate sustainable returns over the long term. Quality companies are about intellectual capital not physical capital, and about operating expenditure like research and development, not capital expenditure like plant and equipment. They are much less capital-intensive, and have a much lower carbon impact. Often they are platforms where every pound they make drops to the bottom line, such as with digital advertising, or they have recurring revenues because of what they sell. The pressure on companies to be sustainable will keep increasing, and quality companies will do better as a result.

Quality has proven to be the key factor in winning against the competition, and we will look to take advantage of volatility and other market-related moves whenever opportunities arise.

Take *LVMH*, the world's biggest luxury company, which we have owned since 2019. The company just reported strong sales, which are up 20% for Q3 this year. Because investors are concerned about the impact of the Chinese government's 'common prosperity' policies, LVMH's shares sold off 15% over the summer and its valuation de-rated even more – by 25%, on our estimates for the company's earnings. We think these concerns are misplaced, though: the Chinese government's goal is to double the size of the middle class which has annual disposable income of USD 15,000–75,000 from the 400 million recorded in 2020 to 800 million by 2030. That is a lot of consumers for LVMH's brands, and at 28 times 2022 price/earnings we think it is a great opportunity for long-term investors.

Another example is *Salesforce*, the leader in CRM software and similar applications, which we added to the portfolio this year. The company has had consistent sales growth of 20% a year, has a total addressable market that is more than ten times bigger than its sales this year, and is more than four times the size of its next biggest competitors. The pandemic has accelerated the shift from offline to online, so more companies need Salesforce to manage their sales, access their customers, understand their digital behaviour and process their online sales. Salesforce's short-term price-to-earnings multiple looks high, but we think it has a long trajectory of growth and value creation ahead, and we were able to buy it in February this year at a price which was 40% cheaper than it would have been a year before because the shares declined while its earnings went up.

One of the key issues for sustainability is diversity and inclusion. We believe that it is important both for the companies we own and for ourselves, and that the diversity of our own investment team makes us better investors. Our senior adviser Ebru Köksal is a prominent advocate of women's sports and has been recognised as one of the most powerful women in football. Last year she was interviewed by Sue Anstiss MBE, another advocate for women's sport, on her podcast The Game Changers. That is why for our Insight this month, we wanted to share a summary of Susan Anstiss' recent book Game On: The Unstoppable Rise of Women's Sport, which is about the positive impact sportswomen can have in promoting equality in sport, and Ebru's podcast which also highlights the importance of this issue.

World Stars Global Equities

Our World Stars Global Equities Fund closed September down 5.4% as equity markets came under pressure on macroeconomic concerns, while year-to-date performance remains robust at 13.4% (both in US dollar terms).

The expected tightening in monetary policy led to a rotation away from 'long duration' assets. Among our affected holdings was *Adobe*, the creative software and marketing solutions provider, which declined 13% during the month. Profit-taking in the company was compounded by Q3 results which saw a more modest level of upside versus market expectations following strong earnings beats in previous quarters. Despite that, the underlying business remains well supported by robust online marketing trends and enterprise software demand. On a similar note, *Facebook* declined 11% as investors rotated away from growth-oriented stocks, and as the company's practices in managing content again came under scrutiny. This was due to claims made by a former employee about the preferential treatment of high-profile individuals and an unwillingness to more forcefully protect vulnerable users. This remains an area that we continue to closely monitor from an ESG and social capital management perspective. We are encouraged by the enhanced policies that Facebook has put in place over the last three years, but we acknowledge that there is more scope for improvement and continue to use our stewardship activities to push for even stronger practices in this area.

As macroeconomic concerns dominated the headlines, our holdings within the industrials sector inevitably also came under pressure. Among the worst affected were *Eaton*, *Sika* and *Otis*, with investors nonetheless taking some profits following strong recent performance. Despite any short-term volatility, our companies remain well positioned to take advantage of the structural opportunities that lie ahead. These include investments in green infrastructure and the transition to a low-carbon economy, which will underpin our companies' earnings trajectories going forward.

On the positive side during the month were our holdings in the spirits industry, namely *Pernod Ricard* and *Diageo*. Pernod rose 5%, driven by strong full-year results which reflected market share gains, resilience in at-home consumption and a progressive recovery in on-trade activity. Industry peer Diageo was up 3%, with the company pointing to similar market normalisation trends in its most recent trading update.

Finally, *Thermo Fisher Scientific*, the world's largest life sciences company, closed the month 3% higher. The company held its annual investor day in September, in which it raised its long-term organic growth outlook to 7–9% from the prior 5–7% level. This reflects the fact that it has successfully utilised the more than USD 12 billion of Covid-19-related revenues which it has realised over the last two years to both invest in the business and further broaden its competitive moat.

Multi-Asset Income

In line with our expectations, volatility increased across asset classes during the month of September. Investors switched their focus from Covid-19 infection development in order to reassess their risk appetite as markets take a step closer to central banks tapering their monetary stimuli and the possible emergence of earlier-than-expected interest rate rises. Topping those factors, the renewed concerns regarding global economic growth have resurfaced, triggered by signs of the Chinese economy slowing down materially, confusing indications from US consumers, and last but not least the sharply rising cost of energy. In this context the income portfolio gave some ground, with a negative 2.5% in US dollar terms from the month of September (meaning it is still up 8% since the start of the year).

World equities were the most volatile asset class last month, and our equity portfolio showed a negative return of 5.7% but was still up a strong 14.5% for the year. Our fixed income portfolio showed strong resilience, with a slight loss of 0.6% (meaning it is still up 6.6% for the year). The non-correlated funds were also affected in September, showing a negative 0.7% and taking performance year to date to a negative 0.5%.

With limited earnings releases last month, the portfolio was mostly driven by general profit-taking on the negative side and by sharply rising oil prices positively supporting some of our investments including *Schlumberge*r, *Kosmos Energy* and *Tullow Oil* +1.8%). Rising US ten-year treasury yields only had a limited impact on our fixed income portfolio because of their short duration of around three years, but a slight widening of credit spreads put pressure on the sector as a whole.

The next few weeks are going to be dominated by the US earnings season, which could reveal the extent of the impact of the supply chain issues and energy price rises on companies' growth and profitability. We feel that those concerns might not fully be priced in by the markets and could further increase the uncertainty during the current transition period. We would expect volatility to increase as a result, especially as markets are trying to get clarity on both the path out of monetary stimuli and the way forward for interest rates.

Our high-quality equity portfolio and very short-duration fixed income holdings should weather this environment, and we look out to the mid-term horizon for further positive returns and strong income generation with lower relative volatility.

Emerging Market Bonds

Our EM bond portfolio was down 0.5% for September amidst a somewhat turbulent market driven by a combination of higher US treasury yields on the back of rising inflation, fears of the Fed tapering and concerns on China growth. This takes our year-to-date return to 3.3%.

Oil prices rallied above USD 80 per barrel, a three-year high supported by the rebound in demand and tight supply. As a result two of our own, Kosmos and Tullow, were the top contributors to performance this month.

Some of our longer-duration bonds such as *Cemex* and *Gold Fields* were impacted by the rate rise, and as a result these were the largest detractors to performance this month,. We also saw some weakness in our Turkish corporates, which sold off on the back of the surprise rate cut by the Turkish central bank when inflation was running at 19%, raising concerns of a return to a more unorthodox monetary policy.

Going into the year end, the key risks we see remain increased inflation and a further rise in rates. However, we believe our portfolio is relatively protected given the short duration of just 3.4 years and positioning in higher-yielding companies which have room for spread compression. Additionally, many of our corporates have been using the low interest rate environment to refinance much of their debt, and are in a fundamentally strong position with low leverage and very comfortable maturity profiles.

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