J. STERN & CO.

The Value of Long-Term Investing

Market commentary

EVERYTHING MAY BE OK

Investment in capacity and technology — the next driver of global growth

Telegraph Media Group Limited

"There is a basic investment principle which by and large seems only to be understood by a small minority of successful investors. This is that once a stock has been properly selected and has borne the test of time, it is only occasionally that there is any reason for selling it at all. However, recommendations and comments continue to pour of the financial community giving other types of reasons for selling outstanding common stocks.

Most frequently given of such reasons is the conviction that a general stock market decline of some proportion is somewhere in the offing. Postponing an attractive purchase because of fear of what the general market might do will, over the years, prove very costly. This is because investors are ignoring a powerful influence about which they have positive knowledge through fear of a less powerful force about which, in the present state of human knowledge, they and everyone else are largely guessing."

Philip Fisher, *Common Stocks and Uncommon Values*, 1957

Fear is a powerful emotion but we must overcome it through positive knowledge. Philip Fisher wrote his seminal book about investing, building on Benjamin Graham's Intelligent Investor, in 1957, at a period when the United States was in the midst of an unprecedented boom, a decade or more of investment in capacity and technology that built the foundation for the growth and prosperity it has delivered in the decades to come.

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It is well worth re-reading Fisher today, not just because of the widespread fear of a general stock market decline of some proportion, as he phrases it, and not just because recommendations continue to pour out of the financial community saying to sell outstanding stocks because of short-term concerns about inflation, interest rates and the impacts they may have on discount rates that are used to value the future earnings and cash flows of companies, but because we are at an important point in the global economy that has parallels to the 1950s when Fisher wrote Common Stocks and Uncommon Values.

Globalisation and digitalisation have been two of the major drivers of the global economy and of stock markets over the past 30 years. Going forward, they will be joined by a third major driver, investment in capacity and technology. There is a tremendous opportunity because populations and economies have grown but companies have not been investing sufficiently to increase their capacity and take advantage of technology at the same rate.

Investment in capacity and technology will help to address the current challenges that the world is facing right now. Short-term these challenges include the current supply chain crisis and the shortages of many materials and products. Much more importantly, long-term they include climate change, the transition to a low-carbon economy and the achievement of Net Zero by 2050.

Over the past decade we have developed a lot of the technology that will allow us to produce the equipment to solve the supply chain crisis and reduce carbon emissions. We just have not produced it yet. The boom in investment in the firms that produce it, paid for by public and private money, will be the next driver of growth in global markets. Were it not for the pandemic, this boom would already have happened.

Global capital goods and industrial companies such as the technology and manufacturing leader Honeywell, the power and smart grid management firm Eaton, or electronic connector provider Amphenol, all will benefit from the much needed and inevitable investment in capacity and technology.

Our approach of investing in companies that have quality and value for the long-term, with strong and sustainable competitive positions in good and growing markets, solid managements and strong balance sheets is grounded in our positive knowledge based on our fundamental investment research and financial analysis.

The companies we invest in can prosper through periods of inflation and interest rates like we will experience as a normal part of the global economic growth we expect over the next several years. This is because they have the abilities and resources to innovate and grow their businesses over time, the pricing power to increase prices with inflation, the scale to purchase their inputs at lower costs than their competitors, and the operating leverage to maintain or increase their margins, allowing them to prosper and generate value over time.

One of our favourite cartoons summarizes our outlook for 2022. We expect that the coming year will thankfully be a year of greater population immunity, either through vaccinations or natural infections. With the aid of new vaccines, therapeutics and treatment capabilities we are in a much better place than ever before to manage future outbreaks. We foresee continued recovery from the impact of the pandemic, although as last year it is unlikely to be in a straight line.

We also believe that investment will join globalization and digitalization as major drivers for the global economy. Finally, we think that inflation and interest rates are a normal part of economic recovery and growth, and that while there will be bouts of volatility as markets react to economic data and policy changes, the positive fundamentals will prevail.

However lunatic it may sound, that is why we think that everything may be OK and remain constructive in our outlook for this year.

Our investment insight at the beginning of the year provides a more detailed discussion of our expectations for markets, industries and the companies we invest in for the coming year. You can read it by clicking on the attachment or following the link here.

World Stars Global Equities

The World Stars Global Equities strategy ended 2021 up 21%, buoyed by a strong performance of 4.2% in December (both in USD terms). Our holdings emerged from the pandemic stronger and well positioned to capture new opportunities, with broad-based performance for the year being a testament to the strategy.

Payment processors *Mastercard* and *Visa* performed well during the month. This was driven by strong in-store sales growth over the holiday period, combined with payment trends during the prior months, showing an acceleration in the international travel recovery.

As the market reacted negatively to slightly softer-than-expected broader sector results during this past quarter, weaker performers during the month featured some of our enterprise software stocks like *Adobe*, the leading marketing and creative software solutions provider. Considering there might be some truth to the fact that some enterprise spending on front office and marketing had been pulled forward in 2021, leaving a more muted demand for the quarters ahead, the long-term fundamental industry drivers nonetheless remain intact.

Taking a step back and looking at 2021 as a whole, we are particularly encouraged by the breadth of the performance of our holdings, as over the past couple of years they have demonstrated resilience during market downturns and are now well positioned to participate in the recovery.

Within healthcare several of our holdings, like *Thermo Fisher*, continued to provide critical solutions, equipment and testing kits for Covid-19. These companies were structural winners in the industry, clearly showing solid bases and deeper customer relationships, and were ready to redeploy the excess cash flow towards organic investments and acquisitions that will drive long-term growth for the years ahead.

Our surgical and medical devices holdings like *Alcon* provided a tailwind for the reopening of the global economy, after elective procedures which had previously been postponed due to the high Covid-19 hospitalisation rates were finally able to recommence.

During a year of economic recovery in the industrial sector, structural acceleration was evident, with key themes including the electrification of the economy and the transition to net zero. Our holdings, such as *Eaton*, benefited from strong demand in numerous verticals, including commercial construction and data centres, with a noteworthy ability to manage cost inflation and supply chain bottlenecks. Importantly, these companies are emerging as key enablers in the transformation of the global economy, supporting their growth profile for the years ahead.

Our holdings within the digital and technology sector, like *Alphabet*, continued to post solid results and gain market share, building on the strength of the prior year. Covid-19 has accelerated the digital transformation of large enterprises due to ever increasing demand for digital advertising and an increase in cloud solutions.

Finally, within the consumer sector our companies benefited overall from the resilience of in-house consumption and a recovery of on-trade demand. Holdings with exposure to cosmetics, haircare, skincare and eyecare also advanced with the reopening of access to retail stores, entering the new year with great momentum and share gains that are expected to continue.

Companies on the weaker side during the year continued to be partly impacted by the pandemic, or navigated the year with company-specific risks. Notably, corporate governance and D&I issues weighed heavily on *Activision Blizzard*. This was an area of active engagement for us as we pushed the company to enhance its practices in this area through both in-person meetings and written communications. We were encouraged to see the company proceeding with changes to its senior management amongst further actions to improve its culture and work environment. The company's shares recovered part of the losses with a double-digit performance during December, reflecting progress in this area. The delay of new games which had been announced in the last quarter of the year disappointed investors, although that is not an unusual development within the video game industry. We will continue to closely monitor developments and actively engage with the company, advocating for the implementation of improved ESG policies and practices.

If investors do not value companies fairly there are others who will. Microsoft's recent announcement that it would take over Activision at a price of USD 95, a 45% premium to its share price, vindicates our view of its long-term value. It is an opportunistic move to acquire a unique asset that will strengthen its gaming franchise and capabilities as it joins other companies in investing in the metaverse. We are disappointed because we think Activision has greater value but understand its decision to accept a takeover at a significant premium after the issues it has had.

Multi-Asset Income

After a couple of volatile months, last year finished on a strong note with the multi-asset income strategy up 2% for the month of December in US dollar terms. This rise took year-to-date performance to 10%, representing a 7.8% annualised net return since inception. All asset classes performed positively for the last month of the year, and for the year as a whole. Equities led as the strongest performer, being up 3.7% on the month (an impressive rise of 22.5% for the whole year). Fixed income and non-correlated funds were respectively up 0.5% (5.6% for the year, following a challenging 2020) and 2% (just slightly positive for the year, although the final figure is likely to be higher due to the lag effect in reporting by some of the funds).

The overall generated cash yield was around 3.5%, which was higher than for the previous year. Most asset classes benefited from the broad monetary support from central banks and posted strong corporate performance, which helped to subsidise default rates throughout the positive but nevertheless volatile news flow on the pandemic front.

Our credit portfolio further recovered from the previous year's correction to go well ahead of our benchmark. Despite the erratic actions of the country's central bank, our Turkish holdings recovered toward the end of 2021, regardless of the increased volatility in short-term USD yields. Our strongest performers were recovery stories, notably *Grupo Posadas*, *Tullow Oil*, *TV Azteca* and *YPF*, which were all affected by the pandemic and lower oil prices. The fixed income portion of the portfolio has an attractive outlook going into next year, with a current yield of 7.3% and a yield to maturity of 9.3% for a duration of around three years.

Our alternative funds portfolio had a difficult year in 2021, and was impacted by the well-publicised supply chain issues which saw goods unable to be accessed or shipped to their final destinations. The situation gradually improved over the course of the year, and the underlying rates of return are now higher than they were pre-pandemic due to the lack of funding supply. As a result (and also because) of this, we have added a number of exciting new investments and we are positive about the prospects for this part of the strategy.

The generation of a superior cash yield with low relative volatility remains our main priority, and our fundamental focus should continue to prevail following two exceptional years. We anticipate 2022 to present further challenges in the form of a number of headwinds. However, the exceptional prospects of most of our investments over the long term, as well as our balanced positioning, will continue to yield superior returns for our investors.

Emerging Market Bonds

2021 was a turbulent year for emerging market corporate debt, with improving credit fundamentals supported by the recovery from Covid-19 whilst competing with macro factors like higher US interest rates and politics-/policy-induced volatility in several countries. Despite this prevailing backdrop, the emerging market corporate debt strategy was up 2.5% for the year (outperforming the reference J.P. Morgan benchmark by 160bps), bringing the annualised return since inception to 7.1%.

The strategy generated an attractive income of 6.1%, partly offset by a depreciation in bond prices which were impacted by the rise in US interest rates. The 60bp rise to 1.5% in US ten-year treasury yields was the steepest annual increase in rates since 2013, driven by an optimism in the US thanks to rapid vaccine deployment and good economic data, combined with expectations of the Fed tightening monetary policy given rising inflationary pressures. Such a rate rise put pressure on emerging market debt yields, whilst credit spreads were relatively flat for the year, confirming the strength of our underlying companies, which saw EBITDA levels higher than pre-pandemic levels, as well as lower leverage and better liquidity positions.

Despite reducing our exposure to the countries, additional headwinds came from idiosyncratic events in Turkey and Ukraine. President Erdogan's preference for unorthodox monetary policy saw the central bank cutting interest rates, pushing real rates further into negative territory and causing the lira to depreciate by 80% over the year. Whilst not being immune to this, Turkish corporates in which we invested were far more resilient and were only down 1–3% over the same period, illustrating their diversified business models, which include a significant percentage of hard currency revenues, as well as balance sheet strength with average leverage of circa 1x. Meanwhile, risk sentiment was influenced by the escalation of geopolitical tensions between Ukraine and Russia thanks to a build-up of troops on the border, stoking fears of history repeating the 2014 invasion of Crimea.

At the other end of the spectrum, there were several positive drivers of performance. The commodity sector was particularly strong, with oil prices rallying 47% over the year and reaching a three-year high of USD 80 per barrel momentarily, supported by the general rebound in demand and tighter supply conditions. At the same time, financials generally performed well as bank profitability increased on lower loan-loss provisioning as visibility on asset quality improved. Finally, individual consumer cyclical stories linked to the reopening of economies and return of business confidence aided positive performance.

Throughout 2021 we viewed market volatility as an opportunity to add several new quality companies to the emerging market corporate debt strategy at attractive valuations, thereby continuing to diversify both in terms of geography and sector. Despite such diversification, the strategy maintains an attractive return profile of 7.3% yield to worst, with a 6.7% current yield and a risk profile of a BB- average credit rating and average security duration of 3.2 years.

As such, the strategy is positioned to deliver on its total return targets in 2022, primarily via carry. We will likely see modest spread compression with robust stand-alone corporate fundamentals, low default rates and supportive technicals (thus increasing investor allocations to EMs and minimal net financing requirements). This will be partly offset by macro challenges, such as the further repricing of the US yield curve and political risks in particular geographies.

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