Investment Commentary

RESILIENCE IN TIMES OF ADVERSITY

This week's invasion of Ukraine by Russia has thrown major new complexities and uncertainties into the geo-political and macro-economic outlook. Markets had already been pricing in the possibility of escalating conflict given the build-up of troops on the Russia/ Ukraine border and the continuous and vocal communication about the likelihood of military action by the US and other countries. However, since the reality of the invasion markets have entered a new phase of risk and volatility.

It is clear that the Covid pandemic, which we finally seem to be overcoming as Omicron remains much more infectious but less severe than previous variants, and as countries across the world are discontinuing the physical distancing measures they have put in place, has accelerated much of the change and disruption we have seen over the past decade. The most obvious is the transition from offline to online and the importance of the digital economy for businesses and consumers. However, another less obvious change and disruption is the disruption of global supply chains, exposing the fragility of off-shored production and just in time delivery. The resulting re-shoring is already happening and will have a significant impact on places that are closer to major end markets.

It seems to us that Russia's invasion of Ukraine will lead to a similar acceleration of change and disruption in the geo-political framework and the transition from a post-war period of hegemony by the US and its allies to a multipolar world in which the US, China and Europe, along with other countries, will have to find ways to co-exist peacefully and to deliver prosperity to their people.

In the same way as we are not epidemiologists, we are not political scientists. It is our responsibility to assess the available information and make judgments about how they will affect our investments.

Russia is one of those 'other' countries with a long history of empire and collapse, a resource-driven economy that provides much of Europe and the world's oil and gas, wheat, fertilizer and non-ferrous metals, a political system that appears increasingly autocratic and and a military, and in particular nuclear, capacity that means it has an outsized global role that is greater than its population or economy would imply. Whether the Russian government's actions are in the long-term interest of the peace and prosperity of their people is not for us to judge.

It is impossible to say how long Russia's current first move will take or what its outcome will be. Russia appears to be looking for an annexation of at least part of Ukraine by Russia and a regime change in Ukraine, even if the short-term economic cost to Russia through sanctions is meaningful. The political will in Russia to achieve this goal appears to be much greater than the ability of Ukraine to resist it or the resolve of Western powers to block it.

The key questions for us as investors are how the invasion will play out, how far the Russian incursion will go, and what response the Ukrainian government, military and most importantly population will have. The outcome and timing will have an impact on how sharp the short-term reaction will be in terms of energy and other commodity prices, what impact this reaction will have in turn on inflation and policy responses by the central banks, and how great the risk is of a significant further escalation or a prolonged period of great uncertainty

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which could materially undermine the current expectation of global economic recovery and strong GDP growth in 2022-23.

We should have a first indication of some of these outcomes in a matter of days or weeks. A scenario could be that annexation/some regime change will occur in Ukraine within two months or so. Russia would effectively take control of the Eastern part of the country including further valuable access to ports on the Black Sea. If active hostilities calmed down during this period, markets would increasingly view it as a regional conflict with limited impact on global growth. The immediate mood of heightened risk in markets would dissipate and the focus would return to the economic costs, increased inflation and likelihood that energy prices would steadily fall back as market conditions normalise, supply increases and supply chains realign. In this scenario we would expect markets to remain volatile but to avoid a prolonged downturn, as in many industries and countries the impact will be manageable. Countries with lower levels of self-sufficiency in energy and companies with high input costs in energy, minerals and agri-commodities would be squeezed the most. Other companies, in particular of the type we invest in, would see limited impact on their operating environment or profitability.

In a different scenario of a prolonged conflict of six months or longer, or if other countries including NATO members decided to get involved directly in the conflict, the impact on markets would be more significant. However, while that more problematic scenario would likely have greater short-term volatility, it would not necessarily lead to a more substantial impact on a medium-term view of one to two years or more. We must be careful with precedents but previous geopolitical events of this nature suggests a time-limited downturn in markets. For example, after Iraq's invasion of Kuwait in 1990, the S&P 500 was 13% down in USD after six months, but 10% higher after 12 months. On a smaller scale, when Russia annexed Crimea in 2014, the S&P 500 was 3% higher after three months and 15% higher after 12 months.

Fears over the Ukraine crisis have added to market fears around inflation and significant monetary tightening that were already prominent since the turn of the year. After a 29% rise in 2021, the S&P 500 fell 10% in the first few weeks of January, and after a brief rally, is now 11% down year to date. This is a correction, but a manageable one.

The greatest economic pressure to come out the Ukraine situation is likely to be a broader inflationary pressure which will include energy, materials and agri-commodities. The question will be how central banks respond to inflation that is up to 2% higher than previous estimates, and for quite an extended period. Will the Fed, the ECB and Bank of England lift rates further and faster than current expectations, raising the risk of choking the economic recovery. Or do they fear a potential recession more than inflation, and will they adopt a more measured approach?

We believe that policymakers will see recession as the greater current risk given the geopolitical situation, the still uncertain recovery from the pandemic and the potential for polarised political outcomes in domestic elections in many countries this year, in particular the US mid-term elections and the French presidential elections.

These will be complex judgements, not least because underlying economic growth has been robust, as evidenced by the US jobs market and PMI data from various countries in January and particularly February. The huge success of vaccine programmes and the rapid fading of Omicron has initiated the early stages of a cyclical recovery, with changes to the mix of

consumer demand (e.g. more holidays and services, fewer consumer durables), a progressive easing of supply chain issues, and a significant rise in investment by corporates and governments. The Financial Times reported today that economists' consensus on global GDP currently appears to expect moderate reductions in global GDP as result of the conflict, about a 0.3% reduction in 2023 and slightly less in 2024 compared to a baseline of 'no conflict'. The US would be resilient at 0.2% reduction while the EU and the UK, with their greater reliance on imported energy, would suffer estimated cuts to growth of 0.5% or more in 2023.

As in the Covid crisis of 2020, we expect our underlying companies to be resilient. Our rigorous approach of investing in companies that have quality and value for the long-term leads us to invest in the world's largest and best companies, with a global footprint, and minimal direct exposure to Russia or Ukraine.

These companies have enduring and sustainable competitive advantages in attractive long-term growth industries, like digital transformation, consumer products and services, healthcare and life sciences, and industrials and infrastructure. They have above-average pricing power through branding, ownership of intellectual capital or similar and a low exposure to the main areas of current inflationary pressure in their cost base.

Importantly, as one of our key criteria for quality, they have strong balance sheets which enables them to weather periods of adversity, to reinvest in future organic growth opportunities or to finance selective acquisitions. That is why we believe that many of our companies are likely to emerge in a stronger competitive position when the turbulence abates and the global economy returns to a calmer growth path in the same way they have through the Covid-19 pandemic.

We do not seek to time markets, but to choose great companies that will deliver significant returns over time, through economic and investment cycles, and periods of uncertainty and adversity. This philosophy has delivered in previous periods of volatility and we remain confident that it will continue to do so going forward.

World Stars Global Equities

Global stocks retreated from previous highs on increased risk aversion as markets priced in faster interest rate increases by central banks. The World Stars Global Equities Strategy closed January 7.0% lower in US dollars terms as the retreat weighed especially on higher multiple stocks, some of which we hold in the portfolio.

Leading video game publisher *Activision Blizzard* closed the month 19% higher after receiving a $69 billion cash offer from Microsoft. With consolidation in the video game industry ongoing, the ownership of proprietary IP is critical – and Microsoft's offer highlights Activision Blizzard's compelling portfolio of high-quality titles that continue to deliver great value.

Visa and *Mastercard* both recorded gains during January as cross-border payment volumes recovered to above pre-pandemic levels. Similarly, *Raytheon*, the world's largest Tier 1 aerospace systems provider, benefited from improving trends in lucrative commercial aftermarket parts.

Within the consumer sector, *LVMH*, the leader in the luxury goods market, announced strong results in the fourth quarter. It reported sales at its largest division, Fashion and Leather Goods, were more than 50% above 2019 pre-pandemic levels. This stellar performance is a testament to LVMH's brand loyalty, a diversified product portfolio and pricing power.

Some of our portfolio companies on higher multiples came under pressure as the market rotated towards more value-oriented companies. They included *Givaudan*, the leading flavours, fragrances and active cosmetic ingredients manufacturer.

In line with many companies, Givaudan signalled significant raw materials cost inflation and said that these higher prices will be passed on fully to customers. It closed the month 20% lower with investors realising profits following a year of strong capital gains.

Cost inflation will remain a key theme for the markets given continued labour, freight and raw materials pressures. However, we believe companies in the portfolio, such as Givaudan, are exceptionally well placed to deal with the current environment.

Its differentiated product offering and its ability to keep supplies flowing amidst a challenging global supply chain environment, give it a unique position in its sector. This translates into pricing power to shield its profitability and coupled with the strong top-line structural drivers that underpin its sales growth, valuation levels are well supported, providing a floor against current market conditions.

Multi-Asset Income

In almost a mirror image of the final weeks of 2021, volatility again embraced markets in January. The income portfolio contracted 3.4% in USD terms during the month. Equities were the weakest component, dropping 6.9%, while the fixed income portion of the portfolio fell by just 0.4%. Our non-correlated funds were also less volatile than equities but still corrected by -1.1%. This slight dip was largely the result of the investment trusts we recently introduced to the portfolio, which can suffer from mark to market pricing.

This market volatility was not unexpected. Equities have been coming under pressure amid increased tensions between the West and Russia over the Ukraine border stand-off, but more so because of the increasing hawkishness of the US Federal Reserve. During the month, the Fed finally decided that inflationary pressures were stickier than it initially expected and highlighted that, although its actions would be data-driven and therefore adaptable, rate hikes would probably be front-loaded.

Following some strong performance towards the end of the first half of 2021, we reduced our equity exposure and reallocated the proceeds into new opportunities in the fixed income portfolio. This move, and some further optimisation into some Turkish holdings which had suffered from the devaluation of its currency late last year, provided positive contributions for the portfolio. This included *Sisecam Turkey*, one of the largest glass manufacturers in Europe.

Further support was found through our energy bond holdings (*YPF, Tullow Oil, Tupras*), which benefited from the oil price rising to its highest level since 2014. The higher oil price, combined with the rotation from growth to value, also benefited our holding in *Schlumberger*, which is the portfolio's best equity performer so far this year.

Following the US 10-year Treasury yield's rapid upward adjustment, we feel that markets are discounting a good measure of the monetary tightening to come. However, the Russian Ukraine has further heightened volatility, which could remain as investors adjust to the new environment. Although markets are anticipating some earnings slowdown in 2022, we are carefully watching for signs of increased pressures from higher prices on consumer demand and corporate margins.

Our quality and value mindset drives our selection process. Our equity portfolio has diversified exposure to different high-quality companies, whilst our fixed income portfolio benefits from the short duration of most of the selected bonds (average duration of three years) and an attractive current yield of 7.5%.

We are expecting a challenging investment environment this year, but we strongly believe that our strategy is positioned to perform well. Our allocations to uncorrelated funds and the high cash generation from fixed-income assets offer the portfolio some downside protection.

Emerging Market Bonds

January was dominated by continued inflation uncertainty, Fed policy (the 10-year US Treasury yield rose approximately 30 bps and the escalation of geopolitical tension. Despite this very challenging macro environment, our emerging market corporate debt strategy held up relatively well, falling just 0.9% during the month.

Performance was driven by our commodity-related holdings as the price of oil rose to levels not seen since 2014. Its price rose 17% to reach $88 per barrel on supply concerns caused by Iranian attacks on UAE oil assets, in addition to growing fears of the Russian invasion of Ukraine we have seen this week.

The portfolio's top performer, *Tullow Oil*, returned 3.4%. The West-African focused oil and gas company's FY 21 trading update was in the middle of guidance. Its free cash flow (FCF) came inahead of expectations, on the back of higher oil prices and lower costs as the company continues its focus shift from riskier exploration towards producing assets.

Elsewhere, our Turkish holdings recovered partially as its central bank paused its monetary easing measures until the end of March to assess the outcome of the aggressive interest rate cuts that lowered the benchmark rate by 500bps last year. Such a pause, combined with last month's announcement by the Turkish Finance Ministry for a new currency protection scheme for savings, offered a level of stability for the lira after a period of significant volatility.

Our Ukrainian holdings continued to come under pressure and were the main detractors from performance, in light of the escalations in tension with Russia. Whilst an outcome the events is difficult to predict as we outline above, a trading update from MHP, a leading agro-industrial company in the country, confirmed that all production facilities continue to operate at full capacity with increased sales volumes given the export nature of the business.

We continue to look for opportunities to diversify our portfolio. In January, we added *Alsea*, a leading Mexican multi-brand restaurant operator. The company operates across 11 countries under 17 international and local brands including Domino's Pizza and Starbucks, where it has exclusive franchise agreements. Its bonds offer an attractive 6.5% yield to worst and a 7.0% current yield for a company that should benefit from economies reopening – in turn, this should translate into balance sheet deleveraging.

Looking to the year ahead, we believe that robust standalone corporate fundamentals, low default rates and favourable technicals should be supportive for our portfolio, which has an attractive 8.1% yield to worst and 6.9% current yield. The main headwind is likely to come from a further widening of the US Treasury curve, although we believe that much of the inflation concern is priced in. Even so, we continue to keep portfolio duration short to offset such risk.

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