Investment Commentary

QUALITY DOES NOT MATTER UNTIL IT DOES

If it was ever necessary, the last few weeks have provided an object lesson as to why quality does not matter until it does. Over the past year, the US Federal Reserve raised the Fed Funds Rate from close to 0% to almost 5% in response to high inflation. These moves have led to a number of intended and unintended consequences. One of these consequences was the sharpest sell-offs of quality stocks we have seen for as long as there have been markets. We invest in quality and value for the long-term and the shares of many of the globally leading companies we own did poorly because they are in businesses that have strong prospects for sustained growth and value creation and they are perceived as longer duration or more highly valued compared to other businesses. Among the best-performing sectors last year were energy, commodities and financials.

But this year has shown that quality matters. The best-performing sectors are the worst of last year and the worst-performing are last year's best. Our approach is entirely driven by fundamentals and we have kept working to ensure that the fundamentals of the companies we invest in are sound and fulfil our criteria for quality and value. Quality for us is a gating condition: a company can be as cheap as chips but if it does not have the quality we look for we will not invest.

Our four criteria are a strong and sustainable competitive position, in a good and growing market, a management team with a record of value creation and a balance sheet so strong as to weather any kind of adversity. These criteria take us into companies that are involved in digital transformation, consumer products, healthcare and life sciences, and industrials. It takes us away from balance sheet-driven financials, capital and resource-intensive companies, and regulated businesses that rely on licenses or concessions for their returns.

Another of the consequences of the sharp rise in interest rates is the banking crisis that has been gripping markets for the past several weeks. We think that balance sheet-driven financials struggle to fulfil our criteria because they are difficult for outsiders to analyze for three key reasons. First, as we have just seen again in the case of Silicon Valley Bank, First Republic or Credit Suisse, it is impossible to know what the assets or liabilities are given the complexity of the businesses. Secondly, the balance sheet of any bank is inherently unstable because a bank's core business is maturity transformation in which short-term deposits are used to make loans that are often not repaid for years. This means that any bank no matter how large is potentially vulnerable to a sudden outflow of short-term deposits. Third, one of the few certainties is that regulators want to increase the amount of equity required to support the assets on the balance sheet. Therefore the return on equity (ROE) of a bank is highly leveraged and at risk from externalities. The mark-to-market losses from long-dated government and corporate bonds and loans that are at the core of the current crisis result from the rate rises last year. That is why this crisis may be the first to have been caused directly by central banks themselves and we expect there to be further impacts before it is resolved.

Please join us this Monday 27 March at 14:30 London time to hear more about these issues from our Managing Partners Jérôme Stern and Tom Price. They will talk about what we think investors should look out for if they are worried about the current banking crisis and what it means for the funds and portfolios that we manage. They both have extensive experience dealing with financial, structural and regulatory risks. Jérôme, our CEO, was a senior investment banker including at Credit Suisse, heading part of its investment banking business focused on Switzerland. Tom, our COO, was a solicitor focusing on financial structuring at major London law firms and 20 years ago was involved with the very beginning of the development and implementation of bonds for banks that would be considered Tier 1 for capital purposes. These bonds are now known as Additional Tier 1 (AT1), Contingent Convertible (Co-Cos) or Contingent Write-Down bonds and are among those that were written down to zero as part of UBS' acquisition of Credit Suisse, leaving bondholders with a total loss of their principal. Neither J. Stern & Co. nor the Stern family was an investor in those bonds – and we will explain why not. We will provide a short overview of the issues and leave plenty of time for questions and discussion. Please click here to register.

Our Investment Insight this month discusses another important issue. The future of digital advertising has been an important topic for investors over the last two years. Five of the top ten largest companies in the world, Apple, Microsoft, Amazon, Alphabet and Meta, all have exposure to this important industry. The share prices of these companies all declined precipitously last year. After years of robust health, digital advertising has been hit by several short-term factors but reports of its death are an exaggeration. Generative artificial intelligence is both an opportunity and a risk. We asked ChatGPT for its views but it has its limitations. Although it missed some of the most important issues and could not offer judgment or opinion, it can write brilliant Shakespearean sonnets. You can read it by following the link to Insight or by opening the attachment.

As we highlight in our commentary on our World Stars Global Equity strategy, many of our companies have good results for the fourth quarter and strong outlooks for the year ahead. Many of the companies that were hardest hit last year have rebounded strongly. We stayed true to our convictions and held our positions in companies like Nvidia and Disney, which we reinforced during the November lows, or Meta, which has more than doubled since that time.

Looking forward we face many challenges, but a world of sustained global growth, interest rates of 4 to 6%, inflation of 2 to 4%, and real interest rates of 0 to 2%, is a world to look forward to and not to fear. While we think it is likely that headline inflation will decelerate sharply as the sharp increases in energy, commodity and food prices annualize and reverse, we expect that there will be sustained core inflation as incomes adjust upwards.

In this world, public equities will remain the only large and liquid asset class which will allow investors to preserve and increase the real value of their assets over the long term. To generate value, companies will need to have the ability to grow because of the markets in which they operate or because of the technology, innovation and product development they have, the pricing power to raise prices to offset inflation, the scale to absorb cost increases and the balance sheet strength to reinvest in their businesses or to buy other businesses that provide access to new technologies or markets, or other benefits.

There will be more winners and losers and stock picking will be all the more important. We have been consistent in our approach to investing in quality and value for the long term and believe our World Stars Global Equity Fund is well-positioned for the opportunities and challenges ahead.

World Stars Global Equity

Our World Stars Global Equity strategy was down -3.1% during February although it is still up +4.9% year to date, both in US dollar terms.

Our best performer was Nvidia +19%, a global leader in semiconductors, boosted by news flow about generative AI and ChatGPT reaching a tipping point in terms of commercialisation. The company has also benefited from the launch of its next-generation chips for both gaming and data centres. Meta +17%, the owner of social media platforms Facebook and Instagram, also continued to rebound, following the announcement of further cost-cutting measures. The company has widely acknowledged the need for higher efficiency as it enters a period of more normalized growth following elevated levels of demand through the pandemic. We have held these positions through the share price declines last year, increasing the position in Nvidia in November, and are reaping the rewards of our approach.

Global media and entertainment company Walt Disney also reported strong results. The company's theme parks business grew +20% benefitting from resilient consumer spending. CEO Bob Iger also announced measures to improve profitability and reduce spending on content creation spend. Although the stock saw some profit-taking during the month, we believe these changes will help to unlock more value from Disney's brand portfolio. This view is evidently shared by activist investor Nelson Peltz who abandoned his bid for a board seat following these announcements. As with Nvidia, we used the weakness in November to increase our position.

Our holdings within the industrials sector also showed ongoing resilience, supported by solid structural trends including the transition to net zero, reshoring, increased investments in automation and infrastructure, and elevated defence spending. Power management leader Eaton rose 8% after it reported strong Q4 results with organic revenue growth of 15% and EBIT margins at an all-time high of 20.8%. The combined Americas and Global electrical business backlog increased 68% year on year. This strong momentum was echoed in the Q4 2022 earnings releases of many of our portfolio holdings in the sector.

On the weaker side, some of our holdings in digital transformation experienced profit-taking after January's strong rebound. Most affected was software company Adobe -13% on news of continued regulatory scrutiny of its Figma acquisition. The acquisition would deepen Adobe's collaboration platform capabilities and present significant cross-selling opportunities, but in our view, Adobe is equally attractive as a standalone entity if the merger were to be blocked by regulators.

Our decision to reduce our holding in Alphabet earlier in the year proved timely, with the stock down -9% in February as investors tried to assess the competitive implications of ChatGPT on Google as a search engine. We reduced our position in recognition of the potential for shorter-term negative news flow but as we note in our Investment Insight The Future of Digital Advertising this month, we believe that Alphabet's resources and capabilities leave it well-placed to take advantage of generative AI over the medium term.

Multi-Asset Income

Volatile economic data impacted asset prices after the strong start to the year. It was a reminder to investors that the path to normalization is not straight and that this year is likely to be as difficult to navigate as last. Our strategy was down -1.9% during last month and is now up 3.1% since the start of the year, both in US dollar terms. Equities were volatile, down -3.3% in February (up +5.2% year to date). Both our fixed income portfolio down -

1.9% (up +2.6% year to date) and our alternative income funds, only slightly down -0.3% (down +0.9% year to date) joined in the general weakness.

Our equity portfolio experienced profit-taking across the board, but more particularly from stocks that had benefited from a strong January. Among those was Estée Lauder (-12%), which reported weaker Q2 results impacted by Covid lockdowns in China in Q4 2022. However, the outlook is now much better with the re-opening and other stimulus measures in China. Similarly, Schlumberger, previously one of our largest holdings but one which we have been reducing aggressively, fell 6.2% despite surprisingly positive results. On the positive side, Zoetis +1%, our animal health holding, released better-than-expected results and outlook for this year.

Our fixed-income portfolio was mostly affected by the lack of further inflows in the asset class following a record few months. A few company-specific issues impacted the returns (see Emerging Market Bonds commentary below). Lumen Technologies (ex-Century Telecom) came under pressure from worse-than-expected results compounded by the new management's lack of comments regarding a new strategic direction.

On a broader economic front, developed market economies have been more resilient than expected, led by tighter job markets. At the same time, inflation has been persistent despite lower commodity prices. As a result, interest rate expectations have adjusted and markets now expect rates to be higher for longer.

Our current asset allocation should deliver attractive cash generation and lower volatility. In this uncertain investment environment, we believe that it provides us with the best level of visibility on future returns for our investors.

Emerging Market Bonds

After a very strong start to the year, our Emerging Market Bond strategy was down -1.9% in US dollar terms. Risk sentiment softened in February and fixed-income assets were impacted by higher US Treasury yields. Meanwhile, emerging market credit spreads were relatively unchanged and continue to trade around 50 basis points inside the last 20-year average.

Aside from the broader market volatility, the corporate earnings season highlighted some positive underlying fundamentals. In Latin America, Banco do Brasil (financials) reported strong profitability, benefiting from higher interest rates and contained loan provisioning. Management also emphasised that asset quality remains under control. Meanwhile, Grupo Posadas (consumer, cyclical) continued its recovery post-pandemic with positive momentum in hotel occupancy levels.

Having been the strongest performers in January, some of our corporates in Sub-Saharan Africa pulled back, given the region's greater reliance on external financing. Added to this, the restructuring of Ghana's sovereign debt missed certain milestones which would qualify the country for aid from the IMF. This put pressure on all corporate asset prices in the country including Tullow Oil (energy), notwithstanding recent positive news on operations and bond buybacks. Meanwhile, local currency volatility put pressure on Liquid Telecom (communication services) despite earnings showing signs of underlying growth across Africa and improving liquidity.

We believe that performance will continue to be driven by macro conditions, resulting in volatility. Credit fundamentals are starting from a strong base. However, lower growth could see credit metrics slide. Importantly, companies have been proactive in terming out debt maturities at low fixed rates, which mitigates their refinancing risk in a higher-rate environment. Whilst credit spreads are marginally tighter than historical averages, overall yields are still attractive. This should help to support inflows to the asset class whilst the level of new issuance is running below trend, providing a supportive technical backdrop. Such an environment is an opportunity for investors to lock in attractive income and total yields by selectively buying and holding bonds to maturity.

Today, our Emerging Market Bond strategy offers a 12.0% p.a. yield to maturity (in US dollar terms) with a relatively short duration of 3.8 years. This comprises a 7.6% p.a. income yield that provides a degree of visibility on future returns as well as capital appreciation potential given that the average bond price is 87 cents on the dollar.

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