J. STERN & CO.

The Value of Long-Term Investing

Investment Commentary

We have been deeply affected by the attack on Israel last Saturday and the images of horror that have gone around the world. We have always believed that it should be the goal of countries and their leaders to deliver peace and prosperity to their people over time. As hard as it seems right now, we hope that peace will prevail and that the lives and livelihoods of innocents are spared.

Source: Bloomberg, J. Stern & Co. Note: MSCI World and S&P 500 indices in USD.

Prominent market commentators and research providers are calling for a market crash because of the rise in rates. Markets have sold off in September as short-term investors have sought to position themselves and taken profits. For our World Stars Global Equities, like last year it has been driven entirely by factors like value over growth and short duration over long duration businesses.

We invest in companies not markets because it is company fundamentals that generate value over the long-term. Micro is what we do, macro is what we put up with. We do have macro-economic views but they are built bottom-up, from the fundamental research we do into the companies we buy and hold.

One of the macro arguments is that peaks in interest rates have often been followed by crises and market sell-offs. It is undoubtedly true that rates are often cut because of crises but correlation is not causation. We have combined an annotated graph of the US 10-year treasury yield with a graph showing the performance of the S&P 500 and MSCI World over the same period. The message is as clear as it is obvious. Central banks have managed rates proactively to offset the affects of geopolitical and macro-economic events but company fundamentals have prevailed, generating great value for investors who kept owning them.

What the graph of US 10-year treasury yields does show is that the period we have experienced since the global financial crisis is coming to an end and rates have finally

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normalized. A world of interest rates at 4-6%, inflation of 2-4% and real interest rates of 0-2% is a world to look forward to, not to fear.

To preserve and increase the real value of assets in an inflationary environment you need to own companies that can grow because of the innovation they deliver or the markets they are in, have pricing power to offset inflation, have scale to absorb cost increases, and have strong balance sheets and cash flows so they do not rely on debt for their financing and can reinvest in their businesses or buy other companies. That describes the quality companies we own.

With moderating inflation, rates at or close to a peak, full employment, strong demand and attractive valuations, we think we are at a level from which markets and our companies can perform. There is a lot of cash on the sidelines that is hoping to time a market pull-back. We already have had a short-term pull-back in September with a rotation from growth to value. Once it becomes clear that rates have peaked we think markets are poised to perform.

Another factor is China, where the main issue is confidence and the government is taking decisive steps to stimulate the economy. The first positive signs are emerging and if the government is able to reenergize the real estate sector and get it to complete the many half-finished developments, confidence could return quickly. The most recent data was positive and a turnaround would take many by surprise.

Luxury items like Hermes or Louis Vuitton handbags never go on sale but the companies that make them do. Our insight this month discusses our outlook for the luxury sector. Long-term demand for luxury goods is powered by the aspiration of consumers, the increase in middle-income families and the brand equity and pricing power of the companies that make them. Chinese consumers account for almost a third of global luxury demand, their number will double by 2035 and they have only started to go shopping.

All of this could take place much sooner than many people think and means that investors should be guided by fundamentals to take advantage of market volatility. Caveat venditor – seller beware !

World Stars Global Equities

Our World Stars Global Equity strategy was down 7.6% in US dollar terms, which reflected a return of the factor rotation seen last year as well as broad-based profit-taking across markets prompted by an update from the US Fed and the release of the FOMC minutes. The strategy remains up 15.4% year-to-date in US dollar terms, significantly outperforming global indices.

Several of our top holdings were impacted, with *Nvidia*, the leading global advanced semiconductor leader, down 12%. As we reported last month, the company has posted two consecutive quarters of exceptional results reflecting a huge increase in demand for its high performance GPUs for accelerate compute infrastructure and AI. With the stock up 198% year to date, some short-term profit-taking is expected. The company's growth outlook remains very substantial given its unequivocal leadership position in the sector. Some of our other digital transformation companies also experienced profit taking, having posted 50% plus gains so far this year.

Meta, the owner of Facebook and Instagram, defied this trend rising 1.5% and is now up 150% year-to-date. The company hosted an industry event in September, showcasing some of its new AI-related products and services. With strong user engagement and a deep innovation pipeline, Meta is well-positioned to capture an even higher portion of advertising budgets.

Our portfolio companies in the consumer and healthcare sectors also held up well against the market sell-off as the market rotated to parts of the investment universe that had lagged year-to-date despite solid earnings trends.

In terms of stock-specific news during the month, *RTX*, the world's largest supplier of aerospace engines and systems, fell 16% as the company broadened the accelerated inspection program of its GTF engine fleet powering the Airbus A320neo due to a historical manufacturing issue. The program is expected to cost the company US$3bn in cash for the period 2023-2026, which is significant, but needs to be understood in the context of RTX's scale, financial strength and US$185bn order backlog.

RTX is still expected to generate US$7.5bn in free cash flow in 2025, and the management have reiterated the US$33-35bn cash return target for 2020-2025. At the same time, the structural growth trends in RTX's commercial aerospace and defense businesses remain intact, fuelled by the long-term growth in global air traffic, both commercial and leisure, and by ongoing geopolitical tensions boosting defence budgets. In consequence we believe the stock price reaction has been disproportionate to the financial impact and is more than discounted in the FY2024 P/E of 13.2x.

Multi-Asset Income

Our multi-asset income strategy fell 1.9% in US dollar terms, impacted by a further sharp adjustment in market expectations for the US Fed's monetary policy. This put pressure on risk assets in general but particularly on equity markets, which until recently had been resilient. The strategy is up 7.9% year-to-date in US dollar terms.

Our equity portfolio was down 7.4% (up 15.2% for the year) while our fixed income portfolio played a volatility buffer role, gaining 0.8% for the month (up 6.4% since the start of the year) despite the rise in US Treasury yields. Our alternative income funds were down 0.7% in September (now down 3.3% for the year) driven by higher yields in the UK.

Equity prices suffered from broad profit-taking with few idiosyncratic stories. Only a handful of companies were unaffected, including *Siemens Healthineers* (+1.3%). This positive performance came despite cautious news on the impact of the Chinese anti-corruption measures introduced for hospital equipment orders.

By contrast, spread volatility for the fixed-income markets has been somewhat muted, which resulted in an overall balanced picture for bond prices with a few strong performers. They included *MHP* (+24.3%, see commentary for EM Debt below) and Total Play (+22.8%) bouncing back from the previous month.

The strength of the US economy over the past few months has taken markets by surprise and as a result, expectations are that interest rates will remain higher for longer. US Treasury

yields are now reaching levels close to the peak of the pre-financial crisis yields' range, which should have some tightening impact on the overall economic trend, although with a lag.

We expect volatility to increase in the current environment, but we also believe that our portfolio positioning is primed to take advantage of the high-income generation as well as the potential for capital gains for the remainder of the year.

Emerging Market Bonds

Our Emerging Market Bond strategy was up 0.4% in US dollar terms for the month with global risk sentiment impacted by the continued steepening of the US Treasury curve on the back of the 'higher for longer' interest rate narrative from the Fed. Emerging market credit spreads tightened marginally and continue to trade just inside the historical average.

There was some positive underlying corporate news in September. *MHP* (Ukraine; agro-industrial) announced a tender offer to buy back bonds maturing in 2024, proactively addressing the debt profile. It raised US$400m from a group of international financial institutions (incl. EBRD) to fund the tender. *Helios Towers* (Tanzania; industrial) also announced a tender offer to buy back bonds maturing in 2025.

Oil prices continued their momentum higher with OPEC+ committed to curbing supply into year-end, which supported oil and gas companies including *Tullow Oil* (Ghana; energy). We used the opportunity to switch to its secured bonds, crystallizing a profit and reducing credit risk.

The main detractor during the month was *Unigel* (Brazil; basic materials) given the tough environment for both the chemical and fertiliser sectors. The company continued discussions with bondholders to address covenant waivers and short-term liquidity requirements.

Finally, we added a new company to the strategy. *Medco Energi* is an independent energy business in Indonesia, focused on gas. It benefits from a long track record of producing assets, significant reserves and fixed price take-or-pay contracts which mitigate commodity price risk.

The market is focused on economic growth with probabilities skewed towards a soft landing. This would imply interest rates are peaking and should be a supportive environment to generate returns primarily from income.

Today, our Emerging Market Bond fund offers a 12.2% p.a. yield to maturity (in US dollar terms) with a relatively short duration of 3.5 years. This comprises a 7.6% p.a. income yield which provides a degree of visibility on future returns, as well as capital appreciation potential given that the average bond price is 85 cents on the dollar.

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