

Global Equity Observer

Unlocking the Future – The Post-COVID World

ACTIVE FUNDAMENTAL EQUITY | INTERNATIONAL EQUITY TEAM | INVESTMENT INSIGHT | JUNE 2020

Our Global strategies are about resilience. We have a resilient team, working very effectively from home; a resilient investment process, checking that the companies in the portfolio will be able to continue to compound and avoid any permanent destruction of capital; and perhaps most importantly a resilient portfolio, which has once again delivered reduced downside participation in tough times.

This resilience does not mean that nothing has changed for our portfolios in 2020. We laid out our approach to thinking about COVID-19 in our March update. It divided the impacts into three buckets:

- First, there are the direct effects of the virus, and the efforts to control its spread.
- The second is the indirect effect of the sharp economic downturns that have resulted around the world.
- The third is how the world is going to be changed once the crisis is finally past, and how this will affect both sectors and individual companies.

Our view is that the focus is moving from Bucket 1 to Bucket 2, as developed markets exit lockdown, but that it is far from clear that earnings expectations... or multiples... reflect the challenges ahead. There is plenty of thinking still to do on Bucket 3, but the ability to deal with the shift from the High Street (or Main Street) to the Digital Street will be one clear area of differentiation.

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“The ability to shift from the High Street (or Main Street) to the Digital Street will be a clear area of differentiation”



Bucket 1: The Direct Effects

Our base case was, and remains, severe lockdowns lasting roughly a quarter followed by a period of disruption due to social distancing. Clearly, some sectors have been severely affected, notably travel, eating and drinking out, while non-urgent operations have been deferred in hospitals. The list of potential beneficiaries is shorter, such as food retail, sanitising products and software. As mentioned in previous updates, we have trimmed our exposure to beverages, due to our worries about a sustained disruption to ‘on-licence’ sales, i.e., bars and restaurants, which make up around half of revenues. However, in general, as developed markets emerge from lockdown, our focus is moving away from the direct impact of the crisis to the resultant downturns.

“While the start of the recovery may be sharp, the crisis is likely to leave plenty of scarring”

Bucket 2: The Downturn

There is now a small industry speculating about the shape of the economic recovery path, with talk of ‘V’, ‘U’, ‘W’, ‘Swoosh’ and ‘Reversed Square Root’. The word ‘unprecedented’ has been used a great deal, but this is because an unprecedented hit to demand is meeting an unprecedented level of government intervention. While the start of the recovery may be sharp, as lockdowns are relaxed and suppressed spending snaps back with the reopening of shops, the crisis is likely to leave plenty of scarring, as illustrated by the 40 million in unemployment claims over the last 10 weeks in the USA, even before worrying about a second wave. We are not top-down macro analysts, and admit to being temperamentally conservative given our focus on quality, but nevertheless we struggle to imagine that the MSCI World Index’s 2021 earnings will be down only 2% on the 2019 level, as consensus suggests.

If we are indeed too cautious, and 2021 earnings do roughly match the 2019 level, this still implies that COVID-19 will have caused two years of lost earnings growth, yet the MSCI World Index is only down 8% YTD. This modest fall is from market levels that were already expensive at the start of the year, when the MSCI World Index was on 17x consensus 2020 earnings, meaning that we are now over 17x the potentially optimistic 2021 consensus. There are only two ways to lose money in equities, the earnings going away or the multiple going away, and right now after a 35% rise in the MSCI World Index since late March, we are worried about both.

The good news is that our portfolios are not invested in the Index. Instead, they are invested in high quality companies, the ones able to sustain their high returns on operating capital over the long term, or “compounders” as we prefer to call them. They are showing their relative strength once again. Lockdown hasn’t

locked them out. When you consider where compounders are usually found, it is mainly in a few distinct parts of the equity market; consumer staples, software & IT services, and health care. Over 80% of our portfolios are concentrated in these areas, which own hard to replicate intangible assets including brands, networks, patents and licences, giving them pricing power, evidenced by high gross margins. These resilient characteristics have contributed to their relative outperformance compared to the broader market so far this year.

The other advantage compounders have is that when times are challenging, as they are now, they still experience demand thanks to their recurring revenue; patients continue to need saline solutions or dialysis, people still buy everyday essentials from cleaning products to diapers, and businesses depend on IT systems to operate and communicate. The earnings growth may well slow in a sharp downturn, but not nearly as dramatically as for companies facing outright order cancellations for engines, large loan losses or falling prices for a commodity—all problems severely exacerbated if the companies are financially leveraged on top of the operational leverage.

“COVID-19 has revealed the importance of remaining relevant, having the right routes to market, of being dynamic and flexible”

Bucket 3: The Post-COVID World

The team’s main focus up to now has been on dealing with Buckets 1 and 2, modelling the combined impact of the health crisis and the likely economic crisis, and stress testing even more adverse scenarios. However, thoughts are moving towards Bucket 3, the longer-term. COVID-19 and the efforts to contain it have revealed the importance of remaining relevant, of having the right routes to market, of being dynamic and flexible. As mentioned in April’s update, the virus is acting as an accelerator, particularly around the digitization of the economy. Those who had the vision to invest in “Virtual Street”, to bring their businesses online from the High Street, are seeing the benefits. Today, you can create and order a running shoe unique to you, you can order products from all around the world from your own home, you can use your mobile’s camera to assess your skin tone and then order makeup that works for your tone from your phone, you can work from home, you can collaborate with the likes of Teams and Zoom, and invest and save and pay—all online. The way we work, the way we buy, the way we learn, the way we meet, the way we are entertained and even the way we get fit—digitization has given all these habits a new channel, a channel that many millions have become much more accustomed to in a much shorter period of time than can ever have been imagined.

“Being able to build digital moats has become an increasingly essential characteristic of a high quality compounder”

If you have not invested in the new, if your products and services can't be reached, or seen or bought or even delivered to you, but someone else's can, then you've failed to remain

relevant to your consumer or your customer, whether B2B or B2C. As investors, as portfolio managers looking to understand long-term risks and opportunities, it has always been clear to us that companies have to invest to remain relevant if they are to sustain returns. We've always invested in high quality compounders, it's been our philosophy for over 25 years, but where we have found them and what we have had to worry about for them has changed over the quarter century. Today, being able to build digital moats, where relevant, to defend, enhance and extend your franchise has become an increasingly essential characteristic of a high quality compounder.

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