Stewart Investors
Sustainable Funds Group

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COVID-19: implications for performance and portfolio positioning | Worldwide Sustainability All Cap Strategy

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The aim of this piece is to explain: (1) our understanding and perspective on the current crisis precipitated by the COVID-19 pandemic; (2) how our Worldwide Sustainability All Cap portfolios have performed; (3) how we're stewarding our portfolios.

1. Our understanding and perspective on the current crisis

The market shock we're currently experiencing was triggered by a 'black swan' event: a health emergency. Unlike the 2008-09 GFC and most others that preceded it, the current crisis originated outside the economic and financial system; a concomitant Saudi Arabia-led oil price war has added to the shockwaves. However, the antecedents of the current turmoil in markets are, yet again, to be found in excesses and dislocations within our economic and financial system.

The COVID-19 pandemic is unchartered territory. There are many unknowns. But we know enough to understand that the unknowns are unlikely to be resolved quickly. Uncertainty looks set to be the dominant feature of this pandemic for some time.

We know it will be difficult to contain the spread of the virus, even if the eventual duration, severity and human cost cannot be estimated at the moment. We know it will be difficult to contain the economic and financial contagion triggered by the pandemic, even if the duration, severity and economic cost of such contagion cannot be estimated at the moment.

We know social distancing and other measures aimed at containing the spread of the virus are creating a combination of supply and demand-side pressures that will damage growth and corporate profits; many economists are now predicting a global recession, disinflation or even deflation. We know that at some stage in the coming months the sharp shock of the pandemic we are currently feeling will fade. The question is how much economic damage could be done before it does, and how short-lived or lasting the fundamental impacts might be.

In short, what originated as a health emergency has quickly evolved into an economic and financial crisis with some features of previous financial crises: widening credit spreads, looming cash shortages, worries about the resilience of banks and high yield funds, precipitous declines in stock markets, and a significant rotation out of risk assets in general.

Just as governments have announced unprecedented measures to try and manage the health emergency, central banks have tried to reassure markets they are serious about wanting to limit the economic fallout from the pandemic. So far they have employed an all-too-familiar set of tools: rate cuts, asset purchases, liquidity infusions. Markets have not been reassured.

We know from previous crises that monetary interventions and fiscal stimulus measures succeed only if they are appropriate, well formulated, properly targeted, and adequately coordinated. At a time of high expectations, confidence in the ability of policy makers to keep pulling rabbits out of hats seems to be waning. We are not surprised.

Although the economic and financial crisis now unfolding emanated outside the economic and financial system, it is almost certainly being amplified by some long-running systemic and circumstantial political, economic and financial market frailties and pressures. We suspect many of our clients grew tired of us talking about these a long time ago, and now isn't the time to repeat them.

Suffice to say that we think equity markets have been looking vulnerable for years. Since the GFC, monetary policy interventions have tried to inflate asset prices in order to reflate economies and inflate away a growing mountain of debt. At best these monetary policy measures have had some isolated (and in some cases important) successes. On the whole though, they've failed to achieve their intended purpose. Instead, over the years they've morphed into the economic equivalent of a life-support machine that has dispensed enough free money to keep both debt and stock markets humming along, while masking substantive economic frailties, including in the corporate sector.

Over the last decade, a great deal of optically impressive corporate and equity market performance has been built on swathes of debt (corporate debt is now worth USD74 trillion)[1] and debt-funded share buybacks. Company fundamentals have been obscured by a lot of financial engineering, and valuations have diverged from underlying company fundamentals. No wonder then that valuations have become terribly stretched, almost everywhere, but especially in the US, including for many of the high-quality companies we seek out for our portfolios.

When valuations assume an artificial perfection, they are prone to collapse quickly when reality strikes and things go unexpectedly awry. Many of the monetary policy and corporate excesses of the last decade are being illuminated by the current crisis.

2. How our portfolios have performed

We start this section with a disclaimer: anything we say is accurate only at the time of saying it. Over the past month markets have been very volatile, and price moves sharp and steep. All performance numbers are inherently unstable and fast-changing. Trying to identify patterns in the performance of sectors and countries feels like a mug's game, because they seem to fade or change as quickly as they form. So any observations and generalisations we make are liable to change quite significantly in a week, or tomorrow.

But first a few comments on general market dynamics. We are seeing unusually high trading volumes, especially on market openings, but even more so in the final 30 minutes of trading.

1 Source: © Bloomberg L.P. as at March 2020.

It is no longer abnormal for stocks to register double-digit losses and gains on successive days. Much of what we are seeing is being driven by trading algorithms and ETFs. It is also apparent that currency volatility is having a significant impact on the performance of equities.

Of course the general direction of the market and most company share prices over the past month has been sharply down. Year to date, as at 17 March, the MSCI AC World Index (net) is down 11.4% in AUD. Considering how strongly markets rose in January, the decline has been steep, though still not yet nearly as severe as the c.60% fall from the peak that occurred when the sub-prime mortgage crisis struck and Lehman Brothers collapsed in 2008. Year to date, our Worldwide Sustainability portfolio is down 3.9% in AUD (net of fees)[2]. Which means our performance is c.7% less bad than the benchmark index. We know this of little or no comfort to you, our clients, nor should it be; it's deeply unsatisfactory to us.

The capitulation has so far been broad-based. Some sectors have been hit harder than others, but none have been spared. Banks have fallen very sharply, as they seem to in every crisis. Sectors like oil and gas and basic resources have also been hit hard, followed closely by a range of consumer–related sectors like tourism and leisure, auto, transport and travel, retail, food and beverages, and electronics. More recently the popular and generally very crowded US technology sector has also suffered sharp declines, possibly as investors have cashed in on previously strong gains to cover losses elsewhere, or to take sanctuary in cash.

Among this list of sectors that have been hardest hit, our largest exposures are to the retail sector (often indirectly, eg. through consumer staples companies); the auto sector (also indirectly, eg. through software technology companies and service providers); the electronics sector (mostly indirectly, through providers of technology and services to the electronics and semiconductor sectors); and to specialist software technology companies.

Only three portfolio companies are currently still in positive territory year to date: Jack Henry, Elisa and CSL. Over the past month though, almost all holdings have registered negative performance. The three worst performing companies year to date are: Lenzing, Fanuc and Nordson. These names span a variety of sectors and geographies, on both the positive and negative side; patterns are difficult to discern.

We'd have hoped and expected many of our healthcare companies to perform relatively well because their revenues come from critical non-discretionary buying choices. This has proven to be the case for DiaSorin, CSL and Novo Nordisk, all of which are larger positions in the portfolios. But we've been disappointed that some other healthcare names, notably Demant and Alcon, have not held up better. Demant's poor performance is a reminder that hearing aids are sold as much as they are bought, while Alcon's is a reminder that consumers may be forced to rethink their vision care needs, and healthcare providers to postpone purchases of non-critical surgical equipment. We also would have hoped our Indian IT holdings, TCS and Tech Mahindra, might have held up better, as might Deutsche Telekom, but we may yet be pleasantly surprised.

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2 Past performance is not a reliable indicator of future results.
Source: First Sentier Investors and Lipper IM, net of fees. Index data is net of withholding tax.

The performance of our diversified multinational consumer companies has been mixed and quite widely distributed. Unicharm and Unilever, both relatively large positions, have held up reasonably well. Henkel has been disappointing, but half of the business is industrial adhesives, which is prone to any downturn in the auto or broader manufacturing cycle. Of the more specialised consumer companies we hold, Vitasoy, Pigeon and Create SD have so far been a bit more resilient; Marico, Godrej Consumer and Kikkoman less so.[3]

3. How we're stewarding our portfolios

We are not market forecasters, but we think the probability is quite high that markets will weaken further before they stabilise, let alone stage a sustained recovery. The relevance of this is that we are being careful not to rush into initiating or building positions in the current environment. Even after the recent steep declines, many companies are still expensive, and some have yet to surrender the gains of the past 12-18 months.

At the same time, just as the medical emergency will at some point become less acute, we know the severe market shock we're currently experiencing will also subside; market shocks always do. We are trained to invest into crises and are always ready to initiate or build positions in our favourite, high-quality, good sustainability companies when share price falls make valuations acceptable. It makes little difference if the share price falls are driven by fundamental but temporary factors, like supply chain disruptions or slowing consumer demand, or simply by sustained uncertainty, provided the companies concerned are high-quality, good sustainability companies.

We are just beginning to see some decent buying opportunities. In the last couple of days we've initiated new positions in Halma, Coloplast and Edwards Lifesciences (we've held the latter two companies in the past). We've also added to holdings in Fortinet, Constellation Software and Jack Henry.[4]

To help fund these buys, we are (considering) selling down some of the holdings that have either held up well or that we intend to hold less of in future. These include some of the larger consumer staples, healthcare and communication services companies we currently hold.

We're also eyeing up potential opportunities to reduce exposure to some companies with leveraged balance sheets, though fortunately we don't hold very many. We think companies with strong balance sheets will be best positioned to bounce back quickly as the crisis abates. And we're excited about the prospect of being able to buy some of our favourite med-tech, software technology and niche industrial companies.

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3 Past performance is not a reliable indicator of future results.
Source: Stewart Investors and S&P Capital IQ. Data shown for a representative Stewart Investors Worldwide Sustainability strategy account as at 18 March 2020. This stock information does not constitute any offer or inducement to enter into any investment activity.

4 Source: Stewart Investors. Data shown for a representative Stewart Investors Worldwide Sustainability strategy account. This stock information does not constitute any offer or inducement to enter into any investment activity.

We try to always remain focused on the fundamental long-term prospects for each company we hold. All the portfolio changes we're making or considering making are aimed at improving the overall quality of the companies we hold for you. This is the best way we know of ensuring our portfolios are as well positioned as they possibly can be to deliver strong risk-adjusted returns well into the future.

Glossary

GFC: Global Financial Crisis

ETF (Exchange Traded Fund): a type of investment fund that is traded on a stock exchange and tracks an index.

Buybacks: A buyback, also known as a share repurchase, is when a company buys its own outstanding shares to reduce the number of shares available on the open market.

Additional performance

Performance as at 29 February 2020 AUD net of fees	Since launch p.a.	5 years p.a.	4 years p.a.	3 years p.a.	2 years p.a.	1 year	6 months	3 months
Stewart Investors Wholesale Worldwide Sustainability Fund	14.2	9.9	12.4	12.8	11.3	13.9	3.8	-1.7
MSCI AC World Index	15.0	9.7	13.4	13.4	11.6	14.6	5.7	-1.3

Calendar year performance AUD net of fees	2014	2015	2016	2017	2018	2019
Stewart Investors Wholesale Worldwide Sustainability Fund	9.1	12.6	7.8	16.5	5.7	15.9
MSCI AC World Index	13.9	9.8	8.4	14.8	0.6	26.8

Past performance is not a reliable indicator of future results.
Source for fund: First Sentier Investors, net of fees. Source for benchmark: FactSet. Index data is net of withholding tax. Since launch performance calculated from 21 February 2013.

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