Stewart Investors
Sustainable Funds Group

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The current environment and the impact of COVID-19

Worldwide Leaders Fund - Client Update

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April 2020

We have held the view that stock markets are due a correction for some time now. Overly inflated equity valuations, high corporate debt levels, profit margins expanding without any sales growth for a decade – to us, these were just a few of the signs that something needed to change.

The crisis brought on by the COVID-19 pandemic, as with the crises before it, was triggered by an unexpected event. The full scale of this crisis as well as the extent of the ramifications are as yet unknown. Numerous countries have gone into lockdowns, with ongoing uncertainty around how long these will last, alongside entire parts of the global economy coming to a compete standstill.

How are our portfolios positioned to weather this storm?

We don't have any definite answers as to when we will see a light at the end of this tunnel. However, while COVID-19 was the trigger for the current reaction in stock markets, the seeds for this turmoil have been planted over the past decade. We have been increasingly concerned about the record levels of leverage on company balance sheets, the amount of this debt being ploughed into share buybacks to boost earnings per share (EPS) growth (and often management compensation), as well as the startling initial public offering (IPO) valuations afforded to a number of loss making new ventures.

Our portfolios have been positioned defensively for some time now. We have held large positions in consumer staples such as Unilever and Unicharm, alongside high cash levels. To us, these companies represent stable, predictable cash flows with manageable amounts of debt on the balance sheet. Unilever, Unicharm, Beiersdorf, and Nestlé have all performed relatively well through this period. Henkel, a company we have held for some time, has been more disappointing compared to the others. With close to half of the company's operating profits coming from industrial adhesives, Henkel is more exposed to economic cycles than the other consumer staples.

Over this period, the detractors to the portfolio have been some of our cyclical holdings in India. We misjudged the tractor and auto cycle in the country, and bought a position in Mahindra & Mahindra, a high quality conglomerate in the sector. Discretionary consumption is bound to continue to be impacted by this crisis, but a larger proportion of the group's profits come from

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This stock information does not constitute any offer or inducement to enter into any investment activity.

more essential tractors and farm mechanisation products. Through this time, the Mahindra Group has strengthened their balance sheet, improved margins, and undergone a management change. We believe these actions, alongside their strong competitive position, put them in good stead to benefit from a turn in the cycle[1].

In the very short-term, this defensive positioning of the portfolio has proven to be helpful. Year to date to 31 March, the Fund fell 1.6% while the MSCI AC World Index fell 9.7%[2].

What actions are we taking through this time?

We are not convinced that the worst is behind us, but the turbulence of these past months has provided us with an opportunity to begin initiating small positions in companies that have been on our watch list, with sky-high valuations, for some time now. The new significant additions to the portfolios are:

- **Edwards Lifesciences**: The leading producer of heart valves and stents in the US, reinvesting into new geographies as they continue growing. A strong core management team stewards the culture and the quality of their financials including a net cash balance sheet.

- **FANUC**: A dominant robot-maker, with an unwavering focus on research and development (R&D). Long-term managers who have seen numerous economic cycles and their impacts look after the profitability of the business and a strong and stable balance sheet.

- **Constellation Software**: A software holding company with a strong core management team, acquiring smaller software companies that have strong competitive positions in niche areas. We believe their strong balance sheet holds them in good stead to continue on this journey.

- **Watsco, Inc**.: A distributor of heating, ventilation, and air conditioning (HVAC) systems and repair parts, with a strong network across the South East United States, and growing into other geographies as the market consolidates. A net cash balance sheet and family owners in control of the voting rights help maintain a conservative approach.

- **Microsoft**: Steady cash flows from their dominant position in productivity software, built over decades, has helped them reinvest into Azure cloud infrastructure, which continues to grow quickly. This dominance manifests itself as recurring sales and a cash generative franchise.

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1 Past performance is not a reliable indicator of future results.
Source: Stewart Investors investment team.
2 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. All data in AUD.
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- **Coloplast**: The first mover in ostomy care products in Europe, Coloplast has built dominant market share on the continent. The intimate nature of these products ensure that they are hard to displace, making sales recurring common.

- **Arista Networks**: Owner-managers looking after a franchise providing the infrastructure for cloud networking. Arista has been taking market share quickly from the incumbent Cisco, with a focus on research and development and conservative financials.

- **Philips**: A healthcare conglomerate with leading market shares in their core areas: respiratory kit and patient monitoring systems. Philips has been going through a process of divesting non-core businesses and bringing more focus into the business under the current CEO, their direction of travel increasingly positive.

Whilst these companies have individual risks, we believe that the overarching risk for all of them during this time of crisis is deferment of orders and contracts, which could in turn affect sales and earnings. Looking beyond this though to the longer term, these companies have sustainable structural tailwinds supporting their continued long term growth, competent owners or management teams stewarding them, with either net cash balance sheets or low leverage as compared to stable cash flows. All of these companies are still small positions in the portfolio, and we hope the coming months will allow us the opportunity to increase some of these position sizes.

To make way for some of these new additions to the portfolio we have sold out of seven existing holdings. These are: SGS, Merck KGaA, OCBC Bank, Packaging Corporation of America, Illinois Tool Works, Atlas Copco and Kansai Paints.

While we believe that these are all quality companies, the common risks for them were twofold: leveraged balance sheets alongside cyclical cash flows that could fall precipitously over the course of a downturn. These two risks for these companies also sit alongside valuations that left no room for error. Given the arising opportunities to buy into some new ideas which we believe have more predictable cash flows, structural growth, and less leverage, we took the decision to sell out of these companies.

How are we preparing for the uncertainty of the days ahead?

"We will not succumb to irrational exuberance in good times, nor to unjustified gloom in bad times." – Stewart Investors Hippocratic Oath.

We are certainly not oracles of the market – we cannot say with certainty if economic recovery is around the corner, or whether the path will be long and drawn out. It is easy to come up with scenarios of lasting economic pain, especially at a time when lives are at stake and our social fabric is being turned upside down. It is especially at times like these that we try to hold steady to our Hippocratic Oath, and focus on where our skill set lies: bottom-up investing.

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The Worldwide Sustainability Leaders portfolio remains resilient, with a few new additions of strong franchises. We believe the year ahead could provide us with some exciting opportunities to buy or add to our favourite companies – those benefitting from sustainable growth tailwinds and stewarded by some of the best managers. We remain focused on analysing these companies with a bottom-up perspective, and focusing on their long-term future.

Additional performance

Performance as at 31 March 2020 % AUD net of fees	Strategy 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 Leaders Fund	10.3	8.5	10.4	10.3	8.6	6.9	-0.8	-1.6
MSCI AC World Index	10.4	7.5	10.9	9.2	6.8	3.0	-5.6	-9.7

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. This Fund launched in July 1997 and changed to a Worldwide Leaders investment strategy on 4 December 2013. Performance is shown to reflect the newer strategy only.

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