Mark Leach
Portfolio Manager

April 2020

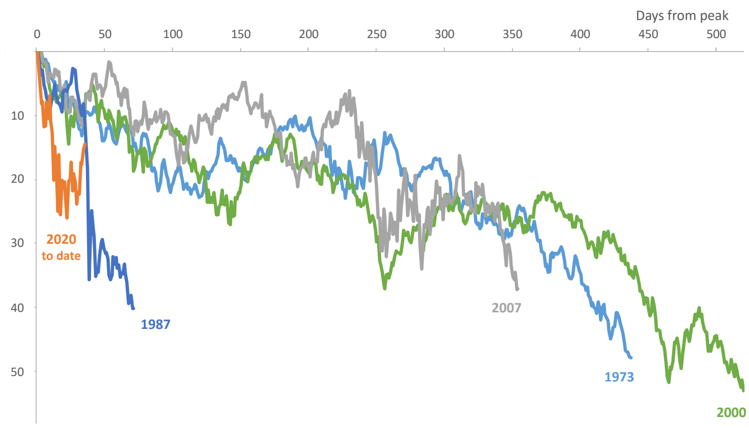
Quality… through thick and thin

> "If anything kills over 10 million people in the next few decades, it's most likely to be a highly infectious virus rather than a war… We are not ready for the next epidemic."
>
> Bill Gates, TED Talks, 2015

Life support

The speed and extent of the market correction in March were unprecedented. Between 21st February and 23rd March the MSCI All World Index fell 33%. The economic implications of a global lockdown on the scale of what we are experiencing today remain impossible to understand or quantify. Faced with a cliff-edge reduction in demand, the market went into freefall with only interventions, both monetary and fiscal, of epic proportions to provide some respite from an otherwise historic loss of capital value.

The shape of historical bear markets



Source: JH&P, using Bloomberg data rebased to 100

The market is a discounting mechanism for future cash flows, but the policy of containment has in a few short weeks pressed pause on the global economy in the hope that social distancing will end the spread of Covid-19. It is akin to putting a patient with severe head injuries into an induced coma, but what are the hopes of reviving the patient once the injuries are no longer life-threatening? What damage is done in the interim?

Whatever your views on this policy or on the lessons we must learn once it is all over, there is one thing we can all agree on: except for a few people like Bill Gates, none of us saw this coming.

> "There are decades where nothing happens; and there are weeks where decades happen."
>
> Vladimir Lenin

For the past 10 years markets have ground higher as low interest rates and weak but positive economic growth have created a benign environment. There have been episodes of stress, such as the commodities recession of 2015/16 or the market declines of late 2018, but in general not much has happened in a long time. It is in these periods that humans extrapolate the near term into the future. A level of complacency drives market values higher, and people forget what high risk and uncertainty look and feel like. The onset of the virus has fundamentally reset this trend, upending all the comforts and securities that had cemented into the market's consciousness. During periods of extremity our senses become enhanced and our perception of time appears to slow. In a very short time, all we know is risk and uncertainty; the move in the markets reflects the speed at which the virus brought this change about. Whatever the cause – a build-up of debt, the bursting of an asset bubble, a war or a global pandemic – eventually bull markets end and recessions follow.

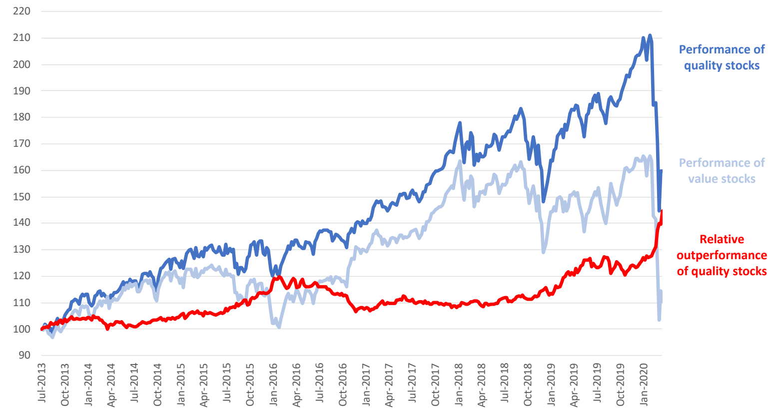
So how do we invest when a world economy built on global supply chains, just-in-time inventory management and consumerism is put on pause? How can any of the companies we invest in make money? In short, the answer is that it is very difficult but there are companies better placed to weather these episodes than others. If we look at the detail, we can see that in past weeks these companies have been significantly better homes for capital than many.

Quality

In recent years companies that are regarded as high-quality have outperformed the wider market and, in particular, *value* companies. This trend has accelerated since the pandemic took hold.

'Quality investing' is a term used to describe companies with higher than average returns on invested capital, strong balance sheets (a low level of debt relative to the profits they generate) and stability in earnings. These are the kind of companies that sit at the heart of our portfolios.

Quality stocks have outperformed value stocks



Performance from 19/07/2013 rebased to 100, MSCI Quality ETF, MSCI Value ETF, MSCI Quality ETF/MSCI Value ETF*100

At James Hambro & Partners, we look for businesses whose products or services are recurring in nature, mitigating the decline in demand during periods of economic weakness while at the same time benefiting from secular trends that drive higher demand in the future. In addition, as proven by their higher profitability, our investments have enduring advantages that allow them to protect prices, continue to generate cash flow and, through continued investment, defend and grow their market share. We look to own these companies through the good times and the bad. One of the key questions we always ask ourselves before making a new investment is: will this company emerge from a recession stronger than it entered it?

Value investing generally involves owning companies where revenues and earnings are more cyclical and returns on invested capital lower. Typically, profits vary due to one or a combination of the following: variable (economically sensitive) revenues, operational gearing (brought on by a relatively high fixed cost base that cannot be easily reduced) and financial leverage (where high fixed interest payments must be paid regardless of the profits made).

> "Buy a business. Don't rent stocks."
>
> Warren Buffett

Successful value investing requires a change in the status quo, a prediction of future change – an improvement in the macro environment, a successful turnaround, an improvement in the price of a commodity. In each case there is a bet that something might change, in many cases exogenous factors outside of the company's control. If we should learn anything about recent events it is that we are not good at predicting the future. So why do so many investors think they can?

Successful investing, in our view, is predicated on time. The shorter the time horizon, the more likely an investment will fail. As can be seen from the chart above, investment markets can be extremely volatile in the short term. The longer the time horizon, the more likely one is to benefit from the underlying growth in company profits rather than a short-term change in the company's share price. Over time, investing in the long term in companies with steady and sustainable returns will provide a powerful compounding effect. This is very different to holding value investments, where the thesis is predicated on short-term change – at some point the asset must be sold and the capital rotated into a new idea. With quality, provided the growth and profit drivers remain in place, the holding period can be unlimited.

We're all human

These dynamics are well understood, but what we regard as often missed by the market is how owning companies with stable and predictable earnings is the best way to save us from our own human tendencies. In times of crisis all humans will to some extent suffer from the same emotional forces that can lead to poor, short-term decision-making. High-quality companies generally have lower volatility of underlying profitability, which in turn leads to a less volatile share price. The companies we buy therefore provide enough stability for us to own them through periods of market weakness, thus avoiding the pitfalls inherent within human nature.

Quality is persistent

Not only does lower profit volatility protect us from ourselves in periods of stress, but higher-returning businesses are statistically more likely to maintain those returns in the future. By default, companies with low returns are statistically less likely to become high-returns companies. Quality endures, good companies stay good.

Of course, there are some companies that will climb into the quality cohort, and investing in these will bring rich returns. But finding them is hard – and doing it on a consistent basis is nigh on impossible.

There is no doubt that value companies will have their day in the sun again. Indeed, should the global house arrest end sooner rather than later and the broader economic damage be contained, it is possible we will see a big upswing in economic momentum, driven by pent-up demand and loose monetary and fiscal policy. In this scenario value will trump quality.

But it stands to reason that to capitalise on this reversal one would have to time the entry into value. If you have owned value stocks during the downturn then you need a stomach made of steel to hold on in the hope of a recovery; having lost 50%, we need to see 100% return to end up back where we started. There is also the risk of permanent loss of capital. The extent of the current shutdown means that some companies with high levels of debt and cyclical revenues simply might not survive in the next few months.

Risk is personal

We are often asked how we value the businesses we own. Quality companies will typically come with higher valuations. It stands to reason that investors should pay more for a return that comes with lower volatility and higher probability. Every investor has a different set of criteria on which their choices are made. These include time horizon, the financial *capacity* as well as the *willingness* to stomach loss – risk and required return are personal. We are much more content holding companies that have a high probability of growing their profits at 10% per annum for a sustained period than a more speculative company that may or may not produce a higher return. The longer one holds quality companies with sustainable returns on invested capital built on superior market positioning, the less relevant the price paid today for those future profits becomes. Provided our analysis is sound and our expectations aligned, owning quality companies through thick and thin should deliver attractive risk-adjusted returns in the longer term.