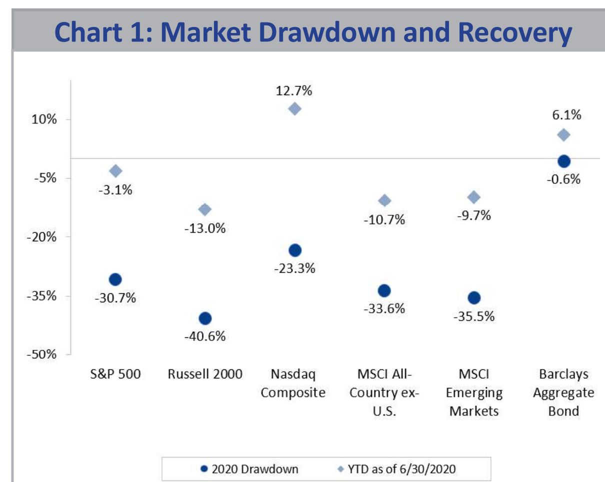
Our View

July 2020

Preface

Global equity markets rebounded strongly in the second quarter from late March market lows (Chart 1), exceeding many investor expectations that were acutely focused on frightful economic data and the continuing health crisis. Unprecedented global liquidity in the form of monetary and fiscal programs, improving economic data, and historically low interest rates, have led investors to the conclusion that equities are the only option for compounding long-term capital. While peak volatility is behind us, our base case is that a recovery to 2019 economic and earnings levels is a long way off. The most critical catalyst for a recovery is, of course, a vaccine or a proven therapeutic solution. There is reason to be constructive, even optimistic, that a vaccine may be feasible in 2021 with over 150 vaccine candidates in development and manufacturing plans already in place to produce on a monumental scale. Nonetheless, this crisis has revealed multiple fragilities that were underappreciated until they were so starkly exposed, and a rapidly evolving investment landscape that is revealing some important conclusions – including three that we believe will impact investors for years to come.

Chart 1: Market Drawdown and Recovery



Source: Bloomberg.

Investment Style - Redefining Growth and Value

Investors of capital in 2020 must confront and respond to breakneck technological innovation and disruption and its impact on the reliability of historical tools and lenses employed. A recalibration of core aspects of an effective investment management approach includes redefining the essential elements of “growth” and “value”. Interest rates and inflation are at the lowest levels in the investment experience of all current investors, as a result it is likely that price earnings ratios will establish themselves at levels considerably higher than the 15x-16x that has been the historical average. Fast and sustainably growing businesses will then deserve a premium valuation multiple above the new market level. In this environment of higher equity valuations, knowing what to pay for a stock will require manager skill at evaluating both the level, and importantly, the duration of the growth rate.

Disruptive innovation has accelerated the paradigm in which a franchise’s intrinsic value can be overwhelmingly derived from intangible assets and pioneering innovation that will ultimately drive future cash flow generation and growth (e.g. Apple, Tesla, Amazon, Facebook, Google, Visa and Mastercard). We are experiencing an explosive increase in our interaction with a digital world wherein companies create value through research and development as much or more than capital expenditures on physical plant and equipment. Value investing’s core tenet of a “margin of safety” is established in this case by a technologically and competitively privileged business position and the resulting durability of its growth prospects rather than metrics such as statistical cheapness, tangible asset values, or financial engineering. Conversely, the disruption of incumbent business models and even entire industries means that traditionally “cheap” companies increasingly carry the risk of getting cheaper as they cede their market share and earnings (e.g. Kodak, Blockbuster, Gannett). Historical frameworks that, for

example, associate value investing with low price-to-book and/or rely on reversion-to-the-mean to catalyze appreciation are too narrow to capture the opportunity set available in this environment. Traditional value opportunities will still arise as greed and fear swing markets from euphoria to panic and industries and companies suffer idiosyncratic dislocations. However, maximizing long-term wealth creation may require investors to deprioritize traditional "value" metrics and ensure their investment framework captures companies with the most robust trajectories towards becoming future leaders in their respective markets.

Portfolio Construction - Pivoting Away from Traditional Fixed Income

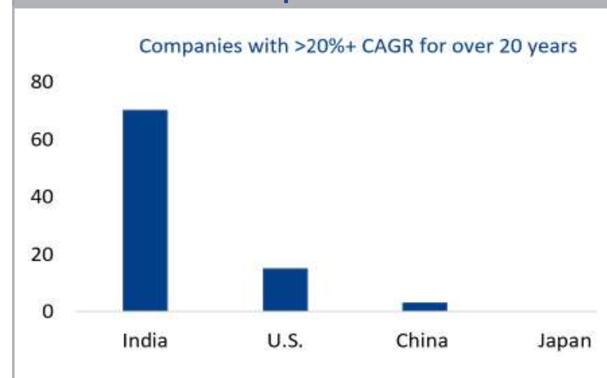
A decade or more of various crises has led to negative real interest rates to the detriment of investors and savers. One can no longer rely on government and investment grade corporate bonds for both income and diversification. Therefore, investors must recalibrate their approach to identify opportunities that will fulfill the role of traditional fixed income in portfolios. This is a serious problem for the standard 70/30 or 60/40 asset allocation model. Expected future returns for these securities have none of the characteristics or potential realized over the last 40 years, nor are they likely to provide the magnitude of portfolio diversification and protection enjoyed over that same time frame.

What does one replace 30%-40% of a portfolio with to reach a historically consistent return target while still maintaining portfolio diversification? As there are no free lunches, one must assume different risks to generate targeted returns. These risks can include less liquidity, lower credit quality, or higher volatility. Consequently, we have been utilizing several alternatives to provide an attractive combination of higher returns, diversification, and low correlation to equities, including managers that specialize in direct lending, music royalties, reinsurance, life insurance settlements and relative value credit to name a few. Many of these niche strategies have barriers to entry such as domain knowledge, and/or have an ample margin of safety that compensate investors for any additional assumed risk such as credit quality or liquidity, while avoiding other risks found in traditional fixed income today such as over-crowded strategies/trades and higher duration, which is susceptible to an increase in future interest rates.

Geography - Focusing on Asia

For U.S. based long-term investors the most attractive geographic region outside the U.S. is developing Asia. Compared with many developed markets and other emerging markets, Asia benefits from secular socio-economic trends that should remain in place for at least a couple of decades and creates a long runway of growth for many companies. This makes the region one of the most attractive in which to find long-term compounders of invested capital. India, for example, has the highest number of public companies that have generated an annual growth rate of 20%+ over the last 20 years (Chart 2).

Chart 2: India Leads the World in Sustainable Compounders



Envision Capital; From 10/1/1999 to 9/30/2019. Data is based on relevant indices (India: BSE 500 Index, U.S.: S&P 500 Index, China: SSE Composite Index, Japan: TOPIX 500 Index). Source: Bloomberg.

In addition, many Asian markets are substantially less efficient than developed markets, with low to no research coverage on publicly traded companies and a high dispersion

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of returns, creating significant opportunities for active portfolio investors. One would also expect a significant tailwind of capital flows into developing Asia in the coming years as index providers such as MSCI adjust their constituent weights to reflect more fairly the market capitalizations, economic sizes and investment opportunities in the region.

Portfolio Positioning

Our conclusion is that to generate strong risk-adjusted returns over the coming years we must adapt. The shifting investment landscape requires us to recalibrate our tools, it requires agility, and it requires avoiding antiquated paradigms that have been rendered obsolete. Practically speaking, it means embracing disruption and the companies that are creating it. It requires avoiding traditional fixed income with negative real yields and seeking a margin of safety and diversification from opportunities that are not crowded. It also suggests that when investing outside the U.S., one look to Asia for the best combination of growth at an attractive valuation, and thus expected returns with reasonable risks. This is how we are positioning portfolios.

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