Investment Managers

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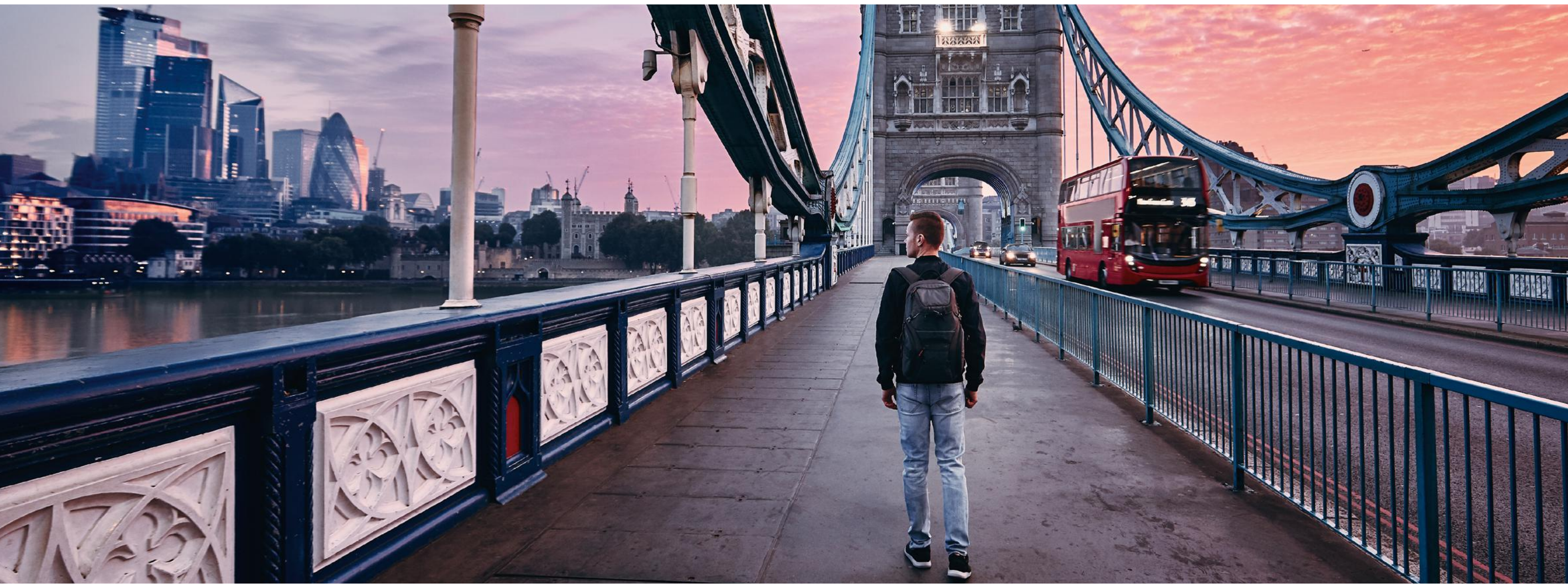
Active investment: Cutting through the geopolitical noise



> **I think that you will all agree that we are living in most interesting times. I never remember myself a time in which our history was so full, in which day by day brought us new objects of interest, and, let me say also, new objects for anxiety.**

Joseph Chamberlain, 1898

The rules of global trade are being redrawn and the pace of innovation – described by the economist Joseph Schumpeter as ‘creative destruction’ – continues to impact traditional industries, and our way of life. This is inevitably creating business dinosaurs as quickly as it is producing the economic generators of the future.

The reporting period has once again been characterised by seismic macroeconomic and geopolitical events. US President Donald Trump has been consistently unpredictable in his quest to fundamentally alter how the US trades with the world, particularly China. His confrontational, bellicose style plays to his core voting demographic; however, the ramifications of his protectionist trade policies are now becoming increasingly noticeable.

Global economic conditions are flashing an amber warning and although the causes may be nuanced – and country specific to some degree – the overall picture is one of economic slowdown. For example, the German manufacturing Purchasing Managers’ Index in September was at its lowest level since 2009. However, central banks have once again responded, increasing monetary stimulus via interest rate cuts such as in the US or further quantitative easing by the European Central Bank.

Global liquidity remains plentiful, inflation remains subdued, anxiety is widespread and over the past year, global equity markets have risen. What will turn this 'wall of worry' into a 'wall of fear' is not clear, while such loose monetary policy and plentiful liquidity is maintained.

In a world where $1.7trn (yes – trillion) of debt is generating negative interest rates , capital misallocation is possible. Although 'creative destruction' driven by technological advances is pervasive, low borrowing costs and plentiful liquidity is allowing the prolonged survival of numerous businesses which are able to refinance at increasingly lower interest rates.

Asset price inflation, fuelled by quantitative easing, continues to force the hand of politicians who must address the increasing frustration felt by those who are no longer able to buy a home – and whose net wealth remains static, while they have seen the net wealth of asset owners soar. Within the UK, this growing frustration has been well publicised – however, this is a global phenomenon. The unrest in Hong Kong, that started in June, has focused principally on the Extradition Bill. However, this is rapidly turning into a wider call-to-arms by young people in particular who feel angry at the practical implications of asset price inflation. Hong Kong property prices have grown fivefold since 2003 and rental costs have risen more than tenfold, and an estimated 1.4 million people there live below the poverty line.[1]

Closer to home, Brexit remains unresolved at the time of writing. The months – or rather years – of uncertainty has forced company management teams to put on a brave face and prepare as best they can for an outcome that they could not predict. In these circumstances, it is wholly rational for them to have halted capital investment, prefer temporary labour over permanent and let cash balances build. Clarity and certainty would benefit all stakeholders, including suppliers, customers and employees.

Focusing on fundamentals – and ESG

The last three years have been incredibly noisy from a geopolitical and macroeconomic perspective. We continue to look through this noise and seek to build well diversified, robust, actively managed portfolios of companies that offer compounding profits and dividends, and where balance sheet strength is supportive of that growth.

We remain in a privileged position where we have almost unfettered access to company management teams, allowing us to develop our understanding of individual company fundamentals, as well as develop strategic thinking that is reflected in our portfolio construction and stock picking. By researching company fundamentals at a granular level, we can build an understanding of the strengths, weaknesses, opportunities and threats that impact both individual companies and the industries in which they operate.

As active fund managers, we can allocate capital and invest in businesses based on their ability to consistently increase their economic output and generate a return in excess of their cost of capital. In addition, we can avoid allocating capital to those businesses that are in structural decline.

An active stock picking approach also allows us to engage with companies in order to help improve their environmental, social and governance (ESG) standards and to encourage the best corporate practices. Nobody, not least Generation X, will thank us for allocating capital via computer algorithms that have no regard for the welfare of employees or the environment.

Our strategic thinking continues to develop with input from numerous sources, in particular the many company management teams we meet and engage with. As fund managers, we tend to comment only on the investments we have made, rather than the ones we have avoided. By developing our strategic thinking, we aim to add value to both decision-making processes.

Unearthing opportunities

Holdings such as Rentokil are benefiting from the increasing expectation in emerging economies that both home and the work place should be pest-free. At the same time, climate change is causing an increase in pest infestation in some areas, including in the US, creating more demand for their services. Worldpay, now owned by FIS, continues to experience a boost from the increase in e-commerce and electronic payments globally. Spirent is seeing ongoing growth in demand for electronic content and data usage as 5G networks and handsets are developed and rolled out.

Meanwhile the global expansion and development of credit offerings, together with the operationally enhancing output of 'Big Data' analytics, is positive for Experian. Dramatic improvements in the understanding of customer behaviour is influencing everything from the type of product to timing and place of launch, in order to maximise the chances of success. As electric cars become more pervasive, Applegreen, owner of the Welcome Break motorway service stations in the UK, is well placed to benefit – footfall and dwell time at these locations are increased as electric car owners wait for their cars to recharge.

UK equities have become one of the most unloved asset classes globally since the decision was made for the country to leave the European Union. The 2016 referendum result was unexpected, and economists, financial markets and currencies reacted violently to the news. Within global equity funds, UK equity allocations are now materially below historic levels, reflective of withdrawals of over $30 billion from the asset class over the past three years.[2] Falling investor appetite, equity withdrawals and general apathy towards UK equities has resulted in a dramatic derating of the asset class relative to global equities. The MSCI UK Index – a proxy for the benchmark for our multi-cap UK equity fund – is now circa 30% cheaper than the MSCI global[3] across a blend of factors – price-to-earnings ratio price-to-book value and dividend yield.

The spread between UK equity earnings yields and bond yields – the FTSE All-Share Index yield was 4.3% in February 2019 versus 1.2% for gilts - has only been wider during the First World War.

[1] In Hong Kong, One in Five are Living in Poverty, Bloomberg, 19 November 2018
[2] EPFR Global Data; Investors pull billions from UK on prospect of no-deal Brexit, The Irish Times, 2 September 2019
[3] Morgan Stanley as at 31 March 2019

This anomaly has been identified by activists, private equity and corporate buyers.

It is worth noting there has been a material rise in corporate activity in the UK equity market, likely driven at least in part by these fundamentally attractive circumstances. RPC, Inmarsat, Cobham, Merlin Entertainments, Entertainment One, Greene King and British Car Auctions (BCA) – stocks within the more domestically UK-focused FTSE 250 Index – have received takeover bids this year, underlining the attraction.

We remain focused on UK- and internationally-exposed businesses, where the fundamental drivers of profit remain entrenched, and equity holders benefit from the capital allocated and risks taken by management. We continue to believe that a rewarding strategy is to actively invest in UK-listed companies that are compounding their earnings and dividends, where corporate governance is world leading, where contract law and title law are dependable, and where company management teams are permanently accessible.

Chris St John

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