WALTER SCOTT

BNY MELLON | INVESTMENT MANAGEMENT

Quarterly Report

GLOBAL COMMENTARY

Quarter ending 31 December 2019

QUARTERLY COMMENTARY

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COMMENTARY

Our fourth-quarter investment commentary of 1999 contained an emotive-sounding, but nonetheless accurate and appealing formula:

INVESTMENT NIRVANA = COMPOUND GROWTH x TIME

There wasn't much of an accompanying explanation, but it was shorthand for extolling the virtues of buying attractively valued companies that are able to deliver consistent and sustainable earnings growth over the long term. Our view then, as it is now, was that holding these compounders of wealth over time represents the best way to maximise returns for our investors, whilst mitigating risk.

In that December '99 report, our focus on stock fundamentals saw us bemoan some of the escapades of the dotcom companies as the decade drew to a close, citing Alan Greenspan's remark about a number of them closely resembling lottery tickets. However, while we were worried about speculative forces running rampant in parts of the US market, we saw signs of some Japanese companies becoming more shareholder-return focused. This latter journey has proved to be a long and winding road, though progress has undoubtedly been made.

"Nobody rings a bell at the top or bottom"

The first ten years of the new millennium saw the bursting of the dotcom bubble, the tragedy of 9/11, and the financial turmoil of the Global Financial Crisis (GFC). It was a 'lost decade' for equity returns - if you owned an index fund. Our investment approach does not comprise of asset allocation, singling out particular sectors, following market trends, jumping between 'growth' and 'value', or market timing. As we noted in a report to clients in December 2009, "Buying at troughs and selling at peaks would have generated a good return, but that is an extremely difficult strategy to pursue successfully, hence the expression 'nobody rings a bell at the top or bottom'". Performance was a function of our belief, "that a disciplined and focused stock-picking investment approach can deliver results in excess of whatever the markets deliver".

The ten years since then have been a period of strong equity market performance as the world has recovered from the GFC, aided and abetted by adoption of extreme monetary stimulus in the form of quantitative easing. China has continued to be a major, though arguably maturing, engine of world growth. The US economy has enjoyed a record-breaking period of economic expansion, although Europe and Japan have experienced relative torpor. The 2010s were not without their own bouts of volatility, induced initially by the multi-year euro-zone debt crisis, and more latterly, as a result of the ongoing trade disputes.

Stock market phases, fads and cycles have come and gone. Throughout these periods our investment approach has been unwavering in its focus irrespective of the market environment. It remains our view that equity markets ultimately reflect the underlying earnings power of corporations. Staying the course in companies that can compound wealth over time avoids the traps set by the twists and turns of market moods.

"Growth, profitability, balance sheet strength, ESG considerations and valuation are key pillars of our analysis"

We care nothing for index weightings. If a company does not meet our rigorous investment criteria, irrespective of its influence on an index (and equity market vogueish-ness) it will not be bought. Over the years we've regularly put the constituents of the FAANGs through the rigours of the research process, analysing and debating their investment worthiness. Growth, profitability, balance sheet strength, ESG considerations and valuation are key pillars of our analysis. We pass judgement on the dynamic between these fundamental metrics. As such, most of the FAANGs do not pass muster in our view.

We acknowledge that FAANGs have been notable contributors to the performance of the MSCI World index over the last ten years. However, from our perspective, the investment universe is replete with opportunities beyond FAANGs. There are many leading companies that have delivered robust earnings growth on a long-term basis across a myriad of industries. These are enterprises that can adapt and innovate whatever the cyclical or structural challenges, whilst maintaining robust balance sheets. Businesses that are at the forefront of secular changes that are shaping our world, and/or are able to create their own opportunities.

"Economic torpor does not necessarily translate into corporate lethargy"

Companies such as NIKE, which has been highly successful in taking advantage of the growing global (and Chinese) appetite for sports apparel. Thanks to constant product innovation and a flair for marketing, it has become one of the most recognisable brands in the world. Similarly, leading publishing software company Adobe, through its suite of leading products, is the enabler of most digital experiences; uniquely positioned as the dominant supplier to both the professional market and an increasingly larger number of casual creative publishers.

Winning companies can be found anywhere. A country's economic torpor does not necessarily translate into corporate lethargy. A tough environment can be a breeding ground for enterprise. There exist many examples of European and Japanese companies that have carved out a strong and sustainable growth niche. How a particular regional index has performed and how portfolios are 'weighted' in it, matters little. We invest where we find the stocks that meet our investment criteria. The razor-sharp focus on individual stock opportunities is ultimately the determinant of portfolio return.

"Value may have its moment in the limelight, but it will be fleeting if not backed up by growth"

The rise in stock markets has resulted in higher equity market valuations at a time of tepid earnings growth, although it is also the case that higher valuations have reflected this investor pursuit of 'quality growth' in a number of sectors. In our view, there may not be much headroom left for valuation expansion. That said, the monetary distortion induced by QE has seen the shadow of negative bond yields spread across parts of the developed world. Even given muted corporate profits growth in the short term, the contrast between bond yields, and earnings and dividend yields, remains as marked as ever. While this monetary largesse has been a recipe for valuation expansion, at some point we may see a rotation towards 'value'. Periodically, particular investment attributes may come into vogue. Value may have its moment in the limelight, but it will be fleeting if not backed up by growth. Assets deserve to look cheap if they are not productive.

A defining trend of the past decade has been increasing investor acknowledgement that environmental, social, and governance considerations (ESG) are vital in the stock evaluation process. We've always woven ESG into the fabric of company analysis. Rather than formulaic box ticking, we examine each stock on a case-by-case basis, often incorporating desk analysis with on-the-ground field work.

Two members of the Research team recently visited Vietnam and Bangladesh to evaluate the economic and ESG aspects of multinational supply chains. We were impressed by Vietnam. The compact between industry and workers is strong for a developing nation, with the latter group able to make a living wage in an acceptable working environment. Less impressive was Bangladesh. Five years ago, a member of the team had visited the country following the collapse of the Rana Plaza factory in the capital Dhaka. In the wake of the disaster, the global apparel industry assisted in improving building safety standards. Unfortunately, local manufacturing appears to have gone backwards in areas such as workers' rights. Wages, although higher in nominal terms, have stagnated or even declined as factory owners have been squeezed by higher regulatory costs. We view this situation as unsustainable. Consequently, the decision by some consumer-facing multinational corporations not to make Bangladesh a strategic pillar of their sourcing strategy appears sensible.

"Research trips such as these are vital ingredients of our investment process"

The energy sector sits alongside global supply chains as one of the most intense areas of ESG focus. A member of the Research team recently joined EOG Resources on the company's first two-day ESG-focused field trip in the US. This gave us the chance to learn more about the specific technologies being used across its operations to address individual environmental issues and risks. EOG Resources is an undisputed market leader in the field of shale oil fracking. Its pursuit of operational efficiency is highlighted by the fact that the oil price required to generate a 10% return on capital employed has fallen from US$81 per barrel in 2016 to US$55 per barrel in 2018. Less heralded have been the considerable advances EOG is making in addressing environmental considerations. This is manifest in the progress the company is making with regards to flaring, gas leakage, water utilisation, and diesel consumption. In the Midland Basin, despite the company delivering high rates of production growth, EOG has managed to reduce the amount of gas it flares to just 1% of its gas production in that field. In the Delaware Basin, EOG is now reusing 90% of its water, compared to 60% in 2018, with only a 9% dependency on fresh water. Overall, our visit demonstrated the progress, success and financial merits of the environmentally focused innovation and investment programme the company is undertaking.

Research trips such as these are vital ingredients of our investment process, and yield far more for us, information and insight-wise, than pontificating about ongoing ‘macro’ uncertainties: Brexit, the impeachment of President Trump, the protests in Hong Kong, the slowdown in China, and strife in the Middle East. Uncertainty and volatility are inherent in equity markets. Far better to focus our research efforts on companies across the globe that can adapt and innovate irrespective of structural or cyclical hurdles. The ‘outlook’ for us will be, as ever, to focus on fundamental analysis at home and on-the ground, investing in financially strong companies that can deliver long-term profit growth.

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