WALTER SCOTT

BNY MELLON | INVESTMENT MANAGEMENT

Quarterly Report

GLOBAL COMMENTARY

Quarter ending 31 March 2020

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QUARTERLY COMMENTARY

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COMMENTARY

How distant the optimism evident at the start of the quarter seems, with new highs in a number of major indices giving way to market falls of the magnitude not seen since the crash of 1987. The restrictive measures enacted to combat the spread of Covid-19 are impacting almost every aspect of economic activity. To counter their effects, extreme monetary largesse is increasingly being augmented by massive fiscal stimulus, as governments grapple with the prospect of recession.

What happens next is difficult to determine. Whether an eventual economic recovery as the virus abates mirrors the V-shaped one redolent of the post-seasonal acute respiratory syndrome (SARS) period, or the world slips into a prolonged downturn remain probabilities that are hard to weigh.

Our investment process is deliberately not founded on making such macroeconomic or asset allocation calls. In turbulent times, we employ a tried-and-tested process that has remained unwavering and rigorous throughout cycles, crashes and calamities.

"Balance sheet strength... is an attribute that comes to the fore in times such as these"

"Truth springs from argument amongst friends". So declared Scottish philosopher and economist David Hume. On a daily basis, we've been analysing and debating; probing balance sheets and stress testing our belief that the companies held will meet our long-term expectations. The rapid onset of the downturn has seen many businesses being squeezed both by a lack of customers and ongoing supply chain disruption, with concomitant effects on revenues and cash flows. Balance sheet strength, a constant and defining requirement of our investment criteria, is an attribute that comes to the fore in times such as these. We've been looking at levels of debt and interest coverage across companies held, gauging corporate resilience to the demand downdraught. We can't say how long the turmoil will last, but we remain encouraged by the financial conservatism inherent in their business models that we believe will stand them in good stead as the economic tide ebbs.

In a post-1987 crash report to investors, we posited that the best thing for the long-term investor was to 'do nothing'. But that statement belied the considerable activity and analysis that went on to ensure the holdings were fit for purpose. This crisis is more virulent. For some companies, the outbreak has tipped the risk and reward scales, and we've acted decisively where the investment rationale of a position has been compromised. However, with equal vigour we've also been looking at opportunities as they arise given the sharp market declines. Stocks on our watch list, which have been deemed worthy of inclusion but too expensive, are being re-examined, and additions to positions are being made as valuations versus long-term earnings prospects become, in our view, more attractive.

"A key component of that process is engagement"

We seek companies with strong balance sheets, proven management teams with an ability to adapt, and cash-generative business models, that can exploit long-term growth drivers despite the occurrence of short-term headwinds. We acknowledge that over the lifespan of a holding, the expected upward path of earnings progression is not always smooth. Competitive threats, technology shifts, economic turbulence, and industry downturns - many of the management teams of our long-standing holdings have successfully navigated crises in the past. Unquestionably, this crisis is severe in terms of its rapid and widespread bludgeoning of economies across the world, and few businesses are escaping, but our confidence in our retained holdings, and indeed our process, remains unchanged.

A key component of that process is engagement. We continue to enjoy good access to management amidst the current turmoil. Different companies face different challenges. Across a wide range of businesses the short-term outlook for earnings is bleak. Inevitably, the consumer sector is suffering significant turbulence. Yet the many discussions we've had with companies in a variety of sectors, continue to paint a picture of strong belief in the long-term drivers of their businesses, and in their ability to leverage on them, notwithstanding current travails.

In China, tentative signs of a return to normality have been seen. At a meeting with a major elevator company in February, the CEO commented that they were re-starting their Chinese production facilities. Underlying customer demand in China remains strong and construction companies are expecting a fast recovery aided by China's aggressive economic stimuli. In similar vein, although the current environment is certainly challenging, we were encouraged by the group chief executive's comments regarding the resilience of his pan-Asian life insurance company, given the political strife in Hong Kong and the Covid-19 damage in China. This has been enabled by the company's embrace of online sales. Now 101 years old, this business, having experienced cycles, political upheavals and wars, has retained its vigour in terms of adapting to new circumstances.

"It's not a question of long-term demand destruction, but near-term demand suppression"

Such companies are typical of many of our holdings. Market-leading products, strong brand identity, good execution of strategy, and robust financial health are defining attributes which in our view, augur well for long-term growth long after the impact of the Covid-19 virus recedes. And it will recede. It's not a question of long-term demand destruction, but near-term demand suppression.

As we survey the current equity market environment, we believe that quality companies with such profiles will prevail, and indeed, in the recent turmoil 'quality growth' has fared relatively better than overleveraged businesses with questionable long-term prospects. Included in our definition of quality are enterprises that adhere to the highest standards of ESG practice; that being intrinsic to the financial success of the business. As such we do not expect companies to take the foot off the gas in terms of further advancing their various ESG initiatives in such challenging times. It's part and parcel of what makes them successful and resilient.

Resilience was not a feature this quarter of the energy sector, which has reeled in the wake of the oil price collapse. This is only partly attributable to the increase in Saudi supply, as it also reflects a significant drop in demand. While it can be argued that a declining price represents a windfall for corporate and personal consumers, the sharp fall and reduced demand create the perfect storm for energy companies, especially so for those that have binged on debt. Consequently, capital and production efficiency, balance sheet rigour, adherence to best ESG industry practice and the ability to generate cash in a more difficult demand and price environment, have remained core in our evaluation of this sector.

"Our clients are best served by us sticking to our investment philosophy"

Since the inception of Walter Scott in 1983, we've witnessed a variety of crises and calamities. With its rapid onset and its reach into so many areas of economic activity, the Covid-19 pandemic is proving to be one of the most severe. It remains to be seen to what extent the barrage of monetary and fiscal stimulus acts as a buffer in an environment of extreme demand suppression and supply constraint. The ever-evolving nature of the outbreak and the concomitant policy responses present a perfect recipe for continued equity market volatility. Guessing an array of possible outcomes is a fruitless pursuit from our perspective. Our clients are best served by us sticking to our investment philosophy. Irrespective of market twists and turns, seeking financially robust, market-leading companies that can deliver long-term earnings growth has remained a constant in our approach. Adhering to that principle is the best course of action in the current turbulent climate.

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