Global Blue Chip Investor Update
May 2022

Fear and Greed

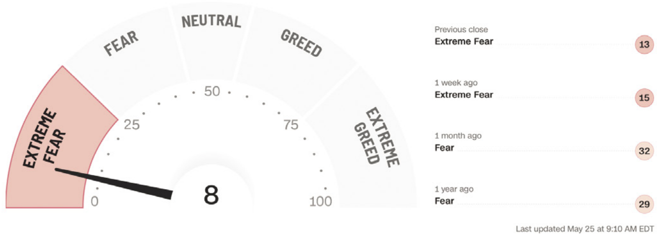
(Originally published 27/05/2022)

In March, we wrote to you to remind you exactly what you own via your holding in the Global Blue Chip strategy. At the time, global equity markets were down approximately 5.8% and your strategy had fared similarly (also down 5.8%)[1]. Two months on, and the situation has continued to deteriorate, fuelled, in part, by fear that inflation will now be more structural (rather than transitory). This calls into question the impact this could have on interest rates as Central Banks look to use the tools available to them to keep inflation at manageable levels. In the past, interest rate hikes have often preceded (and in some cases, caused) an economic recession.

> **Why does this matter for equity investors? For one thing, it casts doubt on a company's ability to maintain profitability at the levels recently witnessed.**

We know input costs (like commodity prices) have increased and if consumer demand depletes, the company will no longer be able to pass these costs onto the consumer. In addition, equity investors typically demand a higher return to compensate them for the additional risk they assume. Risk is relative, so when interest rates rise and investors can obtain improved returns on low-risk assets (such as cash deposits or government bonds) they, understandably, demand a higher return on assets further up the risk spectrum. You can alter returns in two ways: either the future cash flows from the underlying business have to improve, or the cash you initially outlay has to decrease. With little sign of the former happening in the current environment, this has resulted in substantial re-ratings, particularly for long-duration assets (those where the majority of the value is attributable to future growth yet to be achieved).

When you combine these headwinds with investor sentiment, which has plunged to lows not seen since the last time we were in a recessionary period, it is unsurprising to see markets fall 8.9% year-to-date (at the time of writing)[1]. With this backdrop in mind, the Global Blue strategy has held up well (down 8.7%[1]) despite not having any exposure to the Energy sector (the only strongly positive sector so far this year, up over 50%[2]) for reasons previously discussed.



Source: CNN

In the past, investor sentiment has often served as a good contrarian indicator and you will no doubt be familiar with the commonly quoted Buffett adage "to be fearful when others are greedy and to be greedy only when others are fearful". As many around us start to panic, our appetite is increasing and we are beginning to nibble.

What has and has not worked well for the strategy so far in 2022?

Our overweight allocation to the Health Care sector has provided the strategy's largest source of outperformance. Regular readers will know we have maintained this allocation for a number of years.

> **Our capital allocation decision at any one time is driven by the value we believe the underlying holdings offer us – we want to own more of businesses we deem to be trading significantly below our assessment of their intrinsic value (and where future returns are likely to be higher as a result) and less of those we deem to be excessively valued.**

In other words, our overweight allocation to health care is an outcome of the relative value we believed many of our companies within this sector were displaying, rather than a conscious decision to be overweight in a particular industry.

Similarly, performance has also been assisted by the strategy's smaller exposure to technology stocks – many of which required blue-sky thinking in order to justify their elevated share prices and which (although great admirers of many of the underlying businesses) we away from on valuation grounds. It's been pleasing to see this disciplined approach aiding performance during more turbulent times.

On the flip side, our largest detractor has been the stock selection within the Communication Services sector. As a sector, this has cost the strategy approximately 3% year-to-date, of which our investment in Netflix is attributable to around half. The widely held view is that . Whilst we remain sceptical of parts of this narrative, the company did report a decline in subscriber numbers last quarter (Netflix's first decline in a decade), which the market viewed dimly. When we make investments in businesses, we do so with the long-term destination in mind. Progression is rarely linear and our thesis is largely unimpacted by a single quarter's worth of results, which, in this case, fell below the markets' expectations.

That said, having had some time to reflect on our decision to invest in Netflix, it is clear we were too early. However, at current prices, Netflix looks attractive and we are very comfortable holding what we have in the company. Should subscriber numbers show signs of stabilising, we may look to add further to this. We continue to believe that the company is led by a world-class management team who has established a unique culture designed to maximise the value the company is able to deliver to its customers (and by proxy its shareholders) over the long term.

Another area that has been bouncing around harder than we would like has been consumer staples. Traditionally viewed as a defensive sector, regular readers of our updates will now know that input cost inflation (the rising price of commodity ingredients and packaging materials due to Covid disruption) has played havoc with these companies' margins. They were the first to be hit, acting like a canary in a coal mine, but pricing and valuations now look very reasonable. The sell-off has been quite targeted and those staples deemed to have pricing power (i.e. the ability to raise prices and not lose on volume) have been favoured by the market. This has led to a dichotomy within the sector. We have started to rotate out of the more expensive stocks whilst maintaining our position in some of those cheaper staple businesses that have undergone a derating. There is a good chance that, should inflation continue to rise, the derating will spread.

Where do markets go from here?

The truth is, as ever, we don't know!

> **Luckily our inability to reliably and repeatedly predict the short-term direction of markets has no bearing on our investment process.**

We try not to spend time worrying about aspects that influence markets that are beyond our control. Time is a limited resource, and we remain convinced that our investors obtain better outcomes when we redirect the time saved on matters where we have no edge or control to focus on the factors we do have an ability to influence – namely the quality of the businesses we are investing in and the price we are prepared to pay for such exposure (the subject matter of our second part of this investor update series). Provided we get these two aspects right, investors (with an appropriate time horizon) should be rewarded for their patience, irrespective of any adverse price movements in the short term.

With that in mind, we cannot stress the importance of being realistic about your time horizon when determining if an investment in the Global Blue Chip strategy (or any other investment) remains suitable for you. This is a point well illustrated by analysing the performance of the MSCI World over set rolling periods. The chart below shows the total return an investor would have achieved after being invested for a 10-year, five-year or three-year time frame (going back to February 1975, which is the earliest period we have the data for). For example, as of 30th April 2022, anyone who had been invested in the MSCI World Index for 10 years would have been sitting on a 237% return[1]. If the same investor had only been invested for five years their total return would have been 67% and for three years 40%[1].

Source: FE Analytics, Ravenscroft

However, what is important here is not the returns achieved, but the portion of these periods that resulted in a positive return for the investor. Of the 448 periods we have data for, 97% resulted in a positive overall return for an investor willing to stay invested for 10 years, 92% for five years and 86% for three years. The longer your holding period, the more likely you are to have experienced a positive return at the end of your investment journey.

Mike Tyson once quipped "everyone has a plan until they get punched in the mouth". This is quite apt for the investment industry, where it is not uncommon for people to declare themselves as long-term investors when markets are buoyant, only to sell out at the first sign of turmoil. This is a sure-fire way to lose money and something we endeavour to protect our investors from.

For discretionary clients, this is why we conduct suitability questionnaires. However, our ability to make appropriate investment recommendations is only as good as the data on which these recommendations are based. If you believe your circumstances have changed (or are likely to change in the near future) please get in touch with one of the team and we will be more than happy to assist you and ensure that you remain in the most suitable investment product for your unique circumstance.

For long-term investors where exposure to the Global Blue Chip strategy remains suitable, the good news is that, since the inception of the strategy, we have rarely witnessed times where we have been more excited about the future return potential of the overall portfolio. Whilst the strategy is down 9.4% from its November 2021 highs[1], some of the new positions we have been able to acquire are down significantly more. Netflix, Etsy and PayPal (all down in excess of 70%[2]) are good examples. These are businesses that possess the hallmarks of quality we look for but whose previously lofty valuations prevented us from being able to introduce them into the portfolio. As their share prices retreated, we had the opportunity to purchase these at valuations we deem attractive for long-term holders and these were funded by exiting other holdings where the value on offer looked less compelling (improving the profile of the strategy as a whole). In the third part of this update we will write more on the types of business we are looking at closely and how we intend to navigate the portfolio towards them.

'Wonderful' business at 'wonderful' prices

(Originally published 30/05/2022)

> **It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price**

So wrote the Chairman of Berkshire Hathaway in his 1989 letter to shareholders. Generations of investors have taken to such teachings of the Sage of Omaha - we're certainly no different on that front. As is always the case with the wisest elders, Warren Buffett doesn't offer up ready-to-eat answers on a platter. Rather, he points us in a helpful direction so that we may go on our own journeys and figure things out for ourselves. While his words are often profound, there are no shortcuts or simple answers in how to put them into practice.

From our various writings, it should be clear why we focus our attention on wonderful businesses rather than lesser ones. But as a quick refresher, let's turn again to Buffett (speaking to MBA students in the 1990s):

> **Time is the friend of the wonderful business. It's the enemy of the lousy business. If you're in a lousy business for a long time, you're going to get a lousy result, even if you buy it cheap. If you're in a wonderful business for a long time, even if you pay a little too much going in, you're going to get a wonderful result if you stay in a long time.**

So, it's a question of time. If your investment horizon is long, you could make time work to your advantage by sticking with wonderful businesses. Simple but powerful. For this reason, we put great effort into searching for such businesses on your behalf – and there aren't many that ultimately cut it, given that we pass on the vast majority. We generally tend to only think about price later on – if we can build up a wish list of what we consider to be the best businesses for both today *and the future*, we reckon that sooner or later we'll get the opportunity to own them at the right price.

But what is the "right" price? This, of course, is the other part of Buffett's equation and it's at least as much art as it is science. But when Buffett talked about the relative merits of "fair" prices for wonderful businesses, it's not impossible that he was being disingenuous (in his own impish way). When you look at the histories of many of the best businesses, it's not remotely uncommon for them to look "expensive" on the basis of widely used valuation metrics such as the price-to-earnings ratio. But as Buffett himself implied to the MBA students, the best businesses can continue in their successes for years to come, such that the price paid wasn't "expensive" after all!

We would characterise the bulk of the Blue Chip portfolio, from time to time, as sitting somewhere within the greater 'wonderful business', fair price paradigm. Wonderful businesses tend not to carry 'wonderful' prices especially often, for the simple reason that it's usually apparent that they're wonderful. Nevertheless, our *favourite* investments are indeed the best of both worlds: wonderful businesses *at wonderful prices*! For clarity, what we really mean by "wonderful price" is a stock that "looks cheap", and as a consequence is, in fact, *particularly cheap* given that it's a wonderful business to boot. Very roughly, around 20-25% of the portfolio is currently in such names and we're always thinking about how we can increase this percentage. Not only could these stocks increase the prospective return of the portfolio, but they could also *lower the risk* if selected well. We think this should especially be the case in an inflationary environment because wonderful businesses are more likely to be able to pass on costs and maintain their profit margins, although this might be somewhat offset by higher interest rates, which tend to make investors want to pay less for stocks. But if you pay less to begin with, you're already halfway there!

We have tended to find that in order to pick up such names at wonderful prices, there needs to be a stark contrast between the consensus narrative and our own assessment – in other words, the market disagrees that the business is wonderful. These aren't names you commonly see in popular portfolios of the day, so you have to be prepared to look different. These stocks are often therefore overlooked, and this can improve the risk/reward: if we're right the returns could be exceptional, but if we're wrong we've still likely got a fair business at a wonderful price, which perhaps isn't so bad, so long as we correct our misdiagnosis within a reasonable timeframe. When it comes to unearthing such names, we don't claim to be smarter than anyone else. Our method is simple – we focus our efforts on finding management teams that are proven and credible, *and then we take them seriously.* For one reason or another world-class business operators are sometimes disbelieved or simply ignored by the markets – we don't fully understand why, but therein lies the opportunity.

Here are a few current examples:

Stock	Consensus narrative	Our assessment
BMW	Asleep at the wheel	Leading the race
Oracle	Dinosaur going extinct	Butterfly emerging
Regeneron Pharmaceuticals	One-hit wonder	The Beatles

We have no special insights as to how the ongoing market volatility will unfold, as mentioned in part one of our update, but should the consensus narrative turn negative *systematically*, you might reasonably expect the wonderful-business-wonderful-price opportunity set to expand. This has happened in the past - for example very briefly in March 2020 at the onset of the pandemic, and more notably during the Global Financial Crisis of 2008 to 2009. Should we get such opportunities to potentially further improve portfolio risk/reward, we'll take them and this will serve us well in the future (this will be covered more in part three of our update). Volatility isn't always a bad thing if you're a long-term investor – unpleasant as it is to live through. In any case, our collection of wonderful businesses should be able to see us through.

"To be greedy only when others are fearful"

(Originally published 1/06/2022)

If you have read the previous two investor updates you will know how we are currently positioned, what we own and the type of business we would ideally like to own, should we be gifted the opportunity to do so. What we haven't explained is how we intend to get the portfolio from where it is today to where we would ideally like it to be. In this note, we detail that plan but as you may already know from reading part one, no plan is fool proof – especially after the *'first punch to the mouth'* – and this market has already dealt its fair share of blows!

What's the main objective?

We have always wanted to own some of the biggest and best companies that are aligned with our investment themes. Our focus on quality (the subject matter of part two, 'Wonderful' businesses at 'wonderful' prices) remains the same, as is our desire to buy such quality at a reasonable price. Finding 'mispriced' quality during the age of quantitative easing has been very difficult, however, the macro-economic landscape is changing rapidly as a disinflationary backdrop and easy monetary policy gives way to inflation, interest rate rises, and a more hawkish approach by central banks.

> **This transition from loose to tight, disinflation to inflation, low interest rates to a rate rising regime, creates a new set of problems, but also its fair share of opportunities.**

What will be the biggest problem that we are likely to face?

A sustained inflationary environment will see materially higher interest rates. This will increase the cost of capital and therefore the discount rate investors apply to a company's future cash flows in order to determine a net present value from which a valuation can be derived. The higher the discount rate, the lower the amount an investor would be willing to pay for that future cash flow stream. Arguably, the number of rate hikes expected by the market has already been factored in by equity prices. The unknown factor is whether inflation remains higher for longer and if further rate hikes are required.

Rising inflation will create higher input and operating costs for companies, potentially squeezing margins and profitability. Costs for energy, raw materials, ingredients, packaging etc. are already rising due to Covid disruptions and the Ukraine/Russia war. Should inflation become a sustained phenomenon, we should expect companies to incur higher wage bills and higher costs for other services, property and equipment, and their maintenance. In other words, expenses will rise and companies will have to combat this by increasing prices. *This is why we have always favoured companies with pricing power (the ability to be able to raise prices – without unduly impacting volumes).*

Economic growth may also be a problem. If you read the papers and study the stock market, a recession seems to be considered a highly likely outcome. With a Federal Reserve determined to destroy demand and bring it more in line with (Covid disrupted) supply, a 'hard landing', i.e. recession, is favoured amongst most market commentators. *This is why we try and look for economic agnostic growth due to product/service quality and product/service criticality. Is the product important enough or good enough for consumers to carry on adopting it and/or pay higher prices for it?*

> **The biggest problem investors are likely to have is with themselves. Keeping wealth intact through a bear market is tough.**

Emotions can run high and it's important to be able to see the wood for the trees as the narrative and headlines are likely to be very powerful. Negative narratives can invoke panic selling or hesitant buying and drive prices down below fair value into bargain-basement territory. For the patient (and prepared), *this can be a very fruitful environment festooned with opportunity.*

As Warren Buffett wrote in his [1986 letter to Berkshire Hathaway shareholders]:

> *"What we do know, however, is that occasional outbreaks of those two super-contagious diseases, fear and greed, will forever occur in the investment community. The timing of these epidemics will be unpredictable. And the market aberrations produced by them will be equally unpredictable, both as to duration and degree. Therefore, we never try to anticipate the arrival or departure of either disease. Our goal is more modest: **we simply attempt to be fearful when others are greedy and to be greedy only when others are fearful.**"*
> *(emphasis added)*

Are we there yet?

Whether we are there in terms of maximum fear is unknown. Based on the Fear and Greed investor sentiment index highlighted in part one, investor sentiment has been pretty dismal of late. However, just because sentiment is poor doesn't mean a bottom is in. As Mr Buffett suggests above, predicting times of maximum fear and greed is unpredictable, which is why we have always based the decision to own what we want to own on when valuations are attractive enough, thereby compensating us for the risk inherent within the investment.

Despite trying to discover a price at which we feel stock-specific risks are adequately compensated for, we cannot do much about the overall volatility of the market. As we highlighted in part two, we want to own the very best and it is our intention to 'load up' when they are cheap. Quality and cheap are two adjectives that are rarely used in conjunction with each other, yet you will see them during times of maximum fear, holding hands at the edge of the precipice, where investors are throwing in their towels, vowing never to buy another equity ever again!

Deciphering what constitutes as cheap is a hugely subjective matter. As a team, we have always been conservative in the way we model and forecast for the purpose of our discounted cash flow models which we use to determine the return potential of an investment – commonly referred to as the internal rate of return (IRR). We would typically look to initiate a position in a stock that offers a 10% IRR. We set this hurdle based on the assumption that a 7% IRR, all things being equal, would attain roughly the same rate of return as the broader market. The additional 3% would act as a margin of safety should we have overlooked something in the research or the company surprises with some negative news. If everything goes to plan, we should, theoretically, achieve an above-market rate of return.

It has been almost impossible to buy "10 percenters" during the easy money years between 2016 and late 2021 (unless, of course, you selected growth and margin assumptions to suit). As stated above, we do not participate in this folly, trying instead to be as conservative as possible without unduly handicapping ourselves.

> **That said, the number of high-quality stocks on our reserve list entering our buy zone is increasing at a rapid rate.**

The two questions that plague us right now are 1) whether 10% is enough given the uncertainty surrounding future economic growth, inflation trends, rising costs and the impact on profit margins at a time when central banks are looking to quell demand, and 2) which ones do we bring into the portfolio and which ones do we remove?

Nobody said it would be easy!

I started my investment career in 2001 during the 2000-2003 dot.com bear market. It was a prolonged and often brutal affair with lengthy periods of price declines punctuated, seemingly from nowhere, with vicious rallies that would wrong-foot many investors – often sucking them back in just before prices resumed their downtrend. It was probably the best grounding an investor could have asked for; conservatism has been seared into our approach as a result.

Unfortunately, there are few seasoned investors that had hands on the tiller of an equity strategy during the 70s who remain with us – an environment many commentators point to as resembling the scenario investors face today. However, we have studied to some degree that period and the more successful investors of the time owned companies that had pricing power and growth, and importantly they bought them on valuation multiples that were very, very attractive. To illustrate our point we will release an addendum to this series with examples from the period.

In order to give us the best chance to make money in this environment we will first need to minimise the downside. The best way to achieve this is to avoid overpriced securities in the first instance, thereby avoiding the worst of the sell-off. We believe that our conservative approach over the past few years has helped to do a large part of the sidestepping so far, the next step will then be to own the highest quality portfolio with the most attractive valuations on offer. This will require venturing to the precipice, no doubt at times of systemic or idiosyncratic turmoil and negative narrative, to grab 'cheap quality'. We'll make room for the most attractive all-round propositions through a process of consolidation and prioritisation with the intent of emerging with an even more robust and relevant portfolio for the environment we eventually transition into. That's the plan anyway... *now where is that smack in the mouth?*

If you have any further questions about the Blue Chip strategy or any of your investments, please do not hesitate to get in touch.

The Global Blue Chip Team

Sources
[1] FE Analytics (date accessed 17/05/2022)
[2] Bloomberg (date accessed 17/05/2022)

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