



see money differently

A photograph of an open book with white pages, tied with a white string bookmark. The book is positioned on the left side of the page, with the pages fanning out towards the right.

## **Nedgroup Investments Global Diversified Equity Fund**

Quarter One, 2020

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Performance to 31 March 2020	Nedgroup Investments Global Diversified Equity Fund <sup>1</sup>	MSCI ACWI <sup>2</sup>	EAA Global Fund Large-Cap Blend Equity <sup>3</sup>
3 months	-20.50	-22.50	-21.00
12 months	-13.22	-15.48	-14.25

### From safety to where?

I don't think many people saw this coming. An illicit, wild animal, food market in a region in China unleashes a global economic recession in the space of three months (or possibly longer; it depends on whether you trust the information coming out of China). The specifics are almost certainly unforecastable, but the pattern may be predictable.

I have been revisiting the deeper realms of my memory, raiding my university experiences. I dimly remember having an interest in the processes of disequilibria in economics, at a time when conventional theory suggested markets were always in equilibrium. Back in the day, we thought economic systems were rigid and only temporarily disturbed from equilibrium. Temporary disequilibria were thought to be created by 'exogenous shocks'; rare and isolated to world wars and the oil crisis.

Thankfully, theory has moved on. There is a much richer theoretical framework for the workings of complex systems. It harnesses insights from hard sciences and ecology. There is interesting work being done into how and why complex systems display differing degrees of resilience to shocks, how they move between alternative states or collapse and reform entirely. Specific shocks may be random (and exogenous to the system) but the way a system then shifts, either staying within predictable bounds or breaking into entirely new configurations is an endogenous property (and is, in some sense, predictable). Resilient systems can take outside shocks and stay within bounds of predictable equilibrium states. Fragile systems are vulnerable to shocks and can shift to entirely new states, where recent history and norms are no guide to the future. Previously robust systems can evolve into fragile ones. Fragile systems tend to be complex, concentrated, and highly connected, but lacking in diversity and idle, duplicated capacity.

The modern economic system, it seems to me, has evolved into a fragile system. Modern supply chains are highly complex and interconnected, making it very difficult to predict how they will respond to unforeseen interruptions. Many industries have become highly concentrated, with winner-takes-all type competitive landscapes. The ruthless pursuit of short-term efficiency, backed by heavy debt levels, has encouraged the removal of "fat" from companies and entire industries. Highly infrequent economic downturns which, when they rarely occur, are quickly neutered and rescued by government intervention, have allowed patterns of behaviour to take root which view risk as a one way bet. All of this drives the system away from robustness and towards fragility. All it needed was an exogenous shock to send us into a potentially unpredictable future.

This is why this recession is unlike all others we can remember. Triggered, not by the inner workings of a cyclical system (as we were once taught that recessions happened), but by a genuinely unusual, external shock. The shock hit individual behaviour first, then supply. Next it entered a feedback loop into demand. It started in one region in China and then spread to another. Then it spread to the world. It is fundamentally different to 2008 (not a shock, but the result of many years of lax lending) and to 9/11 (a shock but of limited scope), but as the history of behaviour teaches us, we are always doomed to fight yesterday's battles: so the policy response is tailored to the last crisis. Some strategists and commentators are suggesting the future will be different. This seems inevitable to us.

<sup>1</sup> USD Net return for the Nedgroup Investments Global Diversified Fund, A class. Source: Morningstar (monthly data series).

<sup>2</sup> USD net return

<sup>3</sup> USD net return

## Market review

How does this all sit within our framework of CEO, analyst and investor behaviour? First, CEO behaviour: in our view history is important. Where a business was before this crisis hit is the most important thing, rather than CEO behaviour right now. The stock market is still, thankfully, a fairly diverse beast. Businesses varied enormously in their patterns of behaviour leading up to this shock, during the 'good times'. Some behaved recklessly, taking risks, both operationally and financially. They are fragile. The current environment has not, and will not, be kind to them in our view. Others have behaved more responsibly. Some still carry the scars of painful, localised trauma, like many in technology after the long bust phase post-2000: they have low debt, wide profit margins and lots of free cash flow. Others still have a clear sense of purpose and pursue their aims patiently. Almost all companies will experience a demand shock, but their ability to cope and their resilience will vary widely. Demand will recover at some stage. The key, as a stock investor, is to back CEO behaviour which will allow a business to be in a fit shape to recoup that lost demand as it gradually returns.

Current CEO behaviour is, for the time being, redundant. All CEOs are basically behaving in the same way to our eye. They are withdrawing guidance, and shutting down commentary. Most are suspending dividends and stock buybacks. They are all hostage to how they behaved before this all started. We usually pore over management statements, but there isn't anything interesting to read at the moment.

It's all really about judging investor behaviour and there are two sources here. First, there are analysts. Analysts, for us, sit in the middle. They provide valuable insight into both CEOs' and investors' behaviour. They are conduits for information from CEOs; they generally trust CEOs and are led by their guidance and plans. But they are also partial windows into investors. They act as anchors and opinion influencers for those of us with less expert knowledge. We have always been interested in how analysts' views change. It can be tracked in a few ways. First, through their forecasts and recommendations, but these are a bit sluggish. Second, by what they write. Analyst language, as we call it, gives a faster moving window into hope, anxiety and scepticism in stock markets. Three months ago, analysts' language was calm, nay, optimistic. Salved by last year's tremendous performance and dashing of trade war anxiety, many looked forward to a benign year of steady growth and modest returns. Two months ago, little pockets of concern began to rise up. Those inhabiting the tech sector grew a little anxious about the impact on the supply of key components from China, as factories did not restart after Chinese New Year. A gathering recovery, from last year's transient interruption of the trade war, was modestly pushed out. This month, week by week, commentary has shifted and spread. First, analysts outside the tech sector began to work out almost everything has a component which is made in China; hence while China is closed it is difficult to make anything. Supply chains freeze. Still, this was viewed as a temporary interruption and nothing to worry about. Next, the start of all this, COVID-19, moved from being a Chinese problem to a South-East Asia problem. Still not too much anxiety, as we have seen it all before, with SARS and MERS. Then it spread to the world. An interruption changed to a one quarter recession; everything still framed as transitory. Companies would feel an impact, but it would not matter. Now the debate is how deep the recession will be, how long will the recovery take? But everything is still framed around recovery. In our experience, analysts' errors trend. The trend so far has been: dismissive, transitory, V-shaped recovery to slipping time of recovery.

For investor behaviour, the ultimate barometer is stock prices. In aggregate they are down, so clearly anxiety is up. But many relative moves have not really been what most expected. A few types of stocks have behaved as expected, as fears of a recession have built. Makers of basic food and soap, supermarkets and water utilities haven't gone down much. People still consume all of these things regardless. But many other areas which should have performed well, have not. Outside the small band of activities mentioned, very little has shown itself to be truly defensive (from a demand point of view) in response to this particular shock. Cinemas are usually counter-cyclical; they are all closed. Makers and sellers of alcohol? Nope, all the bars are shut and so are the duty free shops. Healthcare? Not really, as an overburdened health system has to focus on COVID-19, crowding out many other procedures. The list goes on. Most stocks now seem to completely ignore results announcements, no matter how good or bad, as investors assume what is happening now is no guide to what will happen next quarter. Instead stocks move as blocks: are they safe, are they not, do they fit this factor or

that? Most investors I read about are writing the same kind of thing: “do nothing, it’s too volatile”. Volatility is through the roof, which usually signifies that investors either have polarised views or are crippled by indecision. Inactivity means liquidity is really thin, so relatively small marginal orders move stock prices a lot. Smaller stocks, where liquidity is worst, have performed much worse than larger ones; an ability to sell a stock now carries a premium.

The other barometer of investor behaviour is the next derivative of prices: valuations. These sow more confusion. Stocks with low valuations before the crisis have performed terribly. This is because many of the cheapest stocks are the ones which have had the most reckless CEOs. They are loaded with debt and had sales and profits which were under pressure before the crisis hit. And valuations sit on shifting sands. Analysts have just started to move from talking to doing, slashing their forecasts for profits, sales and cash flow.

Amidst the wreckage, a few things are clear. Large stocks have outperformed small. This usually happens in bear markets as liquidity (being able to sell your stock) is valuable. So-called ‘value’ has performed much worse than quality growth. Quality growth stocks generally reside in technology. Many of these have rock solid balance sheets, loads of free cash flow and have become so entwined with the way almost every business works that they are more like safe utilities than risky, unpredictable growth stocks. The peculiarities of the crisis, with huge sections of the workforce forced to work from home, have rendered swathes of technology “mission-critical”. Losers have kept losing. Stocks which had performed the worst before the crisis have kept going down. Many reside in areas where the peculiarities of the crisis look likely to accelerate their potential demise.

Where from here? Governments everywhere have thrown caution to the wind. Interest rates have been cut, budget deficits are ballooning. Surely a recovery is inevitable? The debate is still when, not if.


## Portfolio review

Our performance has been as we would have expected. The portfolios have fallen, but in line with the indices. We would have hoped to have done better, but our equal weighting portfolio structure gives us a significant bias away from mega-caps, and mega-caps have held up especially well. The drag from being over-represented (as we always are) in stocks in the \$1-10bn market cap range has been severe.

We have not sat on our hands over the last three months. Early in January we decided to shift the portfolio back towards stocks where CEO behaviour was more orientated towards conservative growth. They varied from plodders like McDonald’s, Yum! Brands and Waste Management, to slightly racier businesses like ServiceNow. Many we had owned before, but became worried by other investors’ potential over-exuberance towards them, especially in the late summer of 2019. Their introduction diluted our exposure to stocks reliant on jittery investor anxiety unwinding (the closest we get to “value stocks”) and gave the overall portfolio more of a growth tilt again.

In early February we became concerned about the shifting environment for growth. We noticed the fanning out of the disruption to supply chains from the Chinese lockdown. We tend to worry when we see conditions getting harder for growth, as this makes it easier for CEO growth plans to miss, which in turn can drive up the risk of poor CEO behaviour (denial, blame and the like). Hence we moved to sell a group of stocks where the path of risk (up) seemed at odds with the path of scepticism (down). They mainly resided in the semiconductor and electronics industries. We sold around nine stocks, reinvesting, as always, into the remaining portfolio.

By late February we became increasingly worried by the spreading of risk. As demand conditions showed signs of weakening everywhere, we became particularly worried about stocks which relied on successfully executed recovery plans; recovery was going to be harder to execute. Hence we sold Royal Dutch Shell, Repsol, Chevron and Celanese. All looked the same to us – worsening profitability, missed plans, crumbling analyst support. We replaced them with another group of previously owned stocks, this time less growth orientated, more conservative. They included Procter & Gamble, Nestlé and National Grid.



In March we tinkered again. We sold the rest of our oil related stocks, in the aftermath of OPEC's collapse. We also decided we had seen enough to work out which business models looked genuinely counter-cyclical in the current environment. Some lay in areas of prior anxiety lingering from difficulties in 2017-2019. They included a video game publisher (Activision) and a large biopharma (Biogen).

We are reasonably happy with the portfolio. We have tried to position it to cope with most plausible scenarios, both dire and surprisingly benign. We are assembling lists of ideas residing in more severely distressed areas of the market, as anxiety is spiralling fast. Almost every stock we currently own now imbues a degree of anxiety, as most have stock prices below the start of the year. But most of them, we still believe, have anxiety which resides in transient reasons. Most (we cannot say all, as we will make mistakes) of our stocks are built to survive and recover. It is likely there will be a time to sell the stocks we feel the most comfortable about (with the confirming balm of stable or rising stock prices) and to enter areas of deeper anxiety. We don't think it is yet, but we are watching.

## Fund performance

Unlike our regional exposure, we do take significant positions between industries. These typically fall into two camps. Firstly, we are significantly underweight financials because we view the entire industry as having opaque reports and accounts, meaning we can't get comfortable with where the risk is. This means we simply don't invest in most financials. Secondly, our sector exposure can vary due to the degree of opportunity we find at a particular time.

**Overweight Industrials:** we can find an unusually large number of conservatively run businesses, with apparent analyst bias or investor bias, as macro worries cloud perceptions. We view many of them as much lower risk than they are given credit for. We have, however, culled a few names: the industrial recession "scar" of 2015-16 no longer seemed to be acting as a biased anchor point for some stocks (scepticism has dissipated), and compounding this, there are creeping signs of inflation, with some areas struggling to pass this through.

**Overweight Information Technology:** an inappropriate sector classification in our view as its scope is so broad, and the companies so eclectic. Within the plethora of tech sub-industries however, we have been able to find many opportunities which we view as low-risk (hard to break, sticky customers etc.), but tarnished with the "risky" traditional label for the technology sector.

**Underweight Energy:** Our energy weighting has varied since 2015. 2016 saw a brief moment of respite (and share price anxiety unwind) in a long cycle of trapped capital, and we saw an investor bias opportunity window open up. And again more recently when there was a run up in oil prices as inflation briefly promised to flicker into life in 2017 (our underweight served as an implicit, unintended macro bet, which we do not like to make). However, despite pockets of capital discipline emerging - particularly amongst large integrated oil companies with long investment cycles and a desire to pay dividends - the industry's fragile peace collapsed, and market share maximising tactics broke out once again. Hence, we sold the rest of our oil related stocks, in the aftermath of OPECs collapse.

Key sectors for relative contribution were Financials and Health Care. Financials is a sector that often gets clobbered as markets head towards a recession. Combined with aggressive global interest rate cuts, this led to the sector lagging the market. Our structural underweight generated significant alpha. Our overweight Healthcare, the best performing market sector, helped drive alpha, bolstered by strong stock selection, with DexCom (US medical devices) and Nihon Kohden (Japanese MedTech) leading the charge.

Key sectors for relative detraction were Industrials and Consumer Staples. Industrials is a sector that tends to be relatively sensitive to any economic crashes. This is one of our largest overweight in the portfolio, so



negative alpha was driven by an allocation headwind. Our Consumer Staples positive asset allocation was offset by negative stock selection, with Brazilian brewer Ambev and South African food distributor Bidcorp, leading the detractors.

Top contributors	Average weight	Performance contribution	Top detractors	Average weight	Performance contribution
Nihon Kohden	0.67%	0.2%	Ingevity	0.42%	-0.4%
Dexcom	0.68%	0.2%	Bidcorp	0.61%	-0.3%
Atlassian	0.72%	0.1%	Ambev	0.49%	-0.3%
Tandem Diabetes Care	0.73%	0.1%	CAE	0.37%	-0.3%
Sartorius	0.56%	0.1%	ALS	0.39%	-0.3%
		<b>+0.7%</b>			<b>-1.6%</b>

Among the analyst bias stocks, we identify companies where unusual or changing business models cause analysts to misunderstand them. Nihon Kohden is a Japanese company that manufactures and sells high quality patient monitors, defibrillators and brain scanners. They sell their equipment cheaply, generating profits from their high margin and recurring consumables business. The high quality of the products has led to word of mouth spreading amongst physicians, and market share gains. Analysts remain anchored on management's past of poor execution, persistently underestimating their unusual predictability and pricing power. Nihon Kohden outperformed in Q1 due to surging demand for patient monitors as hospitals respond to the COVID-19 crisis.

Looking at the analyst bias detractors, Bidcorp is a South African foodservice company, spun off from Bidvest. It benefits from the easy growth from consumer preferences shifting to eating out, and net-net from home delivery. It is also a predictable, and hard to break business as food distribution gives increasing benefits to scale, dense distribution models. Hence it tends to gently roll-up smaller players, gaining increasing barriers to entry in discrete markets. Analysts appear to find it too expensive and overlook its predictability as a business model. Disappointing results, driven by volatile political and economic conditions in many of the countries it serves in February as well as a shutdown of its key end markets in the hospitality industry due to the COVID-19 crisis in March, led to the share price drop during the quarter.

Within our investor bias stocks, declining share prices signal high anxiety. Ambev is a Brazilian beer manufacturer. It has high market share in Latin America and has been able to crank out plenty of free cash flow and reasonable growth. Recent growth has been disappointing (to both investors and analysts) largely due to the macroeconomic environment in Latin America. Analysts have become cautious, and (we think) too quick to interpret this as stemming from structural issues. Ambev's share price decreased 50.6% over Q1 2020. The share price dropped over the quarter as competition increased and weak Q4 2019 results were released at the end of February. March declines were primarily due to COVID-19 demand shock, driven by estimates that as much as 50% of Ambev's sales come from out-of-home channel sales, which have been negatively impacted by the virus.



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UK investors should read the Appendix for UK investors in conjunction with the Fund's Prospectus which are available from the Manager [www.nedgroupinvestments.com](http://www.nedgroupinvestments.com)

The Prospectus of the Fund, the Supplement of its Sub-Funds and the KIIDS are available from the Investment Manager and the Distributor or from its website [www.nedgroupinvestments.com](http://www.nedgroupinvestments.com)

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