NEDGROUP INVESTMENTS

see money differently

Nedgroup Investments Global Behavioural Fund

Quarter One, 2021

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***Fund name changed from Nedgroup Investments Global Diversified Equity Fund on 1st March 2021**

Performance to 31 March 2021	Nedgroup Investments Global Behavioural Fund[1]	MSCI ACWI[2]	EAA Global Fund Large-Cap Blend Equity[3]
3 months	2.2%	4.6%	4.3%
12 months	61.6%	54.6%	51.2%

You Look Good, But So Does Everyone Else

Over long periods we believe stocks (and changes in stock prices) are simple. A stock has two important attributes: the potential for enduring sales and the potential for enduring profits from those sales. In our view stock prices go up for two basic reasons: they are either successful "growth" stocks or successful "recovery" stocks.

A growth stock is a company with a growth plan. Growth plans are usually orientated around growing sales (with the belief profits will follow). When consistently delivered, the successful growth plan drives sales growth faster than average. The stock price goes up at least as much as the growth. Sometimes the stock goes up more than the growth: the longer a company delivers on a plan, the more it is trusted, and the less investors worry about it. This building trust can result in a higher valuation. A great example of this is a stock like Amazon. Over the last 10 years it has grown sales by 26% p.a. Its stock price has gone up 33% p.a. Compared to 10 years ago, there are now a lot more investors who trust Amazon: they believe what has been achieved is sustainable, and current growth plans are credible.

A recovery stock is a company with a recovery plan: a plan to recover what has been lost – sales, profits or both. Companies adopt recovery plans when they have done badly (and missed prior plans). After a company has repeatedly missed its plans it is less trusted. When a recovery stock delivers a recovery plan, its sales, and especially profits, go through a period of unusual growth. If sustained, trust is rebuilt, and the valuation also rises. A good example is Anglo American PLC. Over the last 10 years its sales have barely grown (1% p.a.) and its stock price has barely budged (-3% p.a.). But this hides two very different, lengthy periods. From 2011 to the end of 2015 Anglo American repeatedly missed its plans (initially they were growth plans and then they were recovery plans). Its sales fell by 6% p.a. and its stock price by 39% p.a. By the end of 2015, management finally put together a credible recovery plan. After five years of delivering on their plans, sales have grown by 9% p.a. (profits by a lot more) and the stock price by 25% p.a.

Long periods provide the time for evidence of effective plans to build. Over shorter periods, stock prices move more on shifting beliefs in the credibility of growth or recovery plans. Because, after all, plans are predictions of the future, and plans often fail. Stock prices anticipate success (or failure).

We are musing about such things because this quarter has been an odd one. A quarter when investor beliefs in the relative credibility of these two, very different, types of plans (growth vs. recovery) have shifted a lot. For reasons we will try to explore, investors now find recovery plans for previously poorly performing stocks more credible, while they have become more dubious on the credibility of growth plans, especially for stocks with particularly fast growth over the last few years. For the latter, there is an anxiety that the current good times cannot last. How do we now infer this? From a few simple factors.

There is no simple way to categorise stocks as growth or recovery. It is even harder to categorise them as credible growth or credible recovery. But there are a few proxies we can use. These proxies are called factors.

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[1] USD Net return for the Nedgroup Investments Global Behavioural Fund, A class. Source: Morningstar (monthly data series).
[2] USD net return
[3] USD net return

And the performance of stocks with similar factors can reveal the shifting investor attitudes to this slippery thing called “credibility”.

When a group of stocks with a shared factor perform differently to each other we can make some inferences about shifting investor beliefs. For Q1 2021, it is helpful to look at stocks through the lens of the following factors:

- Valuation: low or high
- Expected growth: low or high
- Past stock price performance (over one year and three years): down a lot or up a lot
- Some proxy for current profitability: low or high

A few key points, based on our experience:

- Stocks that have missed plans (either growth or recovery) tend to be mistrusted by investors. Signs of mistrust are low valuation and/or low past stock price performance.
- Stocks that have consistently delivered plans, tend to have high past stock price performance.
- Stocks that have delivered growth plans tend to have high valuations and high past stock price performance.
- Stocks with growth plans tend to have high expected growth and higher valuations.
- Stocks with new recovery plans tend to have low past stock price performance, low profitability and often low valuations (they are mistrusted).

This year mistrusted stocks with recovery plans have done very well. How do we know? Because stocks with low valuations, poor profitability and poor past stock price performance, as groups, have performed exceptionally well. Why? There are a lot of companies with recovery plans and an unusually high proportion of them have (so far) delivered on their plans. This makes recovery plans generally more believable. Recovery plans are often tricky to pull off, but if you start from a low base, have taken some tough decisions about your business to make it better, your customers have also gone through a similar cycle, and the government is doing their utmost to help you succeed, the odds of success improve. These conditions for recovery success have been building since the summer of 2020.

Conversely, this year trusted stocks with growth plans have not done well. How do we know? Because stocks on high valuations, with stock prices which have gone up a lot for a long time and with high growth, as groups, have not done well. Why? We have been through a strange period. Usually companies with growth plans miss their plans in a macro shock – it’s not their fault. For reasons outside of their control their customers can change their behaviour and spend less. This didn’t happen in 2020. Indeed, the opposite often happened. Many companies already growing quickly before 2020 found their growth plans to be too conservative last year. Their customers’ behaviour changed in unexpectedly helpful ways during the pandemic. Many stocks with growth plans also performed well after March 2020. But this year investors seem more worried about this exceptional growth: is it sustainable?

What does this tell us about the future? So far, 2021 has shown us that investors believe in recovery plans more than usual and it looks like recovery plans are easier to execute. It has also shown us investors are more anxious about the credibility of growth plans despite the evidence they are generally still relatively easy to execute. Investors feel they have more choice when looking for credible plans – more credible recovery plans, and plenty of credible growth plans. This is a significant change from pre-2020. Before 2020, credible recovery plans were scarce. Many companies tried to implement recovery plans over the prior decade, but a lot of them failed. Investors had grown wary and distrustful of companies peddling these types of plans. If you wanted to feel confident and comfortable with CEO plans you didn’t have much choice. You had to crowd into the credible growth stocks. Now you have a lot more choice.

Recovery plans don’t last forever. Once you have recovered, you need a new plan. Fortunately, if you like backing recovery plans, there is still plenty of recovery potential left. The slow path to re-opening, the stuttering roll-out of vaccine programmes, the gradual shift back to pre-2020 consumption patterns, and the actions of governments to smooth the recovery are all still playing out this year. There are many options and avenues for the rebuilding of trust in previously distrusted companies. This doesn’t make growth plans bad, it just makes them less attractive, and for the time being, less valuable.

Portfolio Performance

Key performance contributors	Portfolio weight (%)	MSCI ACWI weight (%)	Base return (%)	Excess return contribution (bps)	Designation
Lenovo Group Limited	0.74	0.02	49.43	29	Recovering value
Penumbra, Inc.	--	--	70.50	24	Easy growth
KIA Motors Corporation	0.66	0.03	26.34	21	Recovering value
Thor Industries, Inc.	0.52	--	44.64	20	Recovering value
Applied Materials, Inc.	0.54	0.20	54.97	16	Recovering value

Key performance detractors	Portfolio weight (%)	MSCI ACWI weight (%)	Base return (%)	Excess return contribution (bps)	Designation
BYD Company Limited	0.59	0.03	-38.11	-29	Easy growth
NIO Inc.	0.61	0.08	-34.81	-25	Easy growth
Alphabet Inc.	0.47	2.00	16.98	-21	Recovering value
Pinduoduo, Inc.	0.66	0.09	-25.34	-15	Easy growth
Elastic NV	0.45	--	-24.30	-13	Easy growth

We did not do well this quarter despite having a mix of recovery and growth. This was frustrating. It is a reminder of how complex and tricky stock investing can be: you can be 95% “right” in your beliefs, but the final 5% can make all the difference. We felt there was an important shift in Q2 2020, recognising that recovery plans should be a lot easier to execute and that there were a lot more of them. We also recognised the tone of many of these recovery plans was more credible than usual. We shifted the portfolio more into “recovery”. However, this year has revealed we did not shift the mix enough. We had too much growth and we got spooked in January out of some recovery.

We started January with a review of 2020. A lot had happened, especially in Q4. The arrival of vaccines transformed a murky, long and hard-to-predict path of re-opening into something far clearer and quicker. However, when we looked in detail at the experience of infections and hospital system stress in the UK, we felt even with vaccines, a quick path to re-opening looked unlikely. As a result, we worried about recovery plans reliant on a re-opening: were they too optimistic? At the same time we were lulled into a false sense on the portfolio’s exposure to recovery. Without getting too much into the weeds of our investment process, we have a few different “flavours” of recovery plans. Amongst our “Investor Bias (IB)” stocks in the portfolio (IB is the short-hand we use for stocks where we think the unwinding of investor anxiety will be the main driver of performance) we had quite a lot of stocks, bought prior to the pandemic, with growth orientated plans and recent downward shifts in growth ambitions. This transition had caused investor anxiety to build and provided us with an opportunity to buy them. Many of them subsequently performed exceptionally well in 2020 as they delivered on their new plans. This process of successful transition meant we started the year with quite a few recovery stocks which were starting to behave more like growth stocks.

To compound matters further, there were a few types of businesses where our assessment of risk has kept us away. In particular Financials (especially banks) and Energy sectors have a high proportion of mistrusted recovery type stocks in them and they performed especially well. We currently have no banks or energy producers. For the latter we are very wary about the unaccounted environmental risk of past carbon emissions. Because we are more distrustful of CEO plans than most, we also tend to have a bias towards some business characteristics (loosely termed “quality”) we feel give you better protection if/when plans go wrong. These quality characteristics also weren’t much in demand last quarter.

At the time of writing, we have completed one of our regular portfolio reviews: a hunt for interesting new ideas and a cleaning out of failing investment cases. The structure of this review has had a slightly different skew to normal. Idea generation has been focused on finding credible recovery stocks we have not looked at before and we have found a few. But it has also focused a little more on selling than usual. The most common reason we sell is when we become nervous about the continued credibility of CEO plans. With the passage of time, we always tend to find new areas of concern: either we have misread things and have to admit our mistakes, or CEO behaviour shifts and starts to stray into a riskier pattern. This review, however, we have sold more stocks for a third reason: to get the overall portfolio balance of recovery vs. growth plans right. We felt we could not get our balance to recovery where we wanted by finding new recovery ideas alone. We had to sell some growth stocks too. Most of the growth stocks we have sold still have credible growth plans, it’s just their stock prices have gone up a lot over the last few years, along with their valuations. They look vulnerable to the abundance of choice for credible plans.

Finally, we intend to dip our toe into the banking sector, which we have avoided in the past. Our experience of 2007-09 led us to believe we could not trust accounting data as indicators of CEO risk-taking in banking. The last 12 years have been an interesting period for banking. Regulations covering risk-taking have tightened considerably. Risk-taking disclosure is much, much better and banks have been forced to divert considerable capital to bolster their balance sheets, and to make them more resilient if they do make poor risk-taking decisions. The industry now has far better risk disclosure and is far better able to cope with risk.

After a three-year internal research project, involving the recruitment of a specialist banking analyst, we believe we are finally in a position to “trust the accounting numbers” again. We believe we can see a clear, collective pattern of risk-reducing behaviour emerge in banking, but so far much of the benefits have been obscured by two things. First the rebuilding of balance sheets has meant shareholders have not benefited yet – spare cash, which previously would have gone to reward investors has had to go into higher capital reserves. This is a form of catch-up for previous under-investment in risk management. We feel 2020 has been a good test for whether the catch-up investment in risk has gone far enough. The banking sector has coped extremely well with 2020. They have recognised credit risk far earlier and far more conservatively than before, and they have had the balance sheet strength to cope. We feel the regulator is unlikely to demand any further risk catch-up from here.

Second, the interest rate environment has been extremely unhelpful for banks in recent years. Low or negative interest rates and sluggish demand for credit make banking very difficult. But banks have had to adapt to survive. We think there is a reasonable chance that, from here, all you need is a stable interest rate environment for the well-run, low-risk banks (there are a few, we believe) to be potentially rewarding. As a result, we have lined up 10 banks around the world that fit our investment process, and we will be investing in them this quarter.

We believe the portfolios now have a better mix of recovery and growth, and the environment for successful recovery plans will remain benign for the rest of the year. We do not anticipate a smooth path to recovery; much still remains unknown about the path to containing the pandemic, and how the experiences of the last twelve months have perhaps permanently changed people’s behaviour. But we believe both recovery and growth plans can work.

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FEES

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