Hosking Partners®

Quarterly Commentary Q3 2023

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Positive performance relative to the benchmark over the most recent quarter, last twelve months, as well as the last three years is a gratifying reminder that Hosking Partners' unconstrained and contrarian portfolio of diversified and unfashionable stocks is more than able to hold its own against a benchmark dominated by the narrow leadership of the so-called Magnificent Seven. The largest 50 stocks in the S&P 500 currently account for 57% of its market capitalisation, a figure which has only been higher on two occasions - July 1932 and November 2000. Over the last 12 months the portfolio's Big Tech underweight has been a drag to performance which has been more than compensated for by the strong returns in the rest of the portfolio. As mean reversion causes the market to broaden, the Hosking Partners portfolio is well positioned.

In what may or may not be a sign of incipient market broadening, the longstanding Apple zero weight was the biggest positive contributor during the quarter. In terms of sector contribution to performance, the greatest impact during the quarter came from Energy, where in addition to primary energy producers, shipping names and oil drillers delivered meaningfully. On the negative side of the ledger the principal individual detractors were US airlines and casinos. The airlines are in part a natural hedge to our Energy overweight which stands as one of the portfolio's largest departures from the benchmark weight, at c.15% versus 5.2%, a difference of around 10%. The difference reflects our recognition of the long-standing and growing supply gap between the amount of energy the global economy needs in order to grow, and the growth in available energy supply, whether from traditional or renewable sources.

Portfolio activity over the quarter broadly reflect the portfolio's direction of travel over the last twelve months across sectors (increase in energy; decrease in tech) and regions (increase in Japan; decrease in North America). Activity was led by additions to the Japan basket, coinciding with a two-week visit to the country by two members of the investment team taking in more than thirty company visits as well as meetings with policymakers, activist investors and other market observers. Elsewhere, as rising day rates gave validation to the supply-constrained oil driller thesis which we

published in the Hosking Post Tangible Assets Strike Back, positions were added to a number of drilling companies. The barriers to entry for new supply in oil drilling were pithily summarised by a leading industry figure at a conference in September, referring to the latest generation of deepwater drillships: “you're probably talking a build cost north of $1 billion, all in, which means you have to believe that starting four years from now, you're going to get for a mid-teens return, a day-rate close to $900,000 a day at 90% utilization for 30 years”.

In reviewing the market outlook, an obvious question is whether the strong recent performance of the Hosking Partners portfolio will continue. As we write, a strong US jobs report has caused expectations for future interest rates to move higher and for longer, with the 30-year US treasury yield breaching 5% for the first time since 2007. The overused word “gyrations” seems a fitting way to describe the market’s reaction, whether expressed through bond and equity prices or the oil price. Investors are experiencing an extreme case of cognitive dissonance as they fitfully come to terms with the realisation that the fixed income bull market that began in 1982 may finally be coming to an end, with one moment hopes prevailing that a so-called Fed pivot will come to the rescue, the next moment the fear that “something will break” moving into the ascendancy.

For a long time now the prices of the Big Tech stocks have been beneficiaries of this confusion, with their prospectus of secular growth whatever the economic climate making them a safe bet whether the sun is shining or the storms blow. More recently, the arrival of artificial intelligence (AI) has reinforced the perception of Big Tech’s all-weather dominance as its balance sheets, scale and data sets allow it to be first to use AI tools to entrench its existing advantages. The Hosking Partners reaction to this gold rush is more prudent than original, that is to provide the picks and shovels in the form of semiconductors and semiconductor equipment manufacturers.

As capital cycle investors we keep a weather eye on capex plans as indicators of the direction of future returns. Analysis by Empirical Research Partners shows that at the start of this year sellside

analysts were anticipating +3-4% capex growth for the large-cap AI plays in 2024; now they are pencilling in +16% growth, a four-fold increase in nine months. It is not yet completely clear how the use cases for the resulting AI capability will be monetised in order to generate a return on the increased investment, something we will follow keenly. As generalists trained on seeing the bigger picture, we also wonder whether shadows on the more distant horizon presage changes in the regulatory environment which will act as a drag on Big Tech's returns, whether these shadows are Lina Khan's Federal Trade Commission (FTC) in her lawsuit against Amazon, the European Commission's various anti-trust and data-protection initiatives or even the UK's Competition and Markets Authority (CMA) in its recently announced investigation into hyperscale cloud providers. With our wider focus on supply rather than demand we are aware that one person's perception of barriers to entry may be another person's verdict of monopolistic behaviour, and the aggregator platforms would generally be vulnerable if there is a change in the application of competition rules.

If such a paradigm shift does occur and the future prospects of Big Tech are discounted a little more heavily, this may also be a catalyst for reversal of the ongoing underperformance of the value factor dating back to 2017, a trend which the contrarian Hosking Partners has been leaning into with increasing emphasis. It strikes us as obvious that it is the natural order of things that interest rates should be higher than GDP growth and higher than inflation if there is to be any assurance of price stability. This is especially so as governments in developed markets have experienced a windfall from the surge in nominal GDP growth which was caused by the bout of post-covid inflation. This means that despite the massive lockdown spending programmes, their combined debt-to-GDP ratios have fallen back to Q3 2019 levels, just before the global pandemic.

Having benefitted from the recent inflation, governments' emphasis is now on putting the inflation genie back in the bottle. A positive real rate of interest would have negative implications for those long-duration stocks whose valuations rely heavily on cash flows which are weighted mainly in the distant future. The portfolio's overweight to the old-economy sectors of Energy and Materials means

that it contains a diverse selection of companies which have put their years in the wilderness of investor apathy to good use by fixing their balance sheets. In the meantime, industry capacity has consolidated and rationalised to the point that now significant cash returns are already being given to shareholders in the form of dividends and buybacks, and improving profits mean that valuations now offer a wide margin of safety.

The portfolio's exposure to Japan, which is already at c. 12.5%, (a c. 6.5% overweight versus the benchmark) reinforces its value characteristics, with the additional benefit of multiple and longstanding cross-shareholdings. The effect of these cross-shareholdings which are now starting to be unwound and turned into cash is that effective enterprise values for our Japan stocks are substantially lower than indicated by unadjusted figures which do not take them into account. Our recent visit to the country highlighted the paradox that as investors gradually come round to the Japan opportunity and share prices increase, so too do the values of the cross-shareholdings, leaving the valuation anomaly almost attractive as it was as at lower prices! Click here to listen to Hosking Partners' Capital Cyclist podcast which focuses on the extraordinary, often hidden, value in Japanese equities at a moment when the country appears to be at an historic turning point.

As well as Japan, investment trips have been made so far this year by members of the Hosking Partners team to Korea, Hong Kong, Singapore, Turkey, Italy, Germany, France, Brazil, Chile and Mexico. The team arrive back at Heathrow feeling excited by the possibilities afforded by their unconstrained mandate and diversified approach. We continue to scour the world for out-of-the-way and undervalued opportunities.

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