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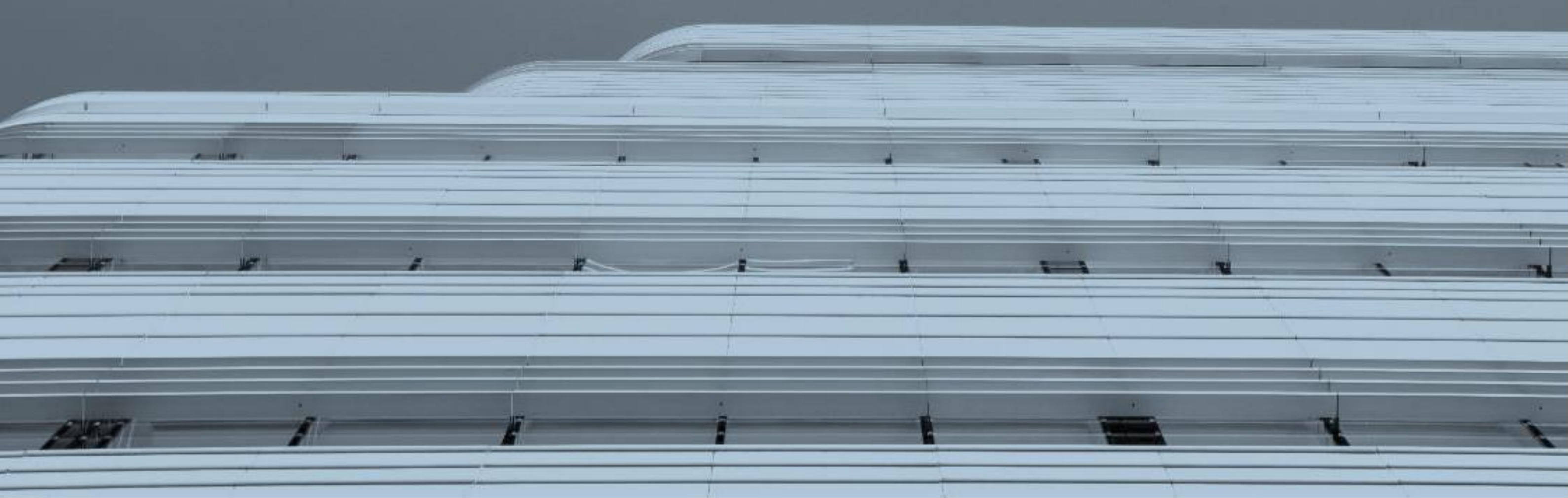
Covid 2020 – An Investment Commentary



No one will be more aware than Hosking Partners' clients that their portfolios entered "Covid 2020" with a skew toward value, and that stance was at least premature and arguably downright wrong. Then, based on a preliminary assessment of the risks posed by the epidemic we further surmised that the bear market would be brutal but short and that attempts (say in February) to raise liquidity would leave clients exposed from an excess of cash at the nadir point of the V-shaped collapse, which would lead us to be whipsawed.

Wrong again, as it turned out. In the midst of the crisis, governments around the world indulged in unpredicted intervention via national and regional lockdowns and even refused to adjust these political strategies in the wake of the Great Barrington "alterative view" of sheltering the vulnerable. Rather like a driver who has taken a wrong turn and won't admit it, it is now going to take many more quarters to reach the largely pre-ordained "correct" destination. Thus, in the popular alphabet-metaphor which investment advisors have been using all year, the V became a U and the U became an L until the tenacity of this virus (or the stop-start lockdowns) has produced the now familiar pattern of third and fourth waves such that the economic and stock market response resembles a "jagged edge W" more than anything else. All this has occurred in an era in which technological progress has been redefining distance and affecting corporate business models. Hence the popular analysis that Covid has catalysed the acceleration of almost all social and economic trends, apart from the popularity of sun-filled vacations on low cost airlines! None of the above is really in too much dispute. We are to embark on a two-year retracement back to a new normal that in some ways will resemble the old normal and in other ways not: "plus ça change, plus c'est la même chose."

What needs to be pointed out in all this is the surprising way that investors have responded. This has been bizarre both in its own way but even more so in contrast with the rather predictable narrative of this strange year, as described above. Hosking Partners has the ability to invest in value stocks as well as growth ones. Thus, although the trajectory of what we are going through has modified from V to mis-shaped W, the ultimate destination has not, in that we will still see an economic recovery powered by government monetary and fiscal policies on the one hand and the attenuation of the negative virus effects on the other. The main issue has been a duration change effect.

One would therefore expect that private sector capital would migrate during the pandemic to a degree, as a result of the profit taking in digital winners on the one hand towards dollar-cost averaging strategies in firms with business and share price recovery potential on the other.

Indeed, this is the very strategy our portfolio managers have been trying to put into effect. Profit taking has been going on all year with reinvestment in companies with: 1) lockdown recovery potential; (2) companies we admire and wished we owned more (or, some) of; and (3) firms with credible strategies of merging the new "digital" techniques with rich "analogue" legacy. Disney is perhaps the poster child of this group of so-called "convergence" companies.

Indeed, this is the strategy we at Hosking Partners have been trying to put into effect, and it is one which seems entirely consistent with the popular epidemic-related narrative. There is execution risk of course, and we are no strangers to the art of snatching defeat from probable victory. Nevertheless, the omens, whilst delayed by the triumphant progress of the virus, are now encouraging. We have expected them to be all year. First, there is the positive relative performance of our client portfolios in the fourth quarter. Second, at micro level, there are the 400%+ bounces since March in the share prices in some of the orphan stocks in the (much despised) long tail of our portfolio's investee companies.

The suspicion is that when the performance data steams out of the computers of the leading asset consultants, it will be found that smart and reputable firms have failed to capitalise on the biggest equity value opportunity since the Great Depression and have instead been doubling down (or rather doubling up) on growth. Of course, the cerebral asset allocation committees that would have stewarded this theoretical re-allocation based on the principle of mean reversion have long since ceased to exist (along with the defined benefit pension fund). Thus, we have found that, according to Sanford C Bernstein, on Vaccine (Pfizer) Monday 9th November, a 24-hour period in which the Hosking Partners portfolio outperformed its benchmark by 200 basis points, the average global equity portfolio suffered losses[1]. Further, many active investors are reported to live in daily dread of the value rotation which has begun to unfold and which, in our view, will continue for the next two years at least.

What is striking is the following. Our strategy - based on buying straw hats in the winter - is logical and consistent with a severe recession. What is paradoxical is that, the above notwithstanding, no investment advisors we are aware of have been moving portfolios in the direction we have. Admittedly, there is a one-third chance the strategy and its context are wrong (and the Covid depression may last forever, after all governments are heavily involved). Also, the strategy might be right but our mis-execution messes it up. Our point is not that we are right, rather it is that regardless of whether we are or not, it is surprising that we find ourselves, to the extent that it appears at present, to be on the road less (not?) travelled.

1 Bernstein (20 November 2020). Alphalytics: A Shot in the Arm for Active Managers?. *Alphalytics by Bernstein.*

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Thus, today's capital market, in our view, if seen through the eyes of the average investment dollar of the average investor is a place of extremely high risk unprecedented in human history.

Consider:

1) Interest rates are going to go up and this will eventually collapse the valuations of leading growth companies.

2) The useful, but ultimately dangerous, distinction between growth and value funds effectively prevents growth investors from buying value shares (and harvesting the alpha between the two categories).

3) The reverse is not true: value funds trapped in the madness of "fund management as a business" see their portfolios migrate toward momentum shares, an irresistible trend in the rat race of a short-term relative performance competition.

4) The AUM obsession causes firms to launch growth funds at all costs, even naming them ESG funds (under the "never let a useful trend go to waste" croupier business model).

5) The architecture of the open-ended fund is uniquely suited to herd mentality as inflows force managers to buy evermore overvalued shares at inflated prices. Overwhelmingly, these are not "investment" decisions as traditionally understood. Rather they are asset allocation preferences expressed by the firm's clients.

6) The continued popularity of indexation strategies (because of their low expense ratio) mean the marginal investment dollar is always buying mega-cap expensive shares and selling inexpensive firms.

7) In a high turnover/short-term holding world, massive confusion has been created in the minds of investors by the auto-correlation in infection, hospitalisation and death-rate data. The trends appear completely linear and reinforce a one-way bet (momentum) mentality.

8) All this is taking place in a social-media driven ecosystem (never before seen in stock

> market history) driven by conformity to the point of herd-idiocy. It makes the tulip mania look like a normal Saturday market in a provincial town.

The factors above help explain to our friend from Mars how Tesla, an automobile manufacturer, comes to be incorporated into the American S&P 500 index, with a weight of 1.6% at an enterprise value of 16 times annual sales, with pundits thinking this is an entirely normal event.

We do not propose here to indulge in the long-standing debate on the evolving definition of these contrasting approaches other than to assert that we think we know either when we see it. As a generalisation the value opportunity set comprises, in the main, investments the genesis of which are a consequence of share price “mispricing”. In contrast the growth universe consists of firms where there is an assessable runway of likely business metric compounding. Of course, there are overlaps between the two.

Jeremy Hosking

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