Hosking Post

Strong back, soft front, wild heart

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"Buddhists speak of needing three things to survive and be happy in life. A 'strong back', to stand tall in the face of adversity, to labour long and hard without flagging. A 'soft front', the ability to remain open and friendly to the world and to others, to not hide behind a brittle, defensive shell. And a 'wild heart', to dream and dream again of things undreamed".

Hitting Against the Spin, How Cricket Really Works
Nathan Leamon and Ben Jones, June 2021

"You can print money, but not oil to heat or wheat to eat".

Money, Commodities and Breton Woods III
Zoltan Pozsar, Credit Suisse, March 2022

In November last year we published a Hosking Post with the title "Tandem - At Length, or How Long is the Cycle". In that piece, we reviewed the positive recent performance being enjoyed by some of the more capital-intensive, 'old economy' stocks in the Hosking Partners portfolio through the lens of capital cycle analysis, in order to ask the question how much further their strong performance had to run. Our suggested conclusion was that because those companies were operating in industries suffering from long-term underinvestment, with various obstacles in the way of rapid capacity expansion, the reversion of their returns to the mean would take a while and their future prospects were commensurately longer.

Looking back a little more than six months since our earlier piece, which admittedly is not the longest investment horizon, but certainly a challenging test period for any portfolio, our thesis that these old economy stocks had an extended runway of future performance has proved largely correct, especially in relative terms. During the period, the Energy, Industrials and Materials sectors, to which the Hosking Portfolio has a c.10 percentage point overweight exposure all contributed positive performance on either a six or a nine-month view.

But congratulating ourselves that selective parts of the portfolio performed well over an arbitrary measurement span is not the purpose of this Hosking Post. Instead, we remind our readers that in a rapidly changing world where the old assumptions can no longer be taken for granted, **the Hosking Portfolio with its long-term, capital cycle approach and contrarian spirit expressed in several hundred stocks is well placed to withstand the shock of shifting conditions and to take advantage of the new opportunities that are thrown up**.

Certainly, the world feels a very different place compared with the end of 2021: in contrast to the COP26 climate conference and post-Covid reopening which formed the rather hopeful backdrop to our earlier piece, the news today is dominated by Vladimir Putin's war in Ukraine, inflation approaching double-digit levels and an unfolding crisis in terms of the price and availability of energy which will disproportionately impact those least able to afford it, whether countries or people. While it may appear to be an unhappy coincidence that these stories are appearing all at once, they are in actual fact linked. As we discussed in our recent "Active Ownership Report", despite an epic miscalculation about his ability to achieve an overnight conquest of Ukraine, Putin launched his invasion in February because he could clearly see how dependent the countries of Europe are on reliable access to cheap Russian energy, and he assumed they would have little stomach to challenge what he hoped to present as a *fait accompli*. Meanwhile, the ongoing conflict in Ukraine has both highlighted and exacerbated an energy crisis which is the result of the historic underinvestment we identified earlier. The energy crisis is itself also a large contributory factor to the inflation which we are now experiencing, and will be important for determining how long it will last.

As well as being interconnected with each other, what these phenomena (war, inflation, the energy crisis) also exemplify is the value of broadly understanding supply dynamics rather than narrowly focusing on demand, a distinction we are familiar with as students of the capital cycle. It is Europe's undiversified supply of energy which presented Putin with what he thought was his opportunity in Ukraine, and *pace* Milton Friedman's statement that 'inflation is always and everywhere a monetary phenomenon', it is supply-side bottlenecks in energy, labour and logistics which are behind today's inflation.

Whether or not central banks' quantitative easing during the last decade and governments' prodigal fiscal response to Covid contributed to inflation via the creation of excess liquidity (and it is difficult to argue they played no part), a key reason why the debate has moved on from whether inflation is 'transitory' or not is because of the increasing global energy gap, the growing (and difficult to close) shortfall between the amount of energy the world needs for GDP growth to remain in positive territory, and the supply of available energy, whether conventional, renewable or nuclear. The rise in energy prices is therefore likely to be persistent for longer than many think likely, and the risk of inflation becoming embedded is higher than the market's forward inflation expectation rates suggest. The question now is merely whether we are already in a recession (the US has recorded two consecutive quarters of negative GDP growth, so by the NBER's formal definition it would appear to be so) or whether that milestone is reached in the next quarter, but whatever the precise timing it seems that a recession of some sort is on the cards.

Faced with this supply-driven threat to the economy, governments and central banks are unable to respond by pulling on their tried and trusted levers of lowering interest rates or quantitative easing. They have abandoned their attempts to use the hypnosis of 'forward guidance' to convince markets that inflation will obey their will. As Credit Suisse's Zoltan Pozsar has written, 'it's easy to print money, but impossible to print gas and oil to fuel industry, transport goods, or heat homes, or to print wheat to eat'. The most obvious course of action left to the authorities is actually to raise interest rates in order to moderate demand, in the hope that increasing unemployment may cause inflation to fall. Such a conflict between the twin objectives of sound money and full employment echoes the cognitive dissonance investors experience as they are faced with the suggestion that inflation approaching double digits can be tamed by interest rates which remain negative in real terms. Most market participants are trying to come to terms with events that have never occurred during their careers, with all but the oldest only knowing the great moderation which began with Paul Volcker's taming of inflation in the early 1980s and appears to have reached its natural limit as interest rates entered the zero bound. The end of history has ended.

If this is where we are today, can we say with any confidence what may lie in the future?

Echoing Harold Macmillan, the British prime minister in the 1960s, who when asked what the greatest challenge a statesman faced, replied 'events, dear boy, events', the agenda is being set by what is happening in the so-called real world rather than the more abstract world of monetary policy making. The recent defenestration of the president of Sri Lanka and his government, after the country ran out of foreign currency as well as fuel, may be a warning of what happens when money loses its value and the price of energy goes up. As the status quo is questioned and earlier assumptions are increasingly challenged, who knows what headlines may next surprise us. Exercising our imagination for a moment, a hypothetical scenario is not unthinkable where Iran takes advantage of the West's energy vulnerability in the wake of the Ukraine war by disrupting production from Qatar's giant North Field, supplier of 4% of the world's gas and source of much of the LNG which Europe is hoping will replace Russia's pipeline gas. The North Field extends across the maritime border with Iran where it is known as South Pars, and both countries in effect compete for the same resource, so such an outcome might one day in hindsight appear to have been eminently predictable.

A reminder of the Hosking Partners approach

Such an eventuality, however, is one of only an infinite number of possible futures. When it comes to certainty no one is in possession of a crystal ball to predict geopolitical events with any practically useful degree of accuracy (as Hosking Partners' overweight to Russia at the end of January painfully attests). However, as generalists, investing globally, with a far longer time horizon than most and an emphasis on supply rather than demand, we should be well placed to join the dots as we navigate these uncharted waters. The Hosking Partners portfolio benefits from the insurance provided by exposure to a collection of industries valued at a discount to the rest of the market, but where the deep supply imbalance provides a considerable margin of safety, as well as some anti-fragility in the face of potential geopolitical earthquakes. Examples include our investments in mining companies (Anglo American, Freeport McMoRan, First Quantum, Sibanye Stillwater, Alcoa, Rio), shipping companies (Pacific Basin, Maersk, Diana Shipping, Scorpio Tankers, DHT, Hafnia, Golar LNG, Flex LNG), refiners (Marathon Petroleum, Motor Oil) and, to a lesser extent, energy companies (ConocoPhillips, Petrobras, Peabody). All these sectors benefit from historic underinvestment identified via a capital cycle approach, and this group of stocks collectively has provided a useful hedge against not only the shift upwards in supply-driven inflation but also against the fallout from the geostrategic ructions which accompanied it. For a fuller exposition of the shipping thesis see our 2017 Hosking Post "What Shall We Do with the Drunken Sailor" which sets out the rationale for initiating these positions and is a reminder of the patience required to profit from these long-cycle situations. The mining companies should also be long-term beneficiaries of the energy transition as we move slowly away from a global economy based on the consumption of fuel to one where the transformation of materials enables the exploitation of renewable energy, and the Hosking Partners portfolio has benefitted from the conflict between local ESG (increasing regulatory impediments in the way of new mines) and global ESG (the need for growth in renewables), reinforcing both the supply and demand aspects of the miners' investment proposition.

To repeat, however, no one has perfect foresight, and we are not claiming that the Hosking Partners portfolio is built with any individual scenario in mind, whether geopolitical, monetary or commercial. This is an important point: as capital cycle investors, we are conditioned to attempt to be broadly correct rather than precisely wrong, with overconfidence to be avoided at all costs. This is exemplified in the diversified nature of the Hosking Partners portfolio, containing over 400 stocks and an extreme outlier among our peer group in terms of portfolio composition. Our portfolio consists of a wide number of bets where we are broadly confident, rather than a concentrated number of bets where we are extremely confident, exploiting the longer-term perspective we share with our investors (and reinforced by the five-year measurement period of our performance fee structure) to capture market anomalies which may not be apparent to those with a different lens. The size of the portfolio allows us to gain exposure to situations which our competitors are prevented from accessing, because their more concentrated portfolios find it harder to accommodate stocks which contain stock-specific risk such as size, liquidity, geopolitics or information quality, so long as the overall thesis is sufficiently compelling to justify inclusion when such risks can be diversified away in a broader portfolio. We may sometimes achieve this diversification by owning a cluster of stocks in a particular situation, confident of the overall industry dynamics but uncertain which stock is likely to be the absolute winner, and shipping is a good example of this, with each company unique in terms of fleet age and profile, end-market exposure and capital allocation, not to mention management quality (beware pirates!). And because we are capital cycle-driven investors, we are truly unconstrained in terms of style: we like high-quality, growthy companies which enjoy barriers to the entry of new capacity such that their high returns are likely to be sustained for longer than the market thinks likely (Costco has been the poster child here), and we like more cyclical companies whose low returns have discouraged new capacity and are therefore likely to see a recovery in their returns sooner than the market's valuation implies. We strive to be as unconstrained as we can be and, as a necessary consequence, contrarian.

Diversification, risk and some thoughts on index hugging

For us, the purpose of diversification is not to eliminate risk, but to accommodate risk, to allow us (quoting Howard Marks) to 'dare to be wrong'. Active share is a portfolio metric we track carefully to ensure we are taking full advantage of the opportunity we have created for ourselves. Incidentally, any misconception that a diversified portfolio is simply a benchmark proxy or a closet index hugger can quickly be dispelled with a little mathematics. There is a range of estimates for the number of listed stocks there are globally, i.e. the number of possible individual constituents of the Hosking Partners portfolio, but assuming a figure of 40,000 companies, and a portfolio size of 400, then the number of potential portfolios that might be created from such a combination can be calculated as 40,000! ÷ (400! x 39,600!), many orders of magnitude greater than the number of atoms in the universe (which itself is estimated to be around 10^{80}). So it does not hold that the more stocks a portfolio contains then the more it is likely its performance will simply track the market.

Turning to the three attributes identified by the Buddhists as necessary to survive and prosper, helpfully brought to our attention by the authors of cricket's equivalent of Michael Lewis' *Moneyball* and summed up in the quotation at the head of this piece, we suggest that the Hosking Partners portfolio possesses all three. It has a 'strong back' in the form of its capital cycle approach which allows it to look through the day-to-day vicissitudes of the market and focus on longer term outcomes; it has a 'soft front' thanks to the large number of stocks it holds, which are able to accommodate many more good ideas than a smaller portfolio would allow; and it has a 'wild heart', thanks to its unconstrained design and contrarian spirit which informs everything we do. In the changing market environment we find ourselves in today, such a combination of resilience, adaptability and idiosyncrasy should be particularly valuable.

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