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Investing in a Rising Interest Rate Environment

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March 2022

We would argue that if inflation proves non-transitory and becomes genuinely ingrained into the consumer psyche, leading interest rates rising beyond current markets expectations, then there are some important economic factors to consider beyond just multiples.

By reasonable extension conditions such as these will tend to tighten liquidity, raise funding costs, reduce available capital and force down real spending power, thus reducing demand and presumably accelerating the maturing of the current cycle. This raises the prospect of lower growth and perhaps a recession and an earnings downturn in extreme. This is an environment where we would expect to do well since we are confident of increasing our intrinsic worth even in tougher macro conditions and our cashflows are more stable/less cyclical (see COVID period where we had significantly less drawdown than the market). This is due to our much higher profitability and access to structural, rather than cyclical, growth opportunities and a focus on recurring or non-discretionary demand wherever possible. We would expect our relative economic profit expansion to be strong in that environment.

We would suggest that Value, which is a very broad cohort and needs to be treated carefully, might not perform as well as some might expect in this environment. Value, while broad, does carry a high share of low return, highly levered, mature and cyclical stocks. And large swaths of 'value' do face structural challenges in their ability to drive acceptable economic profitability (EP) and EP expansion through the cycle. And ultimately it's EP and EP growth that determines share price outcomes. To believe that value outperforms growth over the next 5-10 years must be premised on the basis that Value can expand its economic profits at a higher rate. Structurally that looks challenging. Over the last decade, the Value index has grown earnings by only 55% (compared to 138% of the growth index) and this includes 2022 forecasted earnings. There is not much to indicate that this will change.

Furthermore, stocks that have higher leverage and require external capital are much more susceptible to higher interest rates through costs and increased competition for capital. From a financial perspective our companies are in the main self-funding, more profitable, less levered and are better able to deal with higher rates or tighter capital conditions. From a growth perspective we are exposed to a number of long-term structural shifts that help reduce cyclicality in the portfolio and allow our cashflows to compound up at a more profitable and faster rate. In an uncertain and growth challenged environment these are the companies we would want to own.

If interest rates are rising due to embedded inflation, then we would much rather own companies that have genuine pricing power and high gross/operating margins. They are much better placed to absorb and/or pass on costs increases, require less output price adjustment to offset cost increases and have a higher starting base of economic profits to weather the storm than highly levered (operationally and financially), more mature and competitive industries.

There is a limit to how much one can make or lose from multiple expansion and contraction, ultimately the earnings upon which those multiple are applied is the most important ingredient into long-term returns. In an environment where growth is subdued, because of tighter policy and economic cycle maturity, we would much rather own companies that can genuinely increase their intrinsic worth at a faster and more stable rate than the market average.

Technology - Diversification at its Finest

Like Value, Tech is a very broad set of companies with differing levels of maturity, end market exposures, profitability and cyclicality. It's the least homogenous sector out there and some caution is required when thinking about tech as a uniform sector. In many ways, the technology sector is akin to a modern-day bucket for new business models and new industries. As such, it is a diverse cohort of companies and almost every industry, end market and customer type is represented in 'technology' where expenditure is increasing as technology continues to rise as a share of total expenditure driving productivity efficiency and new services across all aspects of the global economy. Almost all economic shifts are founded upon technological change and so while we have a significant exposure to technology when seen through the traditional GICS sector lens, one should take comfort that there is a substantial amount of diversification of revenue sources, business models and end industries

Drawdown Periods - Share Price Dislocation from Fundamentals Provide Opportunities

The portfolio remains in great shape and valuations have become a lot more attractive. The world seems to be normalising to a higher cost of capital caused partly by inflation and partly by a policy unwind, but that is ultimately a headwind that all asset classes must face up to at some stage, including more levered assets (and unlisted ones). No assets will escape a cost of capital ramp. Our cohort of stocks has marked to market more aggressively than most, perhaps not surprisingly given the post COVID performance, but equally we have the ongoing offset from structural rather than cyclical growth that improves our relative worth every day. When multiples are working against us it is even more important to have the value markers upon which multiples are applied moving ahead a healthy clip. It's the only offset to an unexpected shift up in cost of capital expectations. Meanwhile some valuations are now back to levels that we've not seen for many years and are discounting a lot of bad news. We have even taken advantage of the material weakness to purchase a couple of stocks that have been previously too expensive. We can't unfortunately call the bottom and maybe the band stretches yet further, but at today's prices we're very comfortable that we can continue to meet the long-term mandate.

We have no visibility or insight into turning points and nor do we attempt to time short term market moves, we view this event as being similar in nature to the Q4 2018 dislocation between fundamental and share prices.

Share prices have dislocated from fundamentals and are now at quite extreme levels compared with what we have seen historically, these dislocations are reasonably common over time and their duration can vary. We tend to view these as attractive opportunities to acquire strong fundamentals at more attractive prices as mentioned above. Members of the investment team have even recently increased their own commitment to the strategy on this basis.

The way we view the current situation is akin to stretching an elastic band, there is a constantly rising gravitational pull, a point for the band to return and to which share prices are ever drawn to. Strong fundamentals lead to strong cashflows. There is only so much stretching of the band we can tolerate before regaining lost ground either through investor appetite (bargain hunting) or corporate arbitrage. We don't know when prices will rebound but if the portfolio continues to grow its intrinsic worth at a faster than market rate - we are very confident in that regard - the reconnection between share prices and higher fundamentals becomes increasingly inevitable.

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