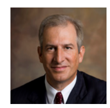
How the Coronavirus Is Reshaping the Blue Chip Universe

Defining potential winners and losers—near and longer term.

June 2020



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KEY INSIGHTS

- The current health crisis and economic dislocation are clouding near-term earnings forecasts for many U.S. companies, including blue chip names.
- Three key categories help to define how companies may be impacted—both near and longer term.
- Certain companies have key qualities that single them out as advantaged long-term businesses—even if they are negatively impacted near term.

Equity markets have rebounded well from the pandemic-related lows of March 2020, displaying an encouraging level of resilience. While this is positive, we remain circumspect about the potential time frame for economic recovery. Our sense is that the current crisis could have a longer-than-expected tail, delaying the recovery beyond what the market consensus is currently anticipating. Meanwhile, the environment is likely to remain uncertain for some time.

Regardless, our investment approach and portfolio focus remain unchanged. We continue to look for high-quality companies that can potentially produce durable growth in earnings and free cash flow over time.

Given the extreme economic dislocation, near-term earnings forecasts for many companies have become clouded. To better understand the longer-term picture and potential outcomes, we allocate the companies within our investment universe into three main categories.

- **Category 1—Long-term losers:** This includes companies that are being negatively affected by the current health crisis and the severe economic dislocation in the short term, but that are also likely to be negatively impacted on a longer-term basis.
- **Category 2—Long-term beneficiaries:** This includes companies that are negatively impacted by the current crisis in the short term but that we see as being potential beneficiaries over the longer term. These companies could emerge from the crisis in a potentially improved position.
- **Category 3—Short- and long-term winners:** This category has fewer names but contains those select companies that are currently benefiting in the short-term environment and are also expected to be key longer-term beneficiaries.

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Identifiers of Quality

The companies that we look to invest in have various, consistent qualities that single them out as potentially advantaged long-term businesses. Such attributes include high barriers to entry, low availability of substitute products, industry leadership, and pricing power with both suppliers and customers. Also essential is capable management that can allocate capital effectively and efficiently. These quality identifiers are particularly relevant for companies currently allocated to Category 2, for example. Despite earnings being negatively impacted in the short term, and share prices falling sharply in some cases, these qualities give us confidence that the companies can not only recover, but go on to excel, longer term.

At this point, it is worth highlighting some of these "all season" growth companies—examples from both Category 2 and Category 3—and what we believe are the durable qualities that identify them as potential long-term growth compounders.

Under Pressure in the Short Term, but Potential Long-Term Beneficiaries

Technology/consumer services giants Alphabet (Google) and Facebook are good examples of companies currently in Category 2. Both have been hurt by the current crisis and suffered steep share price declines during March; however, we believe that both businesses could ultimately be beneficiaries of the current environment.

The largest portion of both Google's and Facebook's revenues comes from digital advertising, an area of spending that has seen significant cuts in the current environment as companies can turn it off very quickly during times of stress. Compare this to TV advertising, for example, which tends to be more contractual in nature and paid forward, so not as easy to unwind.

What is most encouraging however, and underpins our positive long-term view of each business, is that as quickly as digital advertising can be switched off, it can be switched back on again. Digital advertising is the most measurable, and return-on-investment visible, spending that companies have at their disposal. As such, we believe that it will be the first place they return to as soon as any budget becomes available.

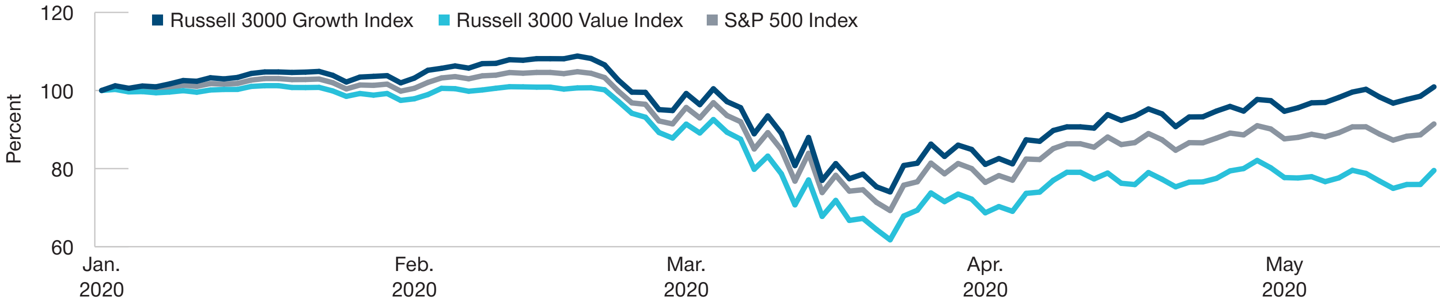
Also potentially benefiting Google and Facebook on a longer-term basis is the growing "cord cutting" trend currently evident among companies and consumers. This trend (which is perhaps most prominent elsewhere, among content streaming platforms) is also increasingly evident in the advertising realm. Prior to the onset of the crisis, many companies had already set aside substantial sums for TV advertising. However, with limited new content presently being made and, crucially, with no live sports being shown on TV, companies are looking to reallocate their TV advertising budgets to digital, and, in many cases, this money has been making its way to Google and Facebook. And once the cord is cut, be it by companies or consumers, data has typically shown that a large percentage never go back.

Short-Term Beneficiaries and Potential Long-Term Winners

Clearly, Category 3 is where we want to be most invested, but these companies are also fewer in number. A prime example is Amazon. Since the onset of the crisis and the subsequent shuttering of all but essential retail (brick and mortar) businesses, Amazon has seen a notable acceleration in revenue growth. In our view, the increase in revenues is likely to come at a cost of margins in the near term, as the company was not prepared for the sudden and substantial increase in demand. However, we believe these costs will subside as the company is able to add capacity, which we believe should improve efficiency. Amazon has already hired 175,000 additional staff in the roughly two-and-a-half months since the start of the crisis.

Growth Has Continued to Outperform Value

This Is an Unusual Feature of the Current Crisis



As of May 18, 2020

Past performance is not a reliable indicator of future performance.

Indices rebased to 100.

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Longer term, we believe the sharp revenue acceleration that Amazon has seen in the past couple of months will ease in time. However, we think that there are some long-term consumer behaviors that are being forged currently with many shopping online—and with Amazon—for the first time and across a wider range of categories. We think that this trend will continue and could help Amazon to penetrate some significant market categories, like groceries and consumables.

Some concerns have been voiced about the elevated valuations of higher-growth companies, particularly in areas like technology. An unusual feature of the current crisis is that growth-oriented names have continued to notably outperform their value and defensive counterparts.

As such, certain technology sector names, for example, may appear expensive currently, relative to the broader market. It is our job as investors to research these businesses in detail, all the time looking for any unique qualities or advantages, as well as potential limitations, and determining our own fair valuation based on this analysis. Take Amazon, for example. Amazon is the dominant player in the retail sector, with the potential to extend its reach into other key retail segments. The company's other main businesses, Amazon Web Services and its advertising arm, have offered additional, diversified revenue streams, and the company has generated substantial levels of free cash flow. The combination of these features has given us comfort in our position in Amazon.

Final Thoughts

There is no magic formula or silver bullet for finding quality, durable growth companies. It involves a lot of hard work, digging, and detailed research and analysis. And in unprecedented times like today, it involves continuous engagement with company management teams, asking difficult questions, checking and rechecking investment theses, and ultimately deciding if the company's longer-term strategy can still be delivered.

While consensus opinion is anticipating a relatively quick, "V shaped" U.S. economic recovery, we are of the opinion that a recovery may take longer than expected and be more "U shaped" in nature. We anticipate that earnings revisions will be necessary for many companies, which makes us more cautious about the near-term outlook, particularly given the rapid recovery we have seen in the stock market so far.

That said, we do believe generally that there is a solid return opportunity in U.S. equities, especially looking out over an 18- to 24-month time horizon.

WHAT WE'RE WATCHING NEXT

As an investment team, the message that we continue to reiterate is: "Don't let perfect be the enemy of the good." Even some of our highest-conviction holdings will likely see earnings revisions if the businesses have been closed or unable to trade during the crisis. However, with the quality attributes these companies possess, we believe that they will bounce back in time and continue to deliver potential earnings and free cash flow growth over the long term.

The companies mentioned above represented the top 3 largest holdings in the US Large-Cap Core Growth Equity Representative Portfolio, as of March 31, 2020.

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