



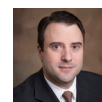
Finding U.S. Companies That Can Emerge Strong From the Crisis

Amid heightened uncertainty, fundamental quality matters.

July 2020

KEY INSIGHTS

- The resilience of U.S. equities, which have rebounded strongly from the lows reached in March, is encouraging. However, a great deal of uncertainty remains.
- Investors appear to be pricing in an optimistic outlook for U.S. equities, anticipating a relatively quick recovery from the effects of the coronavirus pandemic.
- Our view is that a U.S. recovery may take longer than many are currently anticipating, with the potential for increased market volatility in the near term.



Joe Fath

*Portfolio Manager,
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Q. How would you sum up your current view of the U.S. equity market?

We have certainly been surprised at the level of market resilience in recent months, given the dislocating impact of the coronavirus pandemic on the U.S. economy. While the market recovery is encouraging, there remains a great deal of uncertainty and many unknowns. Accordingly, while we are reasonably optimistic about the market outlook, this view is tempered with caution.

A notable aspect of the sharp downturn in March was that many highly valued, growth-oriented companies showed the greatest resilience, with stock prices falling less than the broad market decline. More recently, these same companies have also recovered strongly, again, generally outperforming the broader U.S. equity market. So some of the best-performing companies have

come from the very expensive end of the valuation spectrum. Normally, in a market downturn, particularly one as severe as that we have just witnessed, it is these high-valuation, high-beta¹ stocks that lead the market lower, and that has certainly not been the case this time.

Despite the strong recovery in U.S. equities, we think that there is still a great deal of uncertainty. As such, we could see a higher level of market volatility as businesses and consumers negotiate the ongoing severe economic disruption stemming from the pandemic. With more than 13% of the U.S. population currently unemployed and many businesses still shuttered across the country, these are important signals that cannot be ignored, and they will have increasingly significant market implications the longer the current economic downturn continues.

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¹ Beta measures the volatility, or risk, of a stock relative to the risk of the broad market.

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Q. Do you think the government has done enough to support the economy?

The U.S. government and central bank have been very quick to respond to the economic impacts of the crisis, initiating unprecedented fiscal and monetary support measures. This decisive action in backstopping the economy shows a clear commitment to do “whatever it takes” to get through the crisis and on to a recovery on the other side. This alone is reason for encouragement.

If we also look back to the global financial crisis, one positive to come out of it is that it provided a playbook for global central banks on how to respond to a severe financial and economic crisis. And the response to the coronavirus crisis has been textbook in both execution and effect.

It appears that the U.S. Congress may agree to additional stimulus measures, given the resurgence in coronavirus cases, and some of these measures may be warranted. At the same time, we need to ask whether improved consumer activity can be sustained in the absence of fiscal stimulus.

Q. Have you been able to take advantage of the heightened volatility in recent months?

Absolutely. In late February and early March, when markets were around their lows, we focused on companies with sound, defensive growth characteristics, such as balance sheet strength, ample liquidity, and good access to capital. However, as confidence improved, encouraged by the vast fiscal and monetary support, our focus shifted more toward companies that could emerge from the crisis in a stronger position relative to their competitors.

While heightened volatility can be uncomfortable and brings additional risks, it also offers opportunities to take advantage of that volatility. As an active manager, we are always looking to take advantage of these kinds of market dislocations in order to create potential alpha (excess returns) for our clients.

Q. When do you anticipate that companies will start to see a recovery in earnings?

Given the tremendous amount of uncertainty as a result of the coronavirus pandemic, for companies within certain hard-hit industries like travel and leisure, we don’t anticipate getting back to 2019 earnings levels until well into 2022 and possibly beyond; however, other industries with more resilient business models may rebound much sooner. Again, this highlights a disconnect between the strong recovery we are seeing in the markets and the relatively modest earnings expectations coming from company management teams. As such, we think a U.S. recovery might take longer than many are currently expecting. Rather than a quick “V-” or even a “W-shaped” recovery, our view is that we could potentially see a recovery that’s more “swoosh-shaped” in nature.

Certainly, from a trade perspective, it has been interesting to see the disruptive impact of the coronavirus pandemic on global supply chains, highlighting the fragile nature of some of these extended trade networks. Meanwhile, deteriorating trade relations between the U.S. and China only add further pressure to global supply links.

We could potentially see a shift away from a more globalized approach and toward more regionally focused supply chains and providers of goods and services. Within the U.S., the prospect of greater regionalization means that we could see an increase in industrial automation in U.S. factories, for example.

Q. Where do you stand on current market valuations?

It is worth pointing out that, as a firm, we think about valuation a little differently than most. The standard valuation ratios and measures, while important, are not the be all and end all. This is because we aim to identify and invest in companies that are secularly advantaged. These exist in both the growth and value domains,

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and the unique advantages that these companies possess inform our valuation view. This may differ considerably from the consensus view.

For example, a number of growth-oriented companies have been advantaged by the pandemic, as it has effectively changed the way businesses and employees interact as well as consumption habits. So, while these companies—notably the major technology platform giants—have risen to seemingly elevated valuation levels, we believe there are good reasons to be optimistic about further upside potential. That said, valuations cannot continue to rise forever, and if we were to see a cyclical rebound in the economy at some point, then we would expect to see some market rotation and a resurgence in value stocks.

Q. What are your expectations for U.S. equities?

We are mindful that periods of extreme dislocation provide good opportunities for

active investors but also heightened risks. Such an environment requires careful analysis to seek out quality companies that have the financial strength, competitive position, and management quality to survive the crisis and potentially emerge in a stronger position.

Over the longer term, we believe that markets will recover as the health crisis recedes and a feeling of normalcy returns. However, we think some changes will prove permanent. For example, the pandemic will almost certainly affect the calculus of the U.S. election later this year, and certain companies and industries will likely be fundamentally altered. Regardless, our investment approach and portfolio focus remain unchanged. Overall, we will continue to favor companies that we believe are more in control of their own destinies, are positioned to benefit from powerful secular trends, and, through innovation, are disrupting less efficient business models and reshaping industries.

WHAT WE'RE WATCHING NEXT

The coronavirus pandemic has understandably consumed the public's attention in recent months and overshadowed the upcoming U.S. presidential election. However, as November 2020 draws ever closer, the election has the potential to be a further source of U.S. market and economic uncertainty. Not only who wins the presidency, but also which party ultimately gains control of the U.S. Senate will be key influences on the market and economic outlook.

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