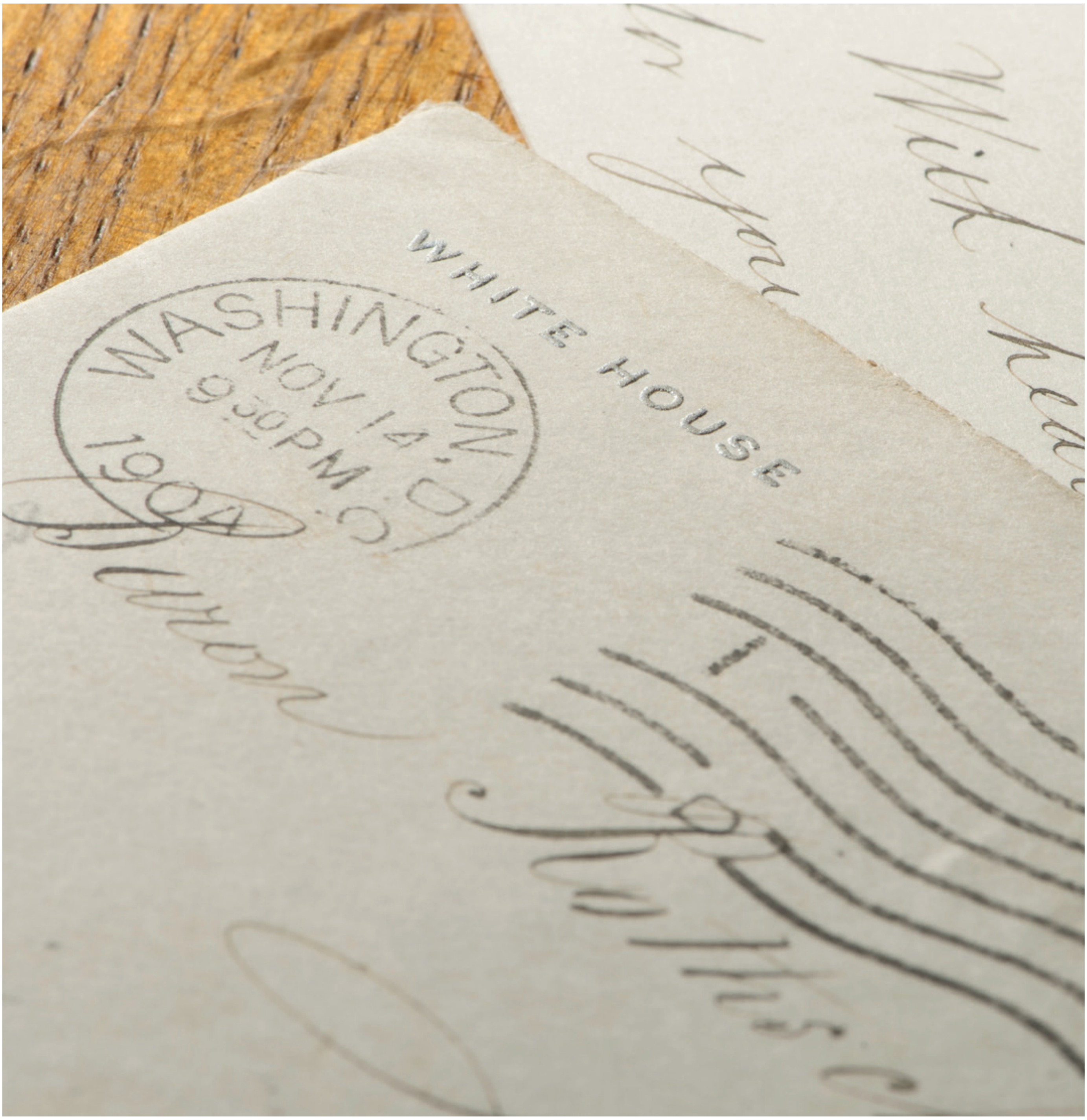
Navigating challenging investment seas

Quarterly Letter

Issue 22 | April 2019



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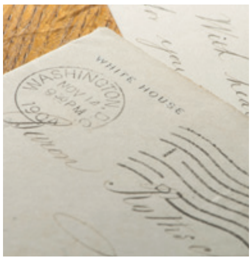

Cover image:
Envelope from a Presidential 'Thank you' sent to Nathaniel 1st Lord Rothschild (1840–1915), Senior Partner N M Rothschild & Sons, from President Theodore Roosevelt (1858–1919) in 1904. Courtesy of The Rothschild Archive

Rothschild & Co Wealth Management
New Court
St. Swithin's Lane
London
EC4N 8AL
+44 20 7280 5000
rothschildandco.com

Publication date: April 2019.
Values: all data as at 31st March 2019.

Foreword

English is a language rich in maritime metaphors. Though we might not even realise it, when we tell someone to pipe down, are left high and dry or shop at a flagship store, we are using terms that originate from seafaring.

We're also quick to reach for images of being on a ship out at sea whenever investment markets are volatile. Commentators talk about battening down the hatches, turbulent waters, of storms ahead.

Over the past 12 months, such figures of speech have been used with increasing frequency. As you will probably know, 2018 was a challenging year. December rounded off the worst year for America's S&P 500 in a decade. And it wasn't the only global stock market to struggle. After a sustained period of market expansion, investors received a stark reminder that the value of investments can fall as well as rise.

In the opening months of 2019 the investment markets have been more forgiving. However, the rest of this year is unlikely to be plain sailing. We are late in the cycle and there is a lot of uncertainty out there, from the ongoing Brexit saga to slowing global economic growth.

Our hard work will continue regardless, however choppy the investment seas become. As you will have heard many times, our focus is on the long term. Our portfolios are built to deliver inflation-plus returns whatever the investment weather.

As we explain in this *Quarterly Letter*, much like record-breaking round-the-world sailor Dame Ellen MacArthur, we can see the opportunity in stormy waters. Market downturns can provide our portfolio managers with the scope to invest in new positions or top up existing holdings when they are cheaper. By seizing such moments we aim to increase the intrinsic, long-term value of your portfolio.

Helen Watson
CEO, UK Wealth Management

Navigating challenging investment seas

"It was Christmas Day. I was forging into the Southern Ocean underneath Australia. The conditions were horrendous… The nearest land was Antarctica, and the nearest people would be those manning the International Space Station above me."

Those are the words of Dame Ellen MacArthur[1], the land-locked Derbyshire native who in 2005 became the fastest solo sailor to circumnavigate the globe. During her incredible record-breaking journey at just 28 years old, Dame Ellen faced many challenges, from dodging icebergs to shimmying up 90-foot masts to fix broken sails.

On the Christmas Day in question, Dame Ellen was desperately trying to forge ahead of a "huge storm" which she feared could destroy her boat. She explained, "The waves were already 40 to 50 feet high, and the spray from the breaking crests was blown horizontally like snow in a blizzard. If we [Dame Ellen and her boat] didn't sail fast enough, we'd be engulfed by that storm, and either capsized or smashed to pieces."

As, at times, we are all too aware, storms aren't just something that sailors encounter in icy Antarctic waters. Indeed, there are clear parallels between the situation Dame Ellen faced in the Southern Ocean and the investment environment we face from time to time.

The turbulent moves in stock markets in 2018 have left some investors wondering whether we have entered more challenging investment waters. A decade on from the financial crisis, some are beginning to question whether stock market storms will soon bring the bull market to an end.

Given where we are in the cycle, such questions are valid. This bull market has been the longest in history[2], global growth is slowing and manifold geopolitical concerns have made investors nervous. And just as there are analogies between Dame Ellen's predicament and investment markets, investors can also draw lessons from the way she handled challenges on her epic journey.

Focus on the goal

Throughout her circumnavigation of the globe, Dame Ellen remained firmly focused on a clear and essentially simple goal: to get to the finish line of her 26,000-mile journey. That target is what gave her the impetus and confidence to push on, even when she faced 50-foot waves "2,000 miles away from the nearest town."

Without this focus her courage would have quickly crumbled, she would have caved in and steered for the nearest port. Dame Ellen explained: "You have to understand the big picture in order to have any chance of getting through the Southern Ocean, let alone crossing the finish line."[3]

Much like Dame Ellen, the most effective investors are able to maintain a focus on longer-term targets even when they are being buffeted by unfavourable weather. They are able to plot a course to a destination, even if icebergs, broken masts or a lack of wind temporarily throws them off course.

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At Rothschild & Co, our clear and stated goal is to deliver inflation-beating returns. Inflation is sometimes called the 'silent killer' because investors often fail to understand its impact until it has caused major damage to the real value of their investments. Today's level of current and expected inflation may appear to be benign in historic terms. But even at low levels, over time, increases in prices will erode the spending power of assets if they are growing slower than inflation.

[1] ted.com: 'The surprising thing I learned sailing solo around the world', March 2015

[2] CNN: 'Market milestone: This is the longest bull run in history', 22nd August 2018

[3] London Business School: Dame Ellen MacArthur, 7th November 2013

As many of you will know, our overall aim is to preserve and conservatively grow the real value of our clients' wealth, so setting an inflation-beating target suits our emphasis on preservation-first. Having this 'finishing line' helps us to keep focused on the 'bigger picture'.

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Building from the bottom up

This focus on the bigger picture proved useful in 2018, which wasn't a particularly easy year for investors, including ourselves. Factors such as Brexit, slowing global growth and President Trump's unpredictability mean a climate of uncertainty persists. It could be argued that the market backdrop looks more testing than it has for some time.

But, as we have explained in previous *Quarterly Letters*, we don't make judgments on the basis of top-down forecasts of global growth or valuations of global markets. Indeed, we believe that fixating too much on 'market noise', on sentiment and prevailing market prices, can lead to poor investment decision-making.

Instead, our distinct approach puts the spotlight on the underlying value of companies. Our confidence that we can meet our inflation-beating target over the medium to long term is based on the conviction that we are invested in the right businesses. Looking at our investment portfolio company-by-company, we can see attractive returns going forward. The portfolio is full of businesses that we believe can deliver growth and help us to reach our goals.

There are parallels between the high-quality businesses that form the framework of our portfolio and the infrastructure that played such an important part in helping Dame Ellen set a new world record.

In her case, at its centre was a sleek 75-foot long trimaran, with three hulls and decks made of epoxy-bonded carbon fibre, for maximum strength at the minimum weight.[4] Her boat, affectionately called Moby, included state-of-the-art satellite navigation systems. Dame Ellen was further aided by weather analysis from the New Hampshire-based Commanders Weather Centre, which forecast fronts and wind speeds and helped her plan the best route.

Experience and preparation

However, Dame Ellen didn't just turn up one day to find Moby waiting for her. It took a team of 30 people more than 30,000 hours to build the boat over a period of seven months.[5] This followed years of groundwork. Meticulous planning went into every aspect of the journey, even down to how many kitchen rolls Dame Ellen would need in Moby's cramped quarters. The cabin, in which she spent much of the trip, was just seven-foot wide and five-and-a-half-foot high.

Dame Ellen's boat and equipment were based on the most up-to-date sailing technology. But, of course, the success of the endeavour wasn't just about the boat: it was also about the captain.

The trimaran couldn't be operated to best advantage without Dame Ellen's extensive experience, expertise and knowledge. "Understanding how things worked was as important as any voyage I'd ever undertake," she said.[6]

Dame Ellen wouldn't have reached her goal if she hadn't been prepared for the challenges the journey threw at her. She wouldn't have been victorious if she didn't have the experience to handle the boat and remain composed in changing and sometimes treacherous conditions.

In a similar vein, the success of our investment team, and its ability to interpret the 'weather' and make decisions, is built on experience. Preparation was everything for Dame Ellen – as it is for us. At the heart of our investment decision-making is deep fundamental bottom-up research carried out across our investment team. Our internal research team and analysts get to know companies inside out, meaning we can take decisions with confidence and conviction.

During the evaluation process we are not just interested in the state of a business now, but its likely journey in the coming years – its preparedness for the future. This leads us to focus on the underlying operating performance of a company – the sort of earnings the business could generate over the next five or even 10 years and what sort of value we put on those earnings. Importantly, this is of much more interest than market valuations.

It is our belief, and one borne out over time, that we are not going to deliver the returns needed to grow your capital after inflation by buying companies we believe we can sell at a higher price. That's the approach that many in the market take, and while it can work at times, it is ultimately unstable and leaves you at risk of being capsized by shifts in market sentiment.

[4] The Guardian: 'What is so special about Ellen MacArthur's boat?', 10th February 2005

[5] BBC: 'Backing up MacArthur's bid', 25th January 2005

[6] The Telegraph: Ellen MacArthur: 'I saved up my dinner money for my first boat', 1st January 2012

Instead, we focus on buying companies that can generate the sort of attractive, underlying profits that will help to keep you wealthy. In an environment where short-term thinking often dominates, this long-term perspective helps us to rise above market noise and focus on what really counts in terms of preserving and growing wealth.

Spotting an opportunity

When a storm is approaching, the temptation, whether that be meteorological or market metaphorical, is to flee, or where possible, hide. But experienced sailors and investors also know that tempests can be an opportunity.

With the storm approaching in the Southern Ocean, Dame Ellen recognised it as a threat – she wasn't complacent about the danger – but also knew that she could take advantage. It gave her the speed she "so desperately needed" to help her break the world record. "A few days later, we came out of the back of the low... we'd been able to drive ahead of the record within that depression."[7]

Likewise, when stock market storms occur, we are ready to capitalise on price falls by using them to buy more of what we like at a cheaper price. Our readiness to add to quality holdings when prices dip is demonstrated by a decision to add to Middleby in December.

We first bought shares in this Midwest American industrial kitchen manufacturer last summer. As with all our holdings, this decision came off the back of intensive research where we developed a 'roadmap' for the business defining how we expect it to perform in the future. Our positive expectations for forward returns gave us the confidence to invest in this global leader in food service equipment at around $115 per share.

Towards the end of last year, stock market volatility caused the share price to decrease. We calmly reviewed Middleby and concluded that our forward return expectations and belief in the business hadn't changed.

Indeed, we saw the share price dip as an opportunity and added to our investment in Middleby in December when it was priced at around $102. Our focus on the long-term goal helped us keep calm and view a short-term 'difficulty' as an opportunity.

Making repairs

Of course, there are also times when, much like Dame Ellen, we need to make repairs or adjustments to our portfolios.

The record Dame Ellen had to beat was set by the French skipper Francis Joyon who, in February 2004, had circumnavigated the globe in 72 days, 22 hours, 54 minutes and 22 seconds. Dame Ellen, setting off just nine months later, came home victorious in 71 days, 14 hours, 18 minutes and 33 seconds.

She knocked more than 24 hours off Joyon's time, though her journey wasn't – if you can excuse the pun – all plain sailing. Two weeks into the race, Moby's generator, which powered all the computer equipment, including the desalinator that made drinking water, began malfunctioning. Dame Ellen was forced to carry out emergency repairs even before she had rounded the Cape of Good Hope. In the Southern Ocean she faced mountainous seas and had to dodge numerous icebergs. Back in the Atlantic she almost hit a whale and also had to deal with both no winds and further storms.

Twice during her record-breaking journey, Dame Ellen was forced to scale her trimaran's 90-foot mast to fix the main sail. She described the experience as being like "trying to hang on to a telegraph pole in an earthquake. You get beaten up black and blue. The biggest risk isn't falling, although there is a risk of that – it's breaking an arm or a leg as you slam against the mast."[8]

Our repairs, thankfully, involve less physical jeopardy, though as we explained in the last *Quarterly Letter*, are not necessarily easy decisions to make. Over the past year we have sold some companies whose returns we think could be underwhelming in future years, notably consumer staples such as Unilever and Nestlé. Instead we have allocated additional capital to what we think will be higher returning assets.

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Like all our investment decisions, these portfolio changes were driven by a process that enables us to identify companies with better return prospects. Ultimately, we expect portfolio returns to be driven by the returns of the companies and funds in which we invest. All the companies we hold in the return component of our portfolio are united in having appealing economics. With strong positions in specific markets, we believe they can and will be able to deliver attractive profit margins.

[7] ted.com: 'The surprising thing I learned sailing solo around the world', March 2015

[8] The Guardian: 'Fear keeps you alive', 1st October 2007

These return assets, which currently make up about two thirds of a typical portfolio, are what we expect to drive long-term performance. They give us confidence that we can deliver on our inflation-beating target.

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Following a different route

One consequence of our disciplined bottom-up approach is that our portfolio looks rather different from the market. For example, we have no energy and no mining stocks. At a country level, we have close to zero investment in Japan but have more than the typical market weighting in the US.

In addition, our target to beat inflation is one of the key reasons why the bulk of our portfolios are invested in wealth-creating return assets, the vast majority of which are linked to the stock market.

Among the major asset classes, equities are particularly well placed to offer protection against inflation. That is because inflation itself comes from businesses increasing the prices of their goods and services. Many of the return assets we invest in are able to maintain real cash flows by passing on higher costs to consumers.

Far from being a threat, inflation can act in selective businesses' favour. Take Mastercard, for example, whose revenue is directly tied to nominal prices. Whenever a consumer uses a Mastercard for spending, the company takes a small percentage fee proportional to the value of the underlying transaction. The result being that as prices rise, so does Mastercard's top line.

Last year, Mastercard took an average 0.3% charge on around US$6 trillion of transactions made using its cards. If inflation of 5% means that transactions rise to $6.3 trillion, Mastercard's revenues will also grow by 5%.

When the underlying businesses in our portfolios are able to pass through inflation in this way, it acts as a natural hedge. But what of other assets? Fairly recently, there have been periods when you could have made inflation-plus returns from bonds, but we are not in one of those times now. Due to low interest-rate levels across the world, traditional bonds as well as cash offer little in the way of inflation protection.

We believe the best way to counteract the damaging impact of rising prices is to buy assets that can produce strong returns above inflation over the longer term. In the current climate, that points us in the direction of equities. Where we do own bonds in portfolios, they are typically very short-dated bonds and are held for cash management purposes.

Conclusion

It is important to stress that, even with this rigorous process, we won't meet our inflation-beating target every year – like Dame Ellen, unfavourable weather conditions can temporarily set us back.

However, over longer-term horizons we fully expect to meet our target, and have done so in the past.

Speaking to the London Business School about what it takes to succeed, Dame Ellen said: "The winner of the race is not necessarily the fastest sailor. The winner of the race is someone who is a fast sailor but is able to keep the boat on track, maintain their energy levels throughout three months, able to look at and understand the weather, make the decisions, repair the boat, repair themselves."[9]

At times, Dame Ellen was well ahead of the pace, at other times behind, depending on the prevailing conditions. With just two weeks remaining to beat Joyon's record, she was trailing by 13 hours.[10] Yet by remaining focused on her overall goal, she was able to make history.

You might be hoping we've run out of nautical puns… almost! Like Dame Ellen, our focus is on keeping our boat on track over the long term. For Dame Ellen it was the goal of crossing the finishing line – hopefully faster than anyone else – that drove her on. For us it is a long-term focus on wealth preservation and growth.

We remain confident that we are charting the right course. Thank you for sailing with us!

[9] London Business School: Dame Ellen MacArthur, 7th November 2013

[10] NBC: 'Ellen MacArthur's journey', 28th May 2006

Notes

At Rothschild & Co Wealth Management we offer an objective long-term perspective on investing, structuring and safeguarding assets, to preserve and grow our clients' wealth.

We provide a comprehensive range of services to some of the world's wealthiest and most successful families, entrepreneurs, foundations and charities.

In an environment where short-term thinking often dominates, our long-term perspective sets us apart. We believe preservation first is the right approach to managing wealth.