

QUARTERLY LETTER | ISSUE 36 | OCTOBER 2022

# Navigating challenging investment seas



## Foreword

In last summer's *Quarterly Letter*, we talked about managing expectations.<sup>1</sup> At the time, our portfolios had continued to perform well, despite significant market volatility and the ongoing challenges posed by the COVID-19 pandemic.


We are, of course, always delighted to report that we're on the right tack, steering a clear course when the investment waters are choppy. However, we were also keen to emphasise that the journey won't always be plain sailing – there will be times when we must batten down the hatches as strong headwinds slow our progress.

On the right tack. Plain sailing. Batten down the hatches. Strong headwinds. When describing financial markets, it's common to call upon maritime metaphors to convey turbulence and uncertainty. Given the current economic, geopolitical and inflationary landscape, it's perhaps no surprise that we find ourselves reaching for them again now.

I say 'again' because a sailing analogy featured prominently in a *Quarterly Letter* we wrote three-and-a-half years ago, following a difficult period for stock markets. We recounted the captivating story of Dame Ellen MacArthur's record-breaking round-the-world yachting expedition in 2005, drawing parallels between her ability to overcome adversity and our own efforts to prevail in stormy market weather.

Our investment approach hasn't changed much since then; we still believe, like Dame Ellen, that there are opportunities to be had, even when the forecasts look gloomiest. By seizing these moments, we aim to preserve and grow your wealth, increasing the real long-term value of your portfolio.

Now, as then, we aim to calmly navigate the challenging investment seas ahead. With this in mind, we have dusted off that *Quarterly Letter* and updated it for 2022. It's one of our favourites, and we hope you enjoy reading it.



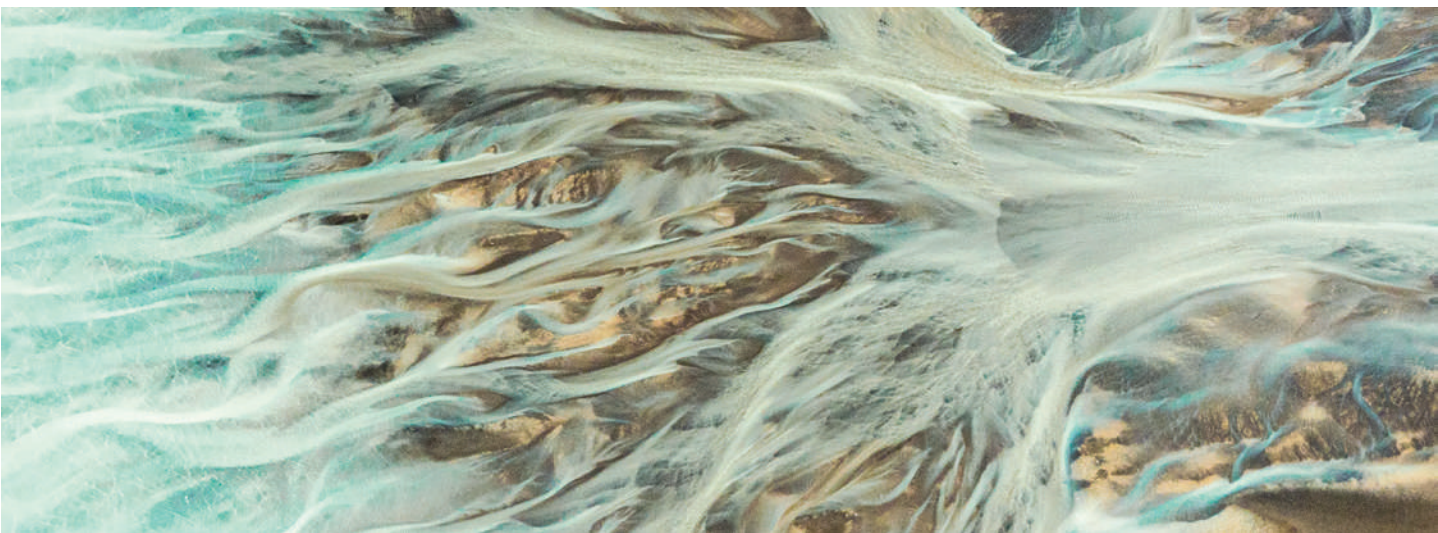
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<sup>1</sup> *Quarterly Letter: What to expect*,  
1 July 2021



# 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,<sup>2</sup> 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 recently have left some investors wondering whether we have entered more challenging investment waters. Given where we are in the cycle, such questions are valid.

Global growth is slowing, and inflation is rising,<sup>3</sup> while 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 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.”<sup>4</sup>

The most effective investors are able to maintain a focus on longer-term targets even when they are being buffeted by unfavourable weather.



<sup>2</sup> ted.com: The surprising thing I learned sailing solo around the world, March 2015.

<sup>3</sup> International Monetary Fund: Global Economic Growth Slows Amid Gloomy and More Uncertain Outlook, 26 July 2022.

<sup>4</sup> London Business School: Dame Ellen MacArthur, 7 November 2013.

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.

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. And following an extended period of relatively benign inflation, we are now entering a more inflationary period. Nevertheless, we remain confident that real investment returns remain possible in this environment.

As many of you will know, our 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’.

### **BUILDING FROM THE BOTTOM UP**

This focus on the bigger picture has proved useful in recent years. Factors such as the COVID-19 pandemic, the war in Ukraine and the unpredictability of the UK’s, and a number of other European Governments, 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.<sup>5</sup> 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.<sup>6</sup> 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.<sup>7</sup>

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.

<sup>5</sup> The Guardian: What is so special about Ellen MacArthur’s boat? 10 February 2005.

<sup>6</sup> BBC: Backing up MacArthur’s bid, 25 January 2005.

<sup>7</sup> The Telegraph: Ellen MacArthur: ‘I saved up my dinner money for my first boat’, 1 January 2012.

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.

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, whether that be meteorological or market metaphorical, the temptation 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.”<sup>8</sup>

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 or buy quality holdings when prices dip is demonstrated by a decision to buy Microsoft in May 2022.

As with all our holdings, our decision to buy Microsoft 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 the business.

When stock market volatility caused the share price to decrease, we reviewed Microsoft, a strong business we had been monitoring for a long time and concluded that our forward return expectations and belief in the business had improved.

We saw the share price dip as an opportunity and decided to buy a small position in Microsoft in May. Our focus on the long-term goal helped us keep calm and view a short-term ‘difficulty’ as a reasonably priced opportunity.

<sup>8</sup> ted.com: The surprising thing I learned sailing solo around the world, March 2015.

We focus on buying companies that can generate the sort of attractive, underlying profits that will help to keep you wealthy.



## MAKING REPAIRS

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.”<sup>9</sup>

Our repairs, thankfully, involve less physical jeopardy, though as we explained in the last *Quarterly Letter*, they are not necessarily easy decisions to make.<sup>10</sup> Over the past year we have sold positions in some companies in order to allocate capital into other opportunities where we had higher conviction in the long-term returns.

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.

Our 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.

## 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.

Among the major asset classes, equities are particularly well placed to offer protection against inflation. 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.

<sup>9</sup> The Guardian: 'Fear keeps you alive', 1 October 2007.

<sup>10</sup> *Quarterly Letter: Changing your mind*, June 2022.

All the companies we hold in the return component of our portfolio are united in having appealing economics.





We estimate that Mastercard made approximately \$0.14 profit on a typical \$100 transaction in 2019. If we factor in 10% inflation, that purchase would cost \$110 today. However, Mastercard's profit on the same transaction rises to \$0.17 – a 13% increase that is comfortably above the inflation rate.

When the underlying businesses in our portfolios are able to pass through inflation in this way, it acts as a natural hedge.

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.

### CONCLUSION

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

However, we fully expect to meet our target over longer-term horizons 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."<sup>11</sup>

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.<sup>12</sup> 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 course 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!

<sup>11</sup> London Business School: Dame Ellen MacArthur, 7 November 2013.

<sup>12</sup> NBC: Ellen MacArthur's journey, 28 May 2006.

# Important information

## 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.

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