



Concentrated Global Growth

Market Overview

Looking back on 2021, there is a distinct sense of déjà vu with this time a year ago as we are once again reporting on a strong year of absolute returns for global equity markets despite the continuing challenges of a global pandemic. The key drivers of equity returns for both years were undoubtedly extremely supportive fiscal and monetary policies, undertaken by governments and central banks around the world, designed to ensure that the economic effects of the COVID-19 pandemic were contained and minimized to the best of their ability. Looking back, it is hard to criticize these actions given the strong economic recovery we have seen in 2021; although, there may well be some more adverse consequences to deal with, down the road, that we will address in the investment outlook. However, as a result of these actions, there is one significant difference between the two years, namely earnings, with 2021 likely to record earnings growth above 50% globally following a fall in earnings in 2020 of in excess of 25%. In 2020, investment performance was entirely driven by expectations of the economic recovery, and fortunately that recovery materialized in 2021.

Overall, the MSCI World Index rose by 21.8% in 2021 (all returns in US-dollar terms), with those sectors and countries that had the strongest earnings momentum delivering the best returns over the year. Notably, the US and Canada were the best performing markets, up 25.2% and 23.4%, respectively. These were the main drivers of global returns as North America now accounts for over 70% of the MSCI World. Within the MSCI World, the next best-performing market was Europe up 13.8%, followed by Japan, which was flat, and China, which was down 22.8%. At the sector level, the best-performing sector was energy, reflecting the dramatic recovery in earnings in that area following its collapse in 2020. That recovery was also seen in financials, where banks, in particular, also saw a strong earnings recovery. Other sectors that performed well were real estate, which continued to benefit from low interest rates, and technology, where the moves to a more digital economy continued apace.

Our Concentrated Global Growth Portfolio benefited from the strong market returns, rising by almost 20% in the year, but lagged the MSCI World by approximately 2%, before fees. This relative underperformance was driven predominantly by our underweight exposure to North America, despite our exposure being nearly 60%, and our overweight to China. The China performance was particularly disappointing as the stocks we owned, namely Alibaba Group and Tencent, performed well at the divisional level but were caught up in a number of significant government regulatory changes focused on delivering “common prosperity.”

At the sector level, the strong rotation into energy and banks, to which we have limited exposure given our focus on stable consistent growth, also hurt our relative performance, most notably in 1Q:21. However, our underweight in these areas had benefitted us in 2020 and we will continue to focus our efforts on stability, believing that is the key to good long-term performance. Detractors from performance included Alibaba, Alstom and Mastercard, one of which was caught up in regulatory concerns in China. Alstom made an acquisition of Bombardier, a rival train manufacturer, in a deal that should be very positive in the medium-to-long term. However, the deal came with some issues, particularly some loss-making contracts that required write downs. Looking forward, we believe that issue is now behind the company and it can start to deliver solid margin improvement. The leading stocks among contributors in 2021 were Capgemini, ASML and Ashtead, all of which benefitted from strong earnings growth.

Turning to the fourth quarter, the Portfolio performed well in both absolute and relative terms, outperforming the MSCI World, which was up 7.8%. This strong performance was driven by robust economic growth, despite the emergence of the COVID-19 omicron variant, which raised fears of further lockdowns. In the US, the legislature passed an infrastructure bill that had been long expected and is seen as a positive for economic growth, although they once again failed to pass the “Build Back Better” program. In China, the government began to loosen monetary policy, fearing growth might stall following concerns about corporate failures in the property sector. The

leading contributors for this period were Zoetis, Cargemini and ADP, all of which benefitted from strong earnings reports. Top detractors for the quarter were Murata Manufacturing, Philips and Alibaba. Murata was caught up in some investor concerns related to supply shortages, which we believe are short-term in nature. Philips suffered from investors uncertainty regarding the recall of its sleep apnea machine, but right at the end of the quarter issued an independent report that stated any issue regarding the foam use in the machine would not typically be anticipated to result in long-term health consequences for patients. Alibaba continued to suffer from regulatory concerns and we sold the position believing the uncertainty regarding regulation was greater than the upside potential warranted.

Portfolio Changes

Within the quarter, we made one major change to the Portfolio—selling Alibaba and buying Booking Holdings. As we have already mentioned, we felt that the risk-return profile of Alibaba was no longer acceptable. This has been a frustrating investment over the last eighteen months, having initially been very profitable post the IPO. We continue to believe the company has a good strategy and solid long-term prospects, but the continued moving of the “goal posts” by the regulators is obscuring the underlying fundamentals. We have argued before that we felt the authorities would begin to take a more rational approach, but this does not seem to be the case with new concerns about Alibaba’s cloud business beginning to surface. Accordingly, we decided to focus our investments elsewhere. We still believe China has some attractive growth characteristics, notably in consumption, manufacturing and healthcare but are looking to access this growth through non-Chinese companies such as Nike and Nidec.

We made the investment in Booking to increase our exposure to the reopening of the travel and leisure market in 2022/2023. The company had suffered from the news of the omicron variant and how it was likely to force the reintroduction of travel restrictions, which it undoubtedly will in the short run. However, the data on omicron suggests that, once we are through the initial infection spike in 1Q:22, there are grounds for believing that high rates of vaccination and infection will help build up greater immunity to a disease that is also showing signs of becoming less deadly over time. Booking is one of the world’s leading travel companies, operating several different travel platforms—specifically, Booking.com, Priceline, Agoda.com, Open Table and KAYAK. On a return to any sort of normality, we believe there is significant pent up demand for holidays and that the company can grow at 16% per annum over the next 5 years, trading on a multiple of 24 times on reduced 2022 earnings.

Investment Outlook

While 2021 had a number of similarities to 2020, it seems likely that 2022 will be a somewhat different animal. The most notable difference will be that the supportive monetary background provided by central banks around the world will be slowly unwound to reflect the underlying economic recovery as well as increased inflationary pressures. This in itself is not necessarily a bad thing as the world begins to normalize, but any withdrawal of liquidity may be unsettling. The recent announcements by the US Federal reserve are suggesting that the first interest rate hike could be as soon as March, with three rates hikes in 2022, now consensus. This would get us to a Federal Funds rate of 1% by year end. Again this is not particularly high in itself, but if bond yields react negatively, believing the Federal Reserve is behind the curve, and move further and faster, then it is possible the negative real yield that has been supporting the market moves positive, putting pressure on valuations.

The bull case for the market is that the omicron variant is very transmissible but not nearly as debilitating or deadly as the delta variant. Because it is so transmissible, infections will increase significantly and this together with vaccinations will move the population toward herd immunity, allowing us to begin to move back toward a more normal environment. In this case, consumption can continue to grow with pent-up demand in many areas, most notably housing, cars and travel. Supply bottlenecks that have been related to COVID-19 will begin to diminish and, as a result some inflationary pressures, will be seen to be transitory—albeit they have been in place for longer than initially expected. This reduction in inflationary pressures allows the central banks to tighten policy slowly and markets can move ahead modestly with some earnings support, albeit at a significantly slower pace than in 2021.

The bear case is that omicron is so transmissible that healthcare systems are overwhelmed, and significant lockdowns are undertaken. This is particularly true in Asia where some vaccines are seen to be less effective and policy measures to shut down large areas of the

economy are very vigorous. This shuts down supply chains, which once again restricts goods availability just as demand is returning. This inflationary move forces central banks to take a more restrictive stance putting up interest rates at a faster clip. This in turn puts pressure on consumers, who are also suffering from the effects of higher prices, and growth begins to slow. In this case, equity markets will worry about earnings falling, partly due to demand and partly due to margin concerns. Valuations will also come under pressure given their elevated level and there will be concerns about rising bond yields.

We will potentially see fears raised about all of these issues over the coming months and it is very hard to be categorical about which scenario is correct. On balance, it seems likely that elements of both scenarios will play out and that will generate volatility with some significant market rotations. We continue to take a balanced approach, slowly moving to a reopening scenario, with investments such as Booking giving us greater exposure to the recovery of areas such as travel. We will continue to focus the Portfolio primarily on companies with a very stable earnings profile, not wishing to get caught up by moving the Portfolio too far in one direction or another, believing that we can generate a solid return from a positive and less volatile earnings mix.

Best regards,

Mark and Dev

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