ROYAL LONDON
ASSET MANAGEMENT

COVID-19 INVESTMENT UPDATE: SUSTAINABLE TEAM UPDATE – 10 JULY 2020

What is happening?

Despite the resurgence of Covid-19 in countries such as the United States, and its ongoing spread in countries such as Brazil and India, equity markets have remained resilient and have actually risen in the last two weeks. Rightly or wrongly, Covid-19 is no longer the primary driver of asset markets. Our view is this does make sense: it is apparent there will be no further shutting down of economies and that we are learning to live with this virus, disruptive as that may be. The debate has moved on to the shape of economic recovery and the influence of central bank and government stimulus measures. On both of these issues there is something for everyone, bull or bear. There are regions, such as Europe (ex UK) and Asia (ex India) which have seen a rapid rebound in economic activity, whilst others such as the UK and USA have struggled. Equally there are those who believe recent central bank actions have been the most effective and timely intervention ever, and those who believe they have warped investment markets beyond all recognition. Our past experience of economic cycles is that at this point in them, after the initial hit and as the recovery starts, having a singular view, bullish or bearish, about how events are likely to unfold in the future is particularly dangerous. Uncertainty is at its highest and opinions at their strongest; this is never a good combination.

One of the more interesting things in the last two weeks has been the acceleration of the performance of technology shares. For someone who started their career investment career in 1999, there has been a faint echo of what happened back then in the technology bubble. It is the question we get asked the most in client meetings: is this a new technology bubble? ‘Bubble’ is one of the most overused words in investing. The number of perceived bubbles versus actual is very low. In my 21 career we have had two: technology in 1999 and housing in 2008. They are actually quite rare despite regular use of the term financial by the media. Our bias is that we do not think this to be a new technology bubble, but we do acknowledge there are strong arguments on both sides of the debate. Our main point is that the proportion of major indices relating to the technology sector is broadly in line with their earnings contribution to those same indexes. Share price increases have been supported by the increasing profits of technology companies. This was not the case in 1999. We also think that technology is a clear Covid-19 winner, within digitisation and cloud computing adoption clearly accelerating. The main challenge to our positive view is more generic: all bubbles start with excess liquidity chasing too few returns. This is arguably what we are seeing now given central bank actions, and technology shares have become something of a one way bet. Certainly we struggle with the valuations ascribed to some of the more nascent business models in the sector, such as Tesla, and this could be a sign of froth appearing. So whilst we are minded to think the rally in the technology shares we own is supported by fundamentals, this is a view we are frequently challenging ourselves on.

What will happen next?

Ultimately the level of stock markets will be determined by two things. First, the overall levels of economic activity post the recently started recovery, as this will have a major bearing on the level of corporate profitability. Second, the discount rate (itself a function of the cost of equity and the cost of debt) applied to those corporate profits. The two are of course interconnected: the lower the level of economic activity, the longer interest rates and the cost of debt (and therefore discount rate) will be kept low. It is only in the interaction of these two variables a view on what happens next can be formed. We, like most, are cautious about the ultimate level of economic activity until a vaccine and/or more effective treatments are found. Ultimately we think economic activity will surpass previous highs, but this may take some time (2022 maybe?) and the shape of it (which companies are winners and losers) could be very different than in the past. We also think it highly likely interest rates, and therefore the cost of debt, will remain exceptionally low for an equally long time. This increases the value of future corporate profits. Our own read on the situation, which is more of a subjective judgement, is that at current levels these two variables are essentially in balance i.e. equity markets are fairly valued. A material fall from here would, we think, be another buying opportunity, but a material rise could well be liquidity driven and make valuation more of concern than it is currently. A sideways market for the rest of 2020, whilst the economy and vaccine progress catch up, would be no bad thing.

What are we doing?

In summary, not a huge amount. For all the uncertainty at the macro level, we do think what is going on at the micro level is much clearer. Those companies which will come out of the current crisis stronger and more valuable, such as healthcare and technology, are a core component of the funds. Whilst we are always on the lookout for new ideas, we think the funds do not need much change from where they are today. We have been reducing one position in the funds however, Descartes. This is a Canadian software company working to make supply chains more efficient and environmentally friendly. It is the one technology stock we own where we think its small size, lower liquidity of shares and strong thematic investment story has pushed its valuation to a level that no longer compensates us for some of the risks inherent in its business model. Price and valuation will always be one element of our investment decision making, and being compensated for the risks we take in all investments we own is essential. Whilst we continue to believe Descartes is well placed, it is an acquisition orientated business operating in a world where global trade may turn out to be lower growth in the future. These are the risks we are less compensated for after the strong appreciation of the shares.

How are we performing?

Performance has been good in the last two weeks. Our mixed asset funds continue to benefit from a pro equity stance, and within that a bias towards more innovative and socially useful companies. Our single asset equity funds are benefiting from good stock selection. This week, Thermo Fisher, a US scientific laboratory equipment company, upgraded guidance based on its role in Covid-19 testing, and the shares responded positively. We have also seen continued strong performance from Rentokil, the pest control and hygiene, as its peers have noted strong demand for Covid-19 related hygiene services, such as office and washroom cleaning. Finally Microsoft continues to perform extremely well as the pace of transition to a digital, cloud computing, based world accelerates. These three companies are good examples of businesses becoming more valuable as a result of the current crisis.

Anything else?

One of the more interesting debates we observe at the moment is the one of investment style. This is often framed as value vs growth investing, especially as the valuation ascribed to both of these styles is so far apart. Choosing an investment style as a fund manager seems to have become the same as choosing a sports team to support: once you have chosen you join a band of like-minded individuals and it becomes heresy to support anyone else. This is strange idea on a number of levels. In any decision making process where there any many potential outcomes, surrounding yourself with like-minded individuals is absolutely the wrong thing to do. It could be argued that some of societal disruptions we are seeing at the moment have their origins in groups of people with self-reinforcing views. Investors are better at growth investing if they understand value investing, and vice versa. Equally is it reasonable to expect over a 30 year investment horizon that the same approach will always work? We would argue not. The first decade of the 2000s was dominated by reversion to the mean investing (another way of thinking about value investing), but this stopped working in the second decade of the 2000s where technological and societal disruption have meant that mean reversion stopped working: the strong have got stronger and the weak have got weaker. Could this change again in the future? Most likely it will. Should fund managers adapt or remain supporting the same team? My answer to that comes from the art world. Those artists, take U2 or Picasso as examples, who lasted for many decades did not do this because they kept remaking the same album or painting the same picture, but by evolving and understanding changing times. It will be no different for fund managers.

Please note that this is a fast moving environment and markets and impacts on portfolios are changing. Opinions contained in this document represent views of our fund managers at time of writing, and performance numbers are estimates and not audited.

Reported yields reflect RLAM's current perception of market conventions around timing of bond cash flows. Heightened uncertainty due to the COVID 19 crisis may impact these timings for bonds with callable feature

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For more information on the fund or the risks of investing, please refer to the fund factsheet, Prospectus or Key Investor Information Document (KIID), available via the relevant Fund Price page on www.rlam.co.uk.

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