



Why we maintain a conviction-based approach to investment

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Investors were worried about the state of the global economy, but received the long-awaited message this autumn that central banks could be counted on once again to do their part. In a synchronised effort the likes of which hadn't been seen since 2009, 60% of the world's central banks cut their key rates in the third quarter.

Alongside this QE barrage, trade tensions between the US and China subsided enough to catalyse an equity market rally, pushing indices through the barrier that had previously kept them from doing much more than repair the damage they'd suffered in 2018. We therefore raised our equities exposure to capture as much upside as possible. However, we have deliberately maintained our investment focus on companies that enjoy secular earnings growth. **In what follows, we will explain what underpins that bedrock conviction**

Central banks are targeting financial markets

As the US economy becomes increasingly financialised, the confidence of consumers (who have a greater share of their wealth invested in financial assets than in real estate) and the leeway available to companies are being supported by financial markets at least as much they are supporting them. That explains why the Fed works unapologetically to keep the US stock market humming – and in the process becoming investors' faithful, objective ally.

With that degree of central bank sponsorship, the stock market rally had little trouble sparking renewed confidence in the broader economy, resulting in a sector rotation towards more cyclical names and a mild uptick in interest rates. **We, however, are quite unconvinced about the potential scope of such a cyclical upturn, and that is a first reason for sticking to our "growth-stocks" orientation.**

Banning recession

Endless central bank subsidies have allowed governments to maintain their excessive debt loads and businesses to keep on investing despite their extremely low profit margins. It thus looks increasingly like a recession has been banned on the grounds that if one were to occur, it would trigger a credit crisis. Once again this year, investors have therefore felt comfortable betting that central banks will do whatever it takes to steer the world economy towards a soft landing.

But there is a price to pay: this approach reduces the economy's medium-term growth potential and results in low secular economic growth rates, increasingly anaemic and short-lived cyclical upswings, and a dwindling number of companies that can grow their profits over the long term. Those are the companies we favour.

The liquidity bubble

This postponement of the day of reckoning has created a liquidity bubble – which is not the same as a speculative bubble. Financial markets aren't being driven by the lure of oversized gains, but rather by savers' need to find somewhere to invest their excess cash for reasonable returns and at acceptable risk levels.

The growing performance dispersion among asset classes bears witness to this trend:

Credit is still enjoying positive inflows, but these are going increasingly to quality issuers, whereas the junk segment is beginning to experience its first accidents.

In equities as well, investor confidence in the overall economy has re-emerged but this hasn't been enough to halt the progression of top-quality growth names; meanwhile, cyclical stocks are being confronted with major strategic challenges.

So even if the current liquidity bubble were to last and to go on fuelling the disparity between financial markets and economic reality, it would not dent the attractiveness of companies with superior business results – quite to the contrary.

The profit recession

The secular slowdown that is forming the backdrop for the various mini-business cycles inevitably entails mounting pressure on corporate profit margins. The growth rate for profits at non-financial US firms has been trending downward for the past ten years, and the same pattern can be seen in both Europe and China.

That means that the ability to keep profitability up throughout the business cycle is now more than ever a key, long-range differentiator. We therefore consider it an additional reason for sticking to our long-term investment style.

Looking further down the road

We are thus convinced that the most robust way for us to achieve long-range returns is to identify business models that can generate powerful growth and substantial profits over a five- or ten-year span. Those business models are quite well suited to the current environment of low-key business cycles and mediocre growth rates.

Moreover, we believe that the broad technological revolution under way is as epoch-making as the industrial revolution in the nineteenth century, and we feel it offers major opportunity for companies that successfully monetise the practical applications of that revolution.

To mention just a few perspectives:

Artificial intelligence is moving ahead by leaps and bounds – fuelled by the expansion of utilisable databases which are buoyed in turn by massive mobile-phone use.

The first tentative applications of AI in virtual reality software is creating tremendous potential, not only in video games, but also in healthcare and education.

The technological revolution will also deeply affect how people consume, travel, and communicate.

All these offshoots of the technological revolution unfolding today provide a glimpse into how exciting investment opportunities can and must be developed on the basis of extremely rigorous analysis. This conviction is what informs our entire style of asset management.

Combining risk management and long-term convictions

2020 will no doubt pan out differently than 2019. The “Bubble of Everything” may not be on the verge of popping, but the stakes for financial markets in the event of an accident have increased considerably. By positioning themselves once again for a cyclical upswing in 2020, investors are wagering that neither US consumer behaviour nor corporate profits will disappoint them (although US banks have tightened their lending conditions and the pace of job creation is winding down). They are also assuming that trade, political, and geopolitical uncertainty will become lastingly less pronounced.

We aren't so sure that we're in for such an improvement in the overall outlook, and we feel that managing market risk could be crucial in 2020 if we encounter turbulence. We therefore feel that our strategic preference for growth stocks that can look forward to predictable earnings is in no way an empty, common-sense boiler plate. It is a major performance driver, based on a highly demanding approach that in our view has a lot more to recommend it than the short-term returns being offered.

Source: Bloomberg, 29/11/2019



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