MAGELLAN
EXPERTS IN GLOBAL INVESTING

Q&A WITH HAMISH DOUGLASS

Hamish Douglass, the Chairman and CIO at Magellan, talks about what market reactions to covid-19 surprised him, why the global portfolio has withstood the market ructions and what makes Estée Lauder and LVMH sound investments still. He concludes by discussing why inflation is not an immediate threat despite the massive fiscal and monetary stimulus.

Q: Are you surprised by the turbulence covid-19 unleashed on financial markets?

A: The extreme market volatility on stock markets didn't surprise us as it was correlated to bleak news headlines and the uncertainty those created. Different types of stocks performed as expected. Non-discretionary retailers such as supermarket chains performed well, as did consumer staples, business software companies and telecoms. At the opposite end, travel, oil and gas producers, banks, discretionary retailers and property trusts struggled as logic dictated.

But some events surprised us. Saudi Arabia's dispute with Russia over oil prices was unexpected. The bond market surprised us when yields edged higher as did the extended selling of some utilities. We would have expected that government bonds and utilities would have performed better due to their defensive qualities. In the rush for cash, however, cash-like assets were sold to meet liquidity needs. That was somewhat counterintuitive during a flight to safety.

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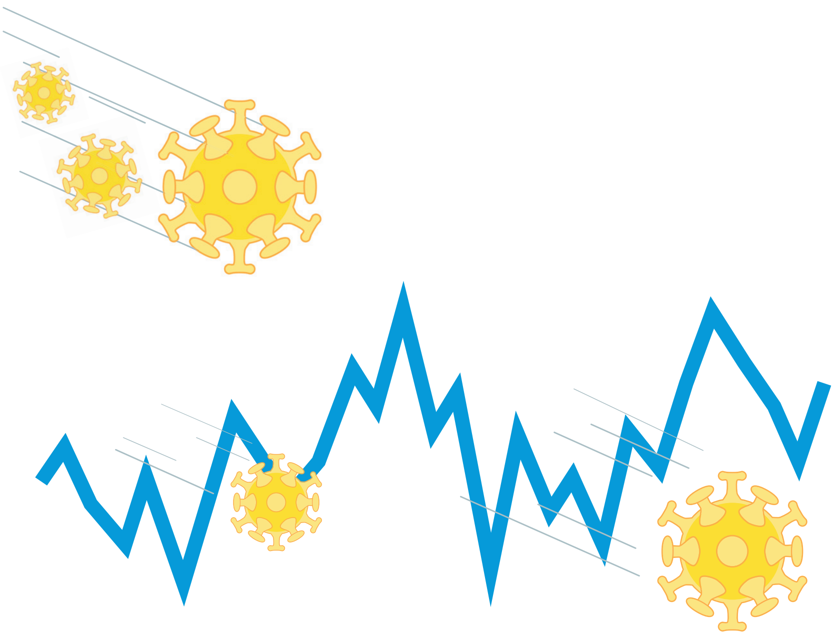


Q: What is your best risk-management tool during a crisis such as today's?

A: Our most important risk-management tool is our portfolio construction. We design a portfolio to deal with the unexpected. This is probably as close as you can get to a 'black swan' event even though, along with a terrorist or bioterrorist event, we have often cited a pandemic as a risk.

"...the most extreme event we have seen in our careers."

Despite the fact that we were close to fully invested when covid-19 struck, our portfolio has proved resilient because we apply conservative risk controls (such as a 0.8 cap on the combined risk ratio) when we build the portfolio and we invest only in quality companies.

As events unfolded, we reduced the risk ratio of the portfolio. So far, we can say we are pleased with the way the portfolio has reacted to the most extreme event we have seen in our careers.

Q: The portfolio includes consumer-discretionary companies such as Estée Lauder from the US and LVMH from France. Do you think consumer behaviour will change after the crisis and are these luxury companies still good investments heading into a recession?

A: We certainly expect the crisis to change consumer behaviour but it is too early to tell how much. How consumers react will depend on the depth and the length of this crisis and how economies recover.

The perspective from which to view Estée Lauder and LVMH is that these stocks amount to only a moderate proportion of the portfolio as we have reduced their positions in recent weeks. That said, and while these companies offer luxury goods that might be less sought after than before, Estée Lauder and LVMH are outstanding companies with outstanding brands and they hold the advantage that about 33% of their sales come from Chinese consumers. We are confident that China will emerge relatively well from this crisis. At the right price, we'd be happy to increase our positions in these investments.

Q: What are the long-term implications of these unprecedented levels of monetary easing and fiscal spending underway? What is the risk of higher inflation or other pressures emerging?

"...the world is likely to have substantial excess capacity, which points to few inflationary pressures emerging for a long while."

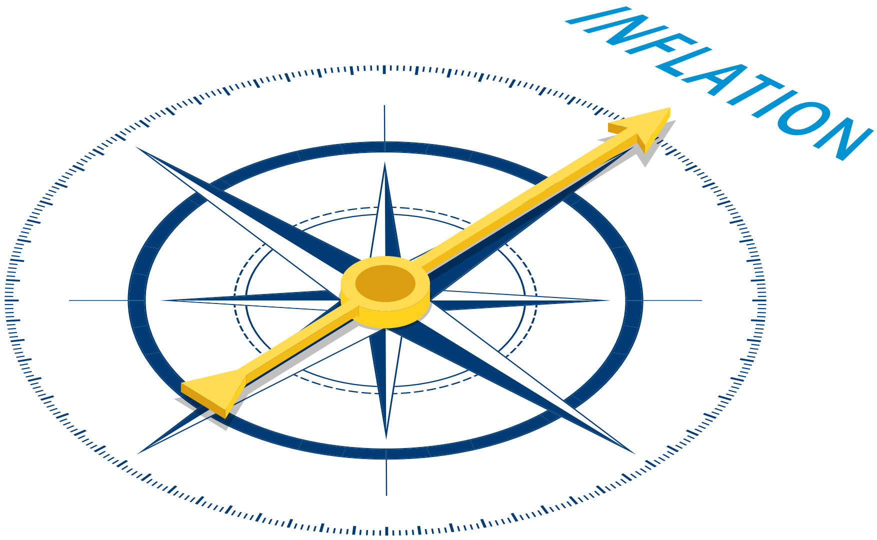
A: Our initial assessment is that inflation is unlikely to be an issue for many developed economies for many years. We're likely to come out of this with a substantial and lasting shock to demand. Therefore, the world is likely to have substantial excess capacity, which points to few inflationary pressures emerging for a long while. It could, however, be a different outcome for some emerging markets.

The other issue we are thinking about is the debt burdens that many countries are incurring when combating the virus (and remember that some countries in Europe had high debt burdens before the crisis). The problem is that these debt burdens could put substantial upward pressure on long-term interest rates. Investors might worry about the solvency of some countries.

The only way to overcome an increase in longer-term interest rates is effectively to transfer the debt burdens to central banks via quantitative easing and maybe by specifically targeting longer-term interest rates as Japan has done.

We are thinking too about portfolio positioning in terms of where we want to be exposed and which currencies we want to be in and which ones we wish to avoid. We are aware that these debt burdens could once again place significant pressures on the eurozone and on the euro. That means we might prefer investments in the US, Switzerland, Denmark, the UK, Singapore and possibly Australia.

We are wary of emerging-market currencies. We have limited exposure to emerging markets outside of China but we still could take action to further reduce this risk.



Q: While it is not necessarily an issue just yet, what might inspire you to deploy some of your cash holdings and move out of defensive stocks?

"You can't just say that stocks will rebound because that's what happened after 2008 and through 2009."

A: I'm glad you phrased that this is not an issue for today because we are not thinking of moving out of cash at the moment. We need to better assess how this crisis is likely to play out. We need to assess how deep and long the recession might be and whether or not central banks are across all the issues around financial stability. History doesn't provide a good reference point for anyone on what might happen next. You can't just say that stocks will rebound because that's what happened after 2008 and through 2009. That would be a misjudgment of this situation.

We are especially mindful that risks might emerge in the financial system. These risks include high-yield credit and what might happen when companies get downgraded from investment grade to sub-investment grade. Another is that there is likely to be further pressure on the capital of banks and insurance companies. Before we took the portfolio to a less-defensive position we would want to see how these risks develop and how regulators, governments and central banks might address them if they were to become threats.

In the meantime, we will stay focused on preserving the capital of our investors. As Warren Buffett has said: "To finish first, you must first finish." That said, we should remind people that we have about 85% of the portfolio invested in global equities and our portfolio is positioned to do well if the economic recovery is better overall than investors envisage.

Q: What long-term changes might covid-19 prompt for the world in terms of supply chains coming back home and how might this influence your future portfolio construction?

A: We've heard a lot about supply chains heading home but we think this is a misplaced notion. Moving all supply chains onshore doesn't necessarily mitigate the pandemic risk. By definition, a pandemic is a global event and it might turn out that China is one of the best places to have manufacturing located because China could be one of the first countries to get their manufacturing working again.

"...China could be one of the first countries to get their manufacturing working again."

The reaction we are more likely to see is the onshoring of warehousing. There will be more stock held in supply chains. The crisis has exposed the fragility of just-in-time supply chains because they had no flexibility when production shut down. Another consequence is that we will have the onshoring of strategic industries such as medical supplies.

From the portfolio point of view, we want to make sure we capture the additional cost of strengthening supply chains in our company models. We need to think about whether or not companies have the pricing power to recoup these costs, which would see them preserve their margins. This might be hard for many companies if we have subdued demand during an extended recession.

Q: Which industries do you think won't bounce back from the virus crisis and which ones might do well?

"The winners will be those companies with resilient business models..."

A: Even though many companies are likely to have materially lower earnings for an extended period, there will be winners and losers. The winners will be those companies with resilient business models such as supermarkets. People are bound to be more conscious of hygiene, which would benefit companies that produce hygiene products. There is likely to be a permanent increase in the demand for software, especially business software. We're all on video conferencing today. This is of benefit to Microsoft. Digital entertainment platforms should benefit as should utilities and consumer staples because their demand should hold up. With interest rates so low, these stocks could end up on favourable valuations.

Some industries certainly appear to be in trouble. Cruise lines, travel companies, airlines, oil and gas producers, some mining companies and certain property investments face challenges, as could financial investments such as banks and insurance companies where the strength of balance sheets is so important.

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