Looking through the uncertainty

Quarterly Letter

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Ordinarily, our *Quarterly Letter* aims to bring to life our investment approach and portfolios through the lens of an interesting theme. With the coronavirus crisis threatening our collective well-being and the consequential upending of everyone's daily lives in response to the threat, this didn't feel appropriate. Instead I want to share some brief comments, with input from our Global Investment Strategist Kevin Gardiner and portfolio managers, on how we are seeking to navigate the investment and business implications of the crisis.

The bigger picture

The arrival of COVID-19 in Europe, North America and beyond has sent tremors through investment markets. The estimated numbers of fatalities and hospitalisation rates caused by the virus are horrifying, but this is not what is causing the market turmoil. Instead, it is the contagiousness – and the resulting impact on overstretched national health services – which has triggered such a dramatic response by governments, in a situation that is constantly evolving.

We are now experiencing the deliberate closure of a substantial part of the global economy to limit the spread of the virus through a range of measures unprecedented in peacetime. At the time of writing, the UK population is one of the latest to feel the effects of a lockdown imposed by its government. Global restrictions on movement will undoubtedly result in some of the most sensational falls in output, spending and corporate profits ever recorded when the official data are published.

While the resulting economic damage is regarded as a necessary 'firewall' against the virus, central banks and finance ministries have responded at incredible speed with measures to limit the risks of more lasting damage to the economy, allowing it to rebound when deemed safe to do so.

The scale and severity of the shutdown has created an exceptional period in financial markets, with sharp rises in volatility and extreme, rapid falls in share prices across the world. Taken at face value, current levels suggest that the corporate sector globally has lost future income equivalent to around one-third of its value. Despite the magnitude of the pandemic and its effects, this seems perhaps excessive to us and could well be an overreaction.

In our opinion, markets are unlikely to wait for the economic data to recover and may instead start to find their feet as contagion rates stabilise. If the news from China is even a rough guide, this may be matter of weeks rather than months. The figures we are watching most closely then, imperfect though they are, are the daily updates published by the World Health Organization.

Portfolio update

When discussing portfolio strategy with clients, we always talk about return objectives in the context of risk. We use 'drawdown' examples, which measure the decline from a past peak either in markets and portfolios, to bring the subject to life. However, hypothetical discussions around risk and paper losses recovered after a period, in the comfort of our own home or calm of a meeting room, can never fully prepare us when markets nosedive.

What we are experiencing now is the reality of risk; that uncomfortable feeling in our stomachs as the media is dominated by alarming headlines, share prices have 'crashed' and the paper value of our wealth has declined. It is a feeling I have experienced several times over my 30-year career, most notably during the dot.com bust in the late 1990s, the financial effects of 9/11, and, more recently, the Global Financial Crisis. While all recessions and crises have a unique set of circumstances, it is important to remember that in each case, the global economy recovered, the world returned to 'normal', much was better than before, and markets and portfolios went on to reach new highs.

While we don’t claim to have predicted coronavirus, nor the impact it has had on the world, we were prepared. The way in which we build portfolios is designed to withstand the tougher times. We have a balance of Return assets, primarily stakes in companies (either directly or through funds), to drive returns in the good times, and Diversifying assets to protect portfolios when times are tougher. As we would have expected, while the paper value of the Return assets has fallen as markets have declined, the Diversifying assets have played their intended role, rising in value and offsetting some of the falls.

Within the Return assets we own a range of companies, some of which are faring better than others. For example, the share prices of those companies in the travel, hospitality, construction and banking sectors have fallen more sharply than those in the farming, telecommunications and car insurance industries.

As you would expect, our team have been working around the clock to re-examine the financial strength and outlook for all the constituents of our portfolios. We’ve pulled apart our models, challenged our assumptions, spoken to industry experts and engaged with the companies themselves. The intensive research we employ allows us to hold our nerve and take opportunities when they present themselves. Our recent work has given us increased confidence that, in aggregate, the companies we own will emerge from this crisis with enhanced competitive advantages, and excellent potential.

In terms of positioning, we are sitting tight for now, maintaining the balance of the portfolios and monitoring our investments very closely, at the same time as looking to future opportunities. As markets have fallen, we are in a strong position to add to existing holdings within our Return assets, at very attractive prices, while also analysing the potential to add new companies to portfolios, which we previously felt were too expensive.

Open for business

It just remains for me to provide some further reassurance that, as far as possible, it is business as usual for us. Rothschild & Co has survived and prospered through many previous crises in its 200-year history. It is this experience that enables us to remain calm when in ‘the eye of the storm’, as well as open and flexible in the face of changing circumstances.

This flexibility has been demonstrated as we invoked our well-established business continuity plans and technology to enable our team to work from home several weeks ago. I am very proud of the way everyone has pulled together and adapted so well to working remotely and continuing to serve our clients.

Thank you for your continued support and understanding during these challenging times.

My very best wishes to all of you and I hope that you and your loved ones remain safe and well.

Helen Watson
CEO, Rothschild & Co Wealth Management UK

Notes

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