Covid-19

Our initial response and thoughts

George Cooper, Chief Investment Officer

Last week we took the decision to move the entire Equitile team to remote working. I'm pleased to say, thanks to Microsoft – now your largest investment – this transition has proved seamless. We have been able to switch to remote working while continuing to operate the business and manage your investments as usual. I am also pleased to report the same appears to be true of all our counterparties and service providers. With the exception of a few valuation reports being mildly delayed by extreme market volatility we have seen no change in operational service due to the rest of the financial industry also switching to remote working. Of course, we hope to return to normal working as soon as possible but, if necessary, we can continue working in this way indefinitely. That said, the transition has not gone entirely without incident. We have already had one yoga related injury in the team! We encourage everyone to avoid the lotus headstand while socially isolating!

The market turmoil caused by the governments measures to combat Covid-19 has been brutal. As at the time of writing your portfolio has fallen in value by approximately 20% since the start of the year. Global stock markets have, on average, fallen even faster losing about one third of their value since the start of 2020. The strong balance sheets of your investee companies and their dominant positions within their respective markets have helped them weather this storm a little better than most. In addition, avoiding the banking and energy sector has also helped. With your portfolio broadly outperforming in the sell-off we have been disinclined to make substantial changes to your investments. We have, in the last few days, added Adidas back into your portfolio to take the place of the Roche, but otherwise we have made few changes.

We are confident your companies are well positioned not just to weather this storm but to come out of it in a stronger competitive position.

Although we have made few changes to your portfolio of investments, we have made changes to our foreign exchange risk management program. Until recently we operated a policy of hedging away foreign exchange risk. In the last few days, as the crisis intensified and the demand for US dollars grew, we took the decision to suspend our foreign exchange hedging program. We believe it is not in investors' best interest to hedge FX exposure, especially USD exposure, at present. So, for now we are operating the fund without the currency hedging program.

It is too early in the crisis to formulate precise views about how the future investment climate will evolve. The degree to which economic activity is being supressed suggests to us when the recovery comes it will be very sharp. There may even be a degree of post-crisis binge spending as newly liberated people adopt a carpe diem attitude. However, we do not think the economy bounces back to the way it was prior to these Covid-19 measures.

This is the first time in history that governments around the world have come together with the express intent of shutting down large sections of their own economies. The economic damage being done to businesses involved in leisure, tourism, hospitality and any activity involving social gatherings, is likely to be profound, long lived and in many cases irreversible. Governments will be able to channel aid to larger companies relatively easily, but for smaller companies it is far from clear the fiscal support measures will hit the mark with sufficient force or quickly enough. We expect huge numbers of businesses will close during the crisis and will never re-open. Obviously the longer this social distancing experiment continues the greater the risk of irrecoverable economic damage.

One near certainty is that post-Covid-19 governments will find themselves taking responsibility for propping up whole sections of society and whole industries. Modern Monetary Theory, the idea that governments need not balance their income and expenditure but should simply fund spending with government borrowing has been simmering away on the fringes of economic orthodoxy for a number of years. To our read the Covid-19 crisis measures will inflict such massive damage to the economy and to government finances that there will be no practical alternative to monetised deficit spending for years to come. In just a few days any serious debate or opposition to this policy path has been shut down by groundswell of popular opinion.

Most of us have grown up in an environment of fiscal prudence, and declining inflation. We think this regime has just come to an abrupt halt. At first the demand shock may make this crisis appear deflationary, however, over the coming years and decades we think the political consequences will mean it morphs into an inflationary problem.

For longer term investors, keen to preserve and grow pricing power over decades or even over generations, we would recommend tilting your portfolios heavily toward inflation protected assets such as equities and real estate.

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