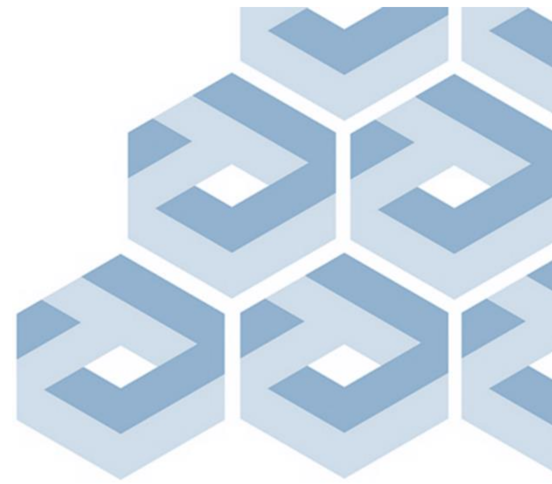


TELLWORTH
Investments

Stocks & Shapes

April 2020

We hope you are all keeping well and stay well. Welcome to a new mid-month missive from Tellworth where we plan to look at broader themes away from the very specific trials and tribulations of our funds that we cover in monthly letters. This idea has long been in our minds and when better to unleash on you than now when every question has a dozen conflicting answers? We look forward to your feedback at IR@bennbridge.com.

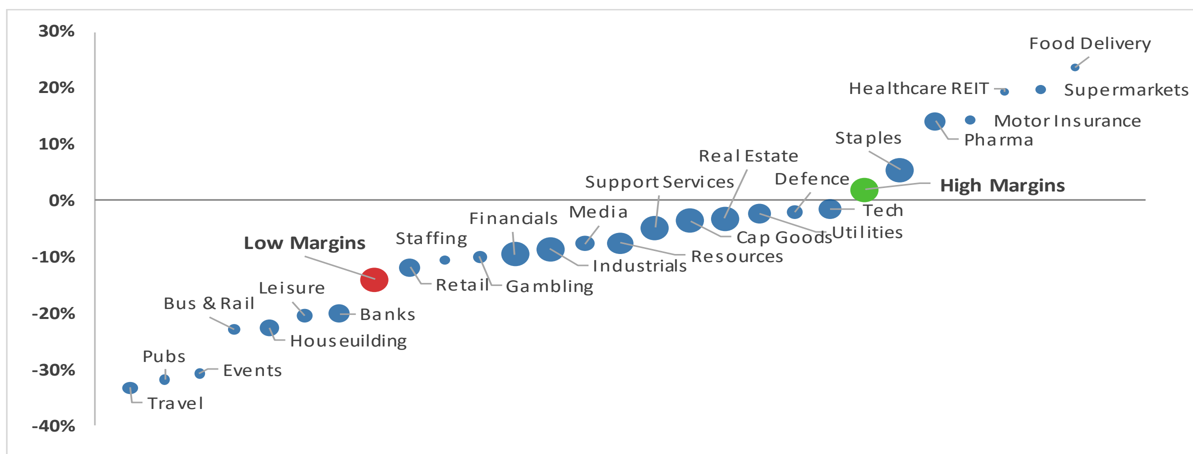
Current state of play – Bunkers have boomed

Forget index records - within markets, the gap between winners and losers has been nothing short of seismic. We have had the largest stock dispersion on record – at a 40% standard deviation of sector returns reported by S&P Global – and all in the space of about a month. UK Travel, Pubs and Events businesses have at least halved in value. But many Food Delivery, Supermarkets and Motor Insurance stocks – we will call them the Bunkers – are well above their pre-COVID levels.

This is, of course, a function of equally unprecedented changes in consumer demand. As we look across our UK ThermoStat indicators, we see searches for holidays down 70%, visits to retail websites down 40%, interest in bankruptcy and insolvency solutions up 20% and new residential listings down 80%. This is not a functioning economy, or one in which consumer focused indicators of any kind really serve any purpose. Simply: everything has stopped.

Aside from whether your customers have totally disappeared, another important market dynamic has been the inevitable 'tree shake' that comes with any systemic risk event. Companies that are less insulated – low margins and high debt – have generally fared much worse than those with stronger models and balance sheets, regardless of sector. The return difference is a chunky 15% – the gap between the green (50 high margin stocks) and red (50 low margin) dots below – again, most of it within the 4 weeks after Feb 20th. This is the time when under-appreciated quality comes to the fore.

Fig 1: Winners and Losers Compendium – Sub-sector relative Return since 20/02/2020, worst to best



Source: Bloomberg, Tellworth Investments. Low Margins = <10% EBIT margin, High Margins >25%. Size of circle = number of companies

Shape of the eventual recovery – Is it the wrong question?

V, W or U? This is the question most asked by the sell-side strategists we read. Most are in camp V. The logic goes that if we see some stabilisation of new case and death numbers – and increasingly this looks imminent – then the market will look through the short-term economic pain much like a natural disaster, so buy the stocks on the left of the above chart and sell the right. The caveat (and strategists love a caveat – see any of my old sell-side notes) is that if there is re-infection (W) or extended lockdown (U) then you should position the reverse. In other words, the *economic* patient and the *medical* patient are one and the same.

This may well prove to be right but it requires a big leap of faith. The examples of brushes with 15% unemployment are relatively few. Examples of these followed by quick recoveries are, we think, zero. True, we have seen some very impressive policy, both in scale and timeliness. This gives us pause for thought. If it can smooth reaction functions in both firms and individuals, then we stand a good chance of some proper catch-up spending in the autumn.

But what we think is being a little underestimated is *frictions*. Aside from the economics textbook 'classics' – consumption's non-linear relationship to *time* unemployed – there are numerous other examples littered across the company reports we read ("capex delayed until FY21", "12 month hiring freeze", "actively reducing inventory" etc.). Uncertainty and economic activity are very closely related – believing in a V-shape requires at least an A-shape in uncertainty – this seems a big ask whilst also telling companies you don't even know when the end of the beginning (i.e. universal lockdown) will be.

Perhaps a bigger albeit more abstract issue is that this is in a financial system that is really not set up for this kind of shock. Gross fixed leverage, driven principally by non-Bank lending in the last 10 years, is at record highs relative to the economy. Deleveraging for companies after this event will be high on the list (not a good thing at GDP level). All said, we find it hard to imagine that the speed of the rebound in the corporate mind-set, and the time spent at zero revenues for many companies is critical here, will be particularly quick.

Opportunities in the As and the Bs… but be careful of the Ds

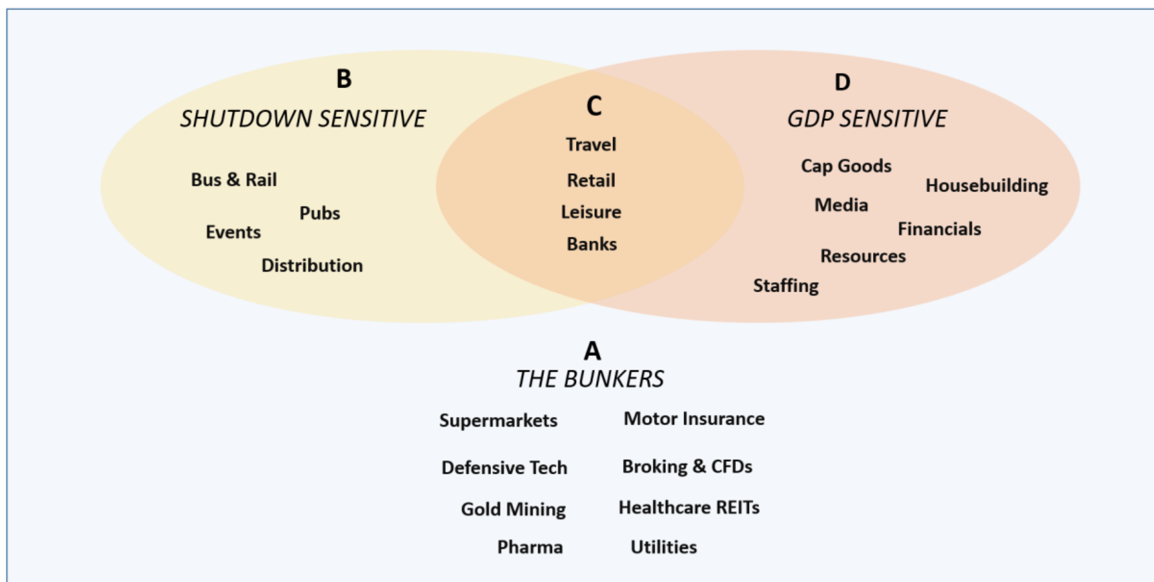
Fortunately, we do not have to make bold economic predictions or make big bets on bond yields. Indeed, our framework at Tellworth is not one typically based on gut-feel judgements such as those in the prior paragraphs. Principally we base it on the most 'live' data we can find on the health of the economy – the indicators within our UK ThermoStat model. Regardless of any former biases, if we see mortgage searches recover strongly, to give one early-cycle example, it would encourage us to do further work on related end-markets – perhaps housebuilding. It is when sizing up the rebound, then, that we hope and expect our indicators to deliver their most valuable insights.

The approach at the moment, however, is more nuanced. We require some judgement on the economy due to the lack of immediately useable data, but it is quite marginal. After the mega-dispersion we have seen, there are enough opportunities and inconsistencies, we think, in the UK equity market at the moment such that we actually want to minimise the exposure to 'factors' – i.e. not have so many near-term winners or losers that swings in sentiment drive our performance.

The biggest opportunity that we can see, and of course we will be oversimplifying, is between groups B and C in the below figure – all similarly big underperformers. This chimes with our earlier thoughts on economics vs. immediate epidemic impact. Indeed, traditional cyclicals in group D, like Cap Goods and Media have been relative winners, despite likely challenging end markets for well over a year.

For professional investors only

Fig 2: Team Sheets – Sub-Sector groupings by exposure, April '20



Our key judgement then, when shaping the UK Select portfolio, is that we want to focus our recovery stocks from **Group B**, where the longer-lasting economic damage will have less of an impact but pricing is keen. Of course, we need plenty from the bunkers too, the **A-team**, to help ensure a reasonable portfolio outcome if we see further shutdowns. The key consideration here is whether their valuation has out-run their defensiveness – this is a micro call. We want a good proportion of our short positions to be from the GDP sensitives (**the Ds**), especially those ona higher valuation – perhaps still on an unwarranted premium for defensiveness. Finally, the **Cs** stand for case-by-case. The double impact of COVID restriction and cyclicality make earnings near impossible to model. If we had a rule here it would be to buy the 'best stocks in the worst neighbourhoods' – we want strong balance sheets and a resilient model, but this typically comes at a hefty premium.

To zoom out a bit, the most important thing for us as stock pickers remains focussing on owning shares in companies that will be innovators and market leaders over the next several years – our tried and tested 'P3M' approach. So whilst the core of the portfolio will remain largely unchanged, retaining the flexibility to be opportunistic is vital in markets like the ones we study today. The record breaking dispersion has brought some of the widest set of opportunities you can see in investing – our job is to use the tools we have developed in the quieter times to take advantage of this.

Seb Jory co-manages our TM Tellworth UK Select fund, a large cap UK absolute return UCITS strategy that has delivered +6.33% YTD (vs the FTSE All Share -23.2%) and +7.27% since Tellworth took on the management of this fund from Sanditon AM on 12/12/2019 (returns quoted are net of fees on the F share class as of 19/04/2020. Source: FE Analytics, Bloomberg).

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