25 March 2020

The Brunner Investment Trust PLC Update

Lucy Macdonald & Matthew Tillett—keeping a more meaningful time horizon in mind can help distinguish between facts and noise.

Lucy Macdonald
CIO Global Equities, Portfolio Manager

Matthew Tillett
Portfolio Manager

Market Review

The past few weeks have seen a sharp pullback in global equity markets, with levels of volatility not seen since 2008. Investors have reacted to the rapid spread of the Coronavirus, as well as the impact of measures taken to mitigate further contagion. In affected areas, both international and domestic travel are greatly reduced, work is conducted from home where possible, and most public gatherings are banned. As a result, both the supply and demand sides of global economic activity will contract, with Goldman Sachs predicting a 1% contraction in Global Gross Domestic Product (GDP)[1]. In addition, a decision by Opec (The Organization of the Petroleum Exporting Countries) to abandon oil production limits has introduced additional volatility into markets via the Energy sector. Investors now expect a real negative impact to company profits, at a time when they were starting to stabilise as US/China trade tensions eased.

Portfolio Review

At the time of writing, the performance of the Trust's underlying investment portfolio is ahead of its benchmark for the financial year to date[2], outperforming its index by 1.63%. Despite negative absolute returns, our portfolio of quality companies, exposed to structural growth trends and on reasonable valuations, has been more defensive than broader equity markets.

Our positions in names like Microsoft, Iberdrola and the Cooper Companies have markedly boosted performance, with stock selection in the Industrials and Basic Materials sectors as an additional positive. From an allocation point of view, the Trust's longstanding underweight to Oil & Gas (on account of the sector's lack of stocks which match our investment philosophy) has been beneficial. Our overweight position in Health Care has also been positive, with Roche, one of the Trust's largest holdings making the leading contribution to performance. The pharmaceutical giant is a quality long-term holding, with a safe dividend that is currently producing a COVID 19 test 10 times faster than current standard, and recently has accelerated trials of its ACTEMRA drug for use in COVID 19 patients with severe Pneumonia.

Indeed, the Coronavirus has hit sectors most exposed to cyclical demand hardest, such as Energy, Travel and Consumer Discretionary. In the portfolio, this has been reflected in holdings like Informa, Wabtec and Bright Horizons. Our overweight allocation to Industrials has also made a negative contribution to performance, given the expectations for lower global economic activity. Here though, our positions are in well-managed businesses, with sector-leading return profiles and balance sheet liquidity. These companies are in position to be long-term structural winners in the industry while weaker players struggle.

Dividend payments are less certain across the entire market, as well as for a number of portfolio holdings. National shutdowns are forcing even quality companies with strong balance sheets to face months of reduced or, in some cases, zero revenues. Correspondingly, the Coronavirus has prompted unprecedented levels of support to business from governments, tax payers, employees, suppliers and banks. There is a risk that repaying such a communal effort by redistributing gains to a relatively narrow pool of shareholders will be seen as a breach of the social contract. As a result, even companies which might have continued to pay out during a more normal downturn, are choosing to pass or cancel their dividends.

However, over the past year, we have taken steps to increase the portfolio's underlying income generation. In addition, we have analysed the potential for each stock in the portfolio to cut or cancel its dividend. Under our current predictions, any income deficit should easily be coverable with the Trust's long-accumulated revenue reserves.

Outlook

Having said this, given the current level of volatility in equity markets, we would caution against focusing too closely on short-term performance. Periods like the present can be disconcerting. Keeping a more meaningful time horizon in mind can help distinguish between facts and noise. Experience tells us that even the most dramatic declines in global equity markets have been outweighed in the long-run.

What's more, long-term investment in a focused portfolio of excellent companies can deliver meaningful capital growth above those markets. Our investment philosophy favours companies with lower levels of leverage, stronger balance sheets and more resilient cash-flows than peers. These stocks should be best-placed to weather an extended period of suppressed economic activity.

While the current economic background lacks certainty short term, it may expedite longer-term structural trends to which we already have exposure within the portfolio. Mandatory policies to work from home and an increased aversion to public gatherings are likely to boost companies delivering on digitalisation. Likewise, the drive for economic self-sufficiency and reduced global travel could accelerate the development of a high-tech, low carbon economy.

An extended period of elevated valuations has also rapidly given way to a sharp compression of earnings multiples. Promises of both central bank and fiscal support around the world are now starting to remove questions about the survival of large, listed companies. As a result, valuations in some well-managed, consistently high-returning businesses with solid balance sheets are becoming more attractive. Yet until corporate earnings expectations – and therefore valuations – can appropriately reflect the disruption, some caution is warranted.

We have thus refrained from making any knee-jerk changes to the portfolio. Instead, we have used the recent sell-off to buy positions in three quality names whose valuations have become more compelling: **ITV**, **National Grid** and **Redrow**. These are a broadcasting and content production company, one of the world's largest electricity and gas distributors, and a builder of high quality housing. All three are currently on low multiples which materially underestimate their long-term ability to generate sustainable cash-flows. In contrast, we have sold **Howden Joinery** (a maker of kitchens), **Prudential** (financial services) and **Sirius** (a specialist property company). Having weathered recent market volatility well, we took profits in order to fund higher conviction positions.

1. https://fortune.com/2020/03/20/coronavirus-economic-predictions-goldman-sachs-recession-gdp-2q-2020/
2. Portfolio = -21.06%; Benchmark = -23.91%. Note – The Brunner Investment Trust's financial year starts on 1 December. For current Net Asset Value (NAV), share price and associated performance data, please visit www.brunner.co.uk.

All data source Allianz Global Investors, gross of fees in GBP, as of 20/03/2020.