Portfolio Manager Insights: Mid-Year Update

In the first half of 2020, our international all country equity composite delivered a -4.3% return, outperforming the MSCI ACWI ex US Index return of -11.0% by 6.7% (Figure 1).

The investment environment was challenging and characterized by high volatility as the novel coronavirus spread and brought economic activity to a halt. However, our investment approach – which favors investing in economically resilient growth companies with healthy balance sheets – was well suited. Our outperformance is most easily explained by the fact that earnings estimates for the average company in our portfolio fell by 7% less than for the average company in our benchmark. Our preference for companies with defensive characteristics has historically provided downside protection and that was the case again in the first half of 2020. Among the companies that experienced only modest declines in earnings estimates amidst a drastic reduction in economic growth expectations were:

- Leading manufacturers of life-sustaining medical treatments
- IT services players assisting companies with increasingly important digital transformations
- Providers of online gaming and video content

Portfolio Construction Was Also Beneficial

While investing in economically resilient companies with healthy balance sheets has largely allowed us to avoid meaningful tail risks amidst the economic slowdown, thoughtful position sizing and portfolio construction have also helped us take advantage of the dislocation we have seen in equity markets. We size positions by considering both base case and downside case expectations and learning that the COVID-19 spread in China prompted us to more closely analyze the risks facing each of our portfolio companies. We reduced our earnings forecasts for our holdings based on the perceived risk each business faced, and we increased the probability assigned to our downside cases playing out.

In addition, we initiated new positions in high quality companies which were previously on our watch list as they became more attractively valued. We also increased our weightings in strong franchises we own in the financials sector, which saw their stocks pummeled with the rest of the sector despite having more resilient businesses that continued to grow in the new economic environment. It is worth noting that our strategy outperformed by 3.4% in the first quarter – when the benchmark fell -23.4% – and also outperformed by 3.5% in the second quarter, when the benchmark rallied 16.1% (Figure 2).
**Buying Growth and Getting Value**

While our strategy benefitted from exposure to growth-oriented businesses supported by long-term secular trends, we realize that many growth stocks are currently trading at staggeringly high premiums relative to value stocks. Among the stocks that have performed especially well this year are those of e-commerce, enterprise software, and online education companies; these benefitted from government mandated lockdowns and rapid adoption of “work from home” policies. While we participated in the appreciation of stocks in some of these sub-sectors, the market has extrapolated the recent strong growth many of these companies are now experiencing several years out into the future. The outperformance of these shares has meaningfully reduced our expected return forecasts going forward. As a result, we have trimmed positions in some of these holdings and even exited our position in a leading online distributor of manufacturing components – which surged on rising e-commerce penetration – despite seeing a slowdown in its end markets. With the ACWI ex US Growth Index outperforming the ACWI ex US Value by 16% in the first half of the year, the ACWI ex US Growth benchmark is now trading at a 144% premium to the ACWI ex US Value, versus an average premium of 43% over the last 15 years (Figure 3).

**Sustainable Growth Approach Leads to Strong ESG Profile**

Our desire to own companies that will experience consistent earnings growth tends to rule out companies whose earnings swing with commodity prices and limits our exposure to environmental risks. However, our preference for investing in fast growing international small and mid-cap companies requires us to thoroughly evaluate the management and governance of the companies we invest in. While these risks have always been among those we want to understand before making an investment decision, we feel that MacKay Shields’ commitment to the United Nations Principles for Responsible Investment and its collaboration with leading ESG data providers has armed us with better information to assess these risks. In the first half of 2020, we were thankful that a few select international companies that made headlines for the wrong reasons were not in our portfolio, as they were avoided due to information collected during our due diligence process or were exited as we incorporated new information into our assessment of management and governance related risks. As Figure 4 below shows, our investment process has resulted in a portfolio overexposed to companies with Low ESG risk and underexposed to companies with High ESG risk.
Looking Forward

The first half of 2020 brought many unexpected developments and economic and geopolitical risks remain. Given this environment, we are pleased with our investment performance and remain convinced that our sustainable growth investment approach allows us to keep pace with equity markets in good times and preserve capital in more challenging market environments.

With international equities trading at 16.7x next 12 months earnings estimates and US equities trading at 22.1x, we believe that international equities remain attractively valued and we continue to find compelling trends to invest behind. We recently published a white paper on one of those trends, the rising adoption of minimally invasive surgery, which can be found [here](Minimally Invasive Surgery: A Sustainable Growth Opportunity).

IMPORTANT DISCLOSURES


The representative account utilized for this analysis was selected because it is the largest account in the composite and not for performance reasons. Each client account is individually managed, actual holdings will vary for each client and there is no guarantee that a particular client's account will have the same characteristics. It may not represent every portfolio in the composite. This document is for informational purposes only. Portfolio holdings and characteristics are subject to change without notice and are only accurate as of the date of this publication.

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