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Is your equity portfolio ready for a turn in the investment cycle?


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JOHCM Global Opportunities Fund

- The strategy aims to generate long-term capital and income growth through active management of a concentrated portfolio of global listed equities.
- A high conviction, benchmark-unconstrained stock picking fund.
- The fund managers look for opportunities where the market is underestimating the value created by well-managed companies that reinvest wisely to create sustainable compounding returns.
- Benchmark: MSCI AC World Index.
- The use of the index does not limit the investment decisions of the fund manager therefore the shareholdings of the Fund may differ significantly from those of the index.
- Please refer to the Prospectus/KIID for further information.

We have all seen the world change in the past few months, and there is plenty being written about what it means and what happens next. In this era of 24-hour newsflow the short-term always receives a lot of attention, but it is the medium- to long-term dynamics which will have more profound implications for investors. It pays to prioritise the big strategic decisions rather than just short-term tactics.

The big picture is that a number of capital cycles are turning, and investors need to refocus their attention onto supply side dynamics, and towards sectors which have been overlooked for the majority of the post-GFC era. Market leadership is likely to change over the next decade, from technology and social media to industrials, resources and infrastructure. As ever at turning points, benchmark indices are underexposed to tomorrow's winners. The Energy, Materials, Industrials, Utilities and Financials sectors have dwindled from nearly 60% of the MSCI ACWI index in 2008 to less than 35% at the end of 2021. This argues very strongly in favour of funds with an active, benchmark-unconstrained, stock-picking approach, and a strategy which combines Quality and Value characteristics.

Supply-side analysis is the key to understanding the next decade

In recent years, global equity markets have focused on exciting stories of demand-side transformation, enabled by advances in technology and communications. Digitisation is undoubtedly transforming the behaviour of enterprises and individuals. The lockdowns and disruption of Covid-19 accelerated some of these trends. Network effects and scale advantages have resulted in the emergence of a small number of dominant 'winners', natural monopolies which have become an increasingly large component of equity indices as they have benefitted from a virtuous circle of disinflation, falling discount rates, and scarcity of growth.

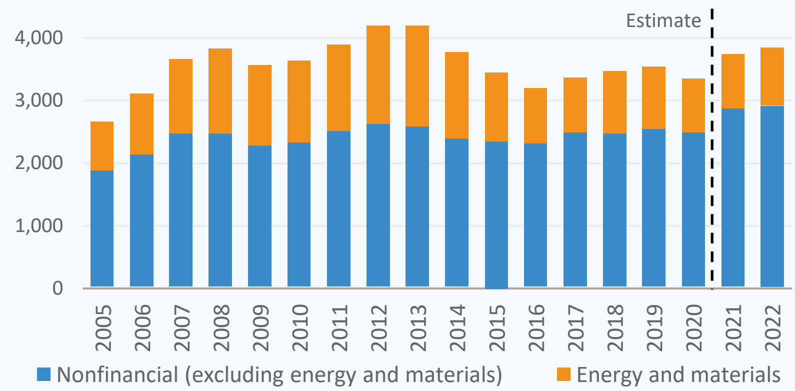
These trends have not yet run their course. However, it is increasingly clear that investors need to refocus their attention on the supply side, as a number of capital cycles appear to be turning. The concept of the capital cycle is simple but very powerful. It is fundamentally a supply-side-focused theory of mean reversion: high returns in a sector attract new capital, which creates overcapacity and drives down those returns; low returns in a sector lead to underinvestment, supply constraints, and ultimately improving returns. It is a tool for navigating long, multi-year cycles, which as patient, long-term-focused investors we find very useful – particularly now.

We have hit a point, in a number of important sectors, where the cumulative underinvestment of years, and in some cases decades, is starting to bite. Just as Covid accelerated but did not cause digitisation, so the Russian invasion of Ukraine is exacerbating these pre-existing supply-side constraints in the West. We believe that this sets the scene for the next decade and has a number of critical implications for equity investors.

Benchmark indices are underexposed to a capex supercycle

The first implication is that global corporate investment is likely to start growing again, having stagnated since the Global Financial Crisis in the era of the 'platform company'. We are already seeing companies, governments and regulators recognise and respond to the need to renew ageing infrastructure, expand domestic productive capacity, and reassess their dependence on foreign energy imports. Decarbonisation and electrification are clearly major structural tailwinds for energy-

Global nonfinancial corporate capex ($bn)



Source: S&P Global Market Intelligence; S&P Global Ratings. Data as at 27 July 2021. Note: Universe is Global Capex 2000; S&P Global Ratings' annual list of the 2,000 largest companies by capital expenditures.

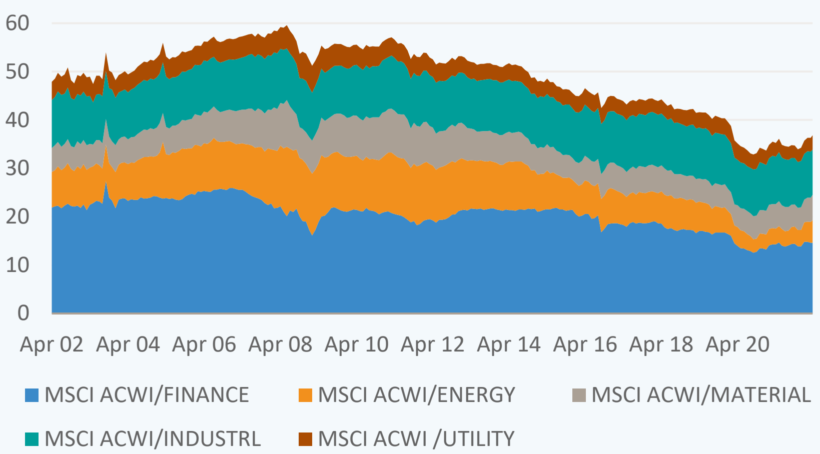
related investment, and there is increasing recognition of the need for a balanced approach including a variety of transitional and complementary solutions such as gas and nuclear. We have grown into and out of the excess capacity created in the TMT boom in the late 90s, so even technology companies are now investing heavily in physical infrastructure. And recent events have the potential to mark a turn in a multi-decade trend of declining European defence expenditure.

In line with the mean-reversion conclusions of capital cycle theory, this has the potential to transform the market's perception of 'quality' and 'growth' across companies and sectors. Supply constraints will affect pricing power, capex booms will drive volume growth, and returns on capital in certain areas could improve significantly. Some companies currently perceived as low quality and low growth will be rehabilitated into market darlings by the end of the decade. We live in a world dominated by passive investors using backward-looking quant screens to identify factor exposures, which will struggle to pick this up quickly. And benchmark-constrained investors will find themselves underexposed to the beneficiaries of these trends, which almost by definition will be found in hitherto underappreciated areas of the market.

Long term investment strategies need to blend a Value bias with a Quality discipline

For tomorrow's Quality and Growth, investors may need to look in today's Value. But they need to do so selectively and carefully, mindful of both short-cycle and inflation risks. The long cycle perspective is important strategically and argues in favour of a shift in sector allocation away from the winners of the last decade towards these capital cycle beneficiaries. But the more cyclical nature of these sectors means that traditional or 'short' business cycles cannot be ignored. There are no prizes for getting the long cycle right if you lose significant amounts of capital in the short run because of overexposure to geared cyclicals going into a recession. For long-term investors, a Value tilt needs overlaying with a Quality discipline.

ACWI Index weight of capital cycle beneficiary sectors



Source:Bloomberg.

The other major implication of supply constraints is inflation, which will root out all sorts of value traps. Regardless of whether current inflation prints soften, it is highly likely that the 2020s will turn out to be more inflationary than the 2010s. It is possible that they will be most inflationary decade since the 1970s. This will be the first major sustained test of pricing power for a very long time, and will sort the wheat from the chaff in terms of resilience of margins, earnings and cash flows. Investors drawn to Value will need to differentiate between where returns are low because of subdued activity sets, which will improve, and where they are low because of poor industry fundamentals, which won't.

Selectivity will be equally important in 'defensive' sectors such as consumer staples and healthcare, where it will be important to avoid 'quality traps'. This is the sort of environment where the strong get stronger, as they are better able to manage inflationary pressures. Again, this argues in favour of active stock selection rather than semi-passive sector allocation. In this environment, the best company in a mediocre sector, such as retail or insurance, is likely to fare better than a mediocre company in a (formerly) good sector. Beware the 'poor man's bellwether'. And investors will need to be just as selective in 'Growth' sectors which were 'winners' in the lockdown environment: after two years of extremely distorted year-on-year growth prints, we are starting to find out where Covid provided a one-off boost or pull-forward of demand, as opposed to a sustainable acceleration in adoption curves.

Rising inflation changes the rules of investing

It is the nature of major turning points that old heuristics and former 'no brainer' decisions will be challenged. We have written previously that a return of inflation would completely change a financial environment which has been prevalent for so long most of us have never known anything different, at least in a professional capacity. In particular, the correlation between equities and bonds would turn positive, robbing multi-asset funds of their natural stabiliser and likely leading to a significant increase in financial market volatility. Risk controls have been rather unfashionable in recent years, simply preventing disciplined managers from fully participating in a rampant bull market. Going forward, we suggest that investment discipline will be much more highly prized, indeed essential, in an environment of rising volatility.

The first quarter of 2022 has provided some indication of this happening. Investors need to reassess their exposure to ensure their expectations are realistic. In particular we believe there is an urgent need for equity funds which combine elements of Quality and Value investing within a patient, disciplined process focused on bottom-up stock-selection and strong risk controls.