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COVID-19: Stress Testing

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While the full impact of COVID-19 on the global economy is still unknowable, we are gaining perspective on its economic impact, and thus its investment implications. Captured below are perspectives from each of our investment teams.

Global Equity
Projected U.S. gross domestic product (GDP) ranges widely in the second quarter, but has the potential to be the largest downdraft since data has been recorded. In this environment, our portfolios have been assisted by our high-quality bias, which is quantified using our systematic tools. We believe this captures the quality components of a company. We have not made significant positioning changes in response to recent market events, staying the course in our Leaders portfolios and making slightly more changes in our emerging markets portfolios, where we have been more nimble. We remain steadfastly focused on seeking opportunities to add to our best ideas, looking beyond transitory virus-related business effects. In particular, we are interested in quality growth companies that have been out of our reach purely from a valuation perspective, as well as high-quality cyclicals that have witnessed significant declines but have the wherewithal to navigate the current crisis. We are also stress-testing companies using a common set of reference points. As quality growth investors, we believe our portfolios are positioned well, but it is still critical to test all of the companies in our high-quality universe, particularly those at the epicenter of the crisis, to determine which will make it through, which will need to raise equity, and which may fail to make it through the crisis. We are spending considerable time estimating how deep the drawdown will be, as well as analyzing what the economic recovery may look like across the globe, making updates as new

information becomes available.

U.S. Growth Equity

While the broader market has been selling stocks somewhat indiscriminately, our approach is to examine the idiosyncratic risks that each company faces and make portfolio decisions based on that bottom-up analysis. Amid the coronavirus outbreak, on a stock-by-stock basis we are focused on determining how much demand has been permanently lost versus temporarily delayed, as well as how much of the disruption has already been priced into the stock. We are examining the business risk, leverage risk, and valuation risk, for both owned and unowned stocks. We are using this framework to analyze individual stock opportunities should this be either a temporary slowdown or a more prolonged recession. Our investment philosophy leads us to companies with durable businesses, whose stock prices are not reflective of our long-term fundamental expectations, that we believe can outperform over a market cycle. In light of valuation shifts between some of our holdings, we reduced our position in a company with exposure to grocery channels that has significantly outperformed amid the "pantry loading" phenomenon. Meanwhile, we increased our exposure to a consumer staples company whose valuation has fallen in recent weeks given it sells into fast food/quick service restaurants—end markets that typically hold up relatively well in a recession, but are clearly under pressure in the current environment. In both cases, we believed the relative valuations reflected an extrapolation of recent trends as being more structural in nature. Ongoing market volatility should continue to present attractive entry points for our fundamental, bottom-up approach. We continue to monitor market movements and will make adjustments as appropriate.

U.S. Value Equity

Our focus remains on quality. In particular, our team is increasingly focused on balance-sheet strength and avoiding significant leverage, as leverage can cause major challenges in extreme market conditions. Still, this is a challenging market environment—and a highly unusual market environment where broad market declines are not just the result of an impending economic slowdown. Correlations have spiked, and we have seen indiscriminate selling of securities regardless of underlying company fundamentals. Even companies with durable cash flow models that typically hold up well during a recession are being penalized as investors focus on COVID-19. Overall, we remain focused on companies with strong balance sheets that can withstand a challenging market environment for an extended period. We have significantly reduced our exposure to energy stocks. We continue to hold a few select positions—for example, a compression company that is well-positioned despite oil price declines—but we are underweight the energy sector. Within financials, we have reduced our exposure to banks, which we believe will be significantly affected by the coming downturn. We feel confident that once the broad fear-based market environment subsides and investors focus on company fundamentals, the higher-quality companies with strong balance sheets will emerge from this crisis in an advantageous position.

Dynamic Allocation Strategies

We are cautious and in a "navigation mode." Earlier this year, we reduced our equity exposure, and have maintained a low equity allocation—exceedingly low if you consider the current valuation opportunities. At this point, the strategies' only significant long equity exposures are in the United States and the United Kingdom. We also de-risked the currency exposures across our portfolios in a series of strategy changes beginning in late January. Since then, we have reduced exposure to currencies that we perceived would be negatively impacted by the subsequent sharp economic contraction driven by responses to the virus, as well as currencies negatively affected by the oil price war. At the same time, we have increased exposure to safe-haven currencies. The two questions that we are analyzing most closely now are: 1) what is the actual economic impact of the virus, as well as the impact of the policy responses, and 2) how much of that impact has already been priced into the market? As we think about potential developments that could begin to bring some clarity to investors' perception of the pandemic's endgame, two events could serve as signposts and opportunities to again increase risk: 1) oncoming stress on global healthcare systems, and 2) continued downward revisions of GDP estimates and increased references to the word "depression." With respect to the economy we do not anticipate a near-term V-shaped recovery, but rather a modified U-shape with a longer tail recovery. For those seeking encouragement about the long-term prospects for the U.S. economy, history provides valuable lessons. If the United States can withstand World War I and the Spanish Flu at the same time, we are confident that the United States can withstand what is happening today.

Fixed Income

Concerns about the economic impact of the COVID-19 pandemic have hit all sectors of the fixed-income market, leading to drastically wider spreads in investment-grade and high-yield credit markets, and extreme volatility in the U.S. Treasury market. While fixed-income markets today reflect extreme uncertainty, we believe that significant actions taken by the U.S. Federal Reserve (Fed) and other central banks around the world will provide some stability going forward. The situation is extremely fluid, with major announcements about monetary and fiscal stimulus efforts coming seemingly every hour. But the Fed has rapidly deployed its tools to provide liquidity and stabilize the markets, and the Fed and the Treasury have both stated that they will do "whatever it takes." Investors need to give the Fed's actions a chance to work. Fixed-income investors are focused on the rate of the spread of COVID-19, and we believe any news of a decline in the spread of the virus in the United States will be viewed positively.

Emerging Markets Debt

The external backdrop is challenging for emerging markets debt (EMD), in particular as a result of the poor growth outlook in the near future as well as the path of the recovery. The oil price war will further weigh on risk assets. While we believe that the risk of sovereign credit events may rise, in particular as a result of the deterioration of fundamental and funding conditions, we believe that over time this will be mitigated by strong support from international finance institutions (such as the World Bank and International Monetary Fund) as well as easing global liquidity conditions. Partly as a result of having a lender of last resort, emerging markets hard currency bonds tend to have much lower ex-post default rates and much higher recovery rates than credit spreads imply. A significant proportion of the universe is trading in highly distressed territory, which we believe is likely to overstate the probability of default and loss given default. This offers great opportunity for alpha generation for active managers such as ourselves. While volatile conditions may give rise to better entry moments, from a valuation perspective current levels offer substantial potential returns over the longer-term horizon.

Corporates went into this environment close to their strongest fundamental position in years and with relatively clear maturities in the next 12 months. We are watching the duration of this shock's effect on issuers' liquidity, but barring a protracted rebound valuations seem oversold, making potential returns going forward attractive.
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