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The Merchants Trust PLC Update

Current market performance comment - an unparalleled situation?

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Market update—coronavirus:

This is primarily a human tragedy, and our sympathies are with the affected people and their families. In thinking about the investment outlook, however, we need to assess the impact on economies and companies from this pandemic. Stock and bond markets have already moved dramatically, with the sharpest stock market falls since the crash of 1987.

We do not claim any particular insight into how COVID-19 will progress and how successful government policies in the UK or elsewhere will be in reducing the impact on people's wellbeing or economic disruption. It now seems much more likely that the UK, and possibly the world economy will have a recession this year. Government and central bank responses of fiscal spending, infrastructure investments, lower interest rates and support to the banking sector may help to counteract some of the worst economic impacts. The collapse in the oil price, due to a breakdown of the relationship between OPEC and Russia, may also be helpful to economic growth, given the importance of energy costs to businesses and consumers.

In terms of the market movements, whilst selling has not been indiscriminate, it has not been that differentiating either. Our understanding is that the majority (90% plus) of trading is being driven by deleveraging of complex strategies or ETF flows, so driven mainly by computers or 'basket trades', as opposed to individual investors taking a view about the long term worth of individual businesses. Normally that ratio is c.50-60%. It feels like there is considerable stress in parts of the financial system, which is also driving futures and derivatives trading. So that means we are seeing quite a few anomalies and strange moves in individual stocks, which is not really surprising given the speed of this decline. We believe this is creating opportunities for active, value investors.

Our focus, as always, is on the fundamental qualities of companies, such as the strength of their competitive position and technology, their long-term growth potential and their cash generation. In this particular situation, the financial position of companies is critical. Even strong businesses will be affected by COVID -19, and those with weak balance sheets may not survive in their current form. We are assessing the direct and indirect impacts of this pandemic on every business in the portfolio, and that has led us to make a number of changes.

The big themes within the equity market in the last three weeks have been:

- Avoid businesses directly affected by demand collapsing: e.g. airlines, cruising, restaurants, exhibitions
- Avoid exposure to falling bond yields and stock market risk: e.g. banks, life insurance, asset managers
- Avoid Commodities: lower demand
- Avoid Energy: lower demand + OPEC (Organization of the Petroleum Exporting Countries) problems
- Avoid high leverage
- Buy defensive earnings: e.g. utilities, pharmaceuticals, supermarkets
- Buy quality / growth / momentum

However there has been quite a bit of differentiation within the moving parts. For example, some of the higher valued and perceived higher quality defensive sectors like food produces, utilities and pharmaceuticals have significantly outperformed those seen to be lower quality, even if they may be just as defensive in a traditional sense e.g. tobacco and telecoms.

Between 21 February and 12 March, when the market is down 28%, the top performing sectors (excluding very small ones) have been:

- Food retail -16%
- Pharmaceuticals -16%
- Personal goods -18%

And the worst:

- Oil equipment & services -44%
- Oil & gas producers -41%
- Travel & leisure -40%

We have not made dramatic changes to the portfolio structure in the last three weeks, but we have made a few changes. We have looked for companies which were not fully reflecting the changed circumstances in their valuations. For example, we sold out of one holding which had both a high exposure to China and Hong Kong, where there are a number of issues (not purely COVID 19) and also an exposure to falling US interest rates and a possible credit shock.

Conversely, we have added to some other more defensive businesses, which had not moved up too sharply in relative valuations.

But we have not simply added defensive positions and sold cyclicals. We have also added to more cyclical companies where we are confident in the long term value, and share prices are particularly attractive.

The overall market direction is hard to call. There could be a very sharp recovery at some point – markets tend to move well before fundamentals improve. We have seen the first signs of a recovery in China after the COVID 19 lockdown period, and other epidemic situations have historically not lasted that long. But we are not complacent either, this could go on for many months and have lasting consequences. So we are trying to add value from stock selection, not from calling when this pandemic gets under control and when markets will recover. Fortunately, there are many very cheap stocks again that we can buy.

We continue with our job of managing the Merchants Trust portfolio in the long-term interests of shareholders. In the meantime we hope everyone stays safe.

Comparing to past market crises

I had only been working in the City for a month, when the 1987 market crash happened. However, that was a relatively short-lived affair. It came after a period of very strong market returns, when valuations were elevated. Although the FTSE100 index fell by nearly 30% in Q4 1987, it was actually up for the year and the market decline had no major economic impact. The 2000 TMT collapse, also followed a period of exceptional market returns, albeit one confined largely to certain sectors of the stock market. Many value investors had thought that a correction of this sort was long overdue. Whilst there was some economic impact, it did not lead to a major economic dislocation, at least in the UK.

The financial crisis of 2007/2008 was very different. Stock markets were coming from a high level in 2007, but the main issue was not equity valuations, rather it was the economic shock from the credit crisis. Only a few people really understood the complex financial products that had proliferated in the banking industry. As these unravelled there was massive disruption. At times there was huge uncertainty about what was really going on in the banking and credit markets. As the cause of the problems was so opaque, it was difficult to ascertain what actions would be needed to address the problems, and how effective these would be.

There are parallels in the current situation, although not necessarily in terms of severity. There is not a credit crunch, or over-leverage in the banking sector, but there is huge uncertainty. The cause is easier to see, but how quickly and how far the virus spreads, and how much human and economic damage it does, are very hard to predict. We have already seen millions of people facing severe restrictions on their movement in both China and Italy. We can see the immediate impact on certain industries like travel and commodities, but the economic ramifications could be far broader.

For investors, it is important to try to understand how companies might be affected by the current situation. It is always important to look at balance sheets, to see which companies can survive a temporary drop in activity and profits. It is also critical to separate short term impacts on industries and businesses (even if they may go on for quite a while) and longer term impacts. Will people change their habits with regard to flying? Will companies change their just-in-time supply chain management processes? These are some of the questions that investors should be thinking about to understand the long-term impact of this virus.