RBC Global Asset Management

RBC Global Equity team update

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What are the short-term and long-term factors your team is looking at when you think about the implications of the COVID-19 pandemic on companies in which you're invested?

- The current investment landscape is vastly different than the one we faced at the beginning of the year. The critical indicators for the macro economy were all fairly positive and robust. However, as 2020 has evolved it has quickly become a lost year in terms of profits for companies.
- Originally, COVID-19 was compared to the SARS outbreak in 2002/03, perceived to be a regional issue touching only a couple industries. The pandemic has moved across industries and geographies, causing a lot of disruptions and decreased aggregate demand everywhere. We have also seen a battle for market share in the oil market between Saudi Arabia and Russia, leading to a more deflationary backdrop for investors to contend with.
- The move from a bull to bear market is usually driven by a buildup of credit – this is not the story playing out here. The situation we are experiencing is characterized by uncertainty and understandably, volatility has increased substantially. Investors are facing quite challenging times.
- The big question that many people are asking is whether this disruption will be short-term or long-term in nature. If there is a 3-6 month period of disruption, there could be profound consequences for households, but the foundation of the economy should bounce back. If the disruption lasts longer, it could be more problematic.

If we are in fact on the verge of a recession, do you and your team have any concerns that we could be headed for a downturn as severe as what we saw in the prior recession during the global financial crisis (GFC) in 2008 and 2009, or are the present circumstances fundamentally different?

- The present circumstances are fundamentally different. In 2008/09 the share price movements made no physical sense. It was like walking into an exam and turning the page to the one question you had hoped wouldn't be on it – your stomach dropped. And it was like that on a daily basis. This period doesn't feel like that.
- In 2008, there was a sense that the plumbing of the financial system was broken, which led to a lack of liquidity and a crisis of confidence. Now, the plumbing works, there is better and more flexible regulation, the world of commerce is working together to supply materials to those in need, and we are seeing a sympathetic tone from central banks.
- However, the economic data could be significantly worse, as this pandemic isn't just a regional issue, but a global one. In 2008, China was impacted to an extent, but was able to recover quickly and was a significant contributor to global growth. Today, as the pandemic is a global issue, the short-term impact on GDP could potentially be more significant than what we saw in 2008.
- Importantly, if we respond well and policy actions are robust, the muscle memory of the economy should be maintained, and it will be able to pull through. It's clear that there will be a recession, and 2020 will likely be a lost year for company profits, but it's unclear at this time whether 2021 profits will also be impacted.

Did you and your team have any experiences during the GFC that you feel equipped you to better navigate subsequent recessions or periods of extreme equity market volatility?

- Yes, the team came out of those years with a shared understanding. The headlines seen in the press currently show the devastation and disruption of the COVID-19 pandemic, which could blur world views and filter through to the portfolio – this could be a mistake.
- In the current episode, there will be a turning point, and a top-down view makes it challenging to rapidly respond to that shift in the narrative. Since 2008/09, we've intentionally tried to avoid looking at the world from a top-down view. We have confidence in the companies we own, and the investment experience we deliver to clients (and ourselves) is driven by the companies we invest in.
- Our view is that you should do the work before the crisis. For example, if you're going to set sail, make sure the ship is in shape before you leave. We position ourselves to be the best we can possibly be if we encounter a period of rough seas, and ensure our portfolio has a natural resiliency to it, especially during times like these.

One of the unique characteristics of your team is that three of its members are dedicated risk and portfolio construction experts, or "portfolio engineers". Can you speak to the importance of portfolio construction in achieving your objectives, particularly in the sort of market environment we've seen of late?

- Portfolio engineering is an important component of what we do. We put a lot of focus and attention on the companies themselves, and the portfolio engineers help us to capture the alpha that comes from stock selection. This enables us to deliver the investment experience our investors expect, during profound periods of volatility.
- During times of increased volatility, the exposures of portfolios are magnified. Really nasty surprises and unknown risk exposures can dominate returns. We are stock pickers, and we want companies to drive returns.
- In the current environment, nobody is talking about specific companies – it is a very macro-oriented market. Headlines are setting the investment narrative, and this is the moment that separates managers who understand the risk exposures in their portfolio from those who don't.
- We continue to focus on individual companies. The portfolio is behaving as expected and keeping up with the market. We are not using cash or leverage to change exposure during this time. Our portfolio engineers provide dashboards to help avoid any lumps or bumps in the portfolio, which has worked well over time.

ESG integration, particularly the assessment of non-financial factors, is a cornerstone of your team's investment process. Can you talk about any specific holdings in your portfolio that are particularly well-positioned in this environment from an ESG perspective?

- The ESG angle has been interesting during this pandemic. Generally, good ESG funds have been doing slightly better, as better ESG companies are usually better managed for the long-term. A large part of the ESG uplift could be driven by the underperformance of energy factors, instead of an inherent ESG quality bias.
- Good ESG tends to exhibit itself over time. Human capital, company culture and other ESG factors result in a modest short-term reward, but can make a big difference in the long-term. We have experienced the most rapid movement from a bull market to a bear market in recent history, and businesses that respond quickly should come out stronger than those who don't.
- Many businesses in which we invest are building their brand and reputation during this time by helping society. There is no dollar amount attributable to ESG in the short-term, but it is incremental in the medium- to long-term.

Your team uses the term "Competitive Dynamics" to refer to the strength of a company's business model, end-market growth prospects, and management team – to what extent do these dynamics tend to change over time?

- When looking at an opportunity, we first analyze the business itself and the quality of its management team to assess whether it satisfies our Competitive Dynamics criteria. Only once this step is complete do we look at the valuation (using a discounted cash flow model), which will determine whether it deserves a place in the portfolio.
- The valuation piece is the more volatile component, as business models are slow to change. In the investment landscape, change is always with us, but the pace of change has become more significant.
- There has been a stark battle for market share in the oil industry, putting downward pressure on the price of oil, which questions the sustainability of businesses in high cost locations. Companies we hold, like Ørsted and Neste, saw these strategic issues coming and did something about it. Both companies started off anchored in the fossil fuel complex, but have moved towards wind generation and biofuels, respectively.

To what extent did you see the market differentiate between good and bad businesses in the recent selloff? Or was the selling largely indiscriminate, with company-specific considerations being of little importance?

- In our experience, there is not a big distinction in the short-term for individual businesses, as it is very much a macro-driven market right now. There is little time to weigh the opportunities of individual stocks.
- When value disruption occurs, it brings a period of reflection and searching. People try to find gems that were knocked down and start picking them up – we start to see selective recovery. This is expected to play out again.

What are your thoughts on valuations today compared to their levels at equity market peaks in February? Do you think that today's valuations are justified by fundamentals?

- We need to keep thinking about fundamentals. Although it's easy to get caught up in the headlines, we need to remember that a company's value is determined by the present value of its future cash flows. Very little of a company's intrinsic value comes from cash flows in the next year or two; most of it comes from cash flows in the medium- to long-term. The knowledge that we are invested in good businesses provides a degree of comfort, but we need to ensure that they have enough cash flow and liquidity to sustain themselves at times of upheaval.
- As investors, we spend time to make sure companies themselves have access to resources they need to capture medium- and long-term value. This is even more important during periods of increased volatility. We do the due-diligence to ensure companies have the liquidity necessary to prevail over the long-term.

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