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A Stock Picker's Reflections for 2022

By Bo Knudsen, Managing Director and Portfolio Manager.
C WorldWide Asset Management Fondsmæglerselskab A/S.

Shifting from one year to the next is a time for reflection. But it is not a guide nor a driver for investment decisions. We don't think in terms of a calendar year when investing. We think it is important to stay consistent and focus on a longer time horizon when investing.

Looking ahead, we see significant growth in at least two areas: 1) the growing awareness of the importance of sustainability and 2) the growth in the virtual world economy. The structure and risk profile of our portfolios is well-positioned to benefit from both these drivers. With this in mind, let me reflect and share our views about the investment environment for the coming year.

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Two defining moments in 2021

We often take the obvious for granted. The global financial system is built on trust and strong political institutions. It was somewhat surreal to witness the January 6 attack on Capitol Hill. In those moments, the fragility of trust and strength of political institutions were exposed. The aftermath of the attack is now being conducted in the courts exemplifying the strength of the US judicial system. The most important country in the global financial system continues to be the US. Also, because of the long list of strong US companies that forms an important backbone of not just the US, but also the global stock markets. These companies are often at the forefront of innovation and have inspired other corporates across the world. Not least in China where some of the leading companies clearly have been inspired by the US business model. During the year, Xi Jinping has made it clearer that China will undergo a shift, and going forward pursue a different route than the US – building a Chinese model of society and becoming more and more precise about what pursuing 'Common Prosperity' actually means.

300

million people in China will enter the middle class.

It was therefore a defining moment when rather draconian measures were taken that decimated the business model of companies in the Chinese education sector and therefore also the related stocks – as shareholders in these companies suffered for the common good of the broader middle class burdened with high costs of housing and education. We recently published a White Paper entitled 'China's relevance for the global investor'. We concluded that we continue to expect China will grow into a global superpower with more than 300 million people entering the middle class over the next 15 years as the country is working to realise Vision 2049. Growth is a key part of 'Common Prosperity'. We continue to see great investment opportunities for shareholders in China, although it is more important than ever to invest alongside and with the Chinese government's priorities. Selective stock picking matters more than ever in a more politicized world.

Transitory inflation pressures?

One of the most commonly used words in 2021 was "transitory" linked to inflation numbers. We suspect and frankly hope that the pandemic is transitory – and a big part of the high inflation numbers are still linked to the unprecedented lock-down and the pandemic. So, a transitory pandemic leads to transitory high inflation, right?

We remain humble when it comes to macro predictions and spend little time on FED watching. We are more confident in predicting the robustness of business models and understanding a company's future right to win! We have all heard a lot about lumber prices and iron ore prices going up, but little about the latest gyrations and drop in these prices – showing that we live in a world where markets still work – where higher prices lead to a supply response and a new balance is found. It is worth noting that the world economy has coped rather well with a marked Covid-related increase in the demand for goods.

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The pre-pandemic price-stabilising forces of technology, aging population and the mountain of government debt are still present. We continue to believe that technology is very important. The price and service comparison mega-platforms keep price competition tough. What has been called the 2nd machine age is crucial to understand. The 2nd machine age is driven by information. With new intelligent data analysis tools we will become more productive/efficient than ever. That matters to inflation.

Recently, wages have been rising faster in the US than the rest of the world. During the Covid pandemic we have seen what has been labelled the Great Resignation. Will we see a permanently lower participation rate in the workforce? It is too early to say, as Covid is also a disrupting factor here.

People have been reluctant to take a people-facing job at fear of becoming sick. Some highlight that keeping children at home from locked-down kindergarten or schools has resulted in a clear decline in the female labour participation rate. This should be temporary. In many regions of the US, it has paid-off to stay at home earning more per hour by staying home during the pandemic rather than taking on a job. This has corrected and will improve the participation rate.

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FED perspectives

The inflation numbers are frustrating for the FED and they need to show that they act responsibly – to look credible. Changing the tone is part of the game of running the most important central bank in the world. The FED needs to say the right thing and then hope that markets settle down. It is a return to the fundamental concept of trust that our financial system relies upon. It is important that the FED just uses its power to lend rather than using it powers to directly spend. The re-elected Chairman Powell has stated that FED only has lending powers. An aggressive Modern Monetary Theory (MMT) like experiment could lead to trust issues and a much more uncertain inflation outlook.

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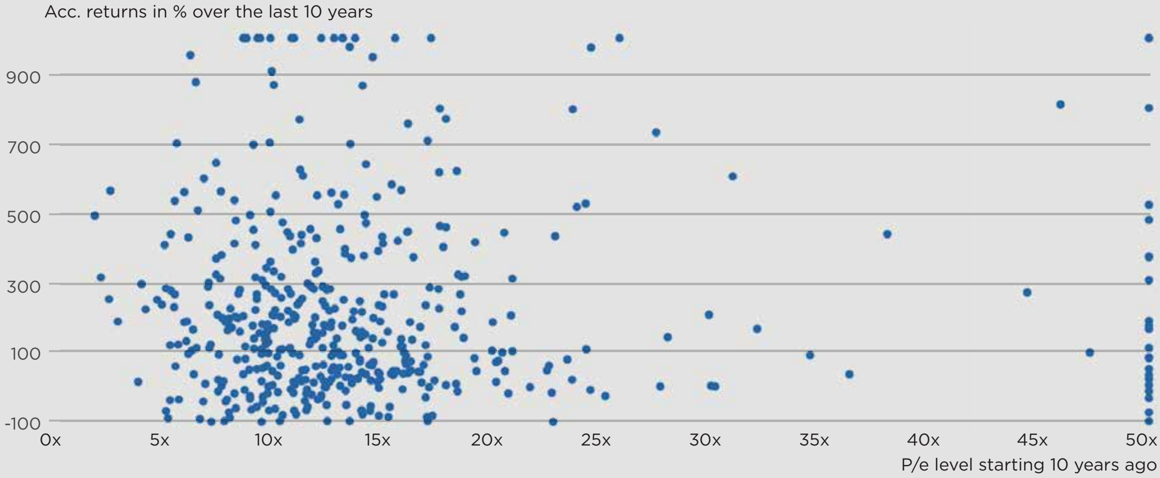
Financial markets have received tremendous support for years. A financial market 'superstructure' has been created with high levels of government debt and financial market dependency that is deeply dependent on liquidity flows and low-interest rates. So, who wants and who can afford higher rates? Who wins? And can they stop QE without interest rates going up? These are the challenges that we are facing in 2022. Financial markets drive the economy in the current financial super structure, not the other way around, as was historically the case. Governments, debtholders, and markets are at risk from higher interest rates. This is probably why a significant rise in rates won't happen. For us to be good forbearers, we have an intergenerational issue to solve – the shift away from fossil fuels to a cleaner energy structure – in other words, addressing the world's climate problem. Low rates make these investments possible. That is why we continue to be optimistic about low real interest rates for many years to come.

Figure 1: No clear correlation between p/e-levels and future returns.



Note: Companies with p/e above 50x or returns higher than 1,000% have been set to 50X or 1,000% respectively

Source: Bloomberg and CWW AM as of December 2021

Portfolio positioning

We do not see a burgeoning inflationary environment but let me state that it is more important now compared to the last decade to focus on the difference between transitory and permanent pricing power. We seek companies with a historic - but more importantly - a position of having future pricing power. We see better permanent pricing in, for example, security and door-lock markets than in lumber and used cars. The pricing power dimension is a very important part of our due diligence both before and while investing in a company.

Equity market outlook

We are looking at a more volatile 2022, at least until the inflation debate settles and we get clarity on the future path of FED policy. However, we continue to see an accommodative monetary policy that will secure low or even continued negative real rates. This is important. Equity markets can handle rising interest rates, if they are not constraining growth or increasing the risk of a recession. Earnings growth is the key driver for healthy stock markets. Overall, earnings growth came from a fairly low base in 2020 and was the key driver in 2021. With the help of continued corporate earnings growth, we remain positive on the equity market outlook in 2022.

I would also add that short-term valuation indicators are often bad predictors of longer-term returns. One example can be seen in Figure 1 – taking next year's P/E on S&P 500 companies 10 years ago versus the actual return generated. There is no correlation at all. Stock picking and a selective approach is paramount, and for us, it is far more important to understand the firm's strategic position and long-term right to win rather than the valuation of the stock.

> **"We continue to believe that it is possible to create a portfolio of 30 stocks that compounds earnings more than 10% per annum, even if the overall market growth is lower.**

We continue to believe that it is possible to build a portfolio of 30 stocks that compounds earnings more than 10% per annum, even if the overall market growth is lower. This means investing in companies that grow bigger over time – and participating in that journey. This has been the key driver for the outperformance that we have generated over the last 30 years. And in a world with low real interest rates, double digit compounding is great.

ESG reflections

ESG will become even more relevant over the coming years. However, it does not come automatically as it has to do with awareness and priorities.

> **"As people get richer and better educated, they tend to care more about the environment.**

It starts with having a collective mindset towards sustainability and to have the capacity to think about the next generations on the planet. The importance of sustainability comes with knowledge and knowledge is key to improving society. The point is that you need the means to gain knowledge – to have the resources to invest time and money in education. As people get richer and better educated, they tend to care more about the environment. Only then will ESG issues be prioritized ubiquitously. Only then will we improve the level of awareness. Prosperity is a key enabler of this process. China's increasing wealth is therefore extremely positive for the planet. We need to have a dynamic rather than a static mindset. Going backwards is not a solution!

If we extrapolate this thinking to the company level and the C WorldWide level – we take our responsibility as active investors and active owners seriously. Engaging directly with the companies in our portfolios makes a difference. Lately, we have adopted several initiatives as part of Climate Action 100+. In fact, we have also taken a broader perspective than climate initiatives, for example, by being part of UN Global Compact and do not invest in companies that don't live up to the 10 principles of the UN Global Compact.

We have just released our first TCFD report – 'task force on climate related financial disclosures'. Transparency increases awareness and knowledge to get to a higher level of prioritization. The investment community will play a significant role going forward, and we are happy to take part.

The role of politicians is also significant. We need clever regulation and here we shared our views in a recent White Paper entitled 'Net Zero Emission – Mission Impossible?' where we highlighted the importance of worldwide pricing of the emission of greenhouse gases. Again, there is no turning back.

Risk factors?

Looking into some of the risk factors for markets and companies, I would like to highlight three observations:

1. Government action matters in the 2020s. Policy mistakes – especially those driven by zero- sum-thinking - is probably the biggest overall risk factor. Zero-sum-thinking builds on the fundamental static model-of-thought that 'gain comes from others pain'. The negative side of nationalism is found here. Conflicts and serious trade wars which are a consequence of the lack of understanding of positive-sum-thinking is a risk. It is important to at least have some level of communication across borders of countries and belief systems. Here, the big challenge of climate change is the connecter – because we must work together and talk together. It could be much better, but also much worse. Some talk about deglobalisation? I think globalisation is taking new forms. The response to the Covid-challenge has been fairly uniform across the world and even if the response could have been stronger and more inclusive – so far, the response with the development of vaccines has been rather fast and impressive.

2. Growth is happening in the digital world economy, where current and future generations spend more time and money – this is disinflationary. Threats to our digital infrastructure are a clear risk to the world economy.

3. From a financial market perspective, I have touched upon the risk of higher interest rates. It is such an important risk factor that it probably won't happen. The primary driver of markets going forward is going to be earnings. As it is hard to see the two other permanent factors of stock markets – lower interest rates and even more risk appetite being core drivers from these levels. Cash flow generation will become more important at the margin in the coming period. This is an environment for selectivity.

Sustainable finance requires long-term thinking

In conclusion, we are not a big believer in calendar-year-thinking. Indeed, let me further preface this by underlining the importance of long-term thinking. Don't get caught-up in managing your time horizon like an accordion – in and out – sometimes shorter - sometimes longer. As an investor, I personally think that this is one of the biggest risks for not delivering strong long-term returns.

> **Sustainability and wealth need to go and will go hand-in-hand – that's positive rather than zero-sum-thinking.**

Finally, sustainable capitalism will grow bigger in a world that becomes wealthier and more prosperous. Sustainability and wealth need to go and will go hand-in-hand – that's positive rather than zero-sum-thinking.

Go to white paper

C WORLDWIDE ASSET MANAGEMENT FONDSMAEGLERSELSKAB A/S

Dampfaergevej 26 · DK-2100 Copenhagen

Tel: +45 35 46 35 00 · Fax: +45 35 46 36 00 · VAT 78 42 05 10 · cworldwide.com