VT Lyndon Fund

Quarterly Commentary 30th June 2020

Global equity markets continued to exhibit heightened volatility, but recovered some of the first quarter's losses in Q2, with the UK market rising by 10%, leaving it down by a little less than 20% for the year-to-date. In relative terms the UK remains a laggard, with the global rally in equities being led by the US stock market, whose on-going strength continues to appear anomalous, given high valuation levels and the US government's inept handling of the Coronavirus pandemic.

Notwithstanding the vast stimulus measures it remains unlikely that the US economy will enjoy the "v-shaped" recovery that is implicit in the US stock market's rally back to pre-Coronavirus levels. The only way we are going to see such a swift and complete economic recovery is if the novel Coronavirus is brought under control, which looks to be some way off, both in the US and elsewhere.

The economic damage to the UK economy so far has been considerable. Between February (the last month unaffected by Covid) and April, UK GDP fell by a wholly unprecedented -25%. Some sectors were considerably worse than even this dire number, with Construction shrinking by -44% over the same period, for example.

April was the low point, though, with the most recent UK data showing that there was a minor recovery in May and June's data, when it's reported, will certainly be stronger again. However, the UK economy is likely to remain well below capacity until a vaccine that confers durable immunity is developed or, failing that, then at least highly effective therapeutics that bring mortality rates down to those more typical of seasonal flus. The alternative is that we may have to learn to live with the virus, for some time at least, in which case a more nuanced approach to lockdown could be attempted in the event of a significant second wave.

The UK's economic weakness has naturally hurt the more economically sensitive sectors of the economy the most and the Fund is significantly exposed to these. In addition to the aforementioned Construction sector, which accounts for c. 25% of the portfolio's equity positions (Travis Perkins, Grafton Group, SIG, Forterra, McCarthy & Stone), the Fund also has significant positions in General Retail (M&S, Kingfisher, Next, Superdry, SCS), which have a similar aggregate weighting. Even here, though, there are some emerging brighter spots, with Kingfisher recently reporting some very decent numbers. Kingfisher owns both B&Q and Screwfix, so is exposed to both construction and retail, and yet group sales on a like-for-like basis were up +14% year-on-year in May, with this accelerating to +25% in June. Following this, the company's management now expects that profits in the half-year to July will be ahead of last year. The market had not anticipated this and the shares were up +55% during the quarter.

Travis Perkins and Grafton also reported better than expected numbers and they both continue to be lowly valued versus history, well capitalised and nicely placed for any upturn in Construction spending. On this theme, we can note that Boris Johnson recently vowed to "build build build" with a programme to spend billions of pounds on infrastructure, including new schools and hospitals, to help drag the UK economy out of its deepest recession in more than 300 years. One wouldn't want to put *too* much weight on this PM's promises, but we know that he genuinely does seem to love a big, self-aggrandising infrastructure project (airports, bridges, HS2) so there must be some chance of follow-through here. It's moot whether this makes it more or less likely, but it really would be a good idea to update the UK's crumbling infrastructure at a time when it's financeable at historically low interest rates. Building a few more houses wouldn't hurt either. The portfolio is well-positioned for either eventuality.

In addition to the construction sector, those areas exposed to housing more generally could stand to profit over the next few years. Should the "working from home" revolution stick, as many think it largely will, then it seems likely that spending on the residential environment will shift structurally higher, whether that be on repair, maintenance and improvement (where portfolio holdings Travis Perkins, Grafton, Kingfisher would be key beneficiaries), new build (McCarthy & Stone, Forterra, SIG) or just more generally making the home a nicer place to be, such as buying a new sofa (SCS), a carpet (Headlam) or furnishings (M&S, Next).

The other significant portfolio exposures are to Food Retail (mainly Sainsbury, with a smaller holding in Morrison) and Commodities (silver, uranium and gold). The Food Retail holdings reflect the belief that the market has not fully apprehended how well these businesses are doing, with management guidance having been excessively conservative. The Fund's position in commodities can be regarded as a "special situation" and is, all equal, not something that will be typical for the portfolio. In the case of both silver and uranium, at the time that the positions were initiated, the market price for the commodities was clearly below any sensible long-term equilibrium level, as both were trading at less than the cost of getting them out of the ground. Such a price cannot represent a stable equilibrium, as producers will not indefinitely operate at a loss, so some will stop mining and the removal of this supply will then drive the market price higher. The gold price has not recently presented such an evident anomaly, but the current environment is one in which some exposure to the barbarous relic seems apposite.

In addition to the equity portfolio the Fund also holds short positions in both the UK and US equity indices, with these intended to mitigate risk. There is also Implicit in the short position in the US equity index a belief that the US market's current level is not supported by fundamentals, that it is fragile and has been buoyed up by a sea of liquidity that will ultimately go out. With the US stock market rising to ever-more bubbly territory, being short the US index has, so far, been a drag on Fund performance. However, as observed by Jeremy Grantham, co-founder and chief investment strategist at GMO, whilst the underlying economic realities have been "temporarily overwhelmed" by central banks' unprecedented stimulus efforts, "it's hard to believe that will continue".

What will cause fundamentals to reassert themselves is, as ever, impossible to predict. Even substantial hindsight does not always help and, so far as we know, no one has ever really identified what caused the tech bubble of the late 1990s to deflate, for example. Some bubbles just seem to collapse under the weight of their own inherent absurdity and the current state of affairs in the US, with the market trading at historically high multiples whilst the economy is suffering an historically significant dislocation, is surely a candidate for this. Or perhaps the drip, drip of bad economic news and the dawning realisation that the snap-back will be neither as quick nor as complete as implied by the market's extended valuation will suffice?

Alternatively, should the Democrats make a clean sweep of the Presidency, Senate and House of Representatives in November's forthcoming US elections, which is currently looking more rather than less likely, then this would probably not be taken well by the stock market. Never mind that the US equity markets have, in aggregate, performed much better under Democratic rather than Republican presidencies, a political regime change at the end of the year would very probably catalyse a similar regime change in the stock market. In particular, the megacap tech stocks (now renamed FANMAGs for Facebook, Apple, Netflix, Microsoft, Amazon, Google) that have been responsible for much of the US market's gains could come under pressure. These are good indeed great businesses, but they are currently priced for something close to perfection and as if they are risk free investments. This they are not.

Big Tech has thrived in an environment in which the payment of tax was increasingly optional, with footloose tech companies able to effortlessly shift their profits across jurisdictions around the world. Regulation has been light (or no) touch, with Facebook essentially getting away with the Cambridge Analytica scandal and the weaponizing of its platform by no end of 'bad actors.' Facebook and Google are widely seen as abusing their hugely dominant positions in the advertising market, whilst Apple and Amazon stand similarly accused of treating their third party suppliers on the App Store and Marketplace, respectively, unfairly. Finally, anti-trust regulators have been asleep at the wheel; how was Facebook allowed to buy Instagram and WhatsApp, for example?

Whether there ultimately is a significant 'techlash' remains to be seen, but the tech giants have undeniably made the most of their favourable circumstances and they have been stunning investments over the last decade. The same cannot be said for many of the more pedestrian market constituents, as whilst high growth 'glamour' stocks have become increasingly highly rated, cheap 'value' stocks have stayed that way (or got cheaper). This is not inevitable. Indeed, it's not normal.

Whilst the classic process of mean reversion seems to have broken down recently, cheap stocks cannot keep getting cheaper indefinitely. As a wise economist once observed, if something cannot go on forever, it will stop. If one looks round at the world over the last few years, it is not immediately obvious that an excess of rationality has broken out or that human nature has changed decisively for the better. That being so, investing on the basis that the market periodically gets irrationally carried away with itself – bidding the prices of favoured, glamorous stocks up to unsupportable heights, whilst less exciting, out-of-favour stocks get neglected and trade at unrealistically low valuations – should have lost none of its relevance or long-term power.

Portfolio activity

After an elevated level of portfolio turnover in Q1, there was a much lower (and more typical) level of trading in Q2, with no new holdings being initiated on the portfolio and no positions were wholly exited. A number of positions that had been added to at the bottom of the market were trimmed after bouncing significantly, notably Grafton and Travis Perkins, whilst the existing holdings in silver and also Next were added to.

Next derives more than half of its revenues and much more than half of its profits from its online business. The group is by some distance the UK's leading online retailer of clothing and its successful push into the retail of third party brands should see this leadership position increase. Given the demise of department stores many third party brands will be looking for alternative routes to market and are understandably wary of getting into bed with Amazon. With its efficient and long established logistics chain Next looks to be very well-positioned to take advantage of this structural shift and the shares are not remotely priced for this scenario, as any comparison with the likes of Asos, Zalando (or indeed Amazon or Shopify) makes clear. Unlike most sector peers the group has a history of successfully navigating change and has the best (by far) management in the UK sub-sector, so this looks to be a free bet that has a decent chance of paying off. Outside of this, the group will be one of the survivors of the general retail apocalypse, so should naturally gain share from the many clothing retailers that fail during the downturn.

David Lynch, Fund Advisor, VT Lyndon Fund, 4th August 2020

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