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From the desk of Amit Lodha

Portfolio Manager
Fidelity Global Equities Fund

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History does not repeat, but does it rhyme? (Part II)

'It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to Heaven, we were all going direct the other way...' So wrote Charles Dickens in 1859 (A Tale of Two Cities), but these words ring true now more than ever.

It's day 83 of 366 in the leap year that is 2020, yet it already feels like we have lived through a decade in the past three weeks, with enough statistics on volatility and capital lost to make the financial history record books, overshadowed only by the human tragedy unfolding as COVID-19 speeds across the globe – 300,000 affected so far, over 10,000 mortalities and a near certainty of many more to come in the days ahead.

With the real economy likely to come to a sudden stop to protect life over the next few days, record high levels of debt and near certainty of a recession, Q2 unemployment in the US expected by the Federal Reserve to soar to 30% – compounded by a global pandemic and an oil shock – is it any wonder that we have not had two consecutive days of stability in the markets?[1]

There are just too many trade-offs and too many decision trees to compute between the bad and the less bad – **the machines lack the data and the humans lack the compute power, making for a powerful, volatile cocktail.** This overload led to quite a few market participants clamouring for market closure last week – **a problem of too many questions and too few answers**.

Everyone has been seeking a parallel to this period. The Marriot International CEO Arne Sorenson (link to his heartfelt message to employees) sees a parallel to his business to a combination of the period post-9/11 and the 2008 great financial crisis.[2] Some have looked at the pandemic as the Spanish flu epidemic of 1918, whilst others have compared this period to 1987 (Black Monday), LTCM (algorithms failing – read Ray Dalio's Linked-in note Our Performance) or 1929 (onset of the great depression).[3]

As Howard Marks eloquently put it – Nobody Knows in his recent memo to clients – investing today is a bit like (to paraphrase the tag line from my favourite television series of all time, Star Trek) **going boldly, where no one has gone before!** This is how investing through 1929 would have felt, where there were no parallels to go back to, or what investing during the great wars must have felt like. (Incidentally, in my view, the great wars possibly offer the best parallel – more on this below.)

However, I believe that what we lack in compute power, we more than make up for with the power that is **imagination**. Machines don't yet have that!

What do we know, what do we not know?

COVID-19-related

- In February, we were debating why we were not seeing more outbreaks outside China. Now it is clear this is a global pandemic, which will require harsh measures of social distancing and quarantines, and in many cases a complete shutdown of everything bar the very essential services.
- What is unclear is:
  - The depth of the pressure on the health care systems.
  - The duration of the epidemic (and the consequent shut-downs and social distancing norms).
  - Secondary recurrence, or a manifestation of a more virulent mutation (like the Spanish flu epidemic of 1918).
- Against this, the full might of the global health care machinery is now racing to:
  - Find a cure/vaccine.
  - Produce more diagnostic kits to (a) diagnose those who have the virus, and (b) tell you if you have already had it and are immune to it.
  - Produce more healthcare equipment as we redefine what peak required capacity really is!

Interest rates, government and central bank response:

- Interest rates are clearly likely to be lower for longer.
- With 2008 still fresh in minds, central banks and the government response has been much swifter than the past, with near unanimity on what needs to be done. Fiscal stimulus/helicopter money is the ventilator support that the economy needs until we restart activity and with everyone doing it, the currency support to do it is very much there. If anything, from the behaviour of the US dollar, the US Federal Reserve (Fed)/Treasury still needs to do more.
- Governments have pledged support to the hardest-hit industries of travel and leisure, airlines, restaurants and retail.
- The question that remains, inextricably related to the duration of the pandemic, is again the depth and duration of this economic shock and whether we come out as 'V' or an elongated 'U'. Again, no one really knows, but the prognosis has gone from blasé to expectations of greater than 20% declines in US GDP in the second quarter (which would rank as the worst in history, as we have never really seen anything worse than a -8.3%, post the wars).
- The open question that remains is whether fiscal stimulus/helicopter money is here to stay, or will it be withdrawn swiftly once the crisis abates?

In the near to medium term, it is important to remember that if you are getting unduly bearish, you are fighting the Fed and nearly every central bank and government in the world, along with the single-minded dedication of various health care professionals and scientists to find a cure or vaccine. Think hard and rationally about your odds!

Country selection, politics and the long term: the 1945 crossroad

- In my note 'Is the end of globalisation the end of global investing?' dated July 2019, I made the point that over the next decade, country selection and politics would have a greater impact on global investing. My thinking was driven by the fact that the rising popularity of the ideas of socialism and the increasing problem of inequalities would all come to a head over the next decade, which would then have different solutions in different countries, depending on their political landscape.
- COVID-19 no doubt accelerates those trends of income inequalities and the necessity for reform of capitalism to work for everyone.
- While Bernie Sanders might have lost the race for the Democratic party nomination, his ideas of universal healthcare (and Medicare for all) may take on a life of their own, just as in the UK, where the Chancellor has taken straight from the Labour playbook to support the wages and incomes of those likely to be heavily impacted by the pandemic (the right call, in my view).
- If fiscal stimulus and helicopter money is employed in the right way, there is no doubt that we must consider the possibility of exiting the period of stagnation. While commentators give the example of the Japanese experience, remember that:
  - (a) With the power of the global reserve currency, the Fed is a lot more powerful.
  - (b) We have no playbook for a global, co-ordinated fiscal stimulus, except possibly after World War II and the Marshall Plan for the reconstruction of Europe (also called the European recovery plan).

The 1945 crossroads and the Marshall Plan

- Imagine for a second (maybe longer...), investing in 1945. The Battle of Stalingrad was fought in 1942, and by then it was clear that with the entry of the United States, the Allies were successfully able to push back the Axis advance.
- Japan and Europe were devastated, Russia had lost more than 20 million people or 15% of its population, and the outlook could not have looked more bleak.
- Yet from the depths of this destruction rose the German and Japanese economic miracles; though possibly the most important change was the beginning of the American century of exceptionalism.
- The US$15 billion promised for the reconstruction of Europe was about 5% of US GDP. Given the pace of announcements, I would not be surprised if we reach 2% to 5% of GDP in terms of fiscal stimulus before we are out of this pandemic. (Currently, as per UBS estimates, we are at 2.04% of global GDP in terms of announced stimulus.)
- Equally important were the social and cultural changes coming out of the war, which went beyond the negative effects of destruction, dislocation and deaths (covered in-depth in 'The Second World War' by Antony Beevor, and the articles of Arthur Marwick, amongst many others):
  - The need to mobilise the entire economy and society to the war effort led to progressive social changes.
  - The war had a social levelling effect, with significant narrowing of the gap between rich and poor in terms of incomes, wealth due to higher taxes and increase in state welfare.
  - While class differences remained, the position of the working class improved. (Watch Ken Loach's 'The Spirit of '45' if you want to get a sense of British history just after the war, and how the institutions of the NHS and state welfare were created.)
  - The singular focus of governments was to maintain high levels of employment and consequently, the power of governments increased (as did the dependency of people).
  - **Central to the recovery in Western Europe (in my opinion), was the synthesis between capitalism and socialism – what I would call 'compassionate capitalism'.**
  - There were many other positives, such as the end of the colonial empires, and that women began to enjoy greater socialy mobility and opportunities. Indeed, the war was socially liberating – women received the right to vote in England and Germany post-World War I, and in France and Italy, post-World War II).
  - It can be fairly argued that many of these changes were a long time coming and the war gave these a final push.

The open questions for the path ahead:

- The above, I think, gives us some guide paths to the changes that we can anticipate.
- Governments will be incentivised to maintain high degrees of employment and with an interconnected society, a lot can be quickly achieved.
- However, global co-ordinated leadership is required and the question is, does America have the leadership to create another Marshall Plan, or will that leadership appear from another part of the world (e.g. China, UK, Germany)?
- Will we be able to resolve these tectonic geopolitical changes peacefully?
- How do governments think about their role of providing life support – do they exit or become omnipresent? As my favourite financial historian, Russell Napier, wrote: 'While it may be attractive for companies in trouble to accept debt from governments, it is better they accept equity as then all interests become well-aligned and we don't compound the problems of the past.'

From the macro to the micro: comments on equity valuations and things to focus on

- If you are only a fundamental investor, the market gyrations are likely to surprise you. **To paraphrase Ben Graham, the market currently seems to be doing a lot of voting and not enough weighing!**
- **Permanent capital destruction is generally a function of one of the following:**
  - Paying higher prices than warranted (simply put, buying something worth $10 for $100 – tech bubble, 2001).
  - Excessive debt/leverage not allowing the business to meet working capital requirementsor pay salaries during periods of shut-down, and leading to equity dilutions at fire sale prices (which is what happened to European banks in the 2008 financial crisis).
  - Regulatory changes/industry changes/innovation changing the long-term earnings power of the business (financials post-2008, taxi medallion values post-Uber).
  - Poor management capital allocation decisions and fraud.
- It is important to continuously scrub the portfolio for any of the above, knowing that some mistakes will be made but, through proper diligence, a fair few will be avoided.
- **Absent the above, the long-term earnings and cashflow generation power of a good business does not change that materially post a recession (therefore, we have always focused on businesses that convert profit to cash flow with the maxim 'profit is an opinion, cash is a fact').**

Let me give you an example of a theoretical high-margin company and its discounted cash flow statement.

Forecast pre-COVID-19

	2019E	2020E	2021E	2022E	2023E	2024E	2025E
Revenue	**$10,740**	**$12,017**	**$13,032**	**$13,993**	**$14,972**	**$16,020**	**$17,141**
y/y growth	*9.3%*	*11.9%*	*8.4%*	*7.4%*	*7.0%*	*7.0%*	*7.0%*
Operating Proft	**$2,817**	**$3,220**	**$3,610**	**$3,974**	**$4,357**	**$4,774**	**$5,228**
Operating margin	**26.2%**	**26.8%**	**27.7%**	**28.4%**	**29.1%**	**29.8%**	**30.5%**
Tax rate	8.4%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%
NOPAT	$2,580	$2,898	$3,249	$3,577	$3,921	$4,297	$4,705
Depreciation	296.00	282.52	305.46	319.66	$305	$312	$318
Working Cap	182.00	-110.07	-139.41	-77.81	-$139	-$141	-$142
CapEx	-461.00	-354.43	-370.51	-396.45	-$371	-$400	-$400
Unlevered FCF	**$2,597**	**$2,716**	**$3,045**	**$3,422**	**$3,717**	**$4,067**	**$4,481**
Unlevered Free Cash Flow	$2,597	$2,716	$3,045	$3,422	$3,717	$4,067	$4,481
		4.6%	*12.1%*	*12.4%*	*8.6%*	*9.4%*	*10.2%*
Discount	1.00	1.00	0.93	0.86	0.79	0.74	0.68
Discounted Free Cash Flow	$2,597	$2,716	$2,819	$2,934	$2,951	$2,990	$3,050

Present Value of Cash Flows	$17,459
Discounted Terminal Value	$62,821
Cash/Debt end FY 2018 + BTG debt	-$9,700
Shares Outstanding	1412.0
Value per Share end 2020	**$50.0**

Forecast post-COVID-19

This is the draconian forecast, assuming that for about three months, revenues are down to zero while costs stay constant (i.e. no job losses or production cuts and, for simplicity's sake, no changes to any other assumptions like capex or working capital).

	2019E	2020E	2021E	2022E	2023E	2024E	2025E
Revenue	**$10,740**	**$9,017**	**$13,032**	**$13,993**	**$14,972**	**$16,020**	**$17,141**
y/y growth	*9.3%*	*-16.0%*	*44.5%*	*7.4%*	*7.0%*	*7.0%*	*7.0%*
Operating Proft	**$2,817**	**$220**	**$3,610**	**$3,974**	**$4,357**	**$4,774**	**$5,228**
Operating margin	**26.2%**	**2.4%**	**27.7%**	**28.4%**	**29.1%**	**29.8%**	**30.5%**
Tax rate	8.4%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%
NOPAT	$2,580	$198	$3,249	$3,577	$3,921	$4,297	$4,705
Depreciation	296.00	282.52	305.46	319.66	$305	$312	$318
Working Cap	182.00	-110.07	-139.41	-77.81	-$139	-$141	-$142
CapEx	-461.00	-354.43	-370.51	-396.45	-$371	-$400	-$400
Unlevered FCF	**$2,597**	**$16**	**$3,045**	**$3,422**	**$3,717**	**$4,067**	**$4,481**
Unlevered Free Cash Flow	$2,597	$16	$3,045	$3,422	$3,717	$4,067	$4,481
		-99.4%	*18902.0%*	*12.4%*	*8.6%*	*9.4%*	*10.2%*
Discount	1.00	1.00	0.93	0.86	0.79	0.74	0.68
Discounted Free Cash Flow	$2,597	$16	$2,819	$2,934	$2,951	$2,990	$3,050

Present Value of Cash Flows	$14,759
Discounted Terminal Value	$62,821
Cash/Debt end FY 2018 + BTG debt	-$9,700
Shares Outstanding	1412.0
Value per Share end 2020	**$48.1**

For a draconian 93% negative change in a year's operating profitability, the change in the franchise value is $2, or less than 5%. This is because this is a business with pricing power where a disproportionate chunk of the value in the business lies over the long term. **Business managers who are focused on long-term value creation will intuitively know this trade-off.**

However, recessions don't treat all businesses equally. Here is the same exercise for a cyclical business, which trades at much lower multiples, with lower margins (hence high operational gearing) and, more importantly, is unfortunately highly levered going into this recession.

Forecast pre-COVID-19

	2019E	2020E	2021E	2022E	2023E	2024E	2025E
Revenue	**$10,000**	**$9,017**	**$10,260**	**$10,363**	**$10,467**	**$10,571**	**$10,677**
y/y growth	*1.8%*	*-9.8%*	*13.8%*	*1.0%*	*1.0%*	*1.0%*	*1.0%*
Operating Proft	**$800**	**$541**	**$616**	**$622**	**$701**	**$782**	**$865**
Operating margin	**8.0%**	**6.0%**	**6.0%**	**6.0%**	**6.7%**	**7.4%**	**8.1%**
Tax rate	10.2%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%
NOPAT	$718	$487	$554	$560	$631	$704	$778
Depreciation	1000.00	1040.00	1081.60	1124.86	$1,169	$1,217	$1,265
Working Cap	-79.44	-110.07	-139.41	-77.81	-$134	-$135	-$137
CapEx	-1000.00	-1000.00	-1189.00	-1125.00	-$1,170	-$1,217	-$1,265
Unlevered FCF	**$639**	**$417**	**$307**	**$482**	**$496**	**$568**	**$642**
Unlevered Free Cash Flow	$639	$417	$307	$482	$496	$568	$642
		-34.8%	*-26.3%*	*56.8%*	*3.1%*	*14.5%*	*13.0%*
Discount	1.00	1.00	0.89	0.80	0.71	0.64	0.57
Discounted Free Cash Flow	$639	$417	$274	$384	$353	$361	$364

Present Value of Cash Flows	$2,154
Discounted Terminal Value	$3,345
Cash/Debt end FY 2018 + BTG debt	-$2,000
Shares Outstanding	140.0
Value per Share end 2020	**$25.0**

Forecast post COVID-19
(A 3-month hard stop with no cost support and 100% drop down on leverage – no other changes to assumptions)

	2019E	2020E	2021E	2022E	2023E	2024E	2025E
Revenue	**$10,000**	**$6,500**	**$7,410**	**$7,484**	**$7,559**	**$7,634**	**$7,711**
y/y growth	*1.8%*	*-35.0%*	*14.0%*	*1.0%*	*1.0%*	*1.0%*	*1.0%*
Operating Proft	**$800**	**-$2,110**	**$445**	**$449**	**$506**	**$565**	**$625**
Operating margin	**8.0%**	**6.0%**	**6.0%**	**6.0%**	**6.7%**	**7.4%**	**8.1%**
Tax rate	10.2%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%
NOPAT	$718	-$1,899	$400	$404	$456	$508	$562
Depreciation	1000.00	1040.00	1081.60	1124.86	$1,169	$1,217	$1,265
Working Cap	-79.44	-120.00	-139.41	-77.81	-$134	-$135	-$137
CapEx	-1000.00	-1000.00	-1189.00	-1125.00	-$1,170	-$1,217	-$1,265
Unlevered FCF	**$639**	**-$1,979**	**$153**	**$326**	**$321**	**$373**	**$426**
Unlevered Free Cash Flow	$639	-$1,979	$153	$326	$321	$373	$426
		-409.7%	*-107.7%*	*112.7%*	*-1.6%*	*16.1%*	*14.2%*
Discount	1.00	1.00	0.89	0.80	0.71	0.64	0.57
Discounted Free Cash Flow	$639	-$1,979	$137	$260	$229	$237	$242

Present Value of Cash Flows	-$875
Discounted Terminal Value	$2,218
Cash/Debt end FY 2018 + BTG debt	-$2,000
Shares Outstanding	140.0
Value per Share end 2020	**-$4.7**

As is apparent, the combination of high financial and operating leverage is a toxic cocktail, which together can destroy significant amounts of capital in a downturn. In this example, three months' loss of revenue and no attendant management action would see the company's equity becoming worthless. (Is it any wonder the high yield market is in such a stake of funk?)

Having said that, this is not to suggest investing in one versus the other. On the contrary, this is where evaluating the difference between market price and your view of franchise value becomes so important. During dislocations, all businesses trade at significant discount or premium to market valuations, and it should not surprise you if you have over 50% to 100% upside on your price targets.

Further, the correct investment strategy in the 2009 recovery was to sell everything that had been defensive in 2008 (good quality, low leverage and had protected capital) and buy everything cyclical that had survived (generally had great management teams who had navigated the cycle with often lower than peer group leverage). In fact, in 2009, the defensive high-quality businesses were not good areas for capital preservation, given the weight of capital which flowed in the other direction.

As soon as governments announce the all-clear on the pandemic, or a cure is found, or restrictions go, expect the 2009-like investment environment to repeat. So, the message is really to be flexible and continue to look through the wreckage in cyclical areas where the market has thrown out the baby with the bathwater (for example, if 9/11 did not make us stop flying, it is doubtful that COVID-19 will).

To repeat what could be described as one of the core tenets of Anthony Bolton's investment philosophy: **'The most money in equity markets is made when things go from bad to less bad.'**

Closing thoughts:

- A change in the decade brings about seminal changes and 2020 is living up to the promise, though at huge human and financial cost.
- While the near term may be uncertain, if you are thinking three to five years out (and assuming fiscal and monetary policy comes to the rescue), the long-term franchise value of good businesses will not have changed and, in fact, you might get to buy some high-quality cyclical businesses at distressed valuations as we progress through this period.
- Until the air clears, diversification (country, geography, sector, security, factor) is extremely important but, equally, the dislocation in valuations will have gone by the time the air clears.
- Investing through the bear market is tough, but differential returns are possible only if you are prepared to do something different from the rest, which in this case might mean having a very cyclically orientated portfolio as **COVID-19 comes up to its expiry date.**
- Navigating this period requires a belief in the Darwinian motto of flexibility and a necessity to fight the urge to get either unduly bullish or bearish: nobody knows (including the machines!). Human nature and Microsoft Excel make us extrapolate the immediate past indefinitely into the future. As I covered in my Part I note, it is unlikely to be as good, indefinitely, and the message of Part II is that it is unlikely to be as bad, indefinitely.
- As we analyse the full impact of the pandemic, the closures, and the government response, it is likely a lot of sacred cows (fiscal deficit targets) will have been sacrificed at the altar of achieving high employment – this might make the longer-term outlook for certain equities and sectors superior to what it was pre-pandemic. **However, this also may mean that taxes will probably rise from the current low levels and long-term corporate margins have probably peaked as the pendulum shifts back toward labour.**
- Flexibility of mindset remains key, which might mean, like a pilot, ignoring the instruments (market prices on the screen) when they are not functioning appropriately and trusting one's own judgement.
- Currently – as macro strategist James Aitken has covered in an excellent podcast – due to poor market liquidity, the world's risk-free curve (and the US 10-year treasury yield) of which every security is priced, is not working.[4] Talk about flying without instruments! (In financial markets, this is akin to the sun not rising at the appointed hour.)
- Related to the above, a functioning fixed income market is the first condition for equities to see some bottoming, improving relative cyclical performance; airlines, commodities would be the next.
- Societal changes will be numerous yet, once we go back to work, the lessons of this period will be quickly forgotten. Just as the changes post the war and the difference between the models of East and West Germany were not visible until ten years later, so it will be for some of the changes we expect.
- This should give patient, long-term capital enough time to reposition the portfolios to the winners of this decade, which are very likely to be different from those of the past. (For more on this, refer to our piece 'Market Leadership – a 2029 view', dated February 2019.)
- Emerging markets, UK, China, health care, technology, commodities (especially those geared toward driving renewable technologies) and ESG-focused investments are some of the areas where, from a global perspective, more work should be done.
- Equally, we should be thinking about:
  - Is this the end of the 30-year bond bull market and its impact on the standard 60:40 asset allocation portfolios?
  - What impact will this have on the US consumer, which has been the locomotive of global growth over the past ten years (like China was prior to the 2008 financial crisis), powering many leaders including the tech behemoths of today?
  - Much more medium term, how the US navigates this period will give us a sense of what lies ahead for the US dollar and its status as the world's reserve currency.

- In recent discussions (pre-COVID-19), governance and social awareness have been high on the agenda of various management teams globally. Now is the time to walk the talk rather than use the recession to take a hiatus on these considerations. **Leadership is all about weighing up the sub-optimal choices, but ultimately doing the right thing even if it is hard. History will be a tough judge.**

On a more personal note, everyone has a guiding philosophy; mine is **'whatever happens, happens for the best'.** It has kept me steady through both good times and bad, and is one that I cling to as I grapple with both the uncertainty in economies and financial markets, and the worry around the health of my loved ones, especially my grandparents (one octogenarian and two nonagenarians).

In that spirit, I wish you and yours the best of health.

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Footnotes and references: 1. Bloomberg News Article Link, U.S. Jobless Rate May Soar to 30%, Fed's Bullard Says, 23 March 2020. **2.** Source: YouTube Video Link, COVID-19: A message to Marriott International associates from President and CEO Arne Sorenson, 20 March 2020. **3.** Source: Linked-In, Article by Ray Dalio, Co-Chief Investment Officer & Co-Chairman of Bridgewater Associates, L.P. Article Link, March 2020. **4.** Source: James Aitken - Systematic Risk in Crisis Podcast Link.

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