Investment Insights

Active Equity Management Amid Turbulence

BESSEMER TRUST

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Highlights

- In the midst of the COVID-19 crisis, internal equity mandates remain focused on investing over a long-term horizon while making adjustments for the new reality.
- Portfolio managers continue to seek companies with strong management teams, balance sheets, and cash flow generation potential.
- Across the platform, the team actively collaborates and leverages their collective experience, having learned many lessons from past crises.
- Portfolios reflect the view that certain trends have been accelerated by the pandemic, and structural shifts may occur in some sectors.

Overview

Chief Portfolio Strategist Peter Langas recently hosted a roundtable discussion with Bessemer equity portfolio managers (PMs) to delve deeper into how they are actively navigating the COVID-19-sparked stock market volatility. He posed a number of questions to them, including their positioning going into the downturn; how they have reacted within portfolios; how they are thinking about current holdings; how they are thinking about earnings, valuations, and distressed sectors; and emerging themes and trends as we move forward beyond the immediate shock of COVID-19 on the world. This *Investment Insights* provides a summary of their conversation.

We continue to offer our heartfelt sympathies to everyone affected by the virus.

Peter Langas (PL): When going through an abrupt downturn, what matters more than what you do in the middle of it, is what you did before the downturn. Can you share how your philosophy and process shaped positioning going into this downturn?

Alex Christie (Large Cap)

A common thread that runs through all of the internally managed portfolios at Bessemer is a long-term and quality focus. Our philosophy is not to make calls about how stocks are going to react in the short term, but we are set up well to capitalize on the winners in the long run; as a collective group of PMs, we have come to realize that quality companies outperform in the long run. When I refer to quality, I mean companies in good industries, companies that have a competitive advantage. They can do something that others can't do, and this allows them to earn more than their cost of capital. They have excess capital they can put to work, and they then become compounders.

We were set up going into this mostly with quality companies — long-term compounders. Some portfolios have different mandates and will own some companies that don't fit that philosophy perfectly. In our portfolio, for example, we own a few banks and energy companies. While we do not consider them compounders, they are in industries that can outperform for multiyear periods. We want to own some of them and have some exposure. Our philosophy here is to try to own the highest quality names — the ones with the best growth prospects.

Michael Morrisroe (Small & Mid Cap)

We also focus on a long-term horizon when looking at companies. We look for companies that are not dependent on the underlying macro environment and ideally are in control of their own destinies. That

being said, we do have a baseline forecast — that two months ago was a low growth world with some potential recovery in the U.S. This has been our base case for an extended period of time, but it has changed a lot in a short period of time.

Jeff Rutledge (Large Cap)

I would offer some additional points about the quality focus. Across the internal mandates, we have strong opinions as to strength of balance sheets. Strong balance sheets provide companies with a key competitive advantage — to take advantage of opportunities when they arise — so this is an important aspect of the quality angle.

PL: In the midst of the stock selloff, how did you and your teams react?

John Hall (Large Cap)

Fortunately, or unfortunately, the PMs have experienced these types of negative shocks to the markets — whether the global financial crisis, or 9/11, or the tech bubble bursting. They are all different, but there are some common learnings. First and foremost, we do not panic. We've been taking months or years to build these portfolios, and we're focused on the long term. We're focusing on the most attractive companies, either in absolute terms or relative to their industries.

We know these shocks can create stresses in the system — and stresses for individual companies and holdings — and our first level of analysis is company balance sheets. Because of our quality focus, we continuously evaluate balance sheets, but there is an immediacy with this type of shock. We want to make sure we evaluate how much cash is currently on balance sheets, as well as current debt maturity schedules, debt facility drawdowns, banking relationships, and covenants.

We have also analyzed the strategy's direct and indirect exposure to the areas most affected, like airlines, cruise lines, restaurants, and theme parks. For all holdings, we want to understand if the earnings and cash flow generation of the company have changed permanently, or is this just a temporary blip? Is there an impact on the supply chain that you need to be worried about? Is that going to be a permanent issue? Is it going to require additional capital or is it going to alter the competitive advantage of this company?

The PMs communicate often during these shocks; we are constantly collaborating. We are fortunate with our corporate structure as there is no barrier to rooting for each other to succeed, because we all have a vested interest in each of our portfolios succeeding.

Alex Christie (Large Cap)

This downturn is different than the previous downturns. Typically a downturn is led by excess in the system; we overbuild, and then the market has to rationalize that excess. Historically, we've had more time to gather information to analyze how this will play out. This downturn happened so quickly because it's been a forced demand destruction. To compensate for the compressed timeframe, we were able to leverage our research networks, and we found it incredibly helpful to be able to quickly get people in the field on the phone to tell us how they were going to react to this in different industries. This helped with our stress testing. We learned that local banks are very happy to give 90-day deferrals on interest payments.

Another element of this downturn was the simultaneous collapse in oil prices, due somewhat to the virus and lack of demand, but also due to Russia and Saudi Arabia fighting over market share. This dynamic added a whole new level to the financing part of the economy because these are very capital intensive businesses and all of a sudden they're looking like they can't pay off their debt, and that just seized up parts of the market, and so we had to go and stress test that aspect.

Michael Morrisroe (Small & Mid Cap)

Another benefit of Bessemer is in many cases, we are long-term owners of the company and can be partners with management. With the majority of our holdings, we were able to reach out to have dialogue

with CFOs or treasurers to better understand their liquidity requirements and availability, and covenants. Many of these companies have long-term banking relationships, and the reality is bankers don't want to take over hotels or retail stores. Understanding this qualitatively and quantitatively gave us a degree of comfort again during the chaotic period in late March.

PL: Now that we've gone through this downturn and you've done your analysis, how are you thinking differently about the companies in your portfolio today versus a few months ago?

Michael Morrisroe (Small & Mid Cap)

We take the perspective that we're buying companies and investing in them for the long term. That's where the majority of a company's value is derived — from its long-term earnings power, not necessarily what happens over the next few quarters. In the short term, there is no clarity on earnings, which is why we're focused on looking past this period of time, and for us, this means looking to 2021 to 2022. Even companies with highly visible business models are unable to guide even on a weekly basis — so forecasts over the next several quarters are likely to be highly variable. But we're doing our best to estimate what our companies will be earning in a more normalized environment.

We are interested in adding to areas that we believe will recover quickly — they're not structurally changed, but business is simply deferred. Examples here include auto repairs and pest control. We're adopting a wait-and-see approach on areas that may see structural change, like air travel and hotels. Here, there is too much uncertainty, and the risk/reward profile does not yet make sense.

PL: Could you comment on how you look at valuations in this highly uncertain environment? How are you viewing the relative attractiveness of different companies?

Michael Morrisroe (Small & Mid Cap)

Frankly, looking at earnings over the next few quarters doesn't really mean much in regard to valuations. As I mentioned before, we're looking out to a more normalized earnings environment as a basis for valuations. We also use discounted cash flow analysis. Taking out a full year's worth of cash flows due to the lockdown and shifting the cash flow stream out one year doesn't make much of a difference to a company's value, and so that is what we are evaluating. If there is a mismatch between the reduction to value from a discounted cash flow perspective and the fall in the stock price — and we still believe in all of the elements in terms of quality, balance sheet, and growth prospects — then it becomes attractive to us.

Jeff Rutledge (Large Cap)

With respect to valuation multiples, a lot of ink has been spilled in the analytical community arguing that the market is more expensive than it was even before the peak, and frankly even before the financial crisis in 2008. Valuations do look very expensive right now, and that's due to earnings going to zero or negative for certain companies for this quarter and potentially the next two; retail, travel, and entertainment are going to be hard hit. We are analyzing companies' ability to generate earnings once the recovery occurs, and thinking about valuations through this lens.

PL: How have you adjusted sector weightings? Are you looking to take advantage of any distressed sectors?

Jeff Rutledge (Large Cap)

We tend not to like sectors that are more commodity-oriented, such as energy, materials, and certain areas of financials; we do not see high potential for long-term compounding. So we will likely continue to be underweight those areas. We have taken the opportunity to adjust certain sector weightings and upgrade holdings; in the aftermath of the market peak, we added new holdings in the pharmaceuticals sector and several technology companies, including a semiconductor chip company with a great outlook. We also added a couple of consumer staples, where we were a little underweight. Despite our generally

bearish view on the sector, we did buy an energy company with a strong AA-rated balance sheet and attractive dividend yield.

John Hall (Large Cap)

Philosophically, we're not really ones to go through the rubble in the most damaged sectors, but we did make a few changes as volatility escalated. We viewed restaurants as a sector that was likely to experience a prolonged downturn, and we sold a food distribution company that services that sector and trimmed a fast food chain. We also took some profits on a warehouse club retailer that had performed well through the downturn, and added to a global beverage name whose dividend yield had become very attractive and where we maintain high conviction. While energy is becoming an increasingly smaller sector within the overall market, we saw a nice opportunity with a company with a strong balance sheet. There may be some areas, like airlines or cruise ships, that perform strongly if there is a V-shaped recovery, but they are unlikely to be attractive to us; they have not historically met our criteria.

Alex Christie (Large Cap)

Our mandate has not made tremendous moves, but we did trim back some areas that are likely to take longer to recover, such as the hotel and aerospace areas. We added to a larger technology name with significant exposure to China, which is now recovering; it also has an improved service business and interesting near-term product launches.

Michael Morrisroe (Small & Mid Cap)

We were happy with positioning going into the downturn. The selloff has heavily favored some of our key holdings, causing valuations to increase. After evaluating the companies' competitive advantages and compounding abilities, we have either added or trimmed some of these holdings. One area we have trimmed is commercial construction, which doesn't appear to have fully priced in the negative impact to the industry.

PL: What are some of the new trends as a result of the virus and themes that may emerge?

Alex Christie (Large Cap)

We generally see two categories of trends — those that are clear cut and those that are debatable. Clear-cut trends that already existed but have been accelerated by the virus include cloud deployment, digital transformation, e-commerce, online food delivery, social media use, teledocs, flexible working, streaming video, connecting more things, and using more silicon. Nationalism or populism was emerging, accelerating globally, and has likely been pushed forward because of the virus.

Debatable trends include travel and leisure; it is unclear whether they are structurally impaired. In the short run, theme parks, live sports events, and entertainment are unlikely to see a lot of visitors, but the longer-term picture is unclear. Another debatable area is supply chains. For the last 20 years, companies have been working on making their supply chains more and more efficient in order to minimize working capital costs. However, we may see a return to localization and flexibility. Also debatable is how much deleveraging or increased savings this crisis creates. In past cycles, these dynamics occurred due to excesses in the system. While corporations and individuals holding too much debt will feel pain, the degree of deleveraging is unclear at this point.

Jeff Rutledge (Large Cap)

Adding to the point on supply chains, companies may realize that having China as a major supplier carries too much risk. There is a reasonable argument to be made that we'll start bringing some manufacturing capacity back to the U.S.; this is a potential longer-term trend. If such a phenomenon were to occur, that would have very positive ramifications, particularly for U.S. companies that were involved in the development and manufacturing of capacity, such as companies within construction and manufacturing technology markets. That's something we'll be watching not just in the coming weeks and months but over the next couple of years — because if it

emerges, there could be some significant opportunities.

PL: How would you summarize our equity mandates?

John Hall (Large Cap)

Our internal equity mandates share similar investment philosophies, though have some differing views on individual companies, on sectors, on regions. We are experienced teams that actively collaborate and share perspectives. Key to long-term success is investing in companies more in control of their own destinies, with good balance sheets, cash flow generation potential, and strong management teams that are aligned with shareholders. Most important is remaining disciplined through this virus-related dislocation.

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