



Q&A

Managing Volatility Through the COVID-19 Crisis



As the effects of the coronavirus pandemic continue to spread around the world, many investors are still anxious about market volatility.

Kent Hargis and **Sammy Suzuki**, Co-Chief Investment Officers of **Strategic Core Equities** talk about their experience in managing the portfolio through the first-quarter market crash and the second-quarter rebound.

Q. How has the market volatility this year been different than prior crises?

Kent Hargis: The speed of the downturn in February and March was unprecedented. The VIX indicator of US market volatility exceeded levels seen in the global financial crisis (GFC) of 2008 within days; during the GFC a similar volatility spike took about 12 months to build up. We went from extreme calm to utter panic. Standard risk models were pressed. Readings from quantitative metrics were not really very meaningful. Betas compressed, so the lowest-beta stocks, which are less risky than the market, started behaving much more like the market. Even in our portfolios, which are defensive by nature and built on holdings that are expected to fall less than the market during a downturn, betas jumped by more than 10 points overnight.

Performance patterns in defensive stocks were also surprising. For example, during the first-quarter sell-off, technology stocks performed relatively well compared to previous downturns. In part, this is because technology has become a fundamental component of day-to-day living and became even more indispensable during lockdowns. Our portfolios have been overweight in technology since inception, as we believe that select companies in the sector provide a good combination of stability and growth potential. Other sectors that typically provided protection in weaker markets, like commercial and consumer services, underperformed as social distancing measures shut down industries such as restaurants and travel. What does this tell us? That investors who target lower-volatility stocks must always be on their toes, because what helps you get through one crisis might not be the same thing that works in the next one.

Q. To what extent does progress in the battle against COVID-19 guide some of your investment decisions?

Sammy Suzuki: We don't focus on the spread of the virus itself when evaluating our holdings and portfolio candidates. Investors aren't epidemiologists and we shouldn't try to forecast the outcome of this pandemic. That's not our expertise and there are too many unknowns. But there's a lot we can do. By evaluating the intricate workings of

company finances, balance sheets and business models, we can assess how they will perform in different scenarios and outcomes. We often talk about building a macro-resilient portfolio. Similarly, our goal is to invest in COVID-resistant companies—with strong cash flows and resilient business models that are likely to withstand the pressures of the pandemic and thrive in a post-coronavirus recovery.

Q. How will things look when we emerge from this crisis and what type of longer-term opportunities might arise?

Sammy Suzuki: The coronavirus crisis will ultimately serve to accelerate many structural trends that were already in place, such as the shift toward a more knowledge-based economy. Companies with intangible assets—strong brands, network effects or innovation—should do better in the long run, whether economies reopen faster or slower than expected.

Kent Hargis: Three themes stand out to me. First, digitization and the acceleration of that across payments, business interactions and consumer e-commerce. Second, we believe that the accelerated transition to the knowledge-based economy will create opportunities in companies that provide information and proprietary data that's essential in a contactless world. Third, post-COVID, we expect to see greater debt, lower interest rates and much more government intervention in financial markets. There will be winners and losers from these trends. For example, as governments try to keep funds flowing through financial systems, we'll see lower interest rates for longer; and cheaper access to capital is good for business in general. On the other hand, some companies, such as banks, will struggle as interest rates stay lower for longer and credit quality weakens.

Q. Do you think about risk management differently in this environment?

Kent Hargis: In this environment, fundamental analysis and deep knowledge across companies is essential to make dynamic, forward-looking assessments. The future isn't going to look like the past, and investment analysis must be based on an insightful understanding of

what's really driving companies and industries to plot a path back to normal from the global demand shock. Two key elements will determine the fate of companies: First, is the company financially solvent? Does it have the cash to survive? Is it leveraged? Does it have a strong balance sheet? And second, we look at earnings risk and cash-flow risk for these companies in the economic downturn. That means we're looking at how flexible business models are to a reduction in revenue. What's the operating leverage, and how variable is their cost structure to support strong and stable cash flows in this environment? Risk models can't predict the complex effects of the pandemic, which are influenced by public health and policy, personal behavior decisions, and macroeconomic trends. That's why relying on independent judgment and data is more important than ever today.

Q. Equity markets have bounced back strongly since they bottomed in early April. Has it been just a mirror image with the same things going up that fell hardest?

Sammy Suzuki: Actually, it's been quite interesting. The initial phase of the recovery was driven by defensive and growth stocks. And since mid-May, cyclical stocks have led the rally. We believe that it's dangerous to try to play this game of cyclical versus defensive rotation. There will undoubtedly be some period of outperformance of low-quality cyclical

stocks, but it's hard to time these shifts, and they don't always last very long. So, we continue to look for companies that offer a combination of quality and stability at attractive prices; those three core elements underpin our investment philosophy in good times and bad. In today's complicated environment, we think quality, stability and price are a good guide to finding companies that can deliver capital appreciation in the long run.

Q. Has anything changed in the way you look for lower-volatility stocks because of the crisis?

Kent Hargis: Not really. Our strategy is a high-conviction equity portfolio designed to emphasize downside protection, while capturing most of the upside in rising markets. We look for companies that have clear strategic advantages, solid business models and excellent management, with stocks trading at attractive valuations. And our research pays especially close attention to the stability of free cash flows, which we think are a particularly important indicator of a company's long-term potential. Of course, the impact of the coronavirus on the global economy affects these variables in different ways for each company. But we still believe that companies with these features are best positioned to deliver strong returns through changing conditions.

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