GOOD NEWS!

A Cyclical Focus Strategy Update

Written by Cyclical Focus Portfolio Managers Ty Cobb, Tom Hancock, and Anthony Hene

We launched the Cyclical Focus Strategy in April to capitalize on strong, cyclical businesses that had been laid low by the Covid pandemic but that we believed would thrive in the long term.

Our thesis was simple: "This too shall pass." We argued that the pandemic would move into stock market history via one of three routes – vaccine, herd immunity, or acceptance. Between April and September, our portfolio of quality cyclical businesses broadly kept up with the global benchmarks. However, because the group had been hit so hard during the downturn – prior to our purchase – they still traded well below pre-Covid levels.

The announcement on November 9th by Pfizer and BioNTech on the potential efficacy of their mRNA-based vaccine helped the Cyclical Focus Strategy to a phenomenal couple of days. The pandemic's route into the history books became much clearer. The selection of positions in the portfolio was given a ringing endorsement by the market, outperforming the MSCI AC World Index by about 9 percentage points. Despite the price moves, we believe the Strategy is more attractive after the good news than it was before.

Why? In project finance, investors routinely consider the difference between the discount rate to use on a development project and the discount rate that might be used by the end buyer once the project is complete. The developer's discount rate takes into account not just the cost of money, but also the risk in gaining appropriate planning permits, managing the construction process, future demand and various other uncertainties. Once the project has been completed – the planning permits issued, the asset built, and the demand known – the end buyer's discount rate is lower because the asset has been de-risked.

The parallels with this week's vaccine news are straightforward. Prior to the announcement, markets were discounting a range of outcomes for the corporate world based on some combination of scenarios from the most rosy (where the imminent availability of a vaccine returns the world to normal in short order) to the darkest (in which an additional seasonal killer becomes a permanent feature of the landscape). This week's announcement means that the likelihood of the darkest realities has been significantly reduced. Even if the specific, excellent vaccine results so far turn out to be too flattering, the chances of a practical solution to Covid-19 from one or more of the hundreds of ongoing vaccine projects is now much higher. Many companies have just been de-risked.

What does this mean for the Cyclical Focus Strategy? Using the de-risking approach, Monday's c. 9% stock price move is equivalent to just a 50 basis point cut in the market's discount rate for these companies. To frame it a different way, we can think about how many more years of free cash flow (at say, 5% of market value per year) are lost to Covid. Moving from a central scenario of three more years of rolling lockdowns to just one more year is consistent with a c. 9% increase in fair value. Neither approach seems much of a stretch.

The price action this week can thus be justified by changes on the ground. Yet many of our holdings in the Cyclical Focus Strategy still trade far below pre-Covid levels while the broader benchmarks now trade significantly above. There is still gas in the tank – quite literally, for example, in the case of the Strategy's energy investments, with crude still a long way from where it started the year. Others, for example in travel, face a less competitive environment as weaker peers have been hit hard. The Cyclical Focus Strategy is dominated by strong players in cyclically afflicted industries. There are no straight lines in finance, but we believe that the prospects for these companies and their stocks just got better.

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