AORIS INVESTMENT MANAGEMENT

Investing during the COVID-19 health and economic crisis

Aoris Investment Management

Aoris is a *specialist* international equity manager founded in 2017.

We are a *focused* business and manage a
single international equity portfolio.

Our investment approach is *conservative*,
fundamental and evidence-based.

The Aoris International Fund

Our portfolio is long-only and highly *selective*.

We own a maximum of 15 stocks, each of which has
considerable breadth or *internal diversification*.

We aim to generate returns of 8–12% p.a. over a market cycle.

Our Quarterly Reports

We are *business investors*, not economists.
As such, our reports focus on the
performance of our investee companies.

We report on portfolio performance
and changes with candour and transparency.

Each quarter, we include a thought piece or feature article on
a topic area with direct relevance to our investment approach.

About the cover image – founded in the mid-12th century, the Hospital of Saint John in Bruges is one of Europe's oldest hospitals. For hundreds of years, it was a place where sick and travellers received care. During this time of coronavirus pandemic, we pay our respects to health professionals around the world.

Investing during the COVID-19 health and economic crisis

INTRODUCTION

The shutdowns in response to the coronavirus have led to declines in economic activity that are extraordinarily deep, abrupt and pervasive across the globe.

The COVID-19 crisis has caused an economic slowdown that is different from prior recessions in at least two important ways. Firstly, this one has seen complete cessation of many parts of the economy, and as a result the reduction in activity has been both deeper and more immediate than prior occasions. During the 2008–09 global financial crisis (GFC), the US economy contracted by 4.2% over an 18-month period. In the Great Depression, the US economy fell by 26% over a four-year period. Moody's Analytics estimates that US economic activity, as at the end of March, has already fallen by roughly 29% in the space of a mere three weeks. Secondly, it has been synchronous across the globe rather than being contained in certain countries, as was the case in the 1997 emerging-market crisis and the 2001 US tech collapse, or cascading from region to region over a period of many months, as was the case in the GFC. Likewise, the government response has been different in two important ways. Firstly, fiscal stimulus has been forceful, creative and immediate in most countries. Secondly, monetary authorities are also working in a determined fashion, drawing on lessons of the GFC, but with interest rates having already been at historically low levels, their scope for impact is more limited this time around.

Lasting impact

Thoughts have already begun to turn to the loosening of the societal restrictions the world has been under in recent weeks and the resumption of manufacturing and workplace activity. However, much like ripples on a pond will continue long after the stone that caused them is at the bottom, it is clear that COVID-19 will have consequences that will last well beyond the time when it is no longer front-page news. At Aoris, we are not economists nor are we health experts. It is useful, though, to contemplate the potential long-term implications of the COVID-19 crisis. These include:

- **Bank capital adequacy –** in the 2020 US Federal Reserve stress test, the 'Severely Adverse Scenario' contemplates a fall in US GDP of 8.5% and a peak in unemployment of 10%, while the comparable European test envisages a 4.3% decline in European economic activity. These test scenarios now look

The COVID-19 crisis will have lasting implications on the size and role of governments as well as on European cohesion, or lack thereof.

hardly 'worst case'. Regulators may be more conservative in their stress tests post-COVID-19 and require banks to hold much higher levels of equity capital, making them safer but less profitable.

- **Intra-Europe political friction –** to date, the health and economic damage of COVID-19 has been far greater in Italy and Spain than the rest of Europe. The differential impact has reopened the bitter north–south debate that simmered throughout the European debt crisis of 2010–12 regarding the extent to which debt obligations of one country should be shared or 'mutualised' with other member states. Italy and Spain may struggle to support both their economies and banking systems without external help.
- **Central government debt –** most developed countries have already legislated government fiscal stimulus packages equal to more than 10% of their respective GDP. Add on the elevated fiscal deficits that will inevitably ensue from high unemployment, and it is clear that most countries will exit the COVID-19 crisis with substantially higher government debt-to-GDP ratios than when they entered it. The consequence may be increased taxes or cuts in government expenditure down the road.
- **Social and political divide –** the coronavirus may not make distinctions based on wealth or socio-demographic group, but the economic costs are not being evenly felt, nor is the government assistance distributed uniformly. It may widen income and wealth disparity across societal groups and fuel resentment that, as was the case post the GFC, is reflected in a shift in political views towards the extremes.

INVESTOR MINDSET DURING PERIODS OF MARKET STRESS

Huge swings in the market, particularly those in a negative direction such as we have just experienced, place market participants under extreme levels of stress. There is a sense of wealth destruction, regret, anxiety over employment and livelihood and, in the case of COVID-19, the added fear for health and personal wellbeing and the disorientating effect of radical changes to daily life patterns. Some of the ways that investor psychology and behaviour changes during bear markets include:

Deep equity market declines present enormous psychological challenges to an investor's ability to think and act independently.

- **Social proof dominates decision making –** equity markets, never exemplars of independent thinking, are made up of humans and the compulsion to 'do what everyone else is doing' becomes powerful during bear markets. When corporate earnings are expected to experience massive declines, their use as a reference point for valuation evaporates. Rather than seeing price and value as distinct, price *becomes* value, and this becomes self-referencing: 'I can no longer estimate what this stock is worth, so it's worth whatever the market says it's worth.'
- **Forget what it is you own –** an equity, or 'share', represents part ownership of a business. During periods of market stress, this notion is quickly discarded. Instead of a buy/hold/sell decision based on the investment merits of individual businesses, participants want to 'reduce exposure to the market' or perhaps 'sell what's liquid'. Investors seek 'safe havens' – there is renewed affection for companies, previously scorned, which are expected to 'hold up' during the economic and market stress.
- **A dramatic shortening of time horizon –** investors become myopic, attaching huge significance to each day's events and market action. Participants also feel compelled to act – when everyone else is frantically selling, it's hard to sit on one's hands and resist joining in. 'Don't just stand there, do something!'
- **Seek the market bottom –** when investors' pain tolerance is reached, they are emotionally exhausted and there is little willingness to buy ahead of further potential declines for fear of looking foolish. Despair sets it. Most people simply want to know 'have we passed the bottom?' They would much rather buy with the market already up 20% and the perception that the worst has passed, than buy at lower prices and risk further falls.

We can't change the fact that we, too, are human and subject to the same biases as other market participants. For that reason, we will work hard to execute our investment process with discipline, think independently, resist the impulse to take action for its own sake, and continue to assess value as distinct from price. We know our decision making won't be flawless, so we will work with humility and collegiality as an investment team to assess new information objectively and identify businesses that no longer meet our quality criteria, or prove more susceptible to the COVID-19 economic downturn than we had anticipated.

OUR INVESTMENT OBJECTIVES – A REFRESHER

We aim to generate returns of 8-12% p.a. post-fees over a market cycle through owning low-risk, wealth-creating businesses.

Let's remind ourselves of what outcome we, Aoris, seek to achieve, over what period of time, how we go about it and, most importantly, what our investments actually comprise. At Aoris, we aim to deliver investors returns of 8–12% p.a. net of fees over a 5–7-year market cycle. We see ourselves as business owners, and the types of business we seek to own are those that become progressively more valuable over time where the risk of disappointment, or shortfall, is low. We want to own each of these companies at a price that is at or below what we assess to be their inherent value.

We actively avoid businesses that are not growing in value and those where we assess the risks of disappointment to be high. As such we eschew, at all points in the cycle, highly cyclical and financially leveraged businesses such as banks, insurers and resource companies. We expect this to serve us well over the fullness of the current downcycle. We also avoid telecoms, tobacco, gaming, and most consumer staples, retailers and healthcare businesses. The second group of companies has seen share prices perform relatively well since the onset of the downturn, benefiting from a perception of 'safe haven'. We see these companies as having risks and structural pressures that may have been temporarily forgotten about but have not gone away, and we will benefit from avoiding them over our investment horizon.

The types of businesses we do seek to own are leaders in their market where the size and scale that comes with being the number one is a distinct advantage. They have high retention rates of happy customers, and their various competitive strengths combine to produce high returns on capital and the opportunity for revenue growth at a rate above nominal GDP.

There are four characteristics that are always important in our evaluation of business quality, which we are placing increased emphasis on through this crisis period:

- **Earnings strength –** we want to ensure that we own businesses that remain profitable and cashflow positive for the coming full year, even if their earnings decline sharply during the shutdown period.

- **Capital strength –** we seek conservative capital structures and want to avoid businesses where their ability to service and refinance debt may be called into question.
- **Management strength and stability –** our expectation is that companies with a team of relatively stable and long-tenured management will make better decisions during a highly unusual and stressful environment than ones where there are many new faces.
- **Competitive strength in breadth –** we want to avoid businesses that may be the leader in their market in aggregate but have material parts, perhaps a division or geography, where they are competitively weak, as these may be areas the company loses market share during this period.

In order for businesses to become more valuable over time, it is not necessary that their earnings only ever increase. We fully expect to see earnings declines this year for most of our holdings. What we don't want to see is the external environment resulting in any of our businesses becoming materially less valuable.

HOW WE SEE OUR PORTFOLIO THROUGH THIS CYCLE

We own businesses with leading-to-dominant market positions. We expect these businesses to exit the crisis with an even stronger market share.

What we are looking to see from the companies we own is that they emerge from the downcycle competitively stronger. We expect our companies to take market share at a rate faster than normal, as weaker peers lose ground. There may be opportunities for some of them to make sensible bolt-on acquisitions of targets that were not previously available for purchase. We ordinarily consider a net debt to EBITDA of below 2.5x to be comfortable. In the current environment we would prefer below 1.5x, though we give consideration to the degree of stability or cyclicality in the earnings of a particular business.

Let's go through each of our investee companies, their strengths, and what we will be looking for from each as the cycle unfolds:

Accenture

Accenture is the world's largest IT consulting and outsourcing company. It has $6 billion of cash on its balance sheet and negligible debt. It has unusually stable management, with an average tenure of the top 5000 executives of 15 years. Accenture has an outstanding record over the last decade of consistently taking market share, drawing on its enormous benefits of size and scale and leadership.

Over the next 6–18 months, some of Accenture's consulting engagements will likely be deferred. On the other hand, many of Accenture's large private and public sector clients will emerge from this period with new problems to be solved, such as the IT infrastructure to better enable safe and productive working from home in the future. We expect Accenture to take market share at an accelerating rate and have additional opportunities for sensible bolt-on acquisitions that add discrete capabilities.

Amphenol

Amphenol is a world-leading maker of electronic connectors, which are used to join electrical circuits. It has a strong corporate culture and managers 'spend shareholders' money as if it were their own'. Tenure at the executive and general manager levels is unusually long. Net debt to EBITDA ended 2019 at 1.4x, a level we view as comfortable.

Sales this year will decline, reflecting soft end markets, particularly automotive production. As end markets begin to recover, we expect Amphenol to take share at an accelerating rate, benefiting from its proven ability to rapidly increase production. Amphenol has an excellent record of adding value through bolt-on acquisitions, and we expect the next few years to be particularly productive on this front.

Automatic Data Processing (ADP)

ADP is the world's largest payroll processing company and provides many other HR-related services to its corporate clients, such as administration of retirement benefits. It benefits from scale, as well as a debt-free balance sheet and long-tenured management.

We expect sales this year to reflect a decline in payroll recipients and fewer new client wins. However, we also expect ADP to continue its long record of market share gains, benefiting from the fact that many of its competitors are unprofitable, and emerge from this period competitively stronger.

CDW

CDW is (by far) the largest reseller of IT hardware and software in the US, focusing on serving mid-sized corporations and public sector bodies. This is a market where size and scale are a huge advantage, reflected in the consistent market share gains CDW has made over the last decade. CDW had net debt to EBITDA of 2.3x at the end of 2019, the higher end of our comfort range but a level we do not anticipate will cause the company any difficulties.

In the coming 6–18 months we expect CDW to benefit from a phase of pent-up demand for IT, reflecting purchases that were put on hold during the shutdown period, as well as additional demand for devices and security software to enable organisations to better manage future work and study from home. A key strength of CDW is the ability to manage surges in demand, and we expect it to gain share at an elevated rate through the recovery period.

Cintas

Cintas Corporation is the largest uniform rental company in the United States, with customers drawn from manufacturing, hotels, casinos, restaurants, among other industries.

There is no doubt that while many of these customer sites are closed, Cintas's revenue and earnings will be under severe pressure. Based on what we know today, we are comfortable holding Cintas, albeit at a reduced portfolio weight. The company has very long-tenured management, low employee attrition and a strong and well-defined culture that we believe will be a real asset during this testing period. The company is the leader in its market, not only for the whole of the United States but in almost every local geography, and has no areas of competitive weakness. This is a business where being the largest has significant advantages, and Cintas has outgrown its market on a consistent basis over the last decade. While we recognise the pressure the business will be under for a period of time, we expect Cintas to draw upon its strengths of size, culture and stable management, and emerge from the crisis stronger and with an enhanced market share.

Costco

Costco is one of the world's largest retailers, operating a highly successful membership model. It benefits from a long-tenured management and a very strong corporate culture, a fortress capital structure (it has net cash on its balance sheet and owns 80% of its stores), and a very relevant and resonant customer proposition. We expect Costco to have another successful year of profitable growth and new store openings in 2020.

Experian

Experian, profiled in detail in the last section of this report, provides credit reports, analytic software and decision tools to banks and other providers of credit. It is a leader in its market, has no areas of competitive weakness and benefits from long-tenured management. Experian has net debt to EBITDA of 2.0x, a level we are comfortable with given the high degree of recurring income.

Some software spending by banks will be deferred this year and the use of credit reports by auto dealerships for new car loans will decline. However, over the next couple of years we expect Experian to benefit from strong demand for its analytic and decision software, to assist both large and small banks in responding to changes in customer-borrowing profiles, payment deferrals, refinancing requests and delinquencies.

Halma

Halma makes products that are used in safety applications, protecting people as well as plant and equipment. The demand for these products is driven by government regulation, making spending on products it supplies relatively insensitive to the economy. Halma benefits from a conservative capital structure, leadership positions in its end markets and long-serving management. It has an excellent record of making value-adding acquisitions of small, often family-owned businesses. Net debt to EBITDA is a very conservative 0.6x.

We expect Halma's sales to decline modestly this year, reflecting closures of many customer sites that Halma sells into. We do expect Halma to benefit from additional opportunities to make sensible acquisitions.

Graco

Graco is a manufacturer of highly engineered equipment used to mix and dispense fluids, one example being professional paint sprayers. Its strengths include a debt-free balance sheet, long-serving management, and leadership positions across most of its markets. It has a long history of GDP+ organic revenue growth and high profit margins.

We expect Graco's sales and earnings to be materially lower this year than last. Some end markets, such as automotive manufacturing, may take several years to fully recover. We expect Graco to manage its costs prudently during the period of depressed earnings, as it has done successfully in prior downturns, while avoiding cuts in product development or manufacturing expertise that would damage the long-term health of the business. We expect Graco to take market share and emerge from the downturn with an enhanced competitive position.

Jack Henry

Jack Henry, provides essential software used to run credit unions and small banks in the United States. It benefits from a very strong corporate culture, no debt in its capital structure and many years of market share gains.

We expect 2020 to be a decent year for Jack Henry, held back only by the reduced opportunity for new sales wins. We expect over the next couple of years to see even stronger demand from banks and credit unions to modernise their software, to cope with changes in loan and borrower profiles, defaults and payment rescheduling, and much greater usage of digital banking software.

L'Oréal

L'Oréal, the world's leading beauty company, benefits from size and scale, a debt-free balance sheet and very stable and long-term-minded management. It has a long history of growing faster than its end markets.

We expect L'Oréal's sales this year to reflect much-curtailed retail activity in many parts of the world. Depressed personal incomes from lower employment may well have an impact that lingers for several years. However, we do expect L'Oréal to benefit as many of its unprofitable, smaller, newer competitors struggle to survive, and for L'Oréal to gain further market share, benefiting from its very strong positions in ecommerce and digital marketing.

LVMH

LVMH, the world's premier luxury goods company, also benefits enormously from its size and scale, the breadth of its leadership across most of its categories, and its strong balance sheet. M. Bernard Arnault has led the company since he became its majority shareholder 31 years ago. Net debt to EBITDA is 0.5x, and will rise to a still-comfortable level of about 1.5x when the acquisition of Tiffany is completed.

Like L'Oréal, LVMH's sales this year will suffer from retail store closures and travel restrictions. As with L'Oréal, we expect LVMH to take market share, leveraging the strength of its leading global brands. We also expect LVMH to benefit over the next couple of years as prime retail real estate in many city centres becomes available, presenting the opportunity for new store openings.

MSCI

MSCI produces indexes that are used in measurement and portfolio construction. It benefits from its absolutely dominant position in global indexes, a very long-tenured and long-term–minded executive team, and the absence of any areas of competitive weakness. Net debt to EBITDA is 2.0x, a comfortable level given the very high degree of recurring revenue.

We expect MSCI to have another strong year in 2020. We also expect over the course of the cycle to see increased interest in MSCI's portfolio risk measurement and analytics capabilities, used by asset owners and asset managers to stress test portfolios to see how they may perform in abnormal environments.

Nike

Nike is the world's largest athletic apparel and footwear brand. It benefits from a debt-free balance sheet, a strong culture and a long-serving executive team. Size and scale are huge advantages. For example, marketing firm Blueleadz ranked Nike the world's most recognisable brand in 2019. None of its competitors even made the top 30.

Nike's sales in 2020 will reflect the reality that retail stores have been closed for part of the year across the world. However, we expect Nike to take market share at an even faster than normal rate over the next couple of years, benefiting from its strong ecommerce platform, its ability to ramp up production and its supply chain as stores come back online, and its ability to remain relevant to and engaged with its customers while they are not shopping, via its apps and direct communication channels.

Nordson

Nordson is a maker of highly engineered dispensing and extrusion equipment, used in applications in consumer electronics, medical devices, automotive manufacturing and the packaged of basic consumer non-durable products. The company has a strong culture, though it has a new CEO and a CFO due to retire this year. Nordson has net debt to EBITDA of 1.9x. a level at the higher end of our comfort level given the cyclicality of earnings, but at a level we do not anticipate causing the company any difficulties.

Like Graco, we expect Nordson's earnings this year to fall materially, reflecting the decline in industrial and manufacturing activity. Nordson has an excellent long-term record of identifying new applications for its proprietary technology, benefiting from its direct technical distribution model and close relationship with its customers, and we expect this to produce strong growth as the cycle recovers.

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