

Commentary

Temple Bar Investment Trust PLC



August 2020

The following commentary gives the views of the investment manager at the time of publication.

As managers of the Trust, we have been as disappointed as our investors with the poor performance recorded over the first six months of this year. We have also been disappointed as investors, since many of us own shares in the Trust, along with our families. While a share price drop such as that experienced by our shareholders can cause distress, we remain confident in the portfolio and its ability to recover its losses. In this letter we would like to share with you the reasons for our optimism

Why we underperformed and how the portfolio is positioned

During the two years prior to COVID-19, we had been positioning the portfolio increasingly in cyclical businesses. The rationale for this was that so many investors were expecting a recession that many cyclical stocks had become so cheap as to already price one in. In UK domestic shares, this negative view had been compounded by Brexit and the ensuing political uncertainty. Conversely, we believed that investors' desire for safety and yield had pushed them to own parts of the market which had displayed less volatility, but which to us seemed expensive. The onset of Covid-19 exacerbated this market segmentation by introducing a new type of uncertainty unknown to most investors. The stocks that have performed best so far this year are those of companies that will see relatively little short-term economic impact from the pandemic, while those that have performed worse are those that will see greater impact. This result is intuitively correct, but we believe that a high enough share price can make an investment in a predictable business dangerous, and that a low enough price can make an investment in a cyclical business safe. This is the reasoning driving our positioning today.

We constantly examine our portfolio and challenge our investment cases, and this crisis prompted more of this activity than usual. It also considerably expanded the number of stocks trading at attractive valuations compared to their long-term potential, and therefore gave us the opportunity to make attractive trade-offs. Among our economically sensitive stocks, we sold some that we think will struggle to recover their earlier profitability, due to challenges that seem to us structural rather than cyclical. These include Marks & Spencer, Land Securities, Superdry, SIG and Dixons Carphone. We also sold or reduced stakes in defensive companies whose share prices had held up well, such as Tesco, Sainsbury's, TP ICAP and GSK, in order to invest the proceeds in businesses that we believe not only offer very attractive valuations, but also solid market positions and attractive growth prospects for years to come. In the UK, these include some travel-related stocks such as Carnival, easyJet and Rolls Royce, but also pub operator JD Wetherspoon, insurer Hiscox and flexible office space provider IWG. In addition, we purchased a number of similarly well-positioned international businesses, including credit card provider American Express, social media company Twitter, pharmaceutical and crop science giant Bayer, auto parts supplier Continental, online travel agency Booking Holdings, and three well-capitalised oilfield services firms.

Our portfolio today is exposed to three broad themes: a UK construction recovery from the low of the pandemic (represented by our homebuilder holdings as well as our builders' merchants Travis Perkins and Grafton Group); a travel recovery (via a number of structurally growing businesses such as Rolls Royce, easyJet, Dart Group, Meggitt, Safran, Aercap, American Express); and a general recovery in economic activity (a blend of banks and well capitalised oil & gas shares, which do not represent high-growth industries but offer extremely attractive valuations today). In addition, we hold a number of diversifying holdings or idiosyncratic stories such as Bayer, Twitter, Capita and Baidu.

We think these purchases will stand us in good stead as the world recovers from the shock of the pandemic, and while the timing of this recovery is uncertain, we are confident that our holdings have the balance sheets and liquidity to wait out the uncertainty. We are excited about the prospects of our portfolio and believe that their upside relative to the broader market has rarely been higher. In the remainder of this report, we would like to offer some context on how we interpret value investing and why we think it maintains relevance at a time when many investors appear to have given up on it.



Why value investing remains relevant

When people talk about a 'typical value stock', they typically imagine a capital-intensive, low-growth company earning mediocre returns on invested capital. For some, the picture is even worse; perhaps a melting ice cube. Since many value investors (including, in part, us) begin by looking for potential investments in corners of the market that are affected by negative sentiment and falling share prices, our universe will indeed contain this type of stock. However, it does not follow that we automatically consider them to be good investments – a blind faith in mean reversion is too blunt a tool for investing in a changing world.

The underlying qualities of attractive businesses are well known: high returns on capital, cash generation, growth and a sustainable, enduring business model. Unfortunately, when it is obvious that any business possesses these characteristics, its share price tends to reflect it too, and the stock is therefore priced for perfection. It is therefore possible for a great business not to be a good investment. We think there is a way round this challenge. We like to define value investing as the practice of buying good companies when a temporary cloud of bad news obscures the underlying attractive characteristics of the business. Ideally, this results in us buying good businesses when they are cheap. Not every investment will turn out well and mistakes are inevitable, and there will be periods (such as today) when any kind of uncertainty is deeply undesirable.

However, we think that the rewards of buying good companies when they are engulfed by uncertainty will endure. The market has shown time and again that, irrespective of the long-term attractiveness of businesses, the share prices of good companies occasionally fall significantly. Often a value investor need not compromise on growth opportunities, sustainability or returns on capital in order to find attractive investments. Most of the time, all a value investor needs to sacrifice is the comforting feeling of absolute certainty.

We think that there will continue to be space for a strategy that gets paid, in the form of a cheap valuation, to take on uncertainty from fearful sellers; we also think that if such a strategy is employed to buy businesses with a promising future it should lead to superior long-term returns. From where we are sitting today, after having experienced a terrible first half of 2020, this may seem like a fanciful claim, but it is the reason that we have confidence in our strategy and in our portfolio. This, we think, is why value investing remains relevant.

No representation is being made that any investment will or is likely to achieve profits or losses similar to those achieved in the past, or that significant losses will be avoided.

This is not a buy, sell or hold recommendation for any particular security.

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