HollAnd Advisors

Holland Macro Views

White Swans + Buckets

We reflect just a little on Covid but also on the mind games it is playing with policy makers and investors alike. At the end of the note we give some stock ideas – We are reaching for buckets, not thimbles.

Covid - Watching for the White Swan

We have never written specifically about Covid feeling that others were doing a perfectly good job of over-analysing every possible angle. Instead during 2020 we have tried to make observations on markets and sectors when we felt sentiment was too extreme. Andrew's Twitter on 4th February asked if Covid might not be a Black Swan event for western markets then trading at record highs. Little did we know how prescient those remarks would be? In May we wrote one of the most uncomfortable notes of our careers when we suggested that the consumer was a Roaring Tiger and would bounce back stronger than many depressed economists then thought. In some sense this occurred with the US retail economy recovering better than expected despite the virus, albeit doing so in unexpected and different areas. Whilst we are moderately happy with these calls sadly we missed the big second order effect, i.e. that Covid would drive greater digital penetration in numerous sectors – as Julia Roberts would say 'Big mistake – huge.'

Throughout the pandemic we have shared (mostly via Twitter) Covid insights that we thought were consensus challenging. In February and March, they were on subjects like how if places like Singapore could not contain the virus, maybe the West should be paying more attention. More latterly we have found the positive slant of greater interest, seeing a little more hope just as others settled nicely into their comforting armchairs of despair. Bill Gates' recent insight and optimism into the coming vaccines should be taken seriously we noted. He is not known for hyperbole and has been super rational throughout this crisis. A few weeks ago we shared studies that raised the idea of herd immunity occurring at lower levels of population infection than we all had previously been told.

Today we share insights from John Authors and Leo Varadkar. Is the latter signalling what wider future Covid policy making might look like? We think so.

> *"As we speak now, only 1 per cent of our hospital beds have Covid patients in them and maybe 10 or 15 per cent of ICU. If it got three or four times worse, it would still be only using up a relatively small amount of our health service capacity."*
>
> *"What I see other countries doing – Belgium is the most recent example – is that they are no longer using case numbers to make their decisions on restrictions and on policy. They are looking at hospitalisations, ICU capacity and deaths".*
>
> *"It is a job for us as politicians to say to the public health people that maybe we should be focusing on that. The objective was to make sure our health service did not get overwhelmed, not to lock down the country and the economy until there was no Covid at all. That is not realistic."*

Leo Varadkar October 1st 2020

Respect authority, but use your freedom to think….and act

It is right that we all obey the rule of law and have respect for authority, particularly in times like this. However those of us that have worked in sectors in past times of stress know how hard it can be to make good decisions under pressure and how easy it is to get stuck on your consistency bias, particularly if you are surrounded by plenty of people reinforcing your views. (Maybe that is what Westminster is like now). Being outside the difficult decision making process of government frees us to think a little differently.

New reflections today – Watch for the White Swan

We find ourselves wondering today if in the coming winter months Covid might surprise us once again by fading (for whatever reason) rather than growing exponentially as many expect.

Clearly Covid will be studied for years as to how it was reacted to by policy makers. But might historians' judge that it was just extremely hard to control and predict. A recent study we read into the 1920 Flu pandemic talked about why it was so deadly. The conclusion being that so many people in the West had not any exposure to such a virus before the global travel that the 1920's brought. Notable in 2020 is the Covid death rates in countries with good healthcare (like UK/US/Spain) being far worse than countries with poor healthcare (Africa/India). Might historians just conclude this is because western medicine had managed to keep a great many 80-90 year olds alive prior to Covid? Thus some countries had a greater pool of vulnerable people than others. In addition the local political reactions we are seeing in the UK/Europe/US has an undertone of needing to do something, needing to be in control. We wonder if this is a reflection of our modern way of thinking that our luxurious, low risk lives have got us overly accustomed to, i.e. we just cannot accept that something is outside our control?

Speaking with one of our elderly parents the other day was instructive "*when we were young there was polio, it was not pleasant and people died but you had to learn to live with it.*" These comments are not meant to criticise, but to make the point that policy makers are searching for the 'control' that our modern low risk lives are used to, and demand. Thus in turn we all think that in taking actions we can regain this lost control – this might be folly.

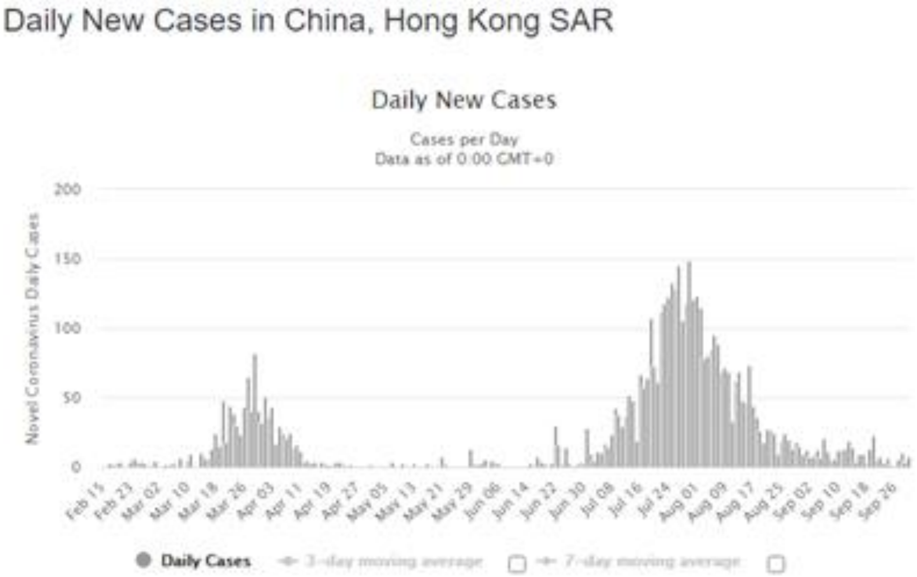
The illusion of 'control' vs. fate

By seeing the need for action to 'win the war' are we missing an important point? I.e. that a virus such as this, that has been <u>extremely</u> unpredictable in how and where it has hit, is just as likely running a life of its own outside of our control. Exponential rate of growth charts provided by medical advisors and exponential fears that now exist in some people minds tend to assume that such a virus left alone is only set for growth, but is that right? The charts of Covid around the world have progressed very very differently; some suggesting an alternate conclusion. Data from China is dismissed by many observers but the chart below from Hong Kong is interesting as to the speed of decline in the second wave of cases. Additionally, it is worth looking at the recent fall in Spanish hospital admissions post their rise in August. Clearly there are many factors that can lead to these trend changes – one of which could be just the virus running its course.

A wider view and recency bias

We recommend reading the Bloomberg article below for a number of reasons. Firstly, it is expressing some of the above ideas i.e. outlining different views as to why second waves might occur in different places and why herd immunity might be reached at lower thresholds. It is also interesting that these ideas are now being expressed a little more openly, i.e. by a respected journalist on Bloomberg. Up to now they have been a little more confined to Twitter's back channels we observe.

Fig.1: Hong Kong daily new cases



Source: worldometers.info

We think many of the views expressed in Bloomberg the article are reasonable and importantly just as likely to be true as the more mainstream current view. This ‘just as likely’ statement is key and leads us to a conclusion for investors. The illusion of control means that policy makers, the population and markets are maybe underestimating the role of luck in what might occur next. It was unlucky that Covid spread the way it did earlier in the year. Maybe that is what a Black Swan event is, just a little bad luck arriving at a time when no one expects it. Well what about a ‘White Swan’ event. Yes, Covid treatments are better; yes, there is reason for optimism on vaccines and; yes, some of the policies make sense to slow the spread of the virus. But the virus surprised us once, might it do so again in the way it has in Hong Kong, China and other parts of Asia? In February we were staggered by how arrogantly the West seemed to dismiss this disease as an Asian problem (markets were high and it was rarely on the news). That the virus is now quietly running its course in those early countries is deemed not to be newsworthy is notable.

Biases and government by consensus

Another bias is maybe at work, reinforcement bias. As such today rarely is good news getting properly reported. The fact that the southern hemisphere has not a flu season at all in 2020 was only reported by The Economist even though it has significant ramifications for European/US winter healthcare resources. https://www.economist.com/graphic-detail/2020/09/12/the-southern-hemisphere-skipped-flu-season-in-2020

The earlier comments we highlighted by Leo Varadkar we thought were telling for being very representative of the current view on the streets of Dublin or London, but along way from current policy. In the spring of 2020 the opposite was true, policy makes were a week behind the population as most voluntarily sought lock downs - government policy duly followed. Today UK government policy looks out of line again.

Optimism

As an untrained young analyst that learnt his trade in the bear markets of 1987-91, your author learnt just by asking questions. This led to a critical eye but often to a little too much scepticism also. He learned a little later the power of cautious optimism seeing the amazing progress that is made by capitalist societies over long periods of time. The more he moved away from 'The City' the greater he has seen this evidenced in small innovative businesses and hardworking people who consistently reinvent themselves. Such entrepreneurial spirit will outlast this virus (and the next one). That this spirt is evident on the street again post lockdown is a welcome and important sight; indeed, frustration with government shows that the country wants to get on with business. That this spirit is today accompanied by wonderful (and cheap) technological tools and super low interest rates is a reason for great longer-term optimism.

Once in lifetime buying opportunities

2020 has been a very strange year for investing. Aside from the digital transformation trend that is unlikely to reverse, it has been a year of knee jerk investing. If you saw your friends buying new caravans, pets or cycling more, you needed just to buy shares of Thor, Pets at Home or Halfords. All have boomed with their recent good fortune. The rub, well that has been felt where the money isn't being spent and where investor depression is lasting. Pubs, Airlines, Hotels, Theme Parks, Prime London property companies – you know the list. What is interesting about this list of casualties is that it is indiscriminating. The leveraged weaker players we are not interested in, but the strong players who will benefit from being the survivors in their field we are laser focused on. Inside these areas are market leading companies with unmatchable low cost positions (Ryanair/JDW). There are also wonderful owner managers who have grown shareholder intrinsic value for decades at say c.12-15%pa (Dart Group, Hiscox). There are businesses with wonderful once converted assets and modest debt levels (Shaftsbury/Capital & Counties/Youngs/Housebuilders). Also, high ROIC (35%) business with brands that consumers love that were growing sales at 9% like for like pre-Covid (Greggs).

It is notable that all of these highlighted ideas are in our back yard (i.e. the UK). Seemingly the UK has become a mistrusted almost emerging market with few optimistic of its future due to the extrapolation of Covid and Brexit risks. We note however how cycles and sentiment can change and we are prepared to be patient. We also note the recovery in trading and share prices of similar companies in US markets (US Housebuilders/McDonalds). This looks to us the perfect storm in the UK of depressed company fundamentals and investor resignation. These could be once in a lifetime buying opportunities.

Great Companies, Great managers + GREAT prices

We have long believed that to get a different investing outcome to others you have to do something different. Sadly, by not paying higher valuations for growth in recent years 'different' can be read as 'worse' or 'wrong'. Hindsight as the saying goes is easy, particularly in the investing business. For some time, we have articulated our process as: **wanting to own the shares of great companies, led by great managers, buying when they are offered at great prices**. There is always much debate in the investing world about the definition of the first two of those metrics, but the latter one is easier to quantify. Businesses we might have had to pay a 15-20x PE for a year ago we might now be able to buy for 7-12x. If well managed with good resilient market positions and balance sheets that can weather the storm these are amazing bargains whatever your investing outlook.

In a number of cases whilst short term trading is still poor, we think the longer-term compounding potential for this business is potentially greater than it was pre-Covid, due to the exiting of weaker competitors during the pandemic (Greggs position vs. independent sandwich shops and Pret-a-Manger being a perfect example). That others are selling these shares we think is evidence of ongoing fear/UK market neglect and recency bias.

Where the puck is going to be

Wayne Gretzky famously talked about not skating to where the puck is but where the puck is going to be. Being an investor and experienced stock market analyst in the summer/autumn 2020 is in truth a deeply depressing experience. A 16-year-old could do the job better right now. "*My mum just bought a Pelton so I am going to buy some shares.*" It was not always this way, and it will not always be this way.

We are watching for White Swans and reaching for buckets (for thimbles for we have no use)*

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https://www.bloomberg.com/opinion/articles/2020-09-30/why-are-markets-so-calm-about-the-covid-second-wave?srnd=opinion&sref=vc6krMMD

*In 2010 Warren Buffett described the investment opportunities as: "*when it is raining Gold reach for bucket not a thimble*"

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