Evenlode Global Investment View

October 2020 – US Election & Uncertainty

The world approaches November 3rd with a mix of trepidation and excitement. The 59th Presidential election of the United States has been fought in an unprecedented time, with the global pandemic providing the temporal backdrop while discussions on race, equality, opportunity, and the threat of impending environmental calamity are all competing for airtime. The political vortex has created vast uncertainty and we expect this to be felt by the financial markets over the coming days. At Evenlode, we see volatility as a friend of the long-term investor and have built our approach to take advantage of the opportunities it offers. Three key tenets underpin this approach.

1) Predicting what will happen is difficult… so we don't place macro bets.

Uncertainty is tough to analyse, as can be demonstrated by the current investment environment. We do not know who will win the US election. Biden is currently the favourite, with the betting markets implying odds of a Democrat presidential victory of approximately 70%. Nate Silver's FiveThirtyEight gives the former vice-president even better odds of just over 5 in 6 - or a similar chance to getting rain in downtown Los Angeles. While this might sound enticing, it is worth remembering that the presidential outcome is binary and that the election will happen only once (hopefully!). A low probability event is not impossible, Trump had worse odds going into the 2016 election and won.

What is more, the repercussions of the election result are also uncertain. While Biden has made clear his policies on healthcare and support for a Green New Deal, the consequences of a Democrat leader remain unclear for wider business. Biden has strong links to industry, with a former lobbyist as his head of staff, but the Democratic party has moved to the left since the Obama presidency. A partial repeal of Trump's corporate tax cuts, a raise in the federal minimum wage, and an increase in anti-trust and competition regulation could follow. Meanwhile, Trump's nationalist and populist policies are focused on reviving the economy though provide little coherent detail, though more tax cuts and international trade tariffs appear likely. In either result, we cannot say with confidence what the overall result of intermingling policies will be for the business environment in the US.

Given the high degree of uncertainty, we do not believe it is responsible to invest in a business based on an external event that neither we nor the company itself can control.

2) Preparing for uncertainty is easier… so we make the portfolio resilient.

While we cannot predict what will happen following the election, either result could lead to dramatic changes in the economic conditions and consumer sentiment. This will present companies with an unforeseen set of opportunities and threats. The ability of a business to respond to these changes will be dependent on both the flexibility of the business model and the resources available to management. A business that is highly diversified by geography, customer-base, and product-set, is unlikely to have its ability to generate cash endangered by a single event. This also allows the company to shift resources and investment away from one geography, product, or service, and toward another more profitable opportunity.

However, such flexibility is only an asset if companies have the capital to invest and take advantage of new opportunities. Fortunately for investors, the available capital can usually be largely inferred from historic financial results. Companies that generate cash flow far above their requirements and have a conservative balance sheet are more likely to have available capital to invest. Companies that barely cover the dividend, require large capital investments to keep the business operational, or have a large debt burden, are all less likely to be able to make the required investments. Importantly, this will hold true whoever wins the election and whatever the economic reaction.

We seek businesses with high diversification, strong cash-flow, and low debt, because we believe these companies are best placed not only to weather the storm but to emerge stronger.

3) Action in response to opportunity requires discipline… so we frame our decisions in terms of risk.

Just as uncertainty creates new opportunities for companies, it also creates new opportunities for investors. As new polling and policy information becomes available and the probabilities of different election outcomes shift and share prices will respond. The market has a tendency to overweight the short-term prospects of businesses and, as a result, stakes in high quality companies will often appear cheap compared to the long-term value. However, it is a mistake to assume that the market is behaving entirely irrationally, particularly under high uncertainty, as there may be plenty of additional information of which you are not yet aware.

To overcome the danger of information asymmetry, we believe investment decisions should not be made on the basis of returns alone, but with a sober reassessment of the risks that businesses face. This means having a risk framework and a prior understanding of the business, asking questions of what has changed in the company's prospects, and checking whether the long-term, investment thesis for the company still holds. Our answer will again depend on the fundamental position of the company; we ask whether the business has enough resources and flexibility to overcome the short-term concerns envisaged by the market. Only after going through this careful checklist of investigation would we consider a new investment.

We believe careful investment in great companies at good valuations, beats a rushed investment into an ordinary stock at exceptional valuations.

These three rules for investment will appear common sense – and they are! However, we believe that their discipline is vital to maintaining a high level of performance and avoiding mistakes when operating in a rapidly changing market. The US elections are momentous political and economic events and are accompanied by huge amounts of noise and market volatility. We will not pretend to be able to predict the short-term outcome for politicians, markets, or individual companies, but we will be prepared and ready to act when opportunities arise.

Ben Peters, Chris Elliott and the Evenlode Team
28th October 2020

Please note, these views represent the opinions of the Evenlode team as of the 28th October 2020 and do not constitute investment advice.